Property Investment

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Structures

Choosing the most appropriate structure depends on your personal circumstances and your plans, both short and long term.

You may be influenced by factors such as the Property Relationship Act, the desire to minimise taxes or other matters.

The key is to sort out the most appropriate structure for you at the beginning, as it may be difficult and expensive to make changes later.

Sole Trader/ Self Employed

Advantages:

- Simple – no administrative overhead eg company annual return filing fees, only 1 tax return, don't need separate bank account and fees etc.
- Can offset losses against other income easily.

Disadvantages:

- No opportunities to split income when making surpluses.
- No opportunities to spread income/ losses over years to minimise tax liability ie all income is taxed in the year earned (and all losses offset in year incurred).
- Difficult to pass to future generations.

Partnership

This is 2 or more people or entities (up to a maximum of 25) operating or owning property together.

Surpluses and losses are allocated to partners in the year incurred according to their partnership share.

Advantages:

- Opportunities for income splitting.
- Can offset losses against other income easily.
- Greater source of finance than sole trader.

Disadvantages:

- No opportunities to spread income/ losses over years to minimise tax liability ie all income is taxed in the year earned (and all losses offset in year incurred).
- Need to complete a separate IR 7 partnership tax return.
- Inflexible – can't change partners without dissolving partnership.

Trust

A person (the settlor) settles assets in a trust. This is usually done by the settlor selling assets to the trust. The settlor gives the trust a loan (interest free repayable on demand) to pay for the assets. Then the settlor gifts the loan to the trust. This can now be done in one "hit" as there is no longer gift duty. There is usually a trust deed and trustees administer and invest the assets for the beneficiaries.

Advantages:

- Allows opportunities for spreading income among low-income beneficiaries (but children under 16 taxed at 33% on trust income).
- Can retain income and losses and choose when to pay out income.
- Can pay capital profits tax free.
- Provides a vehicle for retaining property for future generations (without incurring depreciation recovery). This is done by changing beneficiaries (although if this is done frequently and unfairly beneficiaries can take the trustees to court if they feel they were unfairly excluded).

Disadvantages:

- High set-up cost – around $2,500.
- Potential on-going costs eg separate IR 6 tax return etc.
- Can't pass on losses to beneficiaries.

Company

May be a minimum of 1 director who is also the only shareholder.

Advantages:

- Opportunities for income splitting among shareholders and directors on lower tax rates.
- Viewed as a more commercial entity than a Trust (Trusts are being monitored very carefully by both IRD and the government and new trust administration legislation is expected in the next year or so)
- Low set-up cost – $163.55 on line
- Can retain income and choose when to pay it out ie can spread income.
- Can pass on to future generations through share transfers.

Disadvantages:

- Administrative overhead – preparation of IR 4 tax return and annual return filing fee (latter is $45 on line).
- Losses must be carried forward.
- Cannot take out capital profits without liquidating the company. This is because any distribution from a company is taxable in the hands of the recipient (regardless of whether the distribution is of income or capital). This has huge implications if you sell one investment property out of a portfolio!

Look Through Company (LTC)

- Organised by election through IRD (IR862).
- The shareholders are treated as partners so any profit or loss is allocated to the shareholders according to their shareholding.

Advantages:

- Income splitting and spreading,
- Can distribute capital profits tax free) but also,
- **Can offset losses against personal income.**

Disadvantages:

- On-going costs,
- Any change in shareholding can trigger depreciation recovery unless a property cost less than $200,000,
- Profits must be distributed according to shareholding and cannot be retained in the company.

Summary

- Sole trader is the easiest option early on. However it limits opportunities to split or spread income (and reduce overall taxes) and to pass on income streams to future generations without the depreciation recovery.

- Distributions of capital profits from ordinary companies can not be made tax free.

- LTCs and trusts provide these opportunities.

- The advantage of a trust over a company is that it is easier to change the beneficiaries.

- The advantage of an LTC over a trust is that losses may be offset against shareholder income.

So… again it comes down to your short and long term plans as to which option you choose.

However for most property investors who start out with losses, an LTC is the most appropriate structure.

If you are living off your rental income, a trust may be more appropriate and you can move the income from an LTC to a trust by selling (and then gifting) your shares in the LTC to the trust. The trust then becomes a shareholder in the LTC and the company profits are allocated to the shareholder trustees who then allocate the income to the beneficiaries. Depreciation recovery is triggered when shares in an LTC are sold so transferring the shares from an LTC to a trust is only effective if the property cost the LTC less than $200,000 or if no depreciation has been claimed.

Implications of structures

- If you are a sole trader and you want to move your property to a trust or company, depreciation recovery is unavoidable. You may wish to purchase future properties in the new entity.

- If you die, then transfer of income-producing property to a relative or other beneficiary is a deemed disposal and depreciation recovery is incurred.

- If you purchase a property in a company and you wish to change the company to a Look Through Company (LTC) then the shareholders will need to account for any depreciation recovery in the year of transfer and pay tax on any reserves. This could be expensive.

