Which expenses to deduct from rental income?

ALLOWABLE: There is no 'standard list' of deductible expenses but there are common expenses that can be deducted

The biggest grouse that a property owner has come tax submission season will be the amount of taxes that he has to pay on his property rental income. He will then naturally start to rummage through all the property expenses he had incurred to determine what is tax-deductible and what is not.

In situations of doubt, I have known of property owners turning to other property owners asking, "Do you claim such-and-such expenses in your income tax return?" Well, my sincere hope is that the person he is asking has a good understanding of the tax laws, otherwise it will be a case of the blind leading the blind and both will end up having to face unnecessary tax penalties when it comes to a tax audit.

This article hopes to shed some light on how to determine the tax-deductibility of those expenses.

I have often been asked if there is list of standard expenses that a taxpayer can deduct against the rental income from letting of his investment properties. Quite honestly, there is no 'standard' list of allowable tax deductions as the expenses that a taxpayer incurs may be unique to his/her own situation.

Therefore, the taxpayer will have to fall back on the letter of the law to determine if an expense is tax-deductible against rental income. Essentially, the law states that an expense wholly and exclusively incurred in the production of income under subsection 33(1) of the Income Tax Act (ITA) 1967 and which is not prohibited under subsection 39(1) of the ITA, is allowed as a deduction from rental income. What this means in laymen's terms is, any expenses that you incur for the year to generate the rental income would generally be tax-deductible. This also means that no private or personal expenses are allowable as a deduction.

Common deductible expenses

Aside from the 'standard' list of tax-deductible expenses that a lot of property owners is asking for, what I can provide you here is a list of common expenses that generally may be claimed as a deduction against rental income:

- Advertising for tenants
- Assessment
- Insurance (e.g. fire, burglary)
- Interest on loan(s) to finance the purchase of the property being rented out
- Legal expenses (renewal of tenancy agreement, recovery of rental arrears)
- Maintenance/service charges
- Pest control
- Property agent fees/commission
- Quit rent
- Rental collection fee
- Repairs and maintenance
- Replacement of rental assets

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It is important to note that the expenses are deductible in the year they were incurred, even though you have not made any payment for them during the year.

Having said that, do ensure that your obligations as a landlord towards the expenses which are to be borne by you, are clearly spelt out in the tenancy agreement to avoid any disputes by the Inland Revenue Board (IRB) against your claims for the said expenses.

Non-allowable expenses

Having touched on the tax-deductible expenses, it is also important to know what expenses are not allowable. Typically, initial expenses are not allowed to be deducted from income of letting of real property assessed under paragraph 4(a) or paragraph 4(d) of the ITA since those expenses are incurred to create a source of rental income and not incurred in the production of rental income. Examples of such expenses include:

- Costs of obtaining the first tenant for the property, such as:
  - Advertisement;
  - Introducer's commission;
  - Legal fees incurred for the preparation of tenancy agreement;
- Other expenses incurred prior to the property being rented out; or
- Renovation and improvement costs.

In the case of expenses incurred prior to the property being rented out, particularly relating to annual property expenses such as quit rent, assessment or insurance costs, then the proportion of the expenses in respect of the period before the property is rented out is not deductible and have to be adjusted accordingly.

However, a distinction (although in many situations, a difficult one) has to be drawn between what expense is deemed to be 'repairs and maintenance' (which is tax-deductible) and what is 'renovation or improvement' (which is NOT tax-deductible). Typically, an expense is deemed to be 'repairs and maintenance' if it is incurred on ordinary repair to maintain or restore the real property in its existing state. It will not materially add to the property's value nor substantially prolong its useful life, but merely to keep it in good and efficient operating condition.

In the case of 'renovation or improvement', the reverse would then apply, i.e. the expense incurred would:

- materially add to the property's value;
- substantially prolong its useful life;
- adapt the property to a new or different use;

or

- enhance the property's income-generating ability.

What happens during the period when the property is not rented out?

As explained above, expenses incurred prior to the property being first rented out, are not allowable in calculating the adjusted income from the letting of that property. However, if the property which was previously rented out is left temporarily unoccupied while you are looking for the next tenant, the expenses incurred during the period of non-occupancy will still qualify for deduction. This is on the condition that the property is being consistently kept in a tenantable state and is ready to be let out at any time.

How long then, can a property be 'temporarily' left vacant and yet the property expenses qualify for a tax deduction?

The IRB's Public Ruling 4/2011 further explains under what circumstances where the expenses incurred for the period the property is temporarily not rented out will be allowable. The circumstances are:

- repair or renovation of the building;
- absence of tenants for a period of two years after termination of tenancy;
- legal injunction or other official sanction; or
- other circumstances beyond the control of the person who lets out the real property.

Under the above circumstances, the expenses for the period the property is not let out are allowable, provided that the property is maintained in good condition and is ready to be let out.

Of course, having explained the concept of tax-deductibility of expenses against rental income, one must never forget or ignore the underlying basis for claiming for a tax deduction, i.e. the need to keep proper records and documentation relating to the claim for those expenses. When it comes to a tax audit, the IRB's basis of allowing you a tax deduction for the expenses claimed would all be about the availability of evidence.

PROPERTY Q&A

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Q/A1

Nizam@Setapak: I own an apartment unit which I have been renting out. Last year, I was posted (from Kuala Lumpur) to Sabah by my company and have hardly had time to return due to work commitments. Since then, my current tenant has not been paying rent for many months. He has ignored all my reminders and my patience with him is wearing thin. I made the effort to see him during my recent trips back to KL but he kept avoiding me. I think I have no choice but to force him to vacate the premises. Please advise me of the proper procedures and protocol for removing a tenant.

RED: Kindly check against your Tenancy Agreement whether the terms in the said Agreement allow you to terminate the said Agreement by giving due written notice pursuant to the Agreement and to do the following to evict the Tenant in the event of breach of obligation on the part of the Tenant:

(i) to enter into the premises and to repossess the property;
(ii) to forfeit all the security deposits and utility deposits paid by the Tenant;
(iii) to terminate the electricity supply; and/or
(iv) to terminate the water supply.

In the absence of such clauses, you may engage a lawyer to make an application for a court order to evict the said Tenant from the said premises. ***By Hilary Tan, legal adviser.***

Q/A2

Billy@Kluang: I have a few properties, both landed and apartment units. Most of them are rented out, except for the house that I stay in. I am thinking of selling off some of these properties due to the current appreciation of prices. Are there any guidelines or informal benchmarks (for both landed and apartments) as to how much is a reasonable return on investment (e.g. 10, 20, 30 per cent or more) for me to consider selling my properties?

RED: Without the knowledge of the location and nature (i.e. age, sizes, popularity etc) of the properties, it is hard to make a general estimation of a reasonable return on investment. It is a good idea to contact a local real estate agent in the locations of your properties to secure their assistance on the going market price for the properties to determine the capital appreciation. With that information, you can then decide whether it's better to continue owning the properties and receiving the rental returns or to cash out for other property investments. ***By Chan Ai Cheng, real estate agent***

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Ask the RED expert: Please fax your questions to: 03-2283 1700 or email to nstred@nstp.com.my