

REAL ESTATE INVESTMENT TRUST vs. LAQC's

From approximately 1992 the Government introduced the concept of loss attributing qualifying companies, which have recently been a favoured vehicle of property investors and their advisors.

Most rental properties in New Zealand when purchased, are negatively geared (meaning the investments are not breaking even cash wise, and need to be subsidised) and in the last 5 years most of these properties have been purchased into LAQC companies. Leaving aside the lack of wisdom of purchasing an investment which requires subsidising, there are extremely convincing arguments that the LAQC may not be the wisest choice for purchasing real estate.

Firstly (added to any cash losses) the rental losses stem mostly from depreciation on the bricks and mortar, and especially the chattels. (Incidentally it is surprising how so many new property investors still do not know about separately valuing chattels). However, the reality is that these tax losses in most cases, will only be present for the first 5-7 years of the property's ownership. From about year 8 onwards the property will be in tax profit. Assuming the investment policy is to hold these properties for the long haul, then short term tax outcomes have been the driver of long term structuring.

Secondly the LAQC will always struggle with appreciating real estate assets. This is because the company owns the real estate, and individuals own the shares of the company. Whatever the appreciation of the investments, it will be similarly reflected in the value of the shares. Real estate assets are currently appreciating amazingly quickly. This appreciation is derived from three sources.

- The profit on purchase - most serious investors attempt to purchase at 90% of the market. On a \$200,000 investment this would represent an upfront profit of \$20,000.
- The market escalation - being 14.2% nationally for the June 03 year if compounded, would mean a doubling of the value every 5 years.
- The shareholders' equity increase - by the rents paying down the mortgage, the shareholders equity will increase.

All this high asset appreciation is taking place in the shareholder's own name, which will mean the individual shareholders will always be vulnerable if contested by creditors or other interested parties.

The advocates of LAQC's use two arguments for support. The first is that they can continue the losses for a long time, simply by purchasing more. Unfortunately, the reality is that this simply compounds the very problem of wealth creation in personal names as just outlined. The second method of attempted damage control is to advise clients when profits come on stream in about year 8, to simply transfer their shares to a trust. This is where problems will start to bite. Inland Revenue requires "Fair market valuations" because the shareholders and trust are associated. Simply using book values is inadequate because it will be challengeable. All the escalation will now be revealed in the fair market values, and this total (reduced by mortgages then owing) will determine the total which has to be gifted to the trust. This will be a big undertaking, bearing in mind the present low \$27,000 annual gift, free of gift duty, per settlor.

Also the whole approach of share transfer is flawed. It cannot be denied that the personal shareholders deliberately entered into a tax efficient vehicle. They have taken

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all the losses personally so long as the losses were available. When profits appeared they did not want to receive these, because they would have a higher personal tax liability. On inquiry of their new motives they would struggle to maintain they were only trying to obtain asset protection, and struggle to deny that they were trying to have a second bite of the tax cherry, as the trust will be their future more effective vehicle to distribute the new profits. After all, they could have achieved asset security from day one by purchasing directly into a trust.

There is another long term tax disadvantage with transferring the shares from personal ownership to a trust. All company profits must be taxed at the company tax rate of 33%, prior to any dividend distributions to the trust. In practise this mid tax rate is higher than that for beneficiaries on 19.5% and charities with a zero tax rate. It is factual that the surplus is available to use to credit against other income not taxed at source. However there is no tax provision for any 'theoretical' refunds to in fact be refunded in cash.

In summary it is not possible to distribute losses out of a trust to individuals. However the losses are never lost from a trust, and will be available to offset against future profits. Full asset security is possible in much shorter time, with only the initial equity requiring gifting. The trust is the best vehicle for distribution of profits, as well as estate planning. Using the maxim, control all but own nothing is more certain using trusts from day one.

It would be no consolation for an individual after losing personal assets to reflect and acknowledge in years prior to the loss, that they had good tax reductions.