BAN TACS
National Accountants Group

NEWSFLASH BOOKLET
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Before You Buy A Rental Property

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Important

This booklet is simply a collection of Newsflash articles relevant to rental properties. The articles are transferred from Newsflash into this booklet. It is not re written every time the law changes. Relevant articles from recent newsflashes are added to the end of this booklet at irregular intervals so make sure you read through to the end and read our monthly newsflash to keep our knowledge up to date.

The following are just some of the matters that investors should consider, please discuss your particular circumstances with your accountant before you actually purchase a property as these statements are general in nature and not conclusive. Also the law changes constantly. This document is not advising you to invest in property, just discussing some of the taxation considerations.

This booklet is part of a series that divide the BAN TACS Newsflash articles into the different stages of the property investing experience. Please make sure you read the others Buying A Rental Property, Owning A Rental Property, Selling A Rental Property and Your Own Home. If you would like material that has a more structured approach it is recommended that you purchase Winning Property Tax Strategies http://www.bantacs.com.au/book_winning-property-tax-strategies.php

Recommended Reading

Certainly read every booklet in this series as you go through the property investment journey:

Buying a Rental Property http://www.bantacs.com.au/booklets/Buying_A_Rental_Property.pdf
Owning a Rental Property https://www.bantacs.com.au/booklets/Owning_A_Rental_Property.pdf
Selling A Rental Property http://www.bantacs.com.au/booklets/Selling_A_Rental_Property.pdf
Your Own home http://www.bantacs.com.au/booklets/Your_Own_Home.pdf

The links below are web sites and books that will provide you with information relevant to this first part of the journey, the things you should know before you buy. First you need to educate yourself.

Courses:

Careful here they can be expensive and may just be a disguise to sell you their own overpriced product. www.destiny.com.au provide lots of free content on their site and their courses are competitively priced and independent. They can teach you how to find the right property and watch over you every step of the way. http://www.unisanet.unisa.edu.au/staff/homepage.asp?Name=Peter.Koulizos Peter Koulizos runs a 2 independent property courses through the university of South Australia Business school.

Books:

Making Money Made Simple, Noel Whittaker's number one best seller, will get you thinking like an investor. http://www.noelwhittaker.com.au/shop/making-money-made-simple-new-edition/

Winning Property Tax Strategies, by Julia Hartman and Noel Whittaker this book will be very helpful throughout your investment journey. At this early stage chapters 1 and 4 will be worthwhile reading. http://www.bantacs.com.au/book_winning-property-tax-strategies.php

Twenty Must Ask Questions, Margaret Lomas' book explaining how to get the information you need to find hot spots. http://amzn.to/1EODEV8

Pocket Guide to Investing In Positive Cash Flow Property, by Margaret Lomas http://amzn.to/1LEb4cY

Web Sites:

https://www.bantacs.com.au/topics/property-investors/ and don't forget to sign up for Newsflash

http://destiny.com.au/dotnetnuke/en-au/Media.aspx lots of videos to watch for free

http://www.wefindhouses.com.au/ebook.php free e-book and free phone consultation. They also provide Buyers agent services if you decide to take a more passive approach.

www.realestate.com.au compare prices and market rents

http://www.daftlogic.com/sandbox-google-maps-find-altitude.htm check out how many metres above sea level any property in the world is.

Negative Gearing

This is effectively running the property at a loss i.e the rental expenses (see below) are greater than the rent received. Note that the interest portion only of your loan repayment qualifies as a tax deduction, not the capital portion. This loss is then included in your tax return along with your other income, which reduces your total taxable income, probably resulting in a tax refund if you have paid tax at source on your other income. Your profit is then made when you sell the house. Capital gains tax may be payable but this is only payable on half the gain made and you would try to sell in a low income year. The costs associated with buying and selling property are high (i.e. stamp duty) so the investment would probably have to be long term to make a real profit. As time goes on you will pay more off the house or the rent will increase so the negative gearing may not be there any more. Ideally, you should be in a high tax bracket now and feel that properties are about to increase in value. Example of a negatively geared property:

Rental Income \$200 p.w.	\$10,400	
Less Cash Flow Expenses Including Interest	10,500	See below article Deductible Rental Property Expenses
Cash flow loss	100	
Less Building Depreciation	1,200	There is a nifty tool to estimate this on our web site
	\$1,300 Loss @ 39% tax Equals a Refund of \$507.	

Note the refund of \$507 has only cost you \$100 in real cash because the building depreciation is just a book entry. Building depreciation reduces your cost base for CGT purposes, if the property was purchased after 13th May, 1997. Not many properties stack up as well as the above example.

Note if you earn less than \$37,000 your tax bracket is only 19% plus 2% Medicare levy. Accordingly, a loss of \$1,300 would result in a tax refund of only \$273. If your negative geared properties take your income below \$20,582 you will be paying not tax at all so the deductions that take you below that amount are wasted. Make sure you crunch the numbers for your tax bracket.

Crunching The Numbers

Further on in this booklet is an article with the heading evaluating a rental property that will take you through the process of working out just how much capital gain (after tax) a negatively geared rental property needs to make to breakeven, make back all the money you lost during the time you owned it. You should do the calculations manually at first so you gain a full understanding of the issues. This will give you a better idea of the type of property you are looking for. Unfortunately it is a pains taking calculation so to encourage you to do this for every property you look at we have developed a xl spread sheet that will do the calculation for you. https://www.bantacs.com.au/shop-2/property-breakeven-point-calculator/

Whether the property is negatively geared or not you need to know how much the property is going to cost you to hold, after tax. This is a much simpler calculation which is used at the start of the evaluating a rental property article later on in this booklet. This simple calculation is also available in an xl spreadsheet.

https://www.bantacs.com.au/shop-2/property-cash-flow-calculator/

Deductible Rental Property Expenses

There is much more detail about deductible rental property expenses in the Day to Day Operations Booklet in this series. The following list is just to give you an idea of items you should be putting in your calculations.

- Agent's Commission to manage property.
- Interest on money borrowed in relation to the rental property
- Telephone, Stamps, Stationery, Insurance, Advertising, Land Tax, Secretarial, Bookkeeping, Tax Agent and Legal Fees regarding lease or rent recovery, not buying and selling.
- Body Corporate Fees, Council and Water Rates. If you have purchased the property this year make sure to give us your settlement statement so you can claim the adjustments.
- Borrowing Expenses, if more than $100 must be claimed over 5 years or term of loan whichever is the shorter period. If less than $100 can claim immediately.
- Depreciation on plant and equipment such as carpets, curtains, ceiling fans, some light fittings. Hot water systems, stoves etc.
- Motor Vehicle Expenses in relation to collecting rent, organising repairs, paying expenses, etc. There are various methods and requirements to calculate this claim, refer our Booklet http://www.bantacs.com.au/booklets/Claiming_A_Motor_Vehicle_Booklet.pdf . The most popular method is to claim a rate set each year by the tax office of approximately 76 cents per kilometre based on a "detailed and reasonable estimate" of kilometres travelled. In order to use this method you must not claim more than 5,000 kilometres in the year for all claimable purposes, note if the vehicle is owned by two people they get 5,000 kilometres each. You must own the vehicle, make the appropriate election and personally incur the costs associated with the vehicle. If you do more than 5,000 kilometres you can reduce your kilometres to 5,000 in order to use this method or use another method.
- Travel Expenses as above i.e. airfares. Meals and accommodation are also deductible if you are required to stay away from . A travel diary and receipts meeting the substantiation requirements would be required if away for more than 5 nights. Best to keep a travel diary anyway. An electronic version is available at the bottom of this page https://www.bantacs.com.au/shop-2/
- Repairs and Maintenance, not improvements are deductible. For example if the house needed painting when you bought it then painting it would be an improvement, therefore not deductible. On the other hand if during the time of your ownership the paint starts to peel and you repaint, the expense would be a deduction. No deduction is available for your own labour. Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle (IT180). IT 180 states that to claim, the repair needs to be made during a financial year that rent is received. **Note** improvements can increase your cost base for CGT purposes.
- Depreciation on the building if it was built or renovated after 16th September 1987.

