

## WRAPS Property Trading - the Evolution

Wraps are a niche sector of property trading, whereby an investor purchases a property normally say 10% under market value, and funds this with an 80% mortgage from an institution and 20% deposit from their own funds. Alternatively the trader may attract a finance partner/s who can provide the deposit and qualify for the mortgage. In this situation the trader and finance partner will form a partnership. The finance partner will purchase the property into their own trading trust and take full ownership, but in all other respects will be completely passive. The trader will often split the profit 50/50. A suitable prospective end purchaser will have been pre-qualified. This person will only have a small deposit of 2-3% of the higher on-sale price, and will usually have an impaired credit rating, which denies them qualifying for their own mortgage and purchasing their own home. An instalment sale contract (similar to a hire purchase transaction) is arranged for a price slightly above the market value, with finance provided by the investor at a premium of say 2% above the investors own cost of borrowing.

The result is, finance (effectively a mortgage) is wrapped around the investors own mortgage. These trades while profitable to the trader/investor, also enable individuals (turned away by mortgage providers) to purchase by instalments, their own home, rather than continuing to rent, as do approximately 30% of adults in N.Z.

This type of serious trading, by serious investors which commenced about 3.5 years ago in N.Z., has been credited to property investor expert John Burley (from Phoenix Arizona) who has been holding instructional seminars in Australasia for possibly 6 years. The attraction for the investor is the ability to be classed as a trader and qualify for the refund of GST on the purchase, and a relatively good cash flow, as future capital gains potential has effectively been converted into cash flow. Although more GST has to be repaid than claimed, because the payment is based on 1/9<sup>th</sup> of the sale price, there is a huge time advantage, because the GST repayments are based on, and spread over the many instalments, over potentially many years, which are paid by the end purchaser. The attraction for the instalment purchaser is being provided the opportunity to stop renting and purchase their own home, in which they will likely gain equity over time. Trader/investors from time to time are criticised by the uninformed, as making money out of poor people. However the reality is, professional traders/investors are taking risks that neither Banks nor the Government are prepared to take on, and the end purchasers will gain equity over time and eventually own their own home, rather than perpetually renting. The Wrap contracts normally provide for the end purchaser to be able to resell the property, and also to refinance when convenient to the end purchaser.

Over time, banks, one by one, have become disenchanted with Wraps. This is because on the one hand the person (the occupant) being the end buyer, obtains an 'equitable interest' (but not strictly a legal interest) in the title, which enables them to lodge 'a caveat' on the land title. In the event of non payment of mortgage by the investor, with resulting foreclosure, the mortgagee would be forced to deal and negotiate, with a party, who had an equitable interest, but with whom they had no previous business relationship. An additional problem is that this type of instalment sale Wrap, is not covered by the Residential Tenancy Act which controls residential tenancies. Therefore if the occupant either fails to pay the agreed purchase instalments, then action against them must be taken under the specific Wrap contract, rather than the Residential Tenancy Act. This Wrap contract route would be more problematic, longer time wise and more expensive. In the event of a mortgagee sale the mortgagee would also have to be forced to take action against the occupant to remove them (and their Caveat) under this same Wrap contract. Also on the eventual mortgagee sale of the property, the Banks may face the liability of having to

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unexpectedly pay GST out of the mortgagee sale proceeds. It is hardly surprising that Banks just do not want to lend on these Wrap properties.

Most of these serious full time Wrap traders (who are clients) have for the last 6 months been looking for solutions to the Wrap finance problem. The four essential parts to their business has been, finding under valued properties, finding investors (and forming a trading partnership with them), finding end purchasers and finding finance. Because of this finance problem, many of these traders have somewhat reluctantly just switched, or are in the process of switching from the Wraps with their attractive GST refunds, to another related strategy, called Lease/Options. This strategy is basically a rental property with a separate option to purchase which is provided to this same tenant. This strategy tends to resolve the finance issue, because the mortgagee is essentially lending on a rental. The tenant does not have the ability to lodge a 'Caveat' on the title as there is no equitable interest, and most dealings between landlord and tenant will be subject to the Residential Tenancy Act. This is not a trade (as in the Wrap sales instalment) because no sale has occurred at the beginning of the business relationship of owner and tenant. The potential sale is dependent on the tenant exercising their right under the separate Option Agreement. If the tenant never takes up the option then there will be no sale to that particular individual. In situations where an existing rental is sold by this method, it should be able to be maintained that being no trade, the transaction is exempt for GST. However where a trader purchases the property with the intention to immediately on sell then GST registration should be undertaken.

Each operator's Lease/Option agreements are individual to the particular operator, however most agreements will provide a limited time of tenancy, during which the Option will need to be exercised. If the option is not exercised in the defined period then the Option price will increase by a predefined formula. Traders of Lease/Option properties have also found the accounting requirements far less complex, onerous and expensive than for Wraps.

Another further evolutionary step, is the property trade without any finance being raised by the trader. This strategy is called the "Sandwich Lease/Option" This is the ultimate evolutionary step because without the need to raise finance, there is no limit to the number of transactions which can be concluded. Please find the sequel article by Garth Melville on "Sandwich Lease/Options" in the following month's edition of "The New Zealand Property Magazine".