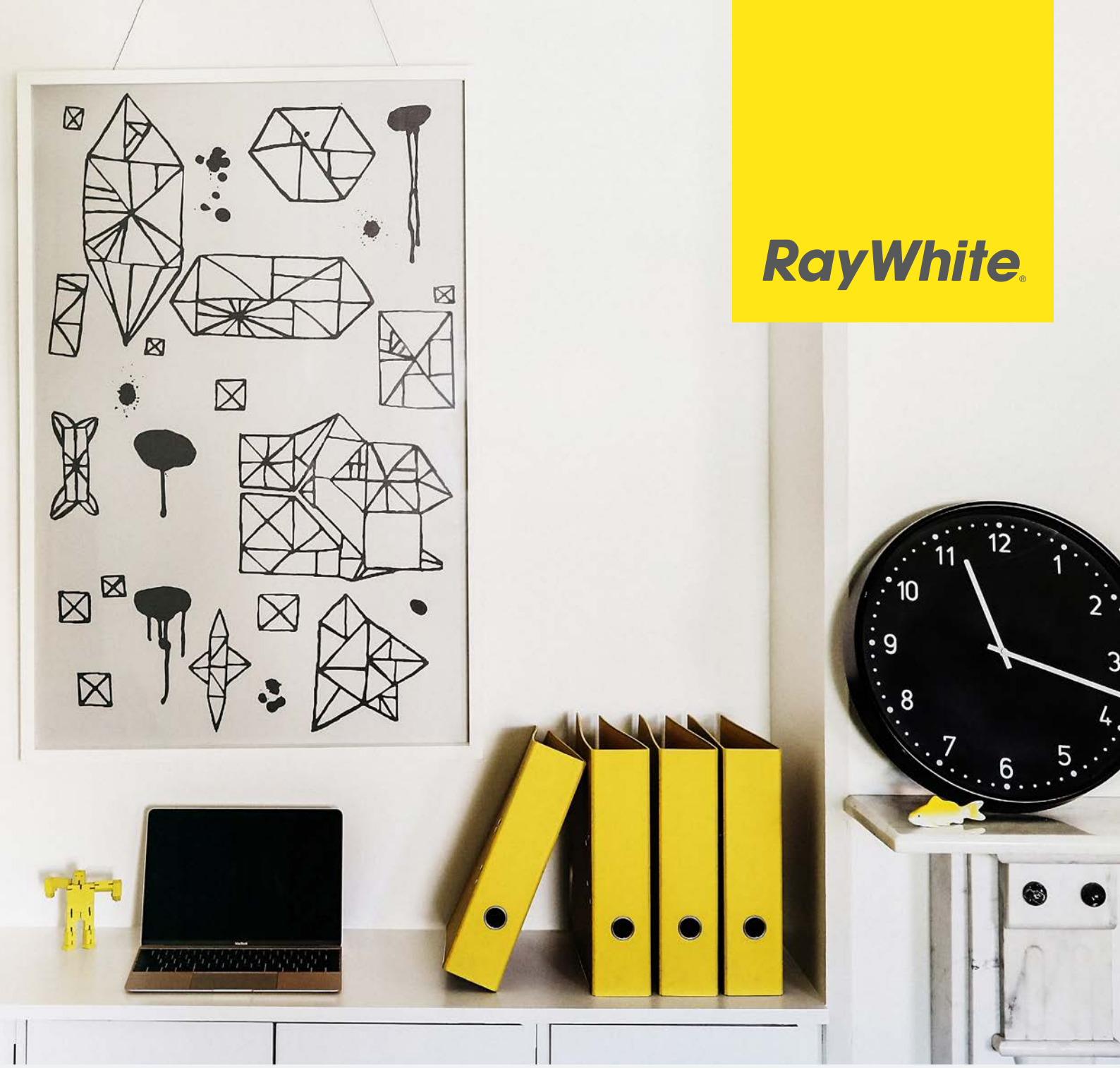

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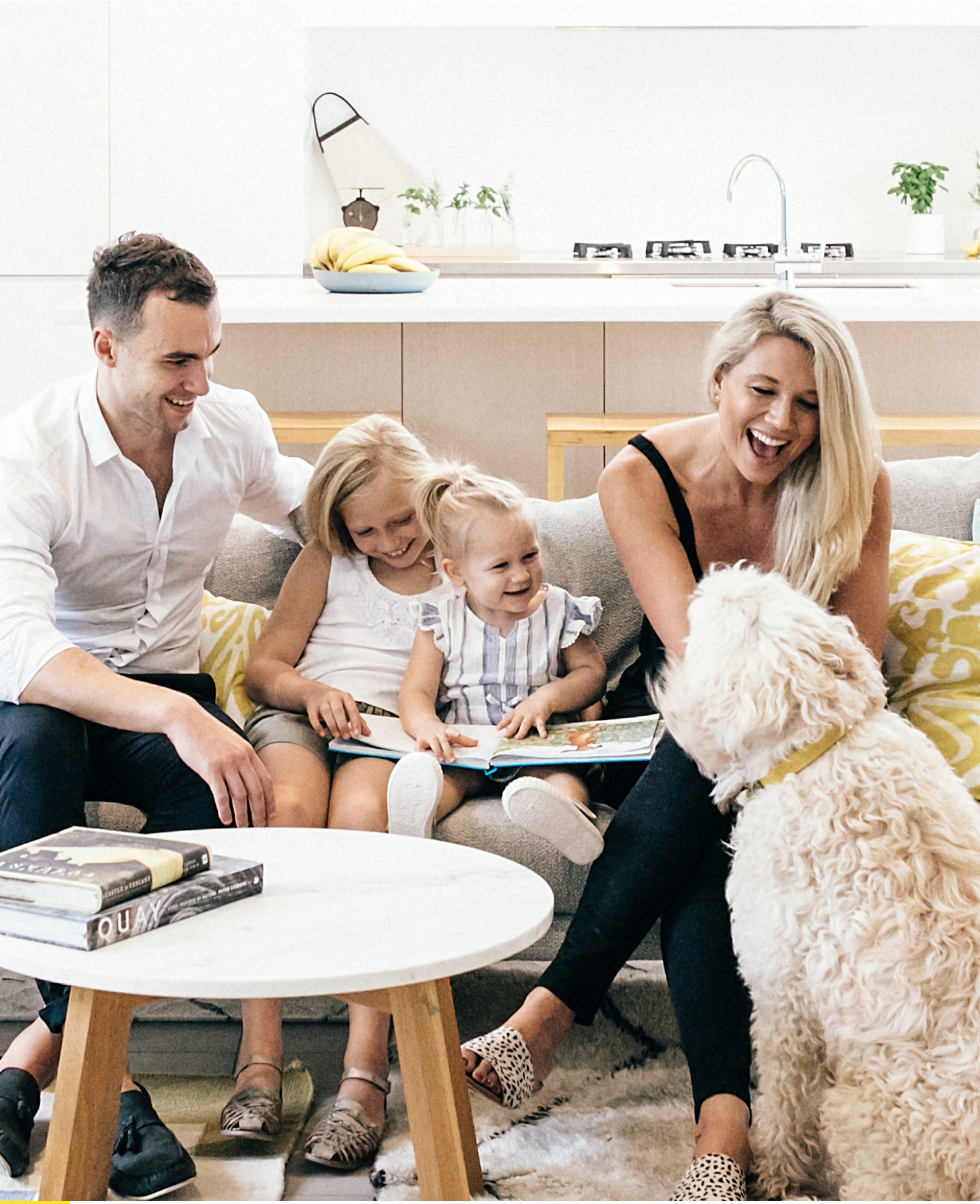
Investment Information Guide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