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Property Investing.Com *'Insider'*

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

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Your Notes

Welcome to your March edition of the Property Investing.Com *'Insider'*.

This month I'll be focusing on two topics.

The first is an outline of my '10 Laws of Property Investing Success', which were recently published in 'Your Mortgage Magazine'. Over each of the next nine months I'll be outlining a new property investing success Law, but in this first edition, I'd like to fully explain the nature of the laws and reveal Law #1 in detail.

Later on in the newsletter I'll also outline an interesting outcome to a property investing tax case which involves a form of split loan financing facility. It is a timely alert for all investors who have, or are considering using, equity in their private home to finance property investments.

The 10 Laws of Property Investing Success

A Free Dose Of Hype?

You don't have to look far to locate a free wealth creation seminar that promises to reveal the secrets of the rich.

It seems like a constant procession of letterbox adverts and ads in papers for free seminars... I've even seen free CDs at the local fish and chip shop that promise to share how the rich use real estate to get wealthy.

With so many secrets, how can we find a balance between what's real and what's thinly veiled marketing hype?

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As a chartered accountant and mentor to successful property investors through my Wrap Library, and more recently my Property Secrets Revealed product, I've heard many hard-luck stories about people who let greed obscure their better

judgement. But you can protect yourself from being ripped off by understanding the nature of the real estate industry and then asking a couple of essential questions.

Know The Industry You're Investing In!

Most investment industries have watchdogs to protect the uneducated - but not real estate.

For example, the stockmarket is regulated by the Australian Stock Exchange and in order to trade shares you must use a licensed stockbroker. In mutual funds, financial planners are generally consulted and all applications must be on a prospectus.

"When it comes to real estate, the best advice for potential property investors is: **Caveat Emptor - let the buyer beware!** "

But in the 'wild-west' of real estate investing, an investor liaises with an agent who is a paid representative of the seller (also known as the vendor). Furthermore, the Real Estate Institute is a professional body, not an independent regulatory authority.

Protection Is Not Rocket Science.

If the responsibility for protection rests with the investor, what can s/he do in practical terms to guard against financial loss arising from buying the wrong property at the wrong time?

Many property investors are doomed from the beginning because they purchase based on greed and fear, when the opposite is required - a clear state of mind and common sense.

Smart real estate entrepreneurs don't decide whether or not to invest tens or hundreds of thousands of dollars on a whim or toss of a coin. They ask questions to ensure the true value of an investment is revealed *before* buying.

Real estate agents sell a property based on the known advantages.

The best way you can protect yourself is to listen to the advantages and then take the time to thoroughly search for problems that aren't known or are glossed over.

Aim to be pro-active rather than re-active, as property mistakes can be very expensive lessons to learn.

Last year I looked at purchasing a property with a swimming pool

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in the backyard. The agent told me that it would be a major attraction to a potential tenant and would lift the rent between $5 and $10 per week.

Financially, the property looked promising with a yield of around 12.5% per annum.

But on closer inspection the pool didn't meet the necessary council fencing requirements. I was also mindful of stories I'd heard from other investors that swimming pools were more effort than reward.

I declined to purchase, but instead took away the idea of providing 'pool passes' to the local baths in summer as a reward to my good tenants (those that pay on time and look after the property).

Greed becomes a problem when you are blinded into taking unreasonable action. For example, if I told you I was thinking about investing $200,000 based on the words of someone who I'd just met (and was being paid for telling me to buy), what would you think?

Sales agents know that a dream sells, whereas reality is someone else's problem that occurs after a commission has been earned. Be alert for the danger signs, such as tales about what you could do with instant riches, dismissing problems as mere inconveniences, investing more than you can really afford and not seeking an independent opinion from a mentor or accountant *before* making a massive financial commitment.

After purchasing more than 70 investment properties, I've heard just about every hard-sell story in the book. How I protect myself from making a poor investment and losing money is by adopting a set of rules which I call my '10 Laws Of Property Investing Success'.

In this edition of 'Insider', I'd like to concentrate on the first law, which is:

Law #1 Choose Your Investing Yardstick

Have you ever noticed that all really important outcomes in life are measured?

For example, your weight at birth is measured and is a guide used to determine health and many other things. Your school records are graded according to merit and determine the career path that you are eligible to pursue. How you retire is not as important as the age at which you reach the milestone. Even in death we cannot die without a death certificate to record and

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measure our lifespan and cause of death.

Throughout life it's not usually the activity that is memorable but the achievement attained. But what is certain is that you are more likely to remember and succeed at activities which are measured in the first place.

Investing in property is no different. Before you can achieve success as a property investor, you'll need a purpose for achieving your goal.

Defining a purpose will allow you to develop a way of measuring your progress, which is what I mean by choosing your investing yardstick. I see two ways in which you can do this:

1. Start from the bottom up. This is a random way of proceeding since you continue to buy property until one day you seem by accident to reach an outcome that you are happy with. You'll never know what you are really doing and what property will bring you closer to your goal because you lack a direction to begin with.
2. Start from the top down. Set the end goal and then work backwards to define what each property must deliver from your investment. Then only buy properties that will propel you towards your goal.

