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Newsletter

No. 7 October 2003

Introduction

Important: GST is due on Friday 31 October and provisional tax is due on Friday 7 November.

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GST

GST is due on Friday 31 October for either 2 or 6 monthly periods ending 30 September 2003.

Remember to make your payment by the due date; otherwise penalties will be incurred: 1% for the first week not paid and then an additional 4% after the first week. Penalties are then incurred at 1% every month and the penalties can add up quite quickly. If the unpaid tax is $100 or less then no penalties are payable.

You can both complete your return and make your payment on line but you will still need your paper return to note your reference number from the top right hand corner.

Provisional Tax

The second instalment of 2004 provisional tax is due a week later, on Friday 7 November 2003.

(This is an expensive time of the year for provisional tax payers who file 6–monthly GST returns!)

If your 2003 tax return has been filed with IRD you should know the amount you have to pay. If not please email me.

Trusts – An Overview

In the last few Newsletters I have discussed Qualifying Companies (QCs) and Loss Attributing Qualifying Companies (LAQCs), and the advantages and disadvantages of companies (whether a QC, LAQC or ordinary company) over the sole trader structure. In this Newsletter we consider Trusts.

I'm often asked whether someone should set up a Trust. Unfortunately there is not a standard answer for everyone.

The main reason people set up Trusts (and the usual one is the discretionary (family) Trust which is a qualifying Trust for tax purposes) is to transfer ownership of their assets to the Trust so that their accumulated wealth is retained by the family.

The following situations prompt people to set up a Trust:

§ Being in business, whether self-employed, a partner, or a director in a company. You may be concerned about being sued by a creditor. This includes landlords who may be sued by OSH for providing unsafe premises.
§ If you have an income-producing asset and you wish to distribute the income to several low-tax paying relatives. Investments are a good example of this.
§ People wanting to quarantine their assets to keep them out of relationship/ matrimonial issues.
§ Fear of having accumulated wealth eroded by asset testing to qualify for rest home subsidies.

To set up a Trust you need to see solicitor who will prepare a Trust Deed setting out the Trustees (usually 2 or 3 people including yourself and your partner) who will jointly administer the Trust, and the beneficiaries, probably you, your partner, your children and their children. The Trust will cost around $1,000 to set up.

If you are transferring your family home to the Trust you will legally sell the property to the Trust (and the names of the Trustees will appear on the title) and the Trust will have a loan to you for the purchase price (usually the market value) set out in

Acknowledgement of Debt. You and your partner will then progressively **gift** the loan to the Trust. This gifting can be done at $27,000 each per year without paying gift duty and is achieved by preparing a Deed of Reduction of Debt and completing and sending an annual Gift Statement to IRD. At $54,000 total per year (ie $27,000 x 2) it will take 7 years to gift a $350,000 loan. Once the loan has been fully gifted the Trust will own the asset without a loan.

If you want to read some NZ books on Trusts, both Martin Hawes and Ross Holmes have written several informative and easy to read books about Trusts in NZ.

Property Investment – An Overview

I am also often asked what I think about property investment.

I like property (as part of a balanced portfolio including shares) for several reasons:

- You don't need any cash to buy property as long as you have other equity that you can provide to a bank eg equity in your own home (even if it is held in a Trust). Therefore you can borrow 100% of the value of the property (including purchase costs such as lawyer's fees) and the interest is all tax-deductible.
- There is no capital gains tax in NZ which means that any profit you make on the sale is tax free unless you're buying a property with the intention of reselling it for a profit, in which case you will be taxed on any capital profit.
- There is no stamp duty in NZ on either purchases or mortgages.
- The property rental will often cover the cash out-goings: interest, rates, insurance, and maintenance. Depreciation will often mean though that there is a loss for tax purposes that you can offset against your other income, reducing your tax bill.
- Property does not generally significantly lose its value.
- If you are providing domestic rental accommodation, there is no GST so less paperwork to deal with.

Most investors start out with domestic rental property as it is more easily understood and manageable than commercial property (and cheaper).

Remember though that property investment is a business and even if you employ a property manager you will still need to keep a watch over your rental activities. Rental properties can look very neglected very quickly.

a Deed of

- The rate of return (or cap rate). This should be 7.5% or more. It is calculated at the weekly rent x 52 weeks divided by the purchase price. For example if a 4 bedroom house in Wellington can be rented out for $400 per week, the annual rent will be $20,800 (ie $400 x 52 weeks) and if the property cost $250,000 the rate of return would be 8.3%. As this is higher than 7.5% you may wish to consider the purchase further. Setting a rate of return at 7.5% generally means that the cash outgoings are covered by the rental income in the current market.

