Pearce & Co

CHARTERED ACCOUNTANTS

Residential Rental Investments

Ring fencing/ Brightline and more..

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13th April 2021

Agenda

- Rental 101
- Interest deduction limitation
- Tax outcomes
- Air BnB
- Revenue account property and Brightline
- Ring fencing rental losses
- Structures to consider for the future

Rental 101

Expenses claimable

Ensure there is a relationship back to rental income

- Accounting fees
- Advertising costs relating to finding a tenant
- Agent fees
- Depreciation – But not on the building...
    - Tools? Mower? Furniture?
- Insurance
- Management fees
- Rates
- Repairs and maintenance on property
- Vehicle costs – inspecting the property, carrying out maintenance etc...
    - % relating to rental or a mileage claim

Timing of Repairs & Maintenance

Timing very important to allow costs to be claimed as an expense.

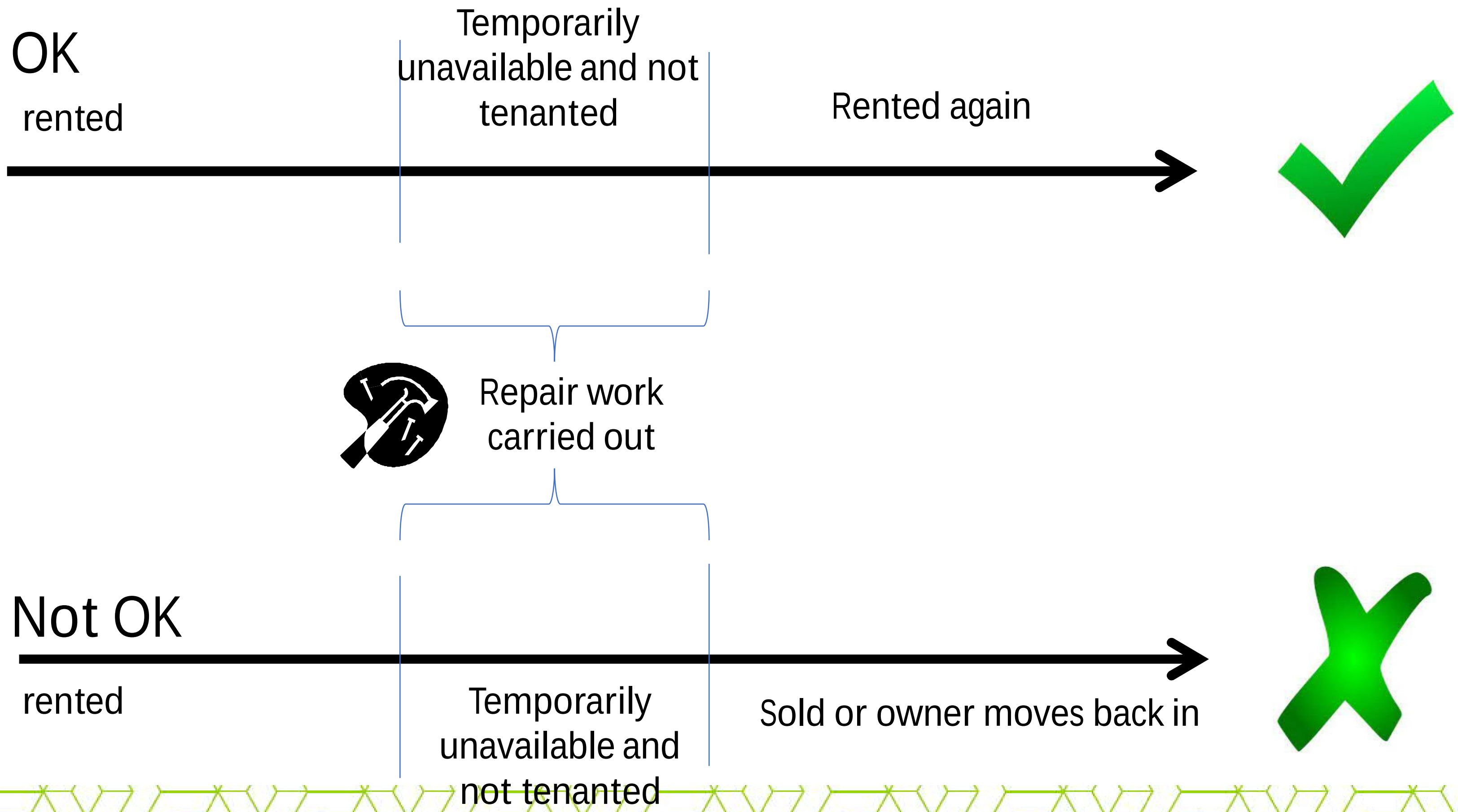
- Be actively searching for the next tenant

- Limit your own time living in the house during renovations
  (if DIY)

- Conduct some R&M during last tenancy
  - After tenancy ends is no good as relates to preparing to sell property.