Must Knows About Lines Of Credit

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A $100,000 loan used solely to purchase a rental property in financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of $2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be $98,000 owing on the rental property. In say 45 days when the borrower withdraws $1,000 to pay off his or her credit card the loan will be for $99,000. However, as the extra $1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

The next time the borrower puts his or her 2,000 pay packet into the account the Commissioner deems it to be paying only 1/99 off the non-deductible portion i.e. at this point there is $96,020 owing on the house and $980 owing for non-deductible purposes. When, 45 days later, the borrower takes another $1,000 out to pay the credit card, there will $96,000 owing on the house and $1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

In addition to the loss of deductibility, the accounting fees for calculating the percentage deductible could be high if there are frequent transaction to the account. The ATO has released TR2000/2 which confirms this and as it is just a confirmation of the law is retrospective.

To ensure deductibility and maximise the benefits provided by a line credit you will need an offset account that provides you with $ for $ credit. These are two separate accounts – one a loan and the other a cheque or savings account. Whenever the bank charges you interest on the amount outstanding on your loan they look at the whole amount you owe the bank i.e. your loan less any funds in the savings or cheque account.

Claimable Loans – The Pointy End of Interest Deductions

Traditionally, the interest is only claimable on a loan where the actual money borrowed is used directly to produce incomes i.e. buy the income producing property. The Roberts and Smith case of July 1992 has changed this. In this case a firm of solicitors borrowed money to pay the partners back some of the original capital they had invested in the firm. The Commissioner argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners; the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of property because technically they cannot owe money to themselves. The ruling goes on to say:
"The refinancing principle" in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships. The joint owners of an investment property who comprise a sec 6(1) tax law partnership in relation to the property cannot withdraw partnership capital and have no right to the repayment of capital invested in the sense in which those concepts are used in Roberts and Smith. Accordingly, it is inappropriate to describe a business, as a "refinancing of funds employed in a business."

IT2423 states that people who own less than three rental properties are not in business and therefore not in partnership under general law. This means that couples wealthy enough to be purchasing their third rental property can rent out their home then borrow the money to build themselves a new home and maybe claim the interest on the loan as a tax deduction against the rent earned on their old home. Note there have been a few cases were taxpayers have unsuccessfully tried to argue they are in business. In Cripps V Federal Commissioner of Taxation 1999 AATA 937 the taxpayers owned 14 town houses and other properties at various time. The ATO was successful in arguing they were not in business but the foundation of the ATO's argument was that they had an agent managing the properties. So it is crucial that you run the properties as a business i.e. fully mange them yourself.

Regarding linked and split loan facilities. These loans link a loan for the rental home and a loan for the private home together so the bank will permit repayments from both rental and wages income to be paid off the private home loan with the interest on the rental home loan compounding. Accordingly, in a short period of time the mortgage can be shifted from the private home to the rental home. As the rental loan was used to purchase the income producing property and pay interest on that property, technically all the interest on that loan will be deductible. The Commissioner says in TR98/22 this is a scheme with the dominant purpose of reducing tax and he will apply Part IVA to deny a deduction for the interest on the interest. The High Court found in Harts' Case 27-5-2004 that it was an arrangement with the dominant purpose of avoiding tax and caught by Part IVA but the court did not rule that interest on capitalized interest was not deductible. For more information on Capitalising interest go to https://www.bantacs.com.au/topics/property-investors/capitalising-interest/

Depreciation – Rental Property

There has been considerable publicity lately about claiming building depreciation on rental properties by having a quantity surveyor calculate the original building costs and value of plant and equipment. A good reference regarding the building costs is ATO ruling TR 97/25 available from the ATO web site. There are a couple of little catches to relying on a quantity surveyor's report. The first one being that you can only rely on a quantity surveyors report if you have exhausted all other means of finding out the original building costs. The legislation even compels the seller of a property to provide you with this information - Subsection 262A(4AJA) of the 1936 Act. The second catch is if the original owner was a spec or owner building the calculation cannot include their labour or profit.

Before you spend money on a quantity surveyor make sure you have exhausted all other means of ascertaining the original building price because the ATO will not permit you to use the quantity surveyor's report if you can ascertain the original cost. You should also find out if the original owner was a spec or owner builder. Further make sure the quantity surveyor you use is aware of the changes in depreciation rates for plant and equipment since 1st July, 2004.

Evaluating a Rental Property

Firstly, I would like to point out this article is not intended to encourage you in any way to buy a rental property. It is simply a tool you can use to consider the potential of the property away from all the selling hype. Before you actually sign a contract please get an accountant to check your workings as the following is a generalisation and there may be specific issues with your particular property.

Data You Will Need

(a) Amount borrowed
(b) Interest rate of loan. Note: unless you have no personal debt the loan should be interest only and the worksheet is based on this.
(c) The tax bracket applicable to the taxable loss or taxable profit on the property. The tax brackets for 2007 are $6,001 to $25,000 16.5%, $25,001 to $75,000 31.5%, $75,001 to $150,000 41.5%, over $150,000 46.5%. So if before buying the property you were earning $75,000pa the tax rate applicable would be 31.5% if negatively geared or 41.5% if positively geared. You need to consider whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
(d) Building depreciation claimable per year if property built after 17th July 1985.
(e) Depreciation on any plant and equipment.
(f) Original purchase price of the property.
(g) How much you think the property will go up in value per year. If this is too difficult, don’t worry as the worksheet will give you a bare minimum required and you can just decide whether it is likely to be more than that amount.
(h) The tax bracket that will be applicable to the capital gain you make when selling the property i.e. you may have retired by then and be in a lower tax bracket. You need to consider here whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
(i) Annual actual out of pocket costs of holding the property such as insurance, body corporate fees, repairs, borrowing expenses (amortised over the first 5 years of the loan), rates, property management fees and sundry expenses such as travel, stationery, phone calls etc.
(j) Rental Income per annum
(k) Estimated future selling costs such as real estate commission, auction fees, solicitor, advertising etc.
(l) Cost of purchasing the property i.e. stamp duty, solicitors fees etc.

Worksheet

Tax Calculation:

Income from Rent as per (j) above		$
Less Expenses:		
Out of pocket running expenses (i)	$	
Interest on the Loan (a) x (b)	$	
Building Depreciation if applicable (d)	$	
Plant and Equipment Depreciation (e)	$	$
	-----------	----------
Taxable Income (Loss)		$

If the above results in a taxable income do not continue with the following. You only need to consider the return verses investment in other products.

If the above results in a taxable loss calculate your tax refund as discussed in (c). Carry this amount to the cashflow analysis below.

Cashflow Analysis:

Tax Refund as calculated above		$
Rental Income (j)		$

		(m)$
Less Expenses:		
Interest Expense on Loan (a) x (b)	$	
Out of pocket running expenses (i)	$	
	------------	(n) $

Net Cash Inflow or Cash Outflow (o)		$

If (n) exceeds (m) i.e. a net cash out flow, you will need to contribute the amount above from your after tax dollars to support the property. To work out how much you have to earn to contribute take (c) away from 100 then divide (o) above by this amount and multiply by 100. Negatively geared properties are all right if you make a capital gain on sale that exceeds the accumulated losses. Note capital gains tax only applies to half the gain if you have held the property for more than a year and you could delay selling until you are in a lower tax bracket then when you claimed the deductions.

If (m) exceeds (n) the property is cashflow positively geared but as the building depreciation is reducing your cost base you still need to consider how much you will make out of the capital gain and consider how the return compares with other forms of investment.