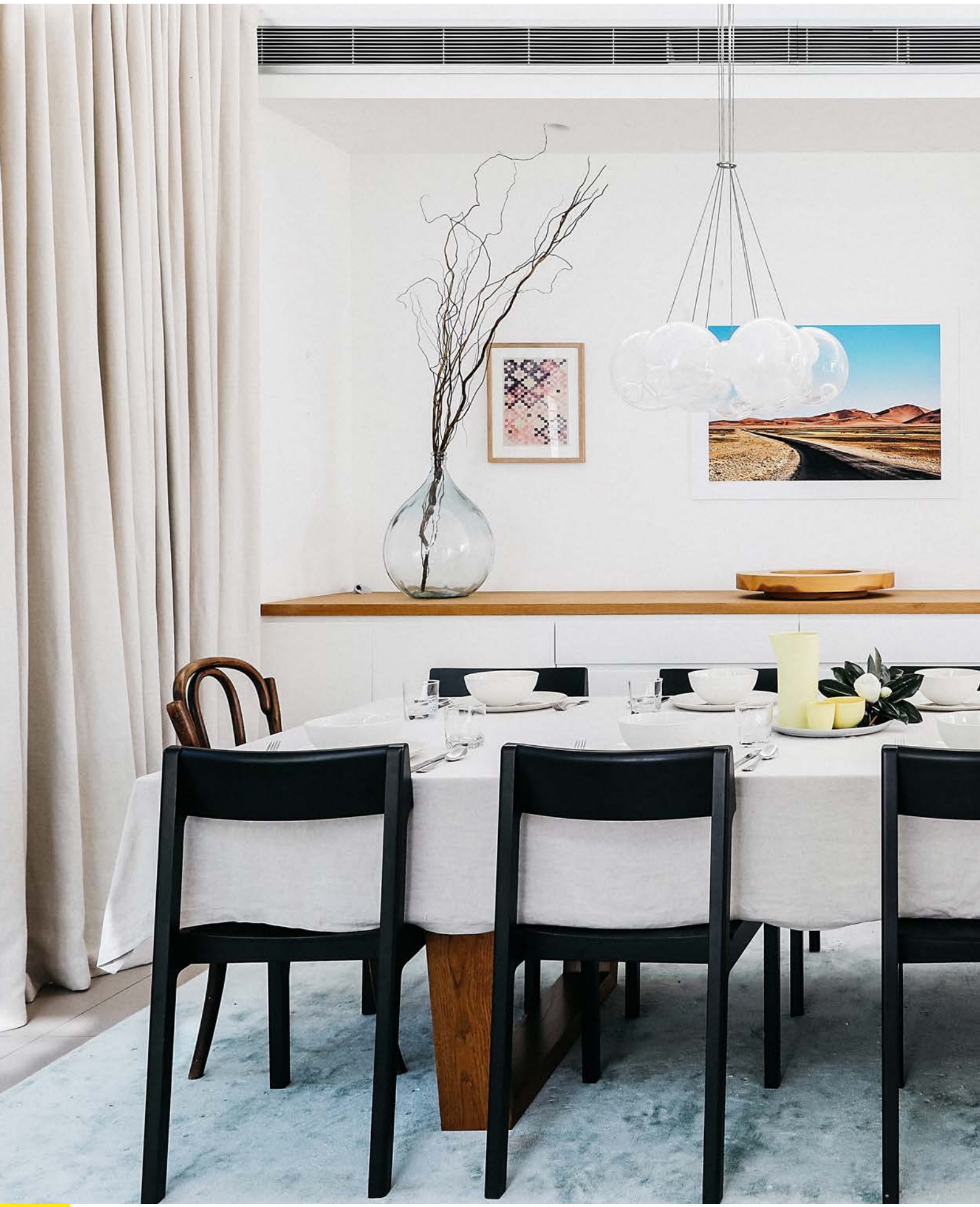
Whether you own one investment property or many, there are numerous financial and taxation factors that can effect the return on your investment and its long-term viability.

