Property Investment: the fundamentals

12 September 2019 by Philip Macey

As accountants, we are often asked by clients whether they should invest in property. Over the last two years, this question has come up more regularly as people come to grips with a low interest rate environment and the difficulty of achieving a reasonable return on financial investments.

While there are numerous articles out there that can guide prospective buyers towards the expected financial returns and tax implications, many steer away from the more practical issues surrounding purchasing and maintaining a property.

So, here are a few pointers that may help in any decision-making process.

Don’t be frightened of taxes and love cashflow!

You only pay tax when you make money, so in that way tax is a good thing. However, paying more tax than required is not good! The last few years have seen significant changes to the rules around residential property investment and the most recent – ring-fencing of losses (discussed elsewhere in this issue), is potentially the worst for investors. Offsetting rental losses against salary and wages for most ‘ma & pa’ investors has in the past been a key part of any investment strategy.

But, let’s be brutally honest, in today’s market of low interest rates and (generally) high rental returns, if you cannot make both a cash and a tax profit on your rental property then your investment needs restructuring. From my experience, the most successful property investors are those that ensure every property generates a net cash return after expenses, which is then reinvested back into the property or debt repayment. Those that own negatively geared properties have been unable to grow their portfolio.

Investors need to understand that as they repay debt, with most loan structures, over time, the interest cost reduces, but the loan payments stay the same. As a result, there is a higher taxable income, but the same pre-tax cash flow. When you are then required to pay tax on your income, it can significantly impact cash flow. I call this the year five effect. Why? Because most investors complete a 5-year cash flow to determine whether they can afford a property. But it is after year five that the above starts to impact significantly and so we recommend that you always prepare at least a 10-year cash flow.

Do you know what your long-term goal is?

It goes without saying that unless you are trading property, any property investment will be a long term one. You need to ensure that this investment aligns with where you will be in 20 years, not just where you are now. Often, we see clients invest in a property, only to have to sell it a few years later as their situation changes e.g. shifting jobs, having children, aging parents' needs, etc. In the past there was potentially a capital gain that was made when the property was sold. However, in today's market and tax regime, gains cannot be guaranteed, and tax may also apply (mainly via the 5 year brightline test).

We encourage clients to think backwards when investing long term in property. Determining your cash flow requirements in 10 years will help you determine the rate and loan structure you need to put into place now in order to set yourself up for the future. Too many property investors structure their borrowings on the maximum the bank will lend and the minimum repayments the bank requires, rather than what is the best for their situation.

Should you own the property your business operates from?

This is a commonly asked question and one that really depends on individual circumstances. As a guide for a new business that plans for growth, it is often better to rent than to own. The reason? Rather than having funds invested in property, they may be better invested in working capital that will assist in business growth. This is assuming the net return of the business is greater than the net growth in the value of the property.

For mature businesses with consistent results, owning your own premises makes good sense, as who could be a better tenant?

However, be aware we often see owners over-capitalise a property in this scenario, as they make decisions that suit an owner, not a tenant. These funds are often not recovered in a subsequent property sale.

Beware too that in this scenario your business may be your only source of income. If it suffers a downturn, then not only do you have a business to turnaround, but you have a property investment at risk. Always set this type of investment up to sell. Owning in a separate entity, establishing market rents and having formal lease agreements means you have established a marketable property that could be sold, should your investment funds be required elsewhere.

Do you invest with others?

Investing with others is a great way to enable purchasing a property that could otherwise not be affordable. But it has its pitfalls. Firstly, knowing your own long-term goals is hard enough, but ensuring those you invest with have similar and aligned goals is difficult. If they are not aligned or their personal situation changes at some stage, the investment could be impacted.

Regardless of the relationship with these other investors – family, business associates or friends, we recommend that a Heads of Agreement is drafted and signed by all parties. While for the most part not legally enforceable, it is always worthwhile clearly documenting the intended structure, duration, funding, ownership rights and expected cash flow of the investment up-front. This should also include processes for the exit of one party, and on winding up the investment.

Beware that if funding is required for a purchase, you will need to carefully review and seek legal advice regarding liability, should there be a default on the loan for some reason. All institutions will seek cross guarantees from all parties or may limit funding depending on the various investors' personal situations.

Commercial or residential?

This is one of the most common questions we see now, given the recent increase in legislation around control of the quality of residential rental property. Generally, I advise clients to treat both the same – as an investment. It does not matter what type of rental it is; just that it generates a suitable return. Commercial properties usually offer longer-term tenants, who sign for long periods. Conversely, the properties typically take longer to find suitable tenants than residential properties. In both instances, you need to do due diligence on the prospective tenants to ensure they can manage the rent payments and will look after your properties.

Commercial tenants are responsible for most outgoings of a property and often carry out significant work to the property to make it fit for their own purpose. But beware, at the end of the tenancy, the property needs to be let again. You will need to ensure that you have the power to ensure that, if required, they return any alterations to their original state. For a comprehensive analysis, see the article Commercial property, not for the faint-hearted on page 8.

In summary, the best advice for anyone investing in property is always:

- Seek out the best quality property you can afford.
- Know what your end goal is.
- Know what your expected return is.
- Select your tenants, don't let them select you.

IRD Numbers to be disclosed on all property transactions

Most property transactions require the buyer and seller to complete a form disclosing their IRD number, under rules that came in with the introduction of the bright-line test.

However, people saying they are purchasing property to use as their main home are not currently required to disclose their IRD number. With effect from 1 January 2020 virtually all land transactions will require the buyer and seller to disclose their IRD number, regardless of the use they will be making of the property. They will also need to disclose if they are using the property as their main home. Non-residents will be required to disclose their foreign tax identification number and their country of tax residence. This is designed to capture land speculators who are avoiding tax and was recommendation number 99 of the Tax Working Group.

The Minister of Revenue also commented that: "Capturing the relevant tax information for property sales will also help us work with jurisdictions in other countries to combat global tax evasion."