Capital Gain:

To calculate the gain after tax on the sale of the property take your cost base, which is either the amount you purchased the property for plus holding costs not already claimed plus stamp duty, solicitor's fees and improvements. If you lived in the house before you rented it and it was first rented after 20th August, 1996 you must use the market value of the property at the time it became income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after you ceased to live in it.

Calculate your capital gain as follows:

The cost of the property i.e. (f) + (l) + improvements you have not claimed **or** market value if first rented after 20th August, 1996 and improvements made since then	$	
Reduce by building depreciation claimed (d) x years held	$	

Sub Total	$	
Add costs of selling such as agents commission, auction fees, solicitors etc. (k)	$	

Cost Base	$	
Less Selling Price	$	

Capital Gain	$	(p)

Tax Payable is the rate discussed in (h) multiplied by half the capital gain (p), if you have held the property for over a year. Note the year is from your agreement to purchase to your agreement to sell not settlement dates.

Breakeven Point

Assuming you had to subsidise the property i.e. (o) was a net out flow. Does the capital gain (p) exceed the cash outflows over the years you held the property i.e. (o) x years held? If not you have lost on the deal.

If you find it difficult to estimate how much the property might sell for in the future it may be easier to calculate how much it must go up in value each year to breakeven. This is not very accurate because the years you are going to hold the property for are unknown so it is difficult to amortise the buying and selling costs. The idea is to calculate the net cost of holding the property as a percentage of the original purchase price of the property as follows note it assumes no improvements to the property.

Cash Out Flow:
Take the amount in after tax dollars that the property is costing per year to hold by the original purchase price and multiply by 100, using the letters from above:
(o) / (f) x 100 = %(q)

Reduction in Cost Base:
The depreciation claimable each year multiplied by half the tax bracket you will be in when you sell, divided by the original purchase price multiplied by 100.
(d) x (h) x 50% = / (f) x 100 = %(r) (Careful probably less than 1%)

After Tax Dollars Translation:
Only 75.75% of any gain made on the property will be available to cover the above after the capital gains tax has been paid. Accordingly, the cash flow and cost base needs to be adjusted as follows:
(q) + (r) = / 75.75 x 100 = % (s)

Conclusion:
(s) is the percentage that the property must go up in value each year just to breakeven. This is before allowing for inflation. If it does not go up by at least this amount you have lost on the deal.

It has been assumed in the above that you have not yet purchased the property so none of the concessions that effect properties bought before now have been considered. The return calculated above should be compared with other investments available. This calculator is also an excellent method of comparing houses with different rent return ratios in areas where capital growth would be different. For example Mount Isa compared to Brisbane.

Wraps – Vendor Finance Arrangements

If the Vendor Finance arrangement has the following features the income stream received, once the wrap arrangement has begun, is considered to be principle and interest by the ATO. The income stream received before the wrap arrangement is entered into is considered rent. Reference ID2003/968.

Typical Features of a Wrap (Vendor Finance Arrangement)
1) The purchaser pays a deposit at the time of entering into the arrangement.
2) The settlement (change of the title deed to the purchaser) does not take place for several years after the arrangement is entered into.
3) The purchaser has the right to occupy the property prior to settlement
4) The purchaser pays a weekly amount (regardless of the name it is given in the arrangement) for the right to occupy the property
5) As part of the arrangement the purchaser pays the rates, taxes and insurances on the property.
6) The balance of the purchase price to be paid on settlement of the arrangement is reduced by the weekly installments.
7) If the purchaser fails to complete the arrangement the deposit and weekly installments are forfeited.

Now what about the profit on the sale of the property? Is that normal income or capital gain and when is it taxable? Assuming an agreement similar to that described above the answer to this question revolves around whether the vendor is in the business of selling houses or an investor just realising an investment.

The key issues in differentiating here, according to ID2004/25, 26 & 27 are:
1) The Vendor did not use the property for any other purpose than to enter into the wrap. A straight rental of a property before entering into a wrap arrangement would avoid this point.
2) The property was sold at a profit
3) The wrap arrangement was entered into within 6 months of the vendor purchasing the property.
4) The Vendor is in the business of purchasing properties to resell. It would be difficult for the ATO to argue this case if the Vendor only bought and sold one property.

If you are caught by all of the above then CGT cannot apply to the sale of the property as the profit on the sale is revenue in nature. If a transaction is caught as income, CGT does not apply or in other words CGT is the last option if income tax doesn't catch it. But even if you weren't caught by the above and CGT applied there would be no discount if the property was held for under 12 months. If you did hold the property for less than 12 months before entering into the wrap it is better to argue that you are in business and caught by the above because the profit on sale would be revenue in nature and as a result not assessable until settlement which could be 25 years away (ID2004/27). If you hold the property for less than 12 months but it is subject to CGT you don't qualify for the discount but would be assessable on the profit in the financial year of entering into the wrap. Note you do not actually have to pay the tax on the gain until settlement but it will be calculated as part of your taxable income in the year that you signed the agreement to sell. You have 30 days from the date of settlement to go back and amend the old return. Refer chapter 6 of the ATO's 2004-2005 rental property booklet.

Section 104-15(1) of ITAA 1997 states that a CGT event happens when the owner of a property enters into an arrangement with another party to allow them to live in the property and title may transfer at the end of the arrangement. Section 104-10(3) states that the time the CGT event happens is the time of entering into a contract for the disposal of the asset, not when settlement (title passes) takes place.

For example this means that the vendor who enters into a wrap on a property that has been previously used as a rental and held for more than 6 months will be subject to CGT on the property in the financial year the wrap agreement is entered into. Accordingly, if at this stage the property has not been held for 12 months no CGT discount will be available even if they eventually end up holding the property for 25 years under the arrangement.

If you are not subject to CGT on the property because it is considered trading stock ie caught by all 4 points above, you are not entitled to claim building depreciation. Reference ID 2003/377.

Lease Options

A lease option is a rental agreement where the tenant has the option to buy the premises at a time set in the future at an already agreed price. You may recall a Newsflash article on wraps in February 2004. This article pointed out that unless a wrapped property had been used for rental purposes, before the current tenant then the sale of the property would not be subject to CGT and the 50% discount. Instead the profits would be taxed as ordinary income but the tax would not be payable until settlement. On the other hand if the property had previously been rented then CGT and possibly the 50% discount applied but the catch was that the tax would have to be paid in the year of the wrap not on settlement.

Lease options remove this problem. The exercise of an option not the granting of it, is the trigger of a CGT event. Further the house being subject to a rental arrangement before the exercise of the option may satisfy the ATO that the primary purpose of owning the property was to derive rent not for resale at a profit. A property purchased to rent out will be subject to CGT on the sale and possibly the 50% discount. On the otherhand where a property is purchased with the intention of resale at a profit it would be subject to normal tax rates with no 50% discount.

Section 104-15 states that tax the CGT event happens when the prospective purchaser has the right to the use and enjoyment of an asset and there is an agreement that the title will eventually pass to that person. The section is stated as intending to apply to hire purchase agreements but does not exclude other arrangements. The ATO in TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option. These two statements can only be reconciled by the assumption that an option is not an agreement where the title will eventually pass because the event is uncertain.

Lease Options certainly seem to be an improvement on wraps from a taxation point of view. If you are new to the whole concept of wraps and lease options have a look at our article on Wraps in our Capital Gains Tax booklet under free publications on the web site. For more information on Lease Options visit
www.naked-investor.com

Please do not take the above as a recommendation of Lease Option arrangements or support of the information on the naked investor web site. We are simply advising on the tax consequences.

Asset Protection

To effectively protect assets held in other entities from people who may sue you personally you must make sure you do not own, in your own name, anything that would give creditors access to these other entities. For example, if you hold your assets in a unit trust and you own the units your creditors would be entitled to those units in the case of bankruptcy and it is quiet probable that the units will give them the right to demand redemption which could lead to the assets being sold and the proceeds distributed to your creditors because they now own the units. Similarly if your assets are in a company and you own the shares your creditors would be entitled to the shares which would give them control of the company allowing them to liquidate the assets and distribute the proceeds to shareholders.