It is important to understand how these factors may have an impact both now and in the future, as many investors aren't aware of where immediate improvements in their return can be made.

This guide has been produced to help landlords make better property investment decisions and highlight where professional advice should be sought.



Claimable Expenses

Many landlords aren't aware of the claims that can be made on property management fees and other expenses associated with owning an investment property.

To maximise the full potential of your investment it is important to properly understand what can and can't be claimed.

Expenses
You Can Claim

Insurance & rates

You can claim back the full cost of insuring your rental property and the council rates associated with the ownership of the property.

Interest

You can claim the interest charged on money you've borrowed to buy your rental property. However, if you borrowed part of the money for another purpose, or topped up the mortgage for another purpose, e.g. to consolidate debt or to buy the house you live in, you can only claim the interest that relates directly to the rental property.

Fees & commission

You can claim 100% of the fees or commission paid to property managers who collect the rent, maintain your rental, or find tenants for you.

Accountant fees

You can claim the fees charged by an accountant for:

- Your accounts to be managed
- Tax returns to be prepared
- Advice

However, you can't claim for any costs involved in the initial set-up of your rental property.

Repairs & maintenance

You can claim back the costs for any repairs to the property or general maintenance. However, if you're doing the work yourself you can only claim for materials, not your own time.

If the work is an improvement to the property rather than a repair, then you can't claim that cost as an expense.

The distinction between repairs and improvements can be tricky, if you're unsure whether work done on your property is repairs or maintenance we suggest you talk to a Chartered Accountant.

Other

Other costs you may be able to claim include:

- Body Corporate fees
- Valuation fees
- Water Rates (only if paid by the landlord)
- Gifts for tenants
- Travel associated with managing your property
- Legal fees, under $10,000 in any given year

You can't claim deductions for capital expenses, private expenses, or expenses that do not relate directly to your rental property.

Expenses
You Can't Claim

You can't claim deductions for capital expenses, private expenses, or expenses that do not relate directly to your rental property.

Capital expenses are the costs of buying a capital asset or increasing its value; for example, the cost of buying the property and making improvements.

Private expenses are things you buy or pay for that are for your own benefit, rather than to generate rental income.

Expenses you can't deduct from your rental income in your tax return:

- The purchase price of a rental property
- Any capital portion of mortgage repayments
- Interest on money you borrow for any purpose other than financing a rental property
- Costs associated with any additions or improvements to the property
- Costs associated with repairing or replacing any damaged part of the property if that work increases the property's value

Legal fees

You can't claim legal fees charged as part of buying or selling the property over $10,000 in any given year, with the only exception being if you are in the business of renting properties. To find out if you are in the business of renting properties, please contact your Chartered Accountant.

Goods & Services Tax (GST)

GST is not charged on residential rent and this means you don't show rental income in your GST return. (If applicable.)

Depreciation

Depreciation is an allowance you can claim to cover the costs of wear and tear and general ageing of furniture and fittings you've bought for your rental property. You can combine assets worth less than $5,000 rather than depreciating them separately.

You cannot claim depreciation on the property's land or buildings. However, this wasn't always the case. This is a complex area, for more information we suggest you speak with a Chartered Accountant.

Other exceptions

If the property isn't rented for the full year, isn't occupied by tenants, isn't available to be rented out at any stage during the year, or is only available for rent for part of the year then you can't claim the full year's ongoing costs (such as rates, insurance and interest).

What about insulation?

All investment properties are subject to minimum insulation standards (see our Landlord Information Guide for further details). Do you know your rights in regards to claiming the expenses associated with this?

In July 2016 new minimum standards around insulation in rental properties came into force. As a landlord do you know for sure if you can claim back the expenses incurred through compliance?

The Inland Revenue Department (IRD) has confirmed that any new insulation would still be considered a capital expense and therefore not tax deductible. However, they added that the tax treatment for a property where existing insulation needs to be upgraded to meet new standards should be considered on a case-by-case basis considering the following points:

- Where a building already has insulation and, in order to meet the minimum standards, the owner is required to 'top-up' the insulation provided. Where this 'top-up' uses the same or similar standard of material that is already being used, then the 'top-up' is likely to be deductible as repairs and maintenance.
- If, while doing this 'top-up', the owner takes the opportunity to install new insulation into another part of the building (e.g. adds insulation under the floor at the same time as topping up the insulation in the ceiling), the cost of the 'top-up' would likely be deductible as repairs and maintenance. However, the new insulation constitutes an improvement and therefore is not tax deductible as repairs and maintenance.
- If a building owner elects to use an improved standard of insulation – say to change from 'Batts' to a blanket type of insulation – then it is possible the new insulation will not be a repair but a new asset and part of the building. However, if the insulation initially used in the ceiling was no longer available and was topped up with material that is reasonably similar (or a more modern equivalent), then perhaps the 'top-up' may be regarded as tax deductible repairs and maintenance.

If the distinction between what insulation you can or can't claim for is still a grey area after reading the points above, we suggest you talk to a Chartered Accountant to ensure you fully comply with the IRD's requirements.

Airbnb vs Long Term Rentals

Airbnb and similar platforms are increasingly being seen as an option for landlords to obtain income through their investment property, however, many do not fully understand the implications.