Timing of Repairs & Maintenance

- OK
- Not OK



New Residential Investment Tax Rules

23rd March 2021 – supplementary order paper released by Government

24th March 2021 – Parliament passed the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill.

30th March 2021 – Royal assent granted and legislation ready to be enacted.

- Extend the bright-line test from 5 to 10 years
- Require consistent allocation of the purchase price of property in an asset sale

AND on 23rd March 2021 Government agreed to change interest deductibility rules for residential properties.

(not yet legislated, though IRD have a "fact sheet" on the current proposals)

Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Act 2021.

Progress of the bill

RA **Royal Assent:** Bill signed by Governor-General and becomes an Act.

Interest Deductibility – Existing borrowings

Income year	Percentage of interest you can claim
1 April 2020 – 31 March 2021	100%
1 April 2021 – 31 March 2022 (Transitional year)	1 April 2021 to 30 Sept 2021 - 100% 1 October 2021 to 31 March 2022 - 75%
1 April 2022 – 31 March 2023	75%
1 April 2023 – 31 March 2024	50%
1 April 2024 – 31 March 2025	25%
From 1 April 2025 onwards	0%

Interest Deductibility – New borrowings

- Residential property acquired on or after 27th March 2021

  will not be allowed an interest deduction from 1 October 2021 (6 months only).
- New borrowings to maintain or improve the property after 27th March 2021 are also subject to 0% claim.
- Property developers (who pay tax on the sale of property) will not be affected by these changes.
- Business loans secured against the residential property are not affected.
- New builds are able to claim 100% of the interest costs.

Refixing a loan = OK

Drawing down a new funds = not OK

Short term accommodation

Air BnB/ book-a-batch/ bed and breakfasts

- Current argument is they are <u>not subject</u> to interest limitation and ring fencing rules as they are a business - not a long term rental

The "business premises exclusion" CB 19 (1)(b), ITA 07

CB 19 (1)(b) to change to note a Substantial business

- Law amended so that full-time AirBnB properties, or baches are subject to the ring fencing rules.
- Currently applies to new property acquired on or after 27 March 2021.

Beware the hidden GST issue and mixed use rules!

Short term accommodation

Depreciation on buildings

Currently 0% for residential property and
100% for commercial buildings (from 2020-2021 year).

Generally speaking,
if there are 4 or more separate units within the same property and they're used for short-stay accommodation (such as AirBnB), they can be depreciated.

Prepare for taxes!

Example:

Property Value $600,000

Mortgage $360,000 (60% LVR), @ 3% interest p.a (25 year term)

Mortgage repayments per month $1,708 (interest $10,800 p.a, principal $9,696)

Rent per week $550 p/w

Rates $3,200 p.a

Insurance $1,500 p.a

Annual Repairs $1,000

Existing Residential Property

Taxable Income	2021	2022	2023	2024	2025	2026
Rent	28,600	28,600	28,600	28,600	28,600	28,600
Expenses						
Interest	10,800	9,195	7,657	4,950	2,396	0
Rates	3,200	3,300	3,400	3,500	3,600	3,700
Insurance	1,500	1,500	1,500	1,500	1,500	1,500
Repairs	1,000	1,000	1,000	1,000	1,000	1,000
Total Expenses	16,500	14,995	13,557	10,950	8,496	6,200
Taxable Surplus	12,100	13,605	15,043	17,650	20,104	22,400
Tax @ 33%	3,993	4,489	4,964	5,824	6,634	7,392

Cash flow considerations

Taxable Income	2021	2022	2023	2024	2025	2026
Taxable Surplus	12,100	13,605	15,043	17,650	20,104	22,400
Less Tax	3,993	4,489	4,964	5,824	6,634	7,392
Less Interest not deductible	0	1,341	2,552	4,950	7,187	10,500
Less Principal	9,696	9,987	10,286	10,595	10,913	11,240
Net cash flow	(1,589)	(2,185)	(2,760)	(3,720)	(4,630)	(5,488)

Revenue Account Property

Existing provisions under Income Tax Act 2007, CB 6 – CB 23

- Intention to dispose at acquisition (speculative traders)
- Building business
- Subdividing or development business
- Rezoning
- Land dealing business
- Major undertakings

Brightline supplemented these rules inserting a CB 6 (A)