I have used both of these strategies. I began with the first and quickly realised that while successful I lacked an ability to transfer my investments into the business of investing.

That's when I sat down with Dave (my business partner) and devised a simple goal of an annual passive income of $250,000 (each) by 9 May 2004. By doing this we arrived at our yardstick - positive cashflow.

" 'Will buying this property bring me closer to or push me further away from my wealth creation goal?' "

Put very simply, the properties we purchased had to be positive cashflow, since buying a property with just $1 of nett passive income moved us forward.

Perhaps I'm a simple guy, but my investing strategy was to only purchase properties that met my investment plan, in which case I'd always be moving towards achieving my wealth creation goals.

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Investors who lose money inevitably lack a plan. Instead of properly evaluating deals they are blinded into buying hyped-up

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properties promising instant wealth with stories about lucky customers who have made a fortune several years ago.

You can protect yourself from making an unwise investment choice by only investing in opportunities that can immediately bring you closer to your wealth creation goal. Let the non-conforming deals pass on by.

Law #1 requires that you set your investing yardstick against which **all** investments you make should be measured. You can only do this if you identify a purpose for investing, which then needs to be broken down into a monetary figure and a deadline.

At its most simple level you should consider whether or not the property brings you closer to, or pushes you further away from, your wealth creation goal.

If you follow my advice then you can't help but remain focused on opportunities that will ensure you achieve your goal. If you don't then you may be tempted to swing from hyped up opportunity to hyped-up opportunity and becoming a jack of all investment trades and a master of none.

Today contains many new opportunities. Let it be the day that you set the most important benchmark of your investing career. If it's really important then start measuring your progress with your new investing yardstick.

I'll continue on with the second Law in the April edition.

When Creative Financing Could Land You In Hot Water!

No one wants to pay too much tax and when an opportunity to save writing cheques to the taxman arises it is eagerly taken.

Whether or not you share my views about negative gearing, saying that a product is 'tax- efficient' certainly increases its saleability.

But property investors must be alert to situations where schemes are advertised as tax minimisation and later deemed to be tax avoidance.

As a Chartered Accountant I continue to keep a foot in the 'professional camp' and regularly receive literature about taxation issues. This month I have come across an interesting case that involves two property investors who used a form of loan called a

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"credit foncier (meaning a loan with principal and interest repayments) arrangement" to minimise tax.

But as you'll see, all they ended up with was a fight with the Australian Taxation Office and later the label of a tax avoider.

By way of some background, in Australia it is perfectly legal to *minimise* your tax bill but it is against the law to *avoid* paying income tax. While there is a whole body of taxation law that draws a distinction between the terms, it seems to be an uncertain climate and any scheme promoter who promises tax benefits is now on shaky ground.

Background

Hart v FCT [2001] FCA 1547 is about two taxpayers who inadvertently crossed the line with a loan product that was marketed to be tax efficient. While you can find the full facts of the case by clicking here, I've provided a summary of the facts below using (and sometimes quoting) the Court report.

The case begins ordinarily in that Richard & Trudy Hart presumably decided that owning investment property was a good idea and went ahead using the buy and hold strategy to purchase a house (financed by the A.N.Z. Bank) in Jerrabomberra - A.C.T.

Despite now having a rental property, the Harts were also in the market for another property to use as their private residence. They later found a house in Fadden - A.C.T.

In the course of seeking finance for the Fadden property the Harts came across a potentially attractive product sourced by a lender called Austral Mortgage Corporation ('Austral').

Austral had a product called the 'Wealth Optimiser Loan' which was designed for persons wishing to finance the acquisition of an income-producing asset and a private residence. The features of the loan facility offered included:

> (a) Only one loan for both the investment property and the home upon which the interest payable over the term of the loan was calculated. Only one monthly repayment need be made.
>
> (b) The option to split the loan into two portions or loan accounts - respectively, a "home loan" account, and an "investment loan" account.
>
> (c) The option, at the call of the borrower, to allocate the monthly repayment to either the home

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loan account or the investment loan account, or to both.

Tax Deductions

In normal circumstances you could expect to claim a tax deduction for the interest on the investment loan, but not the private loan.

The 'Wealth Optimiser Loan' sought to maximise the available tax deduction by allocating the entire loan repayment off the home or private portion while the investment loan accumulated capitalised interest.

Since no portion of the repayments is allocated initially to the investment loan account, the amount outstanding on that portion of the loan does not begin to reduce until the home loan account is fully paid off. As a result, the borrower pays off the home loan account much faster and the total amount of interest paid on the home loan account is less than would have been the case if the borrower had applied the payments to both loan accounts.

Example

While these are not the facts of Hart's case, I've created a simple example to help illustrate the concept of the 'Wealth Optimiser Loan'.