Companies and trust are useful entities in which to place businesses that could be sued as they will normally protect the owners of the entity but they do not work so well the other way around.

In a discretionary trust the beneficiaries have no fixed entitlement so a creditor cannot force the trust to distribute money to them. But be careful, if you have loaned money to the trust a creditor can demand that money be repaid. This is also the case for loans to companies or unit trusts.

The next problem you have with holding an asset in a company or trust is the difficulty, if it is a negatively geared investment, in offsetting the losses against other income. If the investment is held in an individual's name they can offset any losses from the property against their other income for that year and if there is not enough to offset all the losses the balance is carried forward to be offset against income in future years.

Companies and trust cannot distribute losses so any loss from the investment is locked into the entity to only ever be offset against income to that entity. This is fine if the entity has another source of income that can be applied to the loss rather than that income being distributed to you. Note this will not work if the income received by the entity is really your personal services income because the entity is required to distribute that income directly to you with only the deduction of certain direct costs of earning that income.

It is not wise to hold an investment in the same entity as a business. Businesses are generally considered risky and if the business could not meet its financial commitments creditors would be entitled to the investment because it is owned by the same entity.

You can hold the negatively geared investment in a different entity to your business. If the business is in a trust or company and the entity that owns the investment owns shares in the company, units in the unit trust or is a beneficiary of the discretionary trust that holds the business then income can be streamed (with very careful planning) from the business into the entity that owns the investment in order to use up the loss.

You could also hold positive and negatively geared investments together in the one entity so that they offset each other. It would be unusual for an investment to be positively geared when you initially purchase it and depending on the type of investment it may be costly in stamp duty and capital gains tax to transfer it into the entity with the new investment. If you have a positively geared investment already in an entity it maybe worth considering buying your new investment in that entity if it is the type of entity that would be the best choice for the new property.

Note companies are not entitled to the 50% CGT discount so the choice for investments with capital growth would normally be trusts, SMSFs or individual ownership. There is a way you can achieve asset protection while holding an investment in the name of an individual.

Setting up a mortgage trust that has priority over possible creditors on any properties you or your entities own is a form of asset protection that works whether you are protecting your assets from a tenant or another outside party but it takes maintenance. The idea is that you set up a simple trust then in a round robin of cheques in your bank managers office you gift that trust the value of the equity available in the properties you wish to protect. The mortgage trust then lends you the same amount which you use to pay back your bank manager. No doubt he or she will be so full of warm fuzzies from the whole experience of helping you that he or she will neglect to charge you any fees for the transactions. The mortgage trust takes a second mortgage on the rental property as security for the loan. Now this arrangement is not going to help you if you are already or will soon be in trouble because the bankruptcy trustee can claw it back. As the property goes up in value the mortgage will have to be increased by the same round robin of cheques in the bank manager's office. There is no need for the mortgage trust to charge you interest and as a result there is no need for the trust to lodge a tax return. As there are no tax consequences of this arrangement there is no need to consider whether it would be caught by Part IVA.

A mortgage trust can also be utilised to protect your own home and allow you to hold it in your own name so that you qualify for the main residence exemption from Capital Gains Tax.

Rental Property Check List of Dos and Don'ts

1) Pay off non deductible debt as soon as possible but if it is on a home you may one day rent out use an offset account rather than pay directly off the loan.
2) Only use a Line Of Credit with a Credit Card used for private purposes, on a non deductible Loan
3) If other loans for Rental Properties are Lines of Credit, only draw on them for rental property expenses and make sure these expenses are paid direct not mixed with in a private cheque account or a credit card used for private purposes as well.
4) If you do not have a Main Residence or are considering buying a new one and renting out the one you are in, do not use funds in the offset account to pay the property's expenses. Draw them from the Line Of Credit keeping the offset amount as high as possible. The net result has no effect on interest but this

will increase the amount of deposit you will have in the offset account for your Main Residence. When you draw this out, the original loan for the Rental Property or your old home once it is rented, is still fully tax deductible.

5) An offset arrangement is far better than a Line of Credit as it leaves the funds available for private purposes if needed.
6) If only one member of a couple is borrowing for their investment in a rental property try to persuade the bank to only put the loan in that spouses name. Maybe the other spouse could go guarantor.
7) Don't transfer borrowed funds into your personal cheque account.
8) Don't pay interest more than 12 months in advance.
9) Make sure you read our Newsflash to keep your knowledge up to date.

Hybrid Trusts

Warning this and the following article are quite complex and are only important for you to read if you are considering utilising a hybrid trust, which we strongly recommend you do not do. This article explains why. If you will take our word for it and just avoid hybrid trusts you can also avoid reading these articles.

A Hybrid Discretionary Trust is a combination of a Unit Trust and a Discretionary Trust. Initially, the trust is run as a unit trust. This allows the high income earner to borrow money to purchase the units in the trust effectively allowing the units to be negatively geared because the income stream from the trust is, less than the interest on the loan. The unit holder has a fixed interest in the trust so they are entitled to claim a tax deduction for interest on money borrowed to invest in the trust. On the other hand in a discretionary trust there is no fixed entitlement to income, as a beneficiary, so interest on a loan to invest in the trust is only deductible if it is on lent to the discretionary trust at the same or higher interest rate. These conditions on the loan mean it can never be negatively geared.

Getting back to the unit trust situation. The trust buys a rental property with the money subscribed for the units. This rental property is normally the security for the loan. Be careful here as the rental property will need to be held in the name of the trust and the loan will need to be in the name of the unit holder who will be the high income earner in the family.

Eventually the negative gearing advantage will be lost either because rents have increased or the property is sold for a capital gain. After all, that is why you got into the investment in the first place so to plan for this not to happen is to plan to fail. At this point in time the Hybrid trust redeems the units by paying back either the original amount invested or the unit's share of the current market price of the assets in the trust. Which, depends on the terms of the trust deed. Though there is a chance that CGT would deem the pay back price to be the market value of the units. Some argue that if the units only entitle the holder to an income stream, not the capital growth component, the value of the units is less than the unit's portion of the value of the assets held in the trust. Whether the units are redeemed at their original cost, the market value of the future cash flows or at an amount equal to the units share of the trust's assets, each outcome has its own self defeating problems.

If the units in the unit trust have to be redeemed for the market value of their share of the assets in the trust, either as required by the deed or by CGT law. The high income earner will receive taxable income from the trust. If the property investment has gone according to plan this income will exceed the benefit of the negative gearing in previous years. There is the advantage of the capital gain receiving the CGT discount but this would have been available had the property been held in the high income earners name anyway, so at this point in time no advantage has been gained by having the unit trust. After the unit is redeemed there maybe some benefit in the future if the property is not sold ie the reason for redeeming the units was because the property had become positively geared due to rent increases. Now the discretionary members of the trust (low income earners) will receive this income but it has come at the cost of the high income earner having to realise a capital gain that would have not been necessary if he or she had simply held the property in his or her own name. Or even if they did this until it was positively geared then paid the same capital gains tax to transfer it to a low income spouse. The only advantage the trust gives them in these circumstances is that they don't have to pay the stamp duty on this transfer. There are stamp duty concessions for transfers between spouses. It is also possible that the stamp duty on the transfer, necessary if the property is not held in a HDT, may be less than the cost of establishing and running the trust all those years anyway.

If on the other hand the units can be redeemed for the amount that was originally invested, the investor never made a profit on the investment and with the advantage of hind sight the ATO can say the investor never intended to do so. In TR 95/33 particularly paragraphs 30 to 35 and 47 to 51 the ATO discusses how arrangements that have no chance of making a profit cannot be negatively geared. Paragraph 34 discusses how in Fletchers case the AAT found that the taxpayers never intended to stay in the arrangement for until it became profitable. Further with all the PR about HDTs giving a tax advantage the ATO could use Part IVA to claim the whole arrangement void as a scheme to avoid tax.