Brightline Test Extended

	Property acquired before 27/3/2021	Property acquired on or after 27/3/2021
Subject to Brightline?	Yes On or after 1/10/2015 – 2 year rule On or after 29/3/2018 – 5 year rule	Yes On or after 27/03/2021 – 10 year rule
Holding costs deductible against Brightline income?	No (but can claim as a rental expense)	No (but can claim as a rental expense)
Main home exclusion?	Yes 50% threshold test – 'in or out' of the rules test	Yes Mixed use rules - no longer an "in or out", but a proportionate test
Ring fenced rental losses can be used to offset Brightline income?	Yes Take care around portfolio basis vs single basis	Yes Take care around portfolio basis vs single basis
Overseas rental properties caught?	Yes	Yes
Can losses offset other income?	No – with the exception of other land sales	No – with the exception of other land sales

Which Brightline rules?

The application of which Brightline test to apply is based on:

An un-withdrawable offer (even if subject to conditions)

The acquisition start date when applying the Brightline (under the 2,5 or 10 year rule) is:

Generally on settlement (i.e. title transfer).

Ring Fencing Residential Losses

Losses generated by a residential rentals are required to be carried forward until the rental profit is made, or the property is subject to Brightline Tax and can offset this income.

Losses generated by a Brightline disposal are ring fenced and required to be carried forward, or another property was taxed under Brightline or normal land tax rules.

A basis needs to be chosen also:

Portfolio basis Vs individual basis (property by property)

Very limited situations where property by property would be an advantage

(the left over rental losses – after being Brightline income – can be released for other income types)

Portfolio Vs Individual basis

On a portfolio basis – all properties in the portfolio must be disposed and subject to tax (Brightline) in order to release the losses to other income

On a individual basis – only that property needs to be disposed and subject to tax (Brightline)

In both cases, the rental losses need to have offset Brightline income first, before being released against other income

Portfolio basis is the obvious choice to keep things simple, one loss making rental offsets the profit of another rental to arrive at a net portfolio rental surplus or loss.

Take care on the right structure if applying a portfolio basis
(Trust/company/Look through company/partnership/individual holdings)

Structures to consider

Trust:

33% tax rate, losses not able to be distributed, more complex than a partnership or individual holding.

Financial statement required, Trust Law to adhere to.

Company:

28% tax rate, losses not able to be distributed.

Taxable to shareholders when distributed as a dividend or shareholder salary.

Cannot group in portfolio with Trust, Partnership or Individual holding.

More complex than a partnership or individual holding as financial statement required and Company Law to adhere to.

Look through company (LTC):

Taxed like a partnership based on the shareholding (i.e. losses and profits flow through).

More complex than a partnership or individual holding as financial statement required and Company Law to adhere to.

Structures to consider

Partnership:

Taxed in the partners hands based on their partnership share, able to split between multiple partners at differing tax rates. Top tax rate is now 39% for income over $180,000.

Simple to operate as only a tax return is required.

Individual holding:

Taxed in the individuals hands at the taxpayers marginal rate. Top tax rate is now 39% for income over $180,000

Simple to operate as only a tax return is required.

Can portfolio LTC share, Trust income distribution, partnership share with individual holdings.

IRD's position

IRD have indicated if they see excessive use of Trust structures they may increase the trust tax rate to 39%

IRD are very hard on what constitutes repairs and maintenance – as assets attached to the structure are consider part of the building and deprecation is set to 0%

IRD now have some very good data matching processes (LINZ records, IRD records, sharing of information with foreign tax jurisdictions) and have commenced raising enquiry's around Brightline already.

We are still waiting to see what would constitute a 'new build' and whether existing properties that were 'new builds' qualify for the interest deduction.

They disagree with the Governments approach to limit interest deductions.

Our view

Over the last two years significant changes have occurred to the tax rules.

Losses previously were able to be offset against taxable income, a pressure valve for 'Mum and Dad' investors where unexpected costs were incurred.

Brightline and land tax rules are complicated, a straight capital gains tax would be simpler. The Brightline tax is a capital gains tax by stealth.

There is still uncertainty and ambiguity in the interpretation of the rules.

- What types of residential property will be subject to the interest deductibility restrictions – e.g. are retirement villages intended to be caught?
- How will the deductibility restrictions apply where debt is held in a company? We expect debt stacking rules, similar to those in the mixed-use asset rules, given automatic interest deductibility at present for companies.
- For offshore rental properties, if the interest is denied, should the foreign exchange movement (gains and losses) on the mortgage also be ignored for tax?
- The continued need for rental loss ring-fencing?

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WE WOULD LOVE TO HEAR FROM YOU

If you have any questions about our services or would like to discuss your business and see if we could add value, please let us know. We love meeting new people and working collaboratively to help you achieve your business goals!

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