Capital Property Investors

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Outline

- Structures used in the past
- How we structure now
- Implications under LTCs
- Trader vs Investor
- GST
- Commercial property
- Expenses
- Depreciation
- This year’s budget: ACC, mixed use assets
- Changes to financial reporting
- Choosing a property

Structures - past

- LAQC if making losses
- Trust when making profits
- Sell shares in company to avoid depreciation recovery

Structures now

- LAQCs gone from 1 April 2011
- Two years of transition
- Second year change to LTC – QC losses ring fenced

Look Through Companies LTCs

- Similar requirements to LAQCs eg 5 or fewer shareholders, NZ resident etc
- Difference is that legally a company (GST, director liability) but a partnership for tax purposes
- Major difference to LAQC - profits **and** losses are taxed in shareholders' names
- Any sale of shares = sale of the underlying property - triggers depreciation recovery
- Not an issue for new investors as building depreciation not available
- Have to register with Inland Revenue
- Any benefit over owning in your own name? SCA.

Trader vs Investor

- You need to be quite clear which you are
- Traders taxed on their capital gains
- Investors not taxed on capital gains
- Any development activity or quick turnover = trader
- Straight rental activity = investor
- Mixing the two results in tainting so all subsequent investing activity treated as trading unless can prove otherwise
- Previously could operate trading activity through one entity eg a trading trust and then investing activity through a separate LAQC - result of changes to associated persons rules now no longer considered separate entities.
- Be one or the other.

GST

- Applies to:
  - developers
  - commercial property
- Zero rating of land purchases
- Tricky when part commercial and part residential

Commercial property

- GST
- Tenant pays rates, insurance and fit out costs
- Since higher cost to buy, then higher holding costs if untenanted than residential property
- Dealing with contracts, not people

Expenses

- Can claim all costs necessarily incurred in deriving taxable income:
  - Interest on mortgage, not principal, rates, insurance, maintenance, advertising etc
- Home office, travel costs
- Take a reasonableness approach.

Depreciation

- Previously obtained a chattels valuation (usually costing around $400) and could claim building depreciation and depreciation at higher rates on chattels for all components of the building
- Eg 4% DV for buildings plus eg 9% for partitions, plumbing fixtures, electrical reticulation etc
- First change to make parts of building part of building rate
- Then from 1 April 2011, no building depreciation
- Effect = severely limits depreciation claim

Effect of Depreciation Changes

- Much easier to claim the cost of major maintenance work now eg roof replacement, house re-paints, kitchen renovation as long as to a similar standard, because part of the building
- But renovation work eg adding a deck or extra rooms etc still capital and can't be depreciated
- Can't claim the cost of any work done just before sale
- Do maintenance work regularly during and between tenancies, and
- If you are thinking of selling do your remedial work while tenants still in property preferably 6 months to a year before selling.

Depreciation Recovery

- Triggered when a property sells for more than its book or depreciated value
- Book value is recorded in the financial statements
- Is the cost less depreciation claimed at 4% or 3% DV or 2% SL over the years since purchase.
- If the property sells for more than the book value then effectively depreciation has been overclaimed and
- any depreciation claimed must be added back as taxable income = depreciation recovery
- Applies to building and chattels
- Only the accumulated depreciation claimed needs to be added back, any capital gain is tax free.

Capital Gains

- Not taxed at the moment unless you are a trader, builder or developer
- May come in especially for investment properties

This year's Budget

- No major changes – ACC levies reduced

- Last year's – mixed use assets eg holiday homes/ baches
- Needs to earn at least 2% of its capital value in rental income eg $6,000 pa if capital value $300,000 ($100 per night for 60 nights ie 2 months
- Can't be rented for more than 303 days a year (10 months)
- Then costs apportioned according to days occupied.

Changes to financial reporting

- Companies Act requirement
- No longer required
- Bill about to be passed
- Effect 1 April 2014
- Same info required for tax

Choosing a property

- Look for positive cashflow ie rent covers the weekly costs eg interest, rates, insurance plus a margin for maintenance
- Bear in mind that interest rates are likely to go up so don’t commit to too tight a borrowing
- If not positive cashflow then needs opportunity for capital gain either because:
  - Purchased cheaply
  - Opportunity to increase value eg by adding on
  - In a growing/ up coming area

- Check the return ie the rental income as a % of the cost and use to compare properties
- Rule of thumb x 100, eg $300 per week = $15,000 for a year, that’s a 5% return on a $300,000 property.
- Working backwards a $300,000 house needs to get rents of $300 a week to give a 5% return, $600 a week to get a 10% return etc
- 5% about average in Wellington for new purchases at the moment
- Should at least cover the interest cost.

Current ones a wise investment?

- Look critically at existing investments
- Do they cover their costs?
- If not then is that likely to change in the next year?
- If not then it may be better to sell now than hold on to wait for capital gain or the rental market to pick up
- Eg making a loss of $30,000 a year on a property costing $400,000.
- Gives tax benefit of $10,000 at a 33% tax rate so real cost only $20,000.
- But if not making a capital gain then may as well sell now and buy back in 2 years and save $40,000 (2 years losses)

Happy investing!