- If you wish to change from a company to a trust (for example to increase the number of beneficiaries) you can sell the shares to the trust (with an interest free repayable on demand loan which you then progressively gift to the trust). Make sure that the trust only has natural persons as beneficiaries – otherwise you cannot operate a gifting programme. If the shares are in an LTC then depreciation recovery can be triggered.

- If you want to rent out your own house (largely or totally mortgage free) and use the equity to buy another house to live in (with a large mortgage), the mortgage interest on the house you live in is not tax deductible. Therefore you could sell your house to an LTC and the LTC obtains a mortgage to pay you the purchase price. You can then use the sale money to buy a house to live in and the interest incurred on the mortgage on the old house (now rented out) is then fully tax deductible.

Depreciation

Background

- Depreciation is a deduction you can claim to reduce your taxable income.

- You can choose not to depreciate assets (since 23 September 1997). However you would probably only choose not to depreciate if you only wanted to rent out your property for a short period and did not want the financial hardship of having to repay any tax benefit from making the deduction.

- The benefits of inflation make paying less tax early on worthwhile even if you have to pay it back in later years.

Calculations

Refer to the table in the depreciation recovery section for a worked example.

- Depreciation is calculated on a monthly basis (previously 6 monthly).

- 3 methods of depreciation: Straight line (SL), diminishing value (DV) and the pooling method (Pool) (for assets less than or equal to $2,000).

- No depreciation can be claimed on buildings from 1 April 2011.

- Depreciation can be claimed on chattels.

- No depreciation allowed on land.

- No deduction allowed in the year of sale.

- If you inherit a property there is no depreciation deduction available as there is no cost (although IRD has been known to accept a deduction in some cases). One way to achieve a deduction is for the estate to sell you the property at market value (although that will involve a cost to you) or by selling the property to a LTC.

- If you choose not to deduct depreciation you must make an election with your tax return. You cannot then pick and choose the years you wish to claim and not claim.

- Don’t forget chattel valuations – because of inflationary effects, chattels depreciation can be worth claiming (a valuation costs between $350 and $400) although this is now limited to removable chattels. This may be appropriate when you buy a furnished apartment for renting out, for example.

Depreciation recovery

Background

Depreciation recovery arises when you sell a property (or have a change of use from rented to non-rented) for more than its book value.

The effect of the recovery is that you have to pay back to IRD the tax benefit you have received from claiming depreciation.

Generally if the property has retained or increased its value over time, there will be a depreciation recovery when you sell it.

Example

You buy a property in 1987 for $150,000. The value of the building is $80,000 (and the land $70,000)

Depreciating the building at 4% DV for 15 years gives a total depreciation deduction of $34,826. The tax benefit of this amount (assuming a constant 33% tax rate over 15 years to keep this example simple) was $11,493.

The book value of the building is now $45,174.

When the building is sold in 2002 for $160,000 there is a depreciation recovery of $34,826, which is the total deduction, claimed over the 15 years. This amount is added back to your income in the year of sale.

Assuming you are still on a 33% tax rate you will have to pay $11,493 in tax (which is the amount of tax benefit you have received). However the depreciation recovery may push your income for the year into a higher tax bracket in which case more tax will be payable.

Because of inflation you are still better off having had the $11,493 tax benefit accumulated over the 15 years, even if you end up paying back a bit more.

Purchased property 1 April 1987:	$150,000
Value of building:	$ 80,000
Depreciation (DV 4%):	
Year 1 (1988):	$ 3,200
Year 2 (1989):	$ 3,072
Year 3 (1990):	$ 2,949
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Year 12 (1999):	$ 2,042
Year 13 (2000):	$ 1,961
Year 14 (2001):	$ 1,882
Year 15 (2002) (no claim in year of sale):	$ 0
Total Depreciation:	**$ 34,826**
Book Value Building 20 March 2002:	**$ 45,174**
Sold 20 March 2002:	$300,000
Value of building:	$160,000
Depreciation Recovery = Income:	**$ 34,826**
Tax (at 33%):	**$ 11,493**

The amount of depreciation recovery added to your taxable income will never be more than the total amount of depreciation deductions claimed, in this case $11,493 out of a profit of $150,000.

Capital versus Income

Intention is all-important in determining whether the sale of your property constitutes a capital profit or income.

If it was your intention when buying the property to sell it for a capital profit then that profit is taxable.

If the purchase is to rent out the property and earn income, then any subsequent capital gain is incidental and tax-free.

If a pattern emerges of regularly buying and selling, IRD will say that you are a property investor and tax all gains. You should be aware of "tainting" if you sell some properties. To avoid this you may prefer to purchase properties over several different entities – some property investors set up a separate LTC for every property they buy.

However if you can show valid commercial reasons for multiple sales e.g. sale to free up capital for the purchase of a larger commercial property then IRD may accept that the capital gain on the multiple sales is non-taxable.

Similarly if there are valid personal reasons e.g. partner needs immediate expensive medical treatment then IRD may accept the capital profit is not taxable.

Remember to be very careful in what you say to bank mangers, accountants etc about your purchase. IRD can access their file notes.