- Whether the annual costs are covered by the rent and if not, that any loss is covered by a tax refund from claiming depreciation as a tax deduction.

- Do you have enough equity to in another property or cash to satisfy the bank?

- Do you have enough surplus income to support the non-payment of rent? The bank will also have lending criteria based on your personal income.

- Can you buy a property below its market value? If so you have technically made a capital gain almost as soon as you have bought it.

As a general rule of thumb, multiple flat properties will provide a greater return to you but the capital gain may not be as great as one you could receive from a single dwelling on a large section (although the rental return on such a property will not be as high).

Setting up a self-employed business to sell

Often a person runs a business as an individual under his/her own name. My own practice is a good example – Baubre Murray Chartered Accountant, self-employed. Although I may have an established client base and reputation (I hope!) there is little sale value in my business as my reputation does not necessarily transfer to someone else upon sale.

There are several ways around this:

- Don't put your name in your business – use a generic name that emphasises what you do eg Complete Accounting Services.

Generally there are several major considerations when deciding whether to buy a property:

that can be modified for individual customers or clients, standardised presentation etc.

- Employ staff to work based on the procedures and guidelines and standards you have documented. This means that everyone in your business does things the way you do! (This may not always be a good thing so think about the way you would like to see things happen in your business before documenting what you actually do!)

- Go away for holidays and leave the staff in charge – completely! If your procedures and systems let you down, document more detailed procedures and / or change your systems.

Only when your business can operate effectively without you, does your business have value and you can sell it for a reasonable price.

Home Office Costs

If you run your own business (and that includes property investment) then you should be claiming a home office for tax purposes. This recognises that you have incurred costs working in your business from home.

To work out how much you can claim you need to calculate the amount of space that you use for a home office as a proportion of the total house area. This is easy when you have a separate office that is only used for your work but if you use, for example your dining room (when you're not having dinner there) then you can claim that space – just be realistic. The space involved will be around 5- 10 % of your home space but you will be surprised how much it adds up to over a year.

The home office proportion of the following costs may be claimed:

- Interest on your home mortgage
- Rates
- Insurance
- Power
- Gas
- Rubbish collection
- Maintenance on the house
- Cleaner

If you are renting then you can claim a portion of your rent.

You can also claim depreciation but this can create

- Establish detailed and documented procedures for everything you do, just the way you do it. This may include timeliness standards, form letters for every occasion

is now the new baby's bedroom or you don't run a business any more) and if the property hasn't decreased in value to the extent of the depreciation claimed then you will have to pay back the tax benefit of the depreciation claimed. This can cause financial hardship especially if there are several years worth of depreciation involved.

For example, if the QV of your house is $350,000 with $200,000 of that being the value of the improvements ie the building, and your home office takes up 10% of the house then you can claim $800 as an expense for the year. This is $200,000 x 4% (diminishing value depreciation rate) x 10% (home office space). Next year you can claim $768 (this is $200,000 - $8,000 (4% depreciation) x 4% x 10%), and the following year $737. If at the end of those three years you decided not to continue with the business then (as long as your property hadn't depreciated in value) then you would need to declare the three years worth of depreciation claimed as income. This would be $2,305 (ie $800 + $768 + $737) and tax at 33% on that is $761. So you would have to pay back $761 in tax. This sometimes comes as a shock to people who have been claiming the depreciation especially when they have closed down their business because it wasn't making enough money.

Most people therefore decide not to claim the depreciation.

Timeliness

My apologies to everyone who has had to wait longer than usual for responses from me or completion of their financial statements or tax returns.

As many of you will know we have undergone major house renovation over the past 7 months and I have had to move my desk several times. I also under-estimated the number of interruptions I would receive for things such as the type of door hinges I wanted (did there have to be so much choice??), moving vehicles to allow concrete trucks better access etc. The work is almost complete (the result is fantastic!) and I should move into my final office location on 8 November.

So thank you all for your patience!

Contact details:

cashflow problems if you move house or decide to stop running a home office because of the Depreciation Recovery Rules. Basically these say that if you sell your house or there is a change of use (eg the office	**Feel free to contact me as follows:** Phone: 971 1500 or 025 389 972 **Email: Baubre@baubremurray.co.nz**