prosolution Newsletter

Finance for Professionals, by Professionals

June 2005 Newsletter

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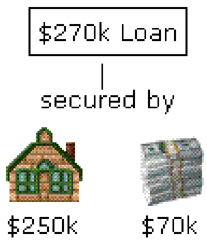
Three planning tips to optimise your tax position

Often people think arranging home or investment mortgage is not a complex task. However, sometimes there are a number of very valuable tricks or tips that can save you a lot of money. For example, it's important to always try and optimise the split between deductible (home loan) and non-deductible debt (investment loan). That is, minimise non-deductible debt. Benefiting from professional loan advice when setting up your loans can be one of the best investment decisions you make. Here are a couple of real examples.

Borrow 100% without paying for mortgage insurance

A client (Leo) was purchasing a small investment property for $250,000. He expected to enjoy some significant capital growth in this property in the short term. Leo is a high income earner and wanted to borrow the maximum against the investment property to maximise his tax deduction. He had approximately $80,000 of cash.

Most lenders will lend up to 80% of a property's value without requiring borrowers to pay for Lenders Mortgage Insurance (LMI). They will also lend 100% of a cash term deposit. Therefore, we suggested that the client offer the new investment property plus a $70,000 term deposit as security for the loan. That way, the client could borrow a total of $270,000 (maximum of 80% of $250,000 ($200,000) plus 100% of the term deposit, $70,000). That is enough money to pay for the full purchase price plus stamp duties.



Once the property's value increases to over $340,000, we can approach the bank and request them to release the $70,000 term deposit, because the loan to value ratio will be approximately 79%, just using the property as sole security.

The alternative to this might have been to contribute the cash to fund part of the purchase price and borrow $200,000 (80%). However, by accepting our advice, the client has been able to borrow 100% of the purchase price plus costs without having to pay for mortgage insurance (which would have cost over $6,000). He will also be able to get his cash back within a few years.

Interest only offset

Some other clients (Sunny and Lilly) were purchasing their first home (apartment). However, Sunny and Lilly's plan was to only occupy the apartment for a couple of years. They then wanted to purchase a larger home and retain the apartment as an investment property. We recommended to Sunny and Lilly to utilise an interest only offset account, so that they will be able to minimise any non-deductible debt in the future, when they purchase their larger home.

Sunny and Lilly purchased the apartment for $350,000 off the plan. They had approximately $150,000 as a deposit. Instead of contributing the full deposit, we recommended borrowing 80% of the apartment's value being $280,000 (instead of contributing the full $150,000 and borrowing $200,000). Once the loan is set up, the clients can retain the surplus cash ($150,000 less 20% being $70,000 = $80,000) in the offset account. Therefore, they will only need to pay interest on $200,000 (because the cash balance offsets the loan balance). While they live in the apartment, they continue to accumulate extra cash in the offset account and only repay interest. If they can save $20,000 per year then they will have $120,000 in the offset account within 2 years. They can then withdraw the $120,000 from the offset account and use it as a deposit for the new home. If they purchase a home for $500,000, then they will have to borrow approximately $400,000 (assuming stamp duty costs of $20,000). Therefore, they will have a home loan for $400,000 (non-deductible) and an investment loan for $280,000 (deductible).

However, if Sunny and Lilly didn't use an interest only offset and contributed all their cash in the initial purchase of the apartment and repaid all savings into the loan (to reduce interest costs), then the apartment loan balance would be $160,000 (purchase for $350,000 less $150,000 deposit less $20,000 of savings per year for two years). When Sunny and Lilly purchase the new home they will need to borrow the full amount because they have essentially "locked" all extra cash in the apartment loan. Therefore, they will have a home loan (non-deductible) for $520,000 (including $20,000 for stamp duty) and an investment loan for $160,000 (deductible).

Summary

	With interest only offset	Without interest only offset
Home Loan	$400,000	$520,000
Investment Loan	$280,000	$160,000
Total	$680,000	$680,000

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Using the interest only offset has essentially resulted in a higher tax deductible loan and a lower non-deductible loan (a difference of $120,000). This results in an annual tax saving of $4,200 (assuming the highest marginal tax rate and an interest rate of 7%).

Any redraws are treated as a separate loan by the ATO. Therefore, you cannot redraw any extra repayments on the apartment loan and claim interest as a tax deduction on the full loan amount (if the redraw is used to finance the purchase of a home). This is a common misconception. Once an investment loan has been repaid, you cannot redraw the money out of the loan again and automatically claim a deduction. It is dependant on what the redrawn money is used for. That's why an offset is useful. You can still benefit from lower interest expense by having spare cash offset your loan but the distinction is that the surplus funds are never actually paid into the loan account. The loan balance is maintained.

Allow some room for property expenses

Normally, property investors can use their loans to pay for ongoing property expenses such as Council rates, insurance, repairs and maintenance, etc. Therefore, when we are helