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PropertyInvesting.com 'Insider'

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

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By Steve McKnight

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Hi,

Welcome to your June edition of Insider. As we wind down to the end of the 2004/2005 financial year I thought I'd take this opportunity to return to my accounting roots to outline one of the biggest dangers associated with property investing. If you or someone you know is planning to use real estate equity to fund your retirement then this newsletter will contain some alarming truths that may help you to avoid making a huge financial mistake.

The topics for discussion this month are:

- Forum post of the month - Do serviced apartments make good investments?
- Beware the danger of using property equity to fund lifestyle expenses!
- Special End of Financial Year Gift: How to maximise your property tax deductions
- How to legally use your kids to lower your tax bill

Let's get going!

Forum post of the month - Do serviced apartments make good investments?

I continue to receive many requests for help from investors confused about various property investing options, which is why I've chosen the following post from Newstart for this edition (see: <http://www.propertyinvesting.com/forum/topic/18025.html>):

"Hello everyone, I've been looking for my very first positive cashflow investment property but I'm unsure which is better:

1. A serviced apartment (Brisbane/Melbourne)
2. An apartment where they guarantee monthly rent (in writing) in Melbourne
3. A house with a tenant on a one-year lease

As part of my due diligence, what should I be aware of? Are there pros and cons between the 3 in terms of cashflow? Any thoughts from experienced investors would be appreciated.

Many thanks. NewStart"

Thanks for your post NewStart.

I understand that it is hard to make a start and commend you on your effort to seek help. To begin with, as a general comment, I think it is far better to buy and fix problem properties than it is to buy and hold what I call 'solution real estate'.

The difference between a problem and a solution can be well explained using the example of a serviced apartment that's sold to an investor. On one hand you have a developer who takes a problem block of land, develops it and makes a profit by selling a solution, and on the other hand you have an investor who buys and has to wait for potential capital gains to create wealth.

In many cases what actually happens is that serviced apartments are packaged up as pretty solutions and sold by developers to investors who want easy deals. Investors are then sold on the sales pitch of future potential and pay an inflated price for deals that are likely to highly depreciate and are unlikely to achieve the usually aggressive capital growth forecasts.

That's not to say that all serviced apartments are dud investments. Just watch out for high body corporate fees, quite savage rental management fees (these are sometimes payable to a management company in which the developer has an ownership interest) and shoe-box style floorplans which financiers are reluctant to lend against (a minimum of 25 square meters is usually needed to gain finance).

Be careful to avoid buying in areas where there are gluts of supply coming on to the market as many unpopular inner city offices have been converted to serviced accommodation. If you are seeking capital gains then look for unique features that cannot be easily copied, remembering that today's state-of-the-art appliances will be sold on E-Bay for cents in the dollar tomorrow.

As far as rental guarantees go, these can be useful but it is wise to remember that they are only as strong as the person or organisation providing the guarantee. It's easy to provide a guarantee in boom times, but when things become tough you can bank on weaker developers going broke and leaving a pile of unfulfilled promises.

Another point to be mindful of is that rental guarantees are often factored into the sales price. To see if this is the case ask the sales agent what is the price without the guarantee and then see if you are paying top dollar for a risk that can be addressed in a more cost-effective way (for example, using rental insurance).

Lastly we come down to the issue of a house with an existing tenant... and while this may be the least solution-orientated alternative, whether or not this is a good financial investment will come down to crunching the numbers. If you are after cashflow then use my 11 Second Solution <http://www.propertyinvesting.com/11secondsolution.html> as a guide.