Imagine that you have a private home and also an investment property valued at $100,000 each. While you can source two loans and make two weekly repayments of $162.75 (25yr, P&I, 7%variable, weekly), you could also set up one loan with one repayment of $325.50 per week.

But if you were creative and you knew that the interest on your investment loan was deductible but your private loan was not, you could structure your loan so that there was one payment for the two sub-accounts and allocate it solely to the private loan.

This way the interest on the investment loan would not diminish and in fact, since the interest wasn't being paid at all, it would just be added to the loan outstanding which has the affect of compounding rather than reducing the interest payments.

Only once the private loan had been repaid in full would the investment loan begin to be paid off.

Back To The Harts

The Harts went on to use the 'Wealth Optimiser Loan' which

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featured a broader loan account with two sub accounts; one for the home and the other which was used to pay out the A.N.Z. Bank on the investment property.

Interest on the total loan was calculated on a variable principal and interest basis and was paid monthly in arrears and debited to the appropriate loan account.

Of course the Harts sought to maximise the interest deduction on the investment loan and allocated the total repayment to Loan 1 (home account) until it was repaid in full while interest on loan two (investment account) accumulated and compounded.

The Issues

There are two issues associated with this case:

1. Was the additional deduction resulting from the compounding interest deductible, and if so
2. Was the 'Wealth Optimiser Loan' a scheme designed to avoid tax and as such void the tax benefits gained under the scheme?

Ordinarily there is no problem having a split loan, but the facts in this case are slightly different to the normal in that the investment loan was not repaid in order to claim a higher tax deduction for compounding interest.

Furthermore, pamphlets produced by Austral outlined various tax advantages of their 'Wealth Optimiser Loan', including the following references: "a tax efficient loan", "a tax reduction system which should prove popular in the 1997 financial year", "gives dramatic tax savings as it often enables you to pay off your home loan within five years", "increase your negative gearing benefits", "you obtain increased deductible interest on your investment loan portion" plus specific references made to the capitalisation of interest during the period that all repayments are appropriated to the residential loan.

The decision in the case was:

1. The nature of the compounding of interest as structured in the Wealth Optimiser Loan does not characterise it as part of capital and accordingly it is deductible in the year incurred. That is, the accumulated interest upon interest that is compounded into the loan outstanding is deductible irrespective of it not being 'paid'. This is a win to the taxpayer.
2. The Austral Wealth Optimiser Loan was a "scheme" where the dominant purpose was to enable the taxpayers to obtain a tax benefit in the form of deductibility of the

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compounding interest. Accordingly the tax benefits as a result of the "scheme" are void, which is a win to the Tax Office.

Summary

Under Australian tax law there is no issue with the tax deductibility of the interest on the investment loan.

However, there is a problem with the way that the Austral loan product allowed for the loan repayment to be allocated entirely off the private home while interest capitalised on the investment property.

The problem was not with the way that the scheme calculated interest, but the way it was marketed as a tax-efficient scheme. In essence, the outcome was that the scheme had no commercial basis and would not be attractive for any other reason but to avoid tax.

Accordingly, any investment loan product that is advertised as tax-efficient is a potential danger if the underlying product has no other basis than to provide a tax benefit to the investor. The Federal Court has deemed such products not to be tax minimisation, but tax avoidance.

As far as the Hart's are concerned, the bottom line is they entered into a scheme and the *tax benefits* of being in the scheme were 'knocked on the head'.

The tax benefit that was disallowed *was not* the total deduction for the interest on the investment property - this is normally acceptable.

What wasn't permissible was claiming a tax deduction for interest resulting from the higher loan balance because previous interest was capitalised or added to the loan outstanding

For example, on our earlier illustration based on an investment loan of $100,000, the weekly repayments were $162.75. In the first year the total interest that is payable under a normal P&I situation is $6,804.49.

However if the payment of $162.75 is allocated entirely to the home loan account, then the amount of interest that would be payable on the investment loan (with the interest compounding weekly) would be $7,101.63.

The tax benefit of the scheme, being the difference of these figures ($7,101.63 - $6,804.49) of $297.14 is **not allowed** since

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the Tax Office deemed this to be an avoidance "scheme". At the end of the day there was no tax benefit available.

Conclusion

My aim in bringing this case to your attention is to help you to understand the dangers associated with cleverly marketed loan products that are designed to save tax. These seem attractive enough until you are deemed to cross the line of 'tax avoidance' rather than 'tax minimisation' and have to argue the finer points in Court against the massive resources of the Tax Office.

Don't go looking for unnecessary trouble and always be vigilant against schemes promoting tax advantages.

Final Word

Not all newsletters will be as long and heavy as this one. It's just that this month there was a lot to cover as I set the foundation for future editions.

I hope you've enjoyed the March Property Investing.Com *'Insider'* and invite you to e-mail it to your friends as you see fit. If they'd like to subscribe to future editions of the Property Investing.com *'Insider'*, they can sign-up at http://www.PropertyInvesting.Com

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