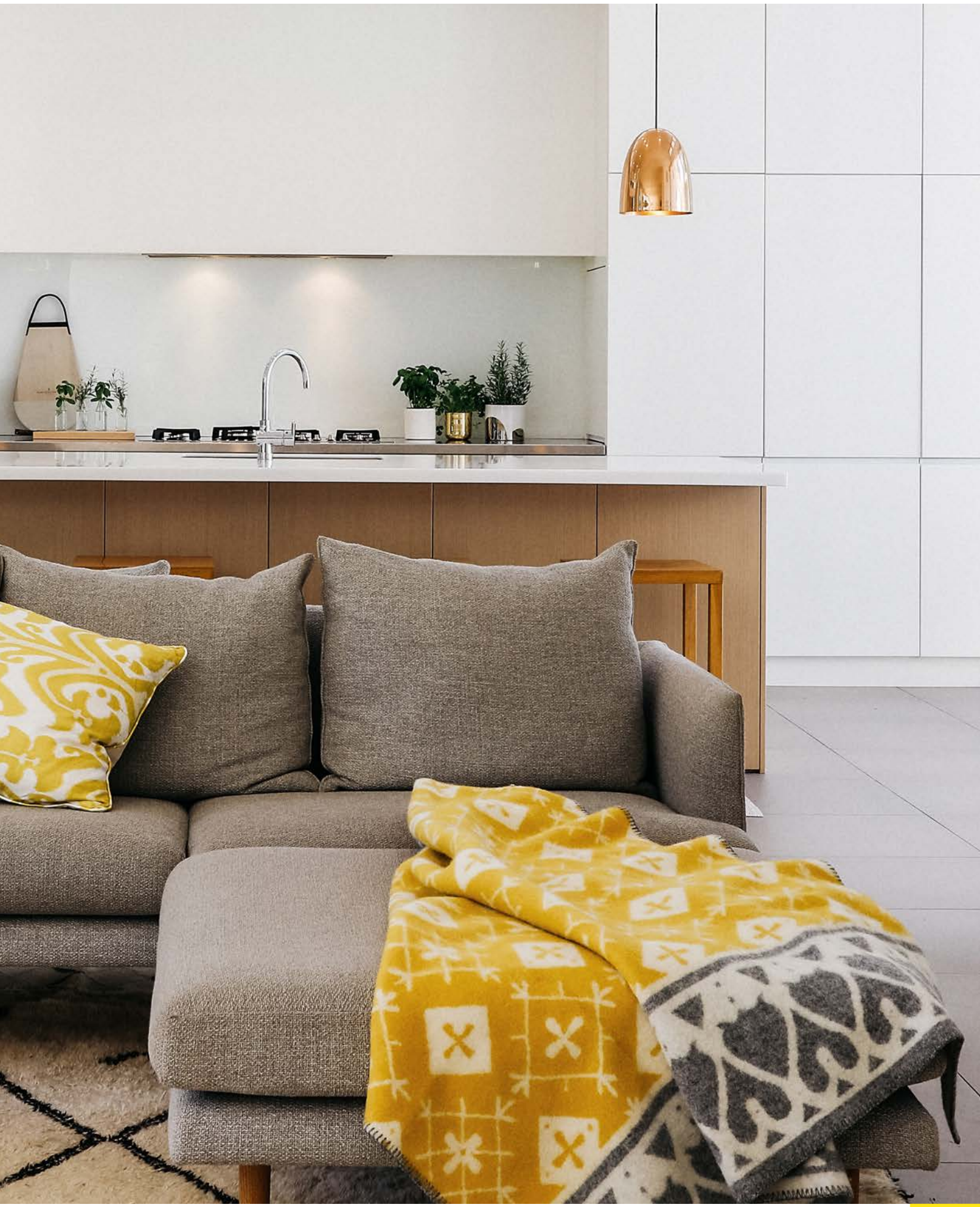
If you are evaluating the pros and cons short-term accommodation vs long-term tenancies as the main income method for your investment property, these implications are something you should investigate and seek independent professional advice on.

Many councils across New Zealand are considering, or have already implemented, new rates specifically for property owners who utilise Airbnb. This has seen rate increases of up to 225% for those investment properties under the jurisdiction of the Auckland Council and is an increase that can wipe out and income gains derived through short-term accommodation.

We advise all landlords to carefully investigate and consider their options before starting this process.

Whilst it may seem straightforward to rent a property on Airbnb, it is an equally straight forward process for the IRD and local council to monitor your activity in this space.

You should consider your financial goals when assessing the viability of short-term accommodation or long-term stable leases as the reality may not be quite what it seems initially.



Investment Property & Ownership Structures

Picking the best ownership structure for your investment property is something that can often be overlooked by prospective landlords, and for good reason. It's an area that is generally poorly understood without seeking professional advice. There are a number of benefits to picking a structure outside the common sole proprietorship/partnership model i.e. owning it in your own name.