In summary, there are two aspects to your potential properties. The first is whether or not you'll achieve a positive cashflow outcome. Sadly, many properties are advertised as positive cashflow but rely on depreciation and tax adjustments to make them this way. Such properties may be appropriate for high-income earners, but for those starting out, they can actually force you into needing a job to earn the money to soak up the tax losses. Luckily, you can protect yourself from dud investments by crunching the numbers yourself rather than relying on dubious financial projections. If you don't know how to evaluate a potential property then consider investing in a resource like BuyerBeware <http://www.propertyinvesting.com/sima/click.php?id=75>

Secondly, serviced apartments are more likely to be growth rather than income assets. Therefore, be sure to look at the unique features of the dwelling from the perspective of your target rental market. For example, if your target market is students then proximity to campus is a key issue. Watch out for gluts of apartments coming on to the market as this will hinder long-term capital gains.

If you'd like to make a comment about this post then please do so at <http://www.propertyinvesting.com/forum/topic/18025.html>

Beware the danger of using equity to fund lifestyle expenses!

Interest is usually the biggest expense that property investors will incur. Therefore, your ability to manage your interest bill will be a very important factor in determining your ongoing success.

A large component of the management of your interest is making as much of it tax deductible as possible. Therefore, understanding what can and can't be claimed as a tax deduction is imperative, so let's delve into this concept in more detail.

Getting down to basics, it's not the nature of the asset (i.e. private versus investment property) that determines whether or not interest can be claimed as a tax deduction. Rather, it's how you use the borrowings that's all important.

This may seem a little confusing, so let's look at two examples to highlight this point.

Example #1: Home Equity Redraw

Interest associated on loans used to buy a principal place of residence (i.e. the family home) won't generally be allowed as a tax deduction because those funds were used to acquire a private and non-taxable asset.

As a side point, it's interesting to note that if private homes were subject to capital gains tax then a deduction may be allowed for the interest similar to what happens in the US. However, for the time being, the government won't permit a tax deduction on one hand for the interest without taxing the capital gain with the other.

So does that mean that interest on a home loan can never be deductible? No! Assuming there is home equity, then this could be refinanced and should the funds be used to buy assets that create taxable profits, then a tax deduction will be allowed for the interest on that redrawn amount.

For example, let's say you bought your home for \$300,000 and that it has increased in value to \$400,000. Your current loan balance is \$150,000 and you are paying 7% interest-only. The XYZ bank has approved refinancing for \$80,000 (i.e. 80% of your \$100,000 in equity) at the same interest rate which you promptly use to pay for the deposit on an investment property.

Your total interest bill would be as follows:

Interest on home loan portion: \$10,500 ($\$150k * 7\%$)
 Interest on redraw portion: \$5,600 ($\$80k * 7\%$)
 Total interest: \$16,100

Only \$5,600 of the total interest bill would be tax deductible as the other portion relates to the borrowings used for private purposes.

Hopefully this draws out the point that it is possible for interest expense to be claimed notwithstanding that the underlying asset is held for private purposes. It is not the asset that is used as security that matters, but rather the use of the borrowed funds that is all-important

Example #2: Investment Property Refinanced

Similarly, interest expense associated with an investment property cannot automatically be assumed to be 100% deductible. A popular theme doing the rounds in financial planning and wealth creation circles is to buy blue-chip property that is well placed to accumulate in value over time and then live off the equity later in life.

This approach is sold as being tax effective as you can access your profits without paying tax since CGT is only payable if you sell the asset, and since you are refinancing rather than selling, there is no tax to pay.

While sounding good in theory, there is a serious flaw to this approach. If you use your investment property equity to fund private expenses then the interest applicable on that refinancing becomes non-deductible. This can be a looming disaster for someone who has retired from the workforce because they will gradually draw down their equity profits in greater portions to pay their interest and lifestyle costs, until eventually the asset will need to be sold at which point there will be a nasty tax liability too.

