KEEP AND REAP

Sometimes a "sold out" project isn't the best result. We look at how developers can build a great portfolio by selling less. **KIERAN CLAIR** [@kieranclair]

Challenging the established formulas of property can yield extraordinary results for savvy entrepreneurs. There are certainly profits to be made by staying the course and relying on the tried and true, but rewards for stepping beyond the norm can also be substantial.

In the world of development, the plan has always been buy the site, build the project, sell the product and move onto the next one – but what if you break that mould? What if you adopted a "keep and reap" approach?

Simply, this strategy sees developers retain one, or all, of the new holdings they create in a project to minimise outgoings and maximise equity.

Retaining developed product has a number of benefits and the long-term results can be extremely satisfying, particularly if you want to be sitting at the pointy end of the aeroplane well before all the other retirees.

PROS

Jo Chivers, CEO of project management company Property Bloom, says it's a great strategy and she recommends it to her high-income, time-poor clients.

"It's always good to hold on to developed stock. While you've got the flexibility down the track to sell off one or two if you need to or want to, the big benefit is really building a portfolio."

There are a number of upsides to adopting the keep and reap approach, not least of which is tax benefits. Rebecca Mackie, a partner at accounting firm Gatherum Goss & Associates, simplifies it.

"If you don't sell anything, then there's no tax to pay."

Mackie points out that you're also holding brand new product, which gives a whole swag of depreciation set to boost your tax return.

> **THE PROS AND CONS**
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> **Pros**
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> - Below-market-value approach to building a portfolio.
> - Reduced tax, stamp duty and other transfer costs.
> - New stock has high tax-deductable depreciation and low maintenance.
> - Holding long-term reduces/eliminates developers' GST requirements.
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> **Cons**
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> - Property is illiquid. Could miss new opportunities with your equity tied up.
> - Can't normally tap in to 100 per cent of the unit/'s value.
> - A "power block" on the body corporate can put buyers off.
> - Developer's liability can extend to the held units.
> - Reduces the potential value of the project's management right.

"Depreciation – it's the golden deduction because it doesn't cost you any money each week, but it can make a positively geared property negatively geared for tax."

There's the benefit of lower maintenance costs when you have new product in your portfolio, too. Best of all, you've acquired brand new rental properties without the unknown dangers of buying off-the-plan, or paying a developer's margin to someone else, because you've actually tipped your profit back into your portfolio.

Next up, Chivers says you can avoid a lot of transactional costs.

"When you add up the entry costs, the stamp duty and the exit costs, which are your sales commission, your taxes and GST, it really cuts into your profit margin."

For GST in particular, Chivers says after a period properties are deemed "second-hand" rather than new, so if you can wait until those years have elapsed, you've avoided a monster impost.

"After that point you can sell them and the GST implication goes away."

CONS

In terms of negatives, the primary downside is that your capital (i.e. profit) is tied up by the holdings and not particularly liquid. Many small developers want to get out of a project, take the dollars and move on to the next deal. If you keep your margin in the bricks and mortar, then refinancing is the most obvious option for releasing equity.

Unfortunately, you won't get access to 100 per cent of it in most cases, and while you can sell later if you need the cash, this takes time. If a great opportunity comes along and you require dollars fast, your locked-away equity may result in missing out on a cracker deal.

Clayton Glenister, managing partner at MBA Lawyers, says there are

> "If you don't sell anything, then there's no tax to pay."
>
> REBECCA MACKIE

INVESTOR SNAPSHOT

Holding on

Marisa Rowe is an experienced investor and boutique property developer whose track record of success has extended across oceans, but it's her "holding" strategy that's set to yield great rewards.

The 56-year-old Perth resident says she's never looked back after retiring from a job in 2006 to take on property investment full-time.

"I started developing about three years ago. During the boom of 2001 to 2006 in Perth, I was building single-home, house-and-land packages."

She evolved into larger scale projects and even hit cash flow pay dirt with her USA investments, but it's her new Croydon, Victoria, townhouse project that's cementing a strategy of growing the portfolio via retaining product. While the site will definitely yield four townhouses, she's trying to get five approved to boost the gains.

"We did the sums and found out that it's very, very profitable. If we get five, it'll be a 30 per cent-plus profit margin. Four will be about 25 per cent."

But rather than take the money and run, Marisa is planning for the future.

"By retaining one townhouse from this project, I'll generate an income of approximately $26,000 per annum gross. I'll be paying less tax and also have the benefits of depreciation on the property."

Marisa says property is purely a numbers game and keeping one or two units for rental income stacks up.

"I don't get emotional about property. If I require income, I sell down a few – rinse and repeat. It's also dependent on the market. If the market is strong, I like to take some profits off the table to reduce debt."

Marisa says you need to choose your retained unit based on smart analysis. If you can sell one of the holdings for more than the other, but the rental income is essentially the same for both, why not take the extra sale-dollars and reduce the debt?

"By retaining as well as increasing income, I'll also be building a portfolio, which will in the long-term grow in value."

Marisa says it's important not to treat this approach to investing as a "set and forget". Constant assessment of your investments is a must.

"In future any of the properties that I retain I'll review after five years – I won't have to pay GST after this period on the property I keep."

implications beyond tying up your dosh, too. If a developer decides to retain the lion's share of stock from a project, it ends up as the controlling power block in the body corporate. This sounds great, but anyone looking to buy in to the project won't agree.

"Let's say it was just a small development of 10 units and the developer intends to hold on to six of them. If I were a buyer buying into that body corporate, I'd be naturally concerned because that developer is going to retain the balance of power forever and a day."

Glenister says when power blocks are used well, they can help preserve the asset and therefore the reputation of the developer, but if used in the wrong way, they can exploit the minority owners.

Finally, the hold strategy can diminish the value of management rights in a project as a manager looking to buy the rights mightn't be comfortable with a single owner having the power to potentially remove a large chunk of rental income all at once.

CHOOSING YOUR UNITS

Decisions on which projects to keep and which to sell will depend on your financial circumstances and market drivers. As Chivers points out, it's fine to try and hold units, but if renters aren't going to front up for your asset, it can be tough.

"You need to look into what rental return you're going to be receiving and that will determine how easy it will be to hold… because if your rent's not covering your holding costs, it's going to be difficult to keep moving forward."

This applies to the particular units within your project as well. Make sure you've thought carefully about which of your new units will yield the best capital gains over time, and which will get the best rental yield. For example, if all the units are achieving essentially the same weekly rent, but one will sell for $20,000 more than another, why not sell the more expensive holding and pay down some debt? Ensure you keep those that are going to suit your circumstances.

STRUCTURE IS IMPORTANT

The best time to decide not to sell isn't at the end of construction when your back is against the wall due to a market downturn. You really need to start the process before all of that – preferably before you even buy the site. The number one tip is to get good advisers onside early – and shoot for those who specialise, according to Glenister.

"There are quite a few developments around that I see that have had these complex structures implemented that no one really understands including, I suspect, the lawyer. It does have a detrimental impact on the value of the individual units going forward, and also the reputation of the developer going forward, too, because it ends up being a real mess."

Good professional help extends beyond legal as well. For example, a poor GST decision will essentially see you lose 10 per cent of the gross profit. Mackie says that tax has caused some novice developers to go broke.

"People don't take into consideration GST, and it can be the difference between making a profit or a loss on a project if you haven't factored it in. If you're a developer, then there is GST on the sale price of your property."

For this reason, Mackie says to seek advice from an experienced accountant if you're looking at retaining end product. She says changes from a "sell out" to a "keep" strategy mid-way through a project compounds tax difficulties.

"If you decide right at the start that you're going to sell two and keep two, then it's easy to apportion the GST, but if you change your mind it can get a bit trickier. With GST, you aren't entitled to claim an input tax credit for the GST you pay on properties you're going to keep, whereas you are for the ones you're going to sell.

"So, if you've got a four-unit development and you're keeping half and selling half, then for the GST on all of the build cost, you can only claim half back."

Another reason to make plans early is asset protection. In a perfect world, everything goes to plan. Unfortunately situations can change, so plan for the best but be prepared for the worst.

Glenister recommends separating out one entity to be the "developer" and another to be the end unit "owner". He reasons that there are liabilities for any developer in a project, and if you retain assets in the name of the developer, these can be at risk in the event of legal action. He says the risk is compounded for novice developers.

"If they're not that experienced at building, there's likely to be building

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>
> CLAYTON GLENISTER

defect issues and potential exposure to litigation and liability, and then all of a sudden all you've given is the opposing party's lawyers something to attach any potential judgment to, being the real estate, which is now being retained by the developer."

Of course, transferring assets between entities usually triggers a stamp duty event, but Glenister says there are strategies to avoid this.

He notes there are legal frameworks available in most jurisdictions to reduce the impact.

"In most states we can do what's called a 'partitioning agreement', so that you can have an agreement done way back at the start of time, which says that after the construction of this is done, this entity will keep, say, units one, three, and five within the development, and therefore you may not be required to pay the full stamp duty or transfer duty in those states."

THE VERDICT

On balance, Chivers thinks it's a smart way to invest.

"The whole strategy gives you more flexibility. You're going to then also benefit from the future capital growth that'll come. You've created that chunk of equity, but then you've also got the new properties that you can re-assess in five years' time.

"I think there are more advantages to holding than there are to selling." API

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