On the final hand as the units are only an entitlement to an income stream, even if the market value substitution rule comes into play their value would be considerably less than the value of the underlying assets in the trust. This strategy puts the investment on very shaky grounds in the early years when it was negatively geared. Again TR 95/33 states that if an investment is made with no real intention of making a profit at some time in the future it cannot be negatively geared. Caught this way is the worst case scenario because the negative gearing advantage to the high income earner is lost and you still have incurred all the costs of setting up and running a HDT.

If you are looking at a positively geared property there is no advantage in a HDT. Instead go for a normal every day discretionary trust if you need flexibility of distributions in the future. If you don't need the flexibility in the future just buy the property in the low income earner's name.

If the property won't become positively geared or be sold until the high income earner retires simply hold it in the high income earners name and save a fortune in set up costs of a HDT.

In Case 2/2008 2008 ATC the AAT held that interest payments on loans taken to purchase units in a hybrid trust were not deductible.

"Under the trust deed, the beneficial interest in the fund was divided into the unit component (held on trust for unit holders) and the discretionary component (held on trust for discretionary beneficiaries). The trustee could, in its absolute and uncontrolled discretion, determine the proportion of either component. The discretionary powers of the trustee applied to a wide range of amounts, including income, profits and capital gains or losses. The trustee could make decisions as to whether any such amounts were capital or income, and whether expenses were to be paid out of capital or income."

TD 2009/17 is the ATO's final ruling on hybrid trust deeds. As expected the ATO have basically said that the unit holders must receive all the benefits from the investment of the borrowed money to be able to claim all the interest as a tax deduction. Further, it is not just a matter of what is received it is a matter of what the trust deed says. So if for example the deed says that the units can be redeemed by the trustee for the original price paid then the trust is caught ie interest not deductible, even if the units are never actually redeemed.

Other clauses that will create problems:

- The units carry no entitlement to capital gains
- The units only carry an entitlement to part of the income produced by the money invested
- The units can be redeemed by the trustee for less than the market value of the underlying assets
- The units only carry an entitlement to the capital gain

The last two points will result in no interest being deductible. The first two will result in the interest being apportioned between the benefit the borrowings provide to the unit holder and the other private expense of providing benefits to the family of the unit holder. A rule of thumb given in the determination is that the interest deduction should not exceed the amount of the income received from the trust.

Even some fixed trust deeds have some flexibility in them that could result in them being considered hybrids. This is the case even if they are never used as hybrids because the ATO looks at the possibilities provided within the wording of the deed, not what has been done to date.

Do not ignore this ruling and hope you will fly under the radar. Every trust tax return has to answer a question on whether it is a hybrid or not so it won't be long before the ATO look into your affairs.

In Forrest vs FCT 5th February, 2010 three judges in the Federal court destroyed some of the ATO's arguments against hybrid trusts.

The ATO's argument was that Minderoo was purely a discretionary trust so no deduction was allowed for the interest on the borrowings. Unfortunately, the ATO pursued this argument with such confidence that it neglected to put forward other possible arguments against the interest being deductible or even that only a percentage should be deductible because some of the money was being used to generate a capital gain for the discretionary beneficiaries.

Case Findings - In response to the ATO's argument that the clauses giving the trustee wide discretionary powers to decide what is and isn't capital showed that the trust was discretionary because this meant that the trustee could effectively decide who received the income from the trust. Forrest argued that this power was only there to allow the trustee to categorise income streams as it chooses, a mere power to classify income, not that the trustee can use it to decide whether the income goes to the unit holders or the discretionary beneficiaries. Forrest further argued that the unit holders right to all income other than capital gain was already stated in another clause in the deed and that clause overrode the discretion in this regard. Once the dissection between capital gains and normal income is made Forrest argued that then and only then the discretionary clause allowed the trustee to classify income within those wide powers, which had only been given to avoid arguments if the nature of the income was not clear. The judges accepted that the argument that the trustee could use the clause to distribute any income as it suited was flawed because to do so would be a breach of the trustees fiduciary duty to the unit holders. The court accepting this meant the unit holder had a fixed entitlement to income so was entitled to deduct the interest on the loan to buy the units. This case also shows that a trust with discretionary beneficiaries can be still classified as a fixed trust.

The ATO have issued their impact statement on Forrest's case
http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/WAD101of2008/00001
Basically they accept that minor discretionary powers will not turn a fixed trust into a discretionary trust but they are holding firm on the argument of apportionment. They are saying the statements made in TD 2009/17 stand, if someone else receives some benefits from the borrowings then the interest has to be apportioned. Generally as a rule of thumb this means no negative gearing.

They now accept that minor discretionary powers will not tarnish the trust as discretionary though of course there still needs to be a clear entitlement to income for the unit holders.

Damage Control by the Promoters of Hybrid Trusts

Just in case someone tries to tell you their hybrid trust deed gets around all the problems remember that this means you will definitely not be able to negatively gear the property in the trust against your own income. So just what advantages are they offering you? Even if you find a hybrid trust that the ATO approve of, ask yourself first why do you want to use a hybrid trust? To meet the ATO requirements there are no tax advantages. Maybe the spruiker is promoting the deed for other perceived advantages such as:

Asset Protection – If you own the units in the trust your creditors will be entitled to those units and as a result the underlying asset. If you try to limit the rights of the unit holders to less than the underlying asset then you are going to be caught as not having a fixed entitlement so you won't be entitled to a tax deduction for the interest on the money borrowed to buy the units. If this is the case you may as well use a discretionary trust.

Succession Planning – If you intend never selling the asset then you do not have to worry about how you will be taxed on the capital gain anyway so the main tax benefit of hybrids is not relevant to you. We have a law in Australia that limits the life of a trust to 80 years. Some deeds claim to be able to avoid this limit. I have asked a few solicitors about this and they claim it is not possible. So if the trust is forced to wind up in 80 years time there will be a forced CGT event. If instead you leave the asset to your heirs in your will and they do the same no CGT will arise until someone sells it. The rollover relief on death can allow a property to pass down through generations indefinitely. If you would prefer your heirs to hold the property in a trust set up a testamentary trust created in your will. This will achieve the same result with the added benefit of allowing your heirs to distribute income to their minor children without incurring to pay the higher rates of minor's tax.

Simply holding the property till you retire maybe all the planning you need. Businesses should consider operating through a trust with a wide definition of beneficiary in the deed so you can distribute before tax profits from the business into a discretionary trust that owns the negatively geared property. This will offset the losses so making the distribution from the business trust effectively tax free and still protect the rental property from the creditors of the business trust.

The ATO has issued a product ruling to Chan & Naylor Australia Pty Ltd, it is PR 2011/15. Before I launch into the details of this ruling the most important factor is that it only applies to trusts where units are issued between the 27th July, 2011 and 30th June 2014, not the deeds they were promoting at the peak of this scam. They have had to modify their deed to the extent there is no real tax benefit anyway.

Other promoters of hybrid trusts have received private rulings along similar lines. At least Chan and Naylor obtained a product ruling so their future clients can rely on it. Anything less than a product ruling and you will need to get your own personal ruling from the ATO.

All these rulings are along similar lines to the, they provide no real tax benefits over and above other trust deeds.

Another Fraudulent Home Sale in WA

The following is a link to a news.com.au story about a WA investment property being sold without the owner's knowledge. The alarming issue is that even after the fraud is proven the property is not returned to the original owners. http://www.news.com.au/breaking-news/fraudulent-home-sale-hits-wa-again/story-e6frfku0-1226112646051

Fees Paid for Financial Advice or Courses

TD 95/60 is an ATO determination on when fees paid to a financial adviser are tax deductible. It differentiates between an upfront fee and an ongoing management or annual fee.