The following outlines the four main types of property ownership in New Zealand and each provides a different mix of limited liability, compliance costs and tax efficiency.

Your own circumstances will be unique compared to another investor so the following information is intended as a guide only. We recommend before making any changes that you seek the appropriate professional advice before settling on any ownership structure for your rental property.

Sole Proprietorship/ Partnership

This is the most common form of property ownership in New Zealand. Your investment property is owned personally, with no limitation on personal liability.

This is a very simple and easy mechanism to offset business losses on personal income, however, this will change on 1 April 2019 when ring fencing of tax losses on investment property comes into affect.

Another advantage of sole proprietorship is that minimal compliance costs are associated with this popular structure.

Trust

Commonly known as a 'Family Trust', there are two main advantages to having your rental property owned by a Trust.

Asset protection is the most obvious advantage as the beneficiaries of the Trust don't actually own the assets held in Trust, the Trustees do so on behalf of the beneficiaries.

We recommend you seek professional advice from your lawyer about the finer points of trust law and asset protection if this is your intention.

From a taxation point of view, a Trust provides you with the tax benefits of income splitting. You can send any taxable Trust income to beneficiaries (anyone over 16, as you're limited to $1,000 per year for those aged 16 or under), who will then pay tax on this at their marginal tax rate. If this rate is less than the Trust tax rate of 33% then you'll potentially have tax savings.

Compliance costs can be high for Trusts and if income splitting is your desired outcome for putting your investment(s) into a Trust, make sure that your tax savings outweigh any professional fees incurred during the year.

Investment Property & Ownership Structures

Company

An investment property under this structure enjoys the benefits of limited liability due to it being a completely separate and distinct legal entity from its owners, but there are limitations to the tax efficiencies that can be applied.

Companies will attract higher compliance costs and there are some possible complications with capital gains when selling any property to related parties.

One of the tax benefits that company's enjoy is the automatic deductibility of interest, regardless of the intention of the loan. This is in contrast with the other business structures outlined here, where interest is only deductible on the loans that were originally taken out on the property.

Again, there are complications around taking out loans and drawing cash out of the company and it is a very different situation to the sole proprietor/ partnership model.

We recommend seeking the professional advice of a Chartered Accountant about whether a company structure is right for your investment.

Look Through Company

This is the successor to the Loss Attributing Qualifying Company (LAQC). It's an ownership model that still benefits from the limited liability of a standard company structure, but with the added benefit of being far more tax efficient.

Taxable profits or losses are passed straight through to its shareholders in proportion to their shareholdings, where tax is paid at their respective marginal tax rates.

This is a model that is less flexible in terms of tax when compared to the distribution options available to Trusts, but compliance costs are generally lower than those of a Trust.

Comparable Returns - Property vs Shares

Residential property has always been a staple of the New Zealand public in terms of creating wealth, or 'getting ahead'. It's easy to understand, tangible and, when leveraged, can provide significant tax-free capital gains (subject to current Bright Line tests).

It's important to understand the role that leverage plays when investing in residential property. As a comparison, residential real estate within New Zealand has returned 10% per year in both capital and revenue over the long term (1994 - 2014). New Zealand shares including dividends have, very long term (1899 - 2012), returned 9% to their owners. While on the face of it there doesn't appear a great advantage to owning property over investing in the stock market, leveraging can change this to the investors advantage.

Imagine this example: You have a house deposit of $100,000 and you buy a nice property for $500,000. The balance of $400,000 is lent to you by the bank at an attractive interest rate. In five years' time you decide to sell the property and achieve a sale price of $600,000.

What has happened to your initial investment? It's doubled. Leveraging has allowed you to make a 100% capital return on your investment at a rate of 14 - 15% per year. Had the property been positively geared, this return would have been even greater.

By understanding leverage you can highlight the benefits of property ownership and why it can be such a strong investment choice, as well as providing a better return for you than shares.

Another point to note is that while shares can be used as security for a loan, just as property can be, banks are far less likely to consider shares to be good security for lending. For this reason it isn't as common that loans are issued for shares or at interest rates as favourable as what is available for property.

We recommend you seek advice from relevant investment professionals before making any investment decisions.

Home Office Expenses

Are you legitimately using part of your own home to run your rental business? If so then you can make a claim on some of your personal expenditure as a 'Home Office' expense.

It's a simple calculation based on the proportion of your home used as a home office.

