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Tax on property rentals

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IF you own a property that you rent out, you should know that besides the prospect for ongoing income and capital appreciation, such investments offer deductions which can reduce the income tax on your profits.

However, what type of property investor are you? If you have been actively looking for housing properties to purchase and selling them at a profit, you may not be a passive investor. It is likely that you could be regarded as a property dealer or trader.

The profits derived by a property trader are taxed as income from a business whereas that derived by passive investor is treated as a capital gain and will be subject to a 5% real property gains tax if the property was held for less that five years. If held longer, there will be no tax.

The law to determine whether you are a property trader is imprecise and the outcome can depend on a subjective evaluation of the relevant facts.

For example, does it mean that if you have sold a property within a two-year period, you will be a property dealer? Not necessarily, since it depends on your intention when you acquired that property and the reason why you sold it.

The sale of a second property will reduce the strength of a claim that you are not a property dealer but again, there may be reasons to enable you to argue otherwise.

Rent received in advance

The money that you receive for rent is generally considered taxable in the year you receive it, even when it is not due or earned. You should therefore include advance payments of rent as income even though they are not due.

Tenant-paid expenses

Expenses paid by your tenant are considered income to you. This would include, say, an emergency repair to an air conditioner while you are out of town. You can then deduct the repair payment as a rental expense.

Trade for services

Your tenant might offer his services in exchange for rent. You must include as income a fair market value of his services.

For example, if your tenant, an accountant, agrees to help you prepare your accounts in exchange for two months rent, you must include the two months rent as income even though you did not actually receive the money.

Security deposits

Such deposits are not taxable on you when you receive them if the intent is to refund the money to the tenant at the end of the lease. If the tenant breaches his lease terms, then you are entitled to use the deposit to make good any defects in the property and return the balance to the tenant.

You must include the amount used to repair the defect as income and at the same time claim the amount spent as a deductible expense.

Repairs and improvements

Owners of rental properties should not assume that anything done on the property is a tax-deductible expense. The tax law looks at it quite differently.

A repair keeps your rental property in good condition and is therefore deductible in the year you incur the expense.

Improvements, on the other hand, will add value to your property and the costs are not deductible. Improvements could include a new patio, a garage or a new roof.

From a tax standpoint, you should carry out repairs as the need arises rather than wait until the problem becomes such as to require extensive renovations where elements of improvements would invariably be present. If you bought a dilapidated property and immediately incurred repair expenses on it, these "initial" repairs are not deductible, being of a capital nature.

Mortgage and other expenses

Expenses incurred to obtain a mortgage are not deductible. These could be appraisal fees, commissions or legal fees.

When you start making your mortgage payments, the amounts paid relating to your rental property will only be deductible to the extent of the interest portion. This would be ascertainable from the annual statement, which your bank will send you.

You will also be able to deduct the cost of insurance on the rental property as well as assessments and quit rent.

Rental as a business

The Inland Revenue Board (IRB), in its public ruling, states that "Where in conjunction with the letting of a property, a person also provides ancillary or support services/facilities, the letting can be considered a business source of income ..." The consequence is that you are entitled to claim "capital allowances" on any plant and machinery used in the business of letting.

These could include air conditioners, refrigerators as well as furniture and fittings. Should the tax-deductible expenses in any one year exceed the rental income, then the excess being a business loss can be carried forward.

Keep good records

The IRB can be reasonable (based on the law) in deciding on the items you can deduct but you need to show them that you have adequate records of the expenses. Always be prepared to back up your claims.

● *Kang Beng Hoe is an executive director of Taxand Malaysia Sdn Bhd, a member of the Taxand organisation of independent tax firms worldwide. The views expressed do not necessarily represent those of the firm. Readers should seek specific professional advice before acting on the views.*