The initial or up front fee to draw up a financial plan is considered to be capital in nature rather than relating to the ongoing management of the portfolio. This is considered to be the case even if the investor already has some investments but enters into a new financial plan. To quote the ruling:

> *"We do not think that the fee for drawing up the plan is deductible ......It is too early in time to be an expense that is part of the income producing process. It is an expense that is associated with putting the income earning investment in place".*
> *"Expenditure on drawing up the plan is incidental and relevant to outlaying the price of acquiring the investment, and is so associated with the making of the investment as to warrant the conclusion that it is capital or capital in nature"*
> *"The character of the outgoing is not altered because the existing investments fit in with the plan. It is still an outgoing of capital"*
> *"However, to be wholly deductible, all of a management fee must relate to gaining or producing assessable income. If the advice covers other matters or relates in part to investments that do not produce assessable income, only a portion of the fee is deductible"*
> *"Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."*

Possibly if the initial financial plan takes into account buying several properties each house acquisition may not be considered a new plan. If you are paying for training on how to find the right property it will probably be considered incurred at a point too soon to be deductible. In considering the deductibility of training, meetings and courses the best example of this is Petrovic's case which examines payments made to Henry Kaye. These payments were not considered deductible because they did not have a sufficient connection with assessable income and was an investment of capital made to prepare Petrovic for future property investments. This is despite the fact he already owned property before attending the courses. Of particular interest is the end of paragraph 14 which states:

> *"At best, the incurring of that expenditure was itself an investment of capital to prepare him for the future commencement of a business property investment should he choose to do so and had the financial ability."*

Careful, if you try to argue that learning how to buy and sell properties is a business expenses ie you are buying the properties to sell for a profit, then the properties would be trading stock, not a passive investment and so the 50% CGT discount would not be available. Training in how to buy and improve properties would be capital in nature and unlikely to even qualify for inclusion in the properties cost base. Trying to align the purchase of your next property to being just like buying another share in you share portfolio, may work to argue that the advice you received regarding the property was part of the management of the original plan but certainly not if you don't already have one property. In Petrovic's case even having a couple of properties made no difference. The trouble with apply rulings like TD95/60 which is directed at share investing, to property investing is that the ATO will probably try to look at each property in isolation, something they would have no chance of with a share portfolio. The only saving grace appears to be this paragraph from TD95/60 "Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."

Deductibility of Property Courses and Coaching

It is rare that any tax deduction will be available for these courses, even at best only a small portion. So before you go spending up big in the expectation of getting a tax deduction before the 30th June, first find out just how much is tax deductible.

In fact, questioning the tax deductibility of a course may be a way to test the credibility of the provider. Do not even accept a letter they may have from an accountant. I have seen one that is very vague and ignores precedents that do not support their case. A product ruling is really the only way you can be absolutely sure the ATO will allow the deduction. Nevertheless here are some references to help you understand the issue.

Petrovic v FC of T 2005 ATC 2169 – Had at various times a commercial property, a residential property, vacant land, provided working capital to developers and had a managed fund investment. Mr Petrovic attended

a Henry Kaye seminar to learn how to extend his property investments and increase his rental income and paid various other fees for property information.
The court found that the expenditure was not tax deductible because it was not "incidental and relevant or sufficiently linked to the derivation of rental income". Further, expenditure relating to purchasing a property is capital, so not deductible against income.
This case is so relevant to many of the property courses currently available a copy of it and ID 2003/324 has been posted on our forum in the beyond newsflash section.
www.bantacs.com.au/forum/viewtopic.php?f=25&t=81&sid=221f72848e519c7435cde0f5a6b19dd1
ID 2003/324 – The taxpayers were allowed to claim 20% of the seminar costs because it was only that portion of the seminar that related to rent and expenses associated with their existing rental properties (implying no deduction at all if you do not have a rental property before you attend the course). The remaining 80% covered how to "establish a strategy or structure for investing in rental properties" which was incurred at a point too soon to be deductible (implying that it cannot even increase the cost base).
TD 95/60 – A fee for initially drawing up an investment plan is not deductible even if it includes existing investments, though it can be included in the cost base. Advice on changing the mix of investments is deductible.

So you need them to give you a detailed apportionment on a time basis of the percentage of time the course will spend on issues relating to tenants and rent as opposed to finding a property, renovating etc. Do not hand over any money until you have this information because it will be harder to get it later.

National Affordable Housing Scheme - NRAS

The government is offering $6,000 federally and $2,000 at state level per year for 10 years tax free and indexed, to investors who participate in this scheme. For properties to qualify, a developer or consortium has to build a minimum of 20 new homes in selected areas but they don't have to be on the same block. The scheme is also about getting housing into the areas with the highest shortages. This doesn't mean you have to build 20 houses, it just means you have to buy off a developer who has participated in the scheme and if you need to sell in less than 10 years from the date the property was constructed then you have to find a buyer who is committed to the scheme otherwise you will have to pay back up to one year of the incentive payments you have received.

The property is normally managed by a non profit organisation for a fee of 10%. It must be rented at 20% below market into the NRAS scheme which will provide you with a long term tenant. This is not housing commission tenancies the tenants are working but not on an above average income ie teachers and police offices.

The $6,000 Federal government incentive can be included in your PAYG variation so you don't have to wait until you do your tax return to get the cash flow benefit.

Who's Name to Buy an Investment Property In

The question usually revolves around whether you prefer asset protection or tax benefits. Combining both gets more complicated.

If you are not concerned about asset protection you would probably prefer to hold a property in your personal name so that any tax losses from the property can be offset against your personal income. Make sure you crunch the numbers if you have a choice between holding the property in the name of a low income earner or a high income earning spouse. If it is only going to be running at a tax loss for a short period of time you should focus more on the tax situation once it becomes positively geared or the capital gains tax on its sale. A close to positive property should be held in a low income spouse's name or a discretionary trust.

The trouble with a discretionary trust is that it cannot distribute losses so they sit in the trust until there is income to offset against them. This means you cannot offset the rental property losses against your own income. That is unless you have a source of income in the trust or another trust that can distribute income into the trust that holds the rental property, this income stream cannot be from your personal services. The advantages of a discretionary trust are that each year you can decide who in your family receives the profits or capital gain and a discretionary trust, being a separate entity from yourself gives you a reasonably good level of asset protection, providing it has a corporate trustee.

Companies are not suitable for investment properties because they do not qualify for the 50% CGT discount. Unit or fixed trusts can give you the negative gearing benefits but as they do not offer any real asset protection or discretion to distribute profits they are no better than owning the property personally but they are more costly to run.

SMSFs offer great asset protection and tax savings (assuming you are not already contributing your maximum amount into super). The main catch is that you cannot borrow against the increased equity in a rental owned by the SMSF as a deposit for another property. This will slow down your investment growth considerably. Not to mention locking your money away until retirement.

So in short none of the structures mentioned so far give you all the answers, outside of SMSF you have to choose either the negative gearing benefits of offset the rental property losses against your own income or asset protection and flexibility to distribute profits. The only exceptions to this are when you can distribute profits from another trust into the discretionary trust that holds the investment property. If the property is held inside a SMSF you have to consider whether you will have enough time to build your portfolio when you can't access your equity.

Self managed superannuation funds allow you to still, through salary sacrificing, offset the investment property loss against you wages income even though the property is owned by the super fund. Up until age 60 any profits made from rent income are only taxed at 15% and capital gains at 10%. After 60 if you retire and put the fund into pension phase all rental income and capital gains are tax free to the fund and tax free when the proceeds pass from the super fund into your hands. The fund can even be put into pension phase when you are 55 if you take a transition to retirement pension.

The asset protection provided by SMSFS is the best you can get providing you don't deliberately divert income to the fund to defeat your creditors. The down side is your money is locked away and you can only borrow against the property once so leverage is limited. For these reasons it is usually better to consider a SMSF in your forties or later.