Let's look at the previous example changing the scenario so that it is an investment property as the underlying asset and that the redraw is to be used to pay for a 14-night Caribbean Cruise. The interest bill can now be divided up as follows:

Interest on investment loan portion: \$10,500 ($\$150k * 7\%$)
 Interest on redraw portion: \$5,600 ($\$80k * 7\%$)
 Total interest: \$16,100

Now the \$10,500 would be deductible and the \$5,600 would not since it is being used to pay for private expenses. Worse still, assuming you are on the top marginal tax bracket, you will now need to earn \$10,874 ($\$5,600 / 0.515$) to cover the interest cost as it will need to be repaid from pre-tax earnings. This extra cash required (i.e. the repaying from pre-tax dollars as the interest is non-deductible) explains why using investment equity to pay for lifestyle costs can be a very dangerous approach!

What's the alternative then? Well, as far as retirement planning is concerned, I subscribe to the golden goose theory in that you should live off the income your investments provide (i.e. the golden eggs) rather than drawing down on the capital (i.e. cooking the goose).

For those that do not have sufficient income in retirement then drawing down on equity to pay for the cost of living may be the only option. If this is the case then it's critical to carefully monitor and manage the exposure to interest rate risk, and in particular the effect of rising interest rates. It may be wise to consider selling the property, paying the required tax and investing smaller parcels of money into other assets to create multiple income streams. Then, as more equity is needed, a parcel of assets rather than the whole portfolio can be sold

to provide the necessary cash injection while the remaining assets continue to provide supporting income.

The message is simple: be very careful when using equity to fund lifestyle costs as the government does not allow a tax deduction for interest on borrowings spent on private expenses.

If you'd like to make a comment on this topic then please do so at <http://www.propertyinvesting.com/forum/topic/18256.html>

Special End of Financial Year Gift: How to maximise your property tax deductions

As a special end of financial year gift, I've been able to reproduce two tracks from the excellent WealthGuardian which you can listen to right now by visiting <http://www.propertyinvesting.com/sima/click.php?id=73>. It's my way of thanking you for your ongoing support..

How you can use your kids to legally lower your tax bill!

While many of the tax perks have been closed in recent years, one or two opportunities remain open. One such opportunity is your ability to legally pass on some of your property profits to your children and for it to be tax-free in their hands!

In order to be able to do this you'll need to be 'properly structured', which in this case means needing a family trust in which your property is owned.

Now, without wanting to get too bogged down in the detail, Australian tax law allows persons under 18 to receive up to \$772 each year before they'll have to pay any income tax. So what happens is that the Trustee of the trust simply distributes up to \$772 in property profits for each child beneficiary of the trust. If your children are over 18 then you have even more potential to use the system to lower your tax bill!

Now, \$772 might not sound like a lot so let me show you how to use the system to its full benefit. Provided the income you're distributing is capital gains, you can double the amount of the distribution (i.e. increase it to \$1,544 per annum) and, because of the 50% capital gains tax discount, your children still won't have to pay any income tax.

This isn't a rort, it's simply using the flexibility built into the tax system for your own benefit.

There are other tax-effective strategies available too, which is why it always pays to be street smart in your understanding of tax matters. If you'd like to increase your awareness then 'WealthGuardian' is a resource that I can strongly recommend. It contains a 180 page workbook that clearly outlines how the tax system works and how you can use it to legally lower your annual tax bill at the same time as increasing your asset protection. It's been put together by two taxation experts who are qualified chartered accountants.

Of course, you could also get your accountant to spend half a day explaining the concepts to you, but you'd end up paying about three times the cost of 'WealthGuardian' and not have the ability to go through the essential concepts at your own pace.

Some of the many topics discussed include:

- The four 'must have' components that will dramatically improve the effectiveness of any financial plan.
- The easy way to map out a structure that meets your needs and is within your budget too!
- Why partnerships are like bear traps for the financially naive, and how you can avoid the dangers.
- Why owning property in a company will result in you paying too much tax!
- How you can use the same model as used by the very rich to protect your assets.
- How to beat the banks through accessing ongoing finance rather than reaching your personal borrowing glass ceiling.
- A comprehensive list of tax deductions for property investors to ensure you are not missing out on claims that you didn't know you could make.
- How Aussie investors can structure their New Zealand affairs.
- And much, much more...

