PropertyInvesting.com 'Insider'

Discover proven tips, strategies and techniques to dramatically increase your property investing profits

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By Steve McKnight

Hi and welcome to your April 2003 edition of *'Insider'* - the PropertyInvesting.com e-bulletin for positive cashflow investors seeking a lifetime of passive income through real estate.

Are you receiving this newsletter for the first time? If so then I'd like to extend you a warm welcome on behalf of the entire Property Investing.com community.

This month's topics are:

As usual there's a lot to get through this month. Let's jump straight in.

6,941 Members And Growing Bigger Every Day!

Any moment now, the number of PropertyInvesting.com members is scheduled to top the 7,000 mark.

This is really good news as one of my aims in establishing PropertyInvesting.com was to build the largest online network of property investors in Australia.

Do you know someone that could benefit from this free newsletter? If so then there's a great facility that you can use to send them an invitation to come and check out the website.

And as a reward, we'll send both you a free gift - a 10-page special investor's insight article titled "Boom, Doom Or Gloom' where I outline what's likely to happen to the future of real estate. This is a valuable resource every investor should read.

If you'd like to refer a friend and access this report then please click here.

Capital Gains... Beware The Tax Deductibility Trap

Last month I outlined that there are three ways to turn your capital gains into cash. They are:

1. Sell the property
2. Redraw on your mortgage
3. Refinance your mortgage

Several years ago I attended a free property investing seminar where the presenter outlined that the best way to beat capital gains tax was to never sell your property.

Instead, once you retire and you're not earning a salary any more, what you could do is refinance/redraw the equity in your property to pay for your living expenses. That way you could access your gains without having to pay any capital gains tax.

This approach works OK in theory, but in practice the outcome may not be quite as rosy as first thought.

Tax Deductibility Status

In Australia, property investors are allowed to claim a tax deduction for costs associated with earning assessable income - but only to the extent that they're not of a private nature.

This means that if you borrow money to buy an investment property then the interest you pay on that money can be claimed as a tax deduction - as are the council rates, insurance costs, and repairs and maintenance expenses.

Tax Deductibility Of Interest On Borrowings

This is a bit of a minefield, but generally speaking, it's the thing you buy rather than the source of the funds that determines whether or not you can claim a deduction for the interest.

Let's look at two examples:

Example One: A home loan for your private residence. Unfortunately, because expenses relating to your home are of a private or domestic nature, the interest payable on your home mortgage ***would not*** be deductible :-(

Example Two: An investment loan to pay for an investment property. So long as you had an intention for your investment to one day make money, then the interest on the investment loan ***would*** qualify for a tax deduction.

Interest Deductibility On Redraws/Refinancing

OK - now the discussion becomes a little more complex so let's make up an example as an illustration.

Let's imagine that you have an investment property that you bought for $150,000 and which you financed with a 100% interest-only loan (secured against other assets you own). You current interest rate is 7.5% per annum.

Under this example, you'd be paying $11,250 ($150,000 x 7.5%) per annum in interest and it would all qualify as a tax deduction.

Having owned the property for a few years, you decide to have it revalued and you discover that it's now valued at $250,000. You approach your lender and they agree to restructure your loan to provide a further $80,000.

You've been working hard for many years without a break and you decide to take your entire family for 'all expenses' week-long junket to Fiji costing $20,000. The other $60,000 you invest in shares.

Here's the important point. Even though the entire $80,000 is sourced from your investment loan - the interest on the $20,000 portion (ie $1,500 per annum) you spend on the trip to Fiji will no longer qualify as a tax deduction as it relates expenses of a private nature.

Repaying In After-Tax Dollars

The true cost of meeting the non-deductable interest payment is made worse by the fact that having lost its tax deductibility status, you'll now have to repay using after-tax dollars. If you're on the top marginal tax rate, then you'll have to earn $2,913 to have $1,500 in after-tax funds to pay the interest.

The Bottom Line

The idea of redrawing or refinancing your loan works well provided you plan to use the funds for investment purposes that will earn assessable income.

However, if you plan to use your equity to fund your living expenses then you'll lose a portion of the tax deductability of the loan interest.

That's why I believe that the argument that you can fund your financial independence using equity is both flawed and dangerous. Once you've retired and you have little or no salary income, I would have thought that the last thing you'd want to do is create a situation of substantial debt, of which an increasing portion of the interest must be funded from pre-tax earnings.

I guess this summarises the difference between the hype that sells property, and the reality that investors must face at the cutting edge of trying to make money.

Topical Forum Post Of The Month

I've selected the following forum post that was recently made by a community member with the forum alias 'dkrsevan'.

> *Hi,*
>
> *I am new to this forum but have been reading previous posts for some time.*
>
> *I have a question which I would like to run by all you experienced property investors. I currently own my principal place or residence (not outright- have mortgage). I own investment property with gearing of around 50% and vacant land on Sydney southcoast which I intend to keep long-term as a holiday house/IP.*
>
> *My dilemma is that I would like to sell my investment property and use my gains to pay down some of the debt on my residence, but I don't like the idea of paying CGT. I would just like some opinions on this matter.*

Thanks

DK

(To see this post and the replies made by other forum members visit: http://www.propertyinvesting.com/forum/topic.asp?TOPIC_ID=1181)

This brings some of the earlier discussion about the tax deductibility of interest payments into a practical context.

The interest payable on DK's private place of residence will not be deductible for tax purposes, whereas the interest on his investment property will.

DK can therefore access a common tax planning technique where he pays the minimum (if any) off his investment loan (where the interest does qualify for a tax deduction) while channelling every possible cent into repaying the home mortgage to pay it off as soon as possible.

So let's go through his choices:

1. He can sell the property, pay applicable capital gains and then use his nett proceeds off his home mortgage.

2. He can redraw or refinance his investment loan and then use the funds to pay off his home mortgage, but if he did this then the interest on his redraw would not be deductible because it was used for private purposes (repaying his home loan).

3. He could set up a new structure, use it to buy his principal place of residence, and then he could rent it back. This would make the interest on the loan deductible, however there would be substantial amounts of stamp duty and closing costs to pay, plus the property would no longer have CGT exempt status as a principal place of residence.

My recommendation to DK would be to first decide if this is a financial or a lifestyle decision. If it's a financial decision then emotion should have little or no part in deciding the right outcome. However, if it's a lifestyle decision then final outcome will depend on a number of financial and non-financial factors.

If I was sure that paying off my home mortgage was the best way to bring me closer to my goals, then I would evaluate each of my other properties and sell the property with the poorest investment return.

What would you do? Help DK out by posting your thoughts at: http://www.propertyinvesting.com/forum/topic.asp?TOPIC_ID=1181

Summary

This month we've continued our review of capital gains returns and found that funding your financial independence with capital gains may not be a rosy as what is mentioned at free wealth creation seminars.

When you live off equity redraws then you'll lose the tax deductibility status of a portion of your loan interest, which may have diabolical outcomes if you have a limited income. You may want to rethink your approach if your banking on capital gains to fund your retirement.

Well, that's enough for this month. Best of luck with your property investing and remember that success comes from doing things differently.

Regards,

Steve McKnight

P.S. Do you have a spare few minutes? Why not refer a friend and then access the special 10-page report outlining my thoughts on the future of real estate in Australia? Click here

P.P.S. To read the backissues of this newsletter visit http://www.PropertyInvesting.com/backissues