6 Point Property Spruiker Test

We are concerned about the large number of mass marketed developments and other dubious investments being promoted in an unregulated environment. Sometimes this is justified by claiming investors should not use financial planners because all they can do is sell you shares. Just remember that non financial planners are under very little regulatory control. So one might say you could be lambs to the slaughter.

In particular with negatively geared property investment, it is about owning something for which the demand has increased. For this to be the case there must be something unique and in short supply about the property. This in itself is not possible in a mass marketed estate. The moral of the story is you need to either pay someone to act on your behalf or do your own research if you want to find something unique.

Spruiker Test:

1) Be wary of one stop shops that provide all professional services. This removes you from independent advice and bank valuation information.
2) Consider why the property needs to be marketed outside its local area. Why aren't the locals buying? This is particularly relevant in mining towns where the locals certainly have the money to buy.
3) Don't make an investment decision because you want to reduce your tax. The investment has to be able to stand on its own two feet. The tax advantage is just a bonus.
4) Take inflation into account when viewing any projections you are given. Inflation means the purchasing power of your dollar is decreasing over time. For example if the inflation rate is 3% then a property can go from $400,000 to $537,567 over 10 years and not make any real gain. The $137,567 increase being just the reduction in purchasing power of the dollar.
5) Consider, is there any property guru you have ever heard of that made their money on mass marketed property developments?
6) Use www.realestate.com au and Australian Property investor magazine to form you own opinion of the value of properties, rent returns and growth potential of the area

For more on spot the spruiker go to our forum under the topic Information Resources is an interesting article on the points to watch for.

Off The Plan Apartments

Stacks the Law Firm have created a useful check list of 12 pitfalls of buying off the plan. The article is available at

http://www.stacklaw.com.au/web/page/top-12-pitfalls-in-buying-property-off-the-plan/news/3028

Buying Off the Plan

It's not as crazy as it sounds, there are some advantages such as benefiting from the capital growth on a property simply for the cost of the interest on the deposit. It is not unusual for these sorts of contracts to take 2 years to reach settlement. Sure you don't have the rental income during that time but you don't have the rental expenses either which is even better if the property is negatively geared. The catch is you don't know what you are getting so it is important to sign with a reputable developer. The risk is the developer could go broke or not produce the unit up to the standard you expected leaving you with a legal battle that isn't worth it for the sake of recovering your deposit.

When you finally settle so do all the other people in the complex. At this time there will be a certain percentage that need to get out because their circumstances have changed and for a while the market maybe flooded and the price could drop. There is also the risk that between signing the contract and settlement your personal circumstances could change and in the end the bank won't lend you the money to settle so you blow your deposit. Further, if the development was directed at investors the rental market may be flooded by many similar apartments coming up for rental at the same time. Many of these supply and demand problems can be minimised by investing in a smaller development but this may mean going with a less reputable developer.

The tax consequences are quite good in that your 12 months for the 50% CGT discount starts from the date you buy off the plan so you may well be able to sell before settlement and still get the discount (Reference ID 2003/456). Of course if you buy with the intention of reselling at a profit rather than holding it as a rental then CGT doesn't apply at all, the profit is taxed as normal income.

If you're an investor and use a deposit bond to pay your deposit you will not be entitled to a tax deduction for the cost obtaining the deposit (Reference PBR 80364) nor is it considered a borrowing expense but the interest will be tax deductible (Reference PBR 65790). The cost of setting up the deposit bond can be included in the first element of the property's cost base (PBR 33799). Some developers pay interest on the deposit, this is of course taxable income to you.

Inflation the Sleeping Giant

Holding your wealth in term deposits may provide a guarantee against market risk (the movement of the market up and down in value), but investors should also give some thought to the risk of inflation when looking at their investment strategy. It isn't deducted from your investment balance, and while it might rate a mention on a news bulletin every now and again, its effects on investments are not made as public as falling markets, as happened with the GFC. Instead, we only come to know and understand this when it is all too late – when its effects are felt in our future balances and the income it generates against what are our future costs.

For Example

Say you estimate you need $50,000 to meet your living expenses (in today's dollars) and this is the standard of living you want to maintain in retirement. An investment balance of $835,000 returning 6% will generate that income amount. But twenty years from now, with inflation running at an average of 3% (the average over the last ten years) your equivalent living costs will at that time be $90,000. With the same 6% investment return you need a lump sum of $1,500,000 to generate your income.

Table – Inflation and the long term

The table below shows what income and lump sums might need to be generated should we continue to experience inflation at 3%.

Today's Income	Equivalent Income in 20 Years	Lump Sum required @ 6%	Equivalent Income in 30 Years	Lump Sum required @ 6%
$50,000	$90,000	$1,505,000	$121,000	$2,022,000
$75,000	$135,000	$2,257,000	$182,000	$3,034,000
$100,000	$180,000	$3,010,000	$242,000	$4,045,000

Property Versus Shares

Personally I have made more money out of property than shares but as I have got older and lazier I have concentrated on shares. Property provides a much better opportunity to make money out of your own initiative, whether it be research, renovation or management. Shares really only provide you with the opportunity to research and even then you are competing with people that have more inside knowledge.

I have heard that shares out perform property and this doesn't surprise me because all share purchases are based on a profit making motive whereas most house purchases do not have profit on resale as a priority so it is not correct to compare these two options simply on statistical data.

The main differences I see between these two markets are:

Liquidity - you can't just sell off the bathroom of a house because you need $10,000 quickly, shares can be sold in $500 lots. Also with shares you can have your money within 24 hours, you would wait months for the funds if you needed to rely on the sale of a house. You might say that is ok I have a LOC that I can draw on in an emergency but this means you do not have money working for you so it is still a drain on liquidity.

Effort - It appears to me that if you have the energy and time to be a pro active property investor then you even as Ms or Mr Average have a better chance of profiting from your efforts than through the share market. This is also a personal consideration about what you like doing.

Leverage - Using real estate as collateral for a loan means you can borrow more and at a lower interest rate and one of the important rules of growing wealth is to have as much money working for you as possible. I wonder, if borrowing costs were factored into the performance comparisons whether shares would still come up as a better return on investment?

Diversity - Is a key risk reducing strategy in building wealth so you should have both but unfortunately with real estate this still means having a lot of your eggs in the one basket. Say you have $600,000 to invest. You could diversify by putting $300,000 into shares and $300,000 into property but this would mean just one type property in one particular area whereas the shares could be diversified across a large variety of industries. A share portfolio can even have exposure to the property market by investing in property trusts but unfortunately property trust, while giving you access to the highs and lows of the property market cannot deliver one of the main advantages of property investment, namely the opportunity to profit from your own effort.

I try to avoid directing clients specifically to shares or property but concentrate on the numbers for each particular investment decision. Though when a client is keen to have as much money working for them as possible in the property market I do recommend at least a small share portfolio as a must have for instant liquidity.

From the tax point of view it depends totally on your profile, investments available and your time frame. I am sure most readers are aware of how a tax refund generated by claiming depreciation can help a property's affordability but many don't factor in franking credits when comparing property to shares. For example let's say you borrow $100,000 at 7% to buy Commonwealth bank shares which you expect to pay a 5% cash dividend that is fully franked. If held in a low income earners name who has other income above $20,582 but after adding in the taxable income below is still under $37,000:

Tax Calculation		**Cash Flow Calculation**	
Dividend Income	$5,000	Cash Dividend	$5,000
Franking Credit	2,143	Tax Refund $2,143-$30	2,113
	7,143		7,113
Interest Expense	7,000	Less Interest	7,000
Taxable Income	143	Cash inflow on bank's Money	$113
Tax Payable $143 x 21% = $30.03		plus capital growth	
Which will be paid by part of the franking credits			

In the same situation for a high income earner the only difference would be the size of the tax bill $143 x 39% (assuming between $80,000 and $180,000) = $56 so the cash flow calculation would be:

Cash Dividend	$5,000
Tax Refund $2,143-56	2,087
	7,087
Less Interest	7,000
Cash inflow on bank's Money	$87 plus capital growth

Not much difference in the tax refund but the tax rate on the capital growth over many years will be significant, just another reason to invest in the low income earners name.

When Do You Need A SMSF?

There seems to be a lot of publicity lately about spruikers and Self-Managed Superannuation Funds (SMSFs). Scare tactics have also been employed by government organisations. Yes, there are a lot of responsibilities in running your own SMSF but they are no more complicated than dealing with GST and other bureaucratic red tape the government seem to think it is reasonable to impose on the average taxpayer. And yes SMSFs are not for everyone but don't be led to think that an adviser who recommends a SMSF is a spruiker. There are many, many good reasons to have a SMSF, especially if you are investing in property.

Once you reach 60 years of age and transfer your superannuation to pension phase its earnings and capital gains will be tax free to the fund and you. Further superannuation is the best form of asset protection that you can get. Even before pension phase the maximum tax on your superannuation earnings is 15% and10% on capital gains yet you will get an effective tax deduction at your marginal rate for contributions to the superannuation fund. The main downside is limited access to the funds until retirement conditions are reached. There has been much discussion about the details of SMSFs in the last couple of newsflashes and our free SMSF booklet should cover all your questions www.bantacs.com.au/booklets/SMSFs_Booklet.pdf this article is not about the details of investing through a SMSF but whether it is suitable for you.

So superannuation has the best tax concessions and asset protection, it is just a question of whether this is the right time for you to lock your money away and whether you should do it in a SMSF or a public superannuation fund. It is a no brainer if you want to invest directly in a rental property. You cannot directly hold a rental property in the superannuation regime any other way than in your own SMSF. It is the same with investing in collectibles. On the other hand, if you want to invest in shares in public companies this can be achieved through the public funds. Some even allow you to make your own choice of the companies you invest in, from their range. So if you choose to direct your superannuation savings to shares then the circumstances when a SMSF is suitable are limited to when you want to diversify into property and/or your shareholding has reached the stage where the management fee that the fund charges you as a percentage of your investment exceeds the fixed costs of owning your own SMSF. This comes into play, as you approach the $200,000 mark in superannuation savings.

The simple solution to knowing whether you should buy your next rental property in a SMSF is to see your accountant before you buy a property; they will know exactly what is right for your circumstances. If you don't have an accountant, well now that you are going to own an investment property you will need one so find one and give them the chance to examine your circumstances before you go making one of the biggest decisions in your life.

Please don't let the entire scare mongering make you distrust advisers and think you have to nut it out on your own. Just make sure you consult an accountant that is independent and knows your circumstances well. They will cost a minute fraction of the amount you will be spending on the property.

Your accountant should be able to evaluate the property, telling you how much it is going to cost you to hold, how much it needs to go up in value on average to breakeven, how to manage your loans, how to keep the appropriate records for your tax return, what the ownership structure should be and why.

Now how to pick the spruikers? Glitz, glamor, lots of advertising and pressure are not the signs of a good advisor. There is probably no one fool proof tactic but word of mouth and independence is a good place to start. Our affiliates page was created to help our clients know who we trust, here is our word of mouth www.affiliates.bantacs.com.au/index.php.

Redirecting Employer Superannuation Contributions

Some big employers and government departments who traditionally paid their employees' superannuation into an employer based fund are loosening their rules a little to allow their employees to have their own SMSF. Unfortunately, in many cases the employer will still pay the employee's superannuation into the employer sponsored fund but that fund then allows the employee to transfer the funds into their own SMSF at monthly or annual intervals.

If your employer will not pay your superannuation directly into your SMSF and you have a negatively geared rental property in your fund then the loss from the property cannot be used to reduce the contributions tax on your employer's contributions.

For example say the rental property in your SMSF makes a $10,000 loss and you choose to salary sacrifice $10,000 into superannuation so that effectively that loss is offset against your taxable income ie you reduce your wage by $10,000. If paid direct to your SMSF no contributions tax is paid because the SMSF has a loss of $10,000 to offset against its income stream of your superannuation contribution.

Here is the problem, if your superannuation contribution detours via another superannuation fund first. That first fund is the one that must pay tax on it so the $10,000 is reduced to $8,500 after tax. All your SMSF is going to receive when the funds are rolled over is $8,500. This is not included as income to your SMSF it is just a rollover balance. So your SMSF has a carried forward loss of $10,000 which it may never use (no tax at pension stage) and you have lost $1,500 out of your superannuation balance. Sort of takes all the fun out of the arrangement, doesn't it.

Holding a Rental Property in a Trust

If you are concerned about land tax, depending on which state you are in, a trust might give you another land tax threshold. For example in Queensland a trust does not pay land tax until the unimproved land held by the trust in the state of Queensland exceeds $350,000. NSW gets complicated but certainly discretionary trusts are not entitled to a threshold at all so will pay land tax on any property they own NT has no land tax. Victoria only gives trusts a $25,000 threshold. Another way of avoiding land tax is to buy properties in different states.

Here is a bit of a run down on the two types of trusts you are likely to considers:

Fixed/Unit Trusts:

Generally you would borrow money to purchase units in the trust. This would give you a fixed right to the income of the trust which then gives you a right to deduct the interest on the loan in your personal tax return. The trust may also borrow but because of your contribution the trust makes a profit which is distributed to you and appears in your tax return so that the interest on your loan is a cost of earning income. If the property is overall negatively geared then your interest will exceed the income you receive from the trust.

This may sound good but all it really provides is protection of your personal assets from anyone suing the trust. If anyone is suing you they would gain access to the trust by gaining access to the units you own; so only a little better asset protection than owning in your own name. The tax outcome is about the same just an extra tax return. There is a stamp duty advantage in that once the property is held in the trust you could transfer the units (for market value) amongst family members without paying stamp duty on the transfer but it would trigger CGT, so you are unlikely to do this.

Discretionary Trusts:

A discretionary trust allows you to decide each year who gets the profits and/or capital gain because unlike a unit trust there is no fixed right to profit. The down side of no fixed right to profit is that you cannot effectively negatively gear in your personal tax return. You have no fixed right to profit so the interest on the money you borrow to put into the discretionary trust is not a cost of earning trust income. To make it deductible (a cost of earning income) you need to charge the trust interest at the same or a higher rate. This means the deduction effectively moves into the trust and is locked in there until it makes a profit as trusts cannot distribute losses. The up side of no fixed right to profit is that if you are sued, your creditors cannot demand that the trust pays them anything. If the property is positively geared anyway then the discretionary trust has no down side and putting a positive property into a discretionary trust gives you something to offset against other rental property losses so you may then be able to afford to hold a negatively geared property in a discretionary trust.

Warning – Any trust that claims to give you the benefits of a combination of those above risks being treated by the ATO as a discretionary trust removing your right to claim the interest on the money used to buy the units; or requires the trust to buy back the units which will trigger a CGT event at market value to the unit holders. Note – Trusts are sometimes marketed as a succession planning tool. A trust can only operate for 80 years, at the end of which the assets must be transferred to the beneficiaries and the trust has to pay CGT. Accordingly, if you must use a trust at all, to control from the grave, it is better to create it in your will so it lasts as long as possible and the tax benefits of distributing income to minors are much better. If you hold a property in your own name you can transfer it to your heirs through your will with no CGT consequences and they can do the same. Keeping a property in the family through personal ownership and wills will completely avoid CGT for an infinite period until someone sells the property.

Buying A Rental Property

Please make sure you read this booklet next.
http://www.bantacs.com.au/booklets/Buying_A_Rental_Property.pdf

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- How does the price compare with similar sales in the area?
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