Start by adding up the personal expenditure on your own home e.g. rent or mortgage interest, rates, insurance for the year etc.
Work out the floor area of your home in square meters as well as the area of this total that is occupied by your home office.

Finally, divide the home office area by the total floor area. This is the percentage of your home expenses that can be claimed and offset against your rental income.

Be sure that you are actually using this space as intended. The IRD are known to conduct home office inspections at random.

The Brightline Test

Effectively a Capital Gains Tax (CGT) on residential property, this was extended to a five year period under the last government. It falls short of a comprehensive CGT in that no income is assessable after the five year ownership period. It is likely that the Brightline Test will cease to exist if a comprehensive CGT were to be implemented in the future.

If you sell your investment property within five years of purchase (based on settlement date), any capital gains are liable to be taxed at your marginal tax rate. This only applies to property purchased after 1 October 2015.

There are some exemptions. For example, if the property is your main home, transferred as part of an inheritance, or transferred as part of your estate.

This is a complex area with a number of pitfalls, so we recommend that you talk to a Chartered Accountant if you are thinking of selling any investment property within the 'five year window'.

Mixed-Use Assets

This is an area investors need to be aware of only if not using the property as a long-term rental e.g. Airbnb, Book A Bach or mixed personal/commercial use situations. The tax rules around Mixed Use Assets changed several years ago and you can't claim the same level of expenses you could prior to 2014. These rules can be quite complex, so please talk to a Chartered Accountant if you think your property falls into the 'Mixed Use' category.

Mixed-Use Asset rules apply to a property which is used for both private (you, your family or associated people) and income earning use in the same tax year. It must also be unused for 62 days of that year. These rules specifically exclude residential property used as a long-term rental.

You can opt out of these rules if your property earnt less than $4,000 in that tax year, however, you won't be able to claim any expenses against this property if you choose this route.

There are three types of expenses associated with a mixed-use property:

- You can claim 100% of expenses related to renting out your property.
  An example of this type of expense would be advertising the property for rent or repairs to damage by tenants.
- You can't claim any expenses that relate to the private use of your property.
  For example, boats or equipment that are locked away when renting the property out.
- Finally, expenses that can't be deemed private or related to renting out the property need to be apportioned. Generally this would include any interest on loans secured against the property, rates and insurance etc.

The easiest way to describe this is with the following example:

Paul owns a mixed-use property in Waihi. He used it privately for 32 days as well as renting it out for 45 days. The expenses that can be apportioned totalled $11,500.

Paul can claim $6,721 of these expenses against his rental:

$$\$11{,}500 \times \frac{45}{32+45} = \$6{,}721$$

There are more complicated rules around quarantining losses (effectively ring-fencing losses from Mixed-Use Assets) and what to claim if your property was sold during the tax year.

If this raises any questions for you around the use of your own investment property, we recommend you seek the advice of a Chartered Accountant.

Ring-Fencing of Rental Property Losses

Confirmed in the 2018 Budget, the government has committed to restrict the ability of investors in residential property to offset tax losses from their rental property.

This doesn't apply to commercial property and is seen as a measure to reduce the perceived tax advantage that investors have over owner occupiers in the residential market.

From 1 April 2019 any tax losses on residential property will be 'quarantined' from personal income such as wages or business income.

The Inland Revenue Department (IRD) released an Issues Paper in early 2018, with submissions towards that paper closing in May 2018.

The IRD's proposal includes:

The rules would not apply to the "main family home", a property that is subject to the mixed-use assets rules or land that is held on revenue account (mainly applies to property developers).

That investors would be able to offset losses from one rental property against rental income from other properties – calculating their overall profit or loss across their portfolio.

Ring-fenced residential rental losses from one year could be offset against residential rental income from future years. Importantly, they propose that ring-fenced losses could be offset against taxable income on the sale of any residential land. This becomes very important should a comprehensive capital gains tax be introduced at a later date.

There will be special rules forbidding "residential property land-rich" entities from being formed or used to side-step the new ring-fencing rules.

Entities will be regarded as "residential property land-rich" if over 50% of the assets are residential properties within the scope of the ring-fencing rules. This includes denying a tax deduction for any loan interest incurred in purchasing one of these entities.

Note: Information pertaining to ring-fencing of losses is correct at the time of printing (October 2018). However, we recommend investors seek professional advice to ensure there have been no further legislative changes.

Ray White_Know How to help landlords protect their investment

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