Considering that you would happily pay several hundred dollars for home insurance on an ongoing basis, wouldn't it be reasonable to pay just \$399 once for a fantastic resource such as 'WealthGuardian'? The answer has to be yes, especially when you are covered by the 14-day risk-free money back guarantee where you can see for yourself - and if not completely satisfied, simply return for a full refund.

Well, a good deal just became even better because we are currently running a financial year-end sale where the next 100 purchasers of 'WealthGuardian' will pay just \$299 (plus postage and handling)!

You may be wondering whether or not you really need this resource, so let me summarise who would benefit from the information it contains:

- YOU, if you own even one investment property in your own name
- YOU, if you use a partnership for business or investing purposes
- YOU, if you are buying growth assets in a company structure
- YOU, if you desire straightforward information on the complicated topic of trusts and how you can use them to reduce your income tax
- YOU, if you want to know how to use effective structuring to access ongoing finance
- YOU, if you own or are thinking about buying real estate in New Zealand.
- YOU, if you want to better inform your accountant of exactly what kind of structure you need in order to increase your asset protection and avoid paying too much tax.

The quickest way to get your hands on 'WealthGuardian' is to buy online at <http://www.propertyinvesting.com/sima/click.php?id=74>. We use the same encryption technology as the banks meaning that your personal details are extremely safe. Another option is to call on 1800 660 630, however this will attract a \$10 booking fee as the call is handled by a secure third-party organisation.

Normally your kids are a significant cost so being able to gain a tax benefit from them is a rare opportunity that should be seriously considered if not embraced!

If you'd like to make a comment on this topic then please do so at <http://www.propertyinvesting.com/forum/topic/18212.html>

Summary

This month we began by examining the issues associated with buying serviced apartments, apartments with rental guarantees, and houses with pre-existing tenants. As with any investment decision, the key is to arm yourself with additional information so that you can avoid buying a lemon. I'm generally opposed to buying serviced apartments as they are more like solutions than problems, and I feel that more money can be made by fixing a problem than waiting for time to make something more valuable. Rental guarantees can be handy, but they are usually factored into the sales price and as such can be an expensive form of third-class insurance. Finally, buying a house with an existing tenant can seem wise but just be careful to make sure you are not inheriting a tenant from hell!

We also looked at the deductibility of interest and found that it is the use of borrowings rather than the character of the underlying asset that determines whether or not a tax deduction will be allowed. Be very careful when planning to use property equity to pay for your retirement as I see this as a huge potential danger. In ten years time people won't be saying 'equity mate', they'll be saying 'equity ouch'.

Finally, I also outlined the basics of how you can use your children to legally reduce your income tax. There are other strategies too, and these are well outlined in the excellent resource 'WealthGuardian' (see: <http://www.propertyinvesting.com/sima/click.php?id=74>).

That brings us to the end of another edition of Insider. Just before I sign off I thought I'd let you know about a small improvement that's just been added to the forums as we now have a spell checker functionality. This can be accessed by clicking the ABC button (that features a blue tick on it) which appears on the screen where you enter your data for your post.

I sincerely hope you've been able to profit from the insights outlined in this resource. Until next month remember - success comes from doing things differently!

Sincerely,

Steve McKnight

P.S. Don't forget that the recommended retail price for WealthGuardian is \$399, however, for the first 100

purchasers or until the 5th July, it has been reduced to just \$299 (plus postage and handling). Buy now while this offer remains at <http://www.propertyinvesting.com/sima/click.php?id=74>

P.P.S. Don't forget to listen to your free audio clip outlining more about the deductibility of interest. You can do this now by visiting <http://www.propertyinvesting.com/sima/click.php?id=73>.

Disclaimer: This newsletter is not intended to be a substitute for taxation advice. It is a broad discussion to provide a general understanding. You should seek specific advice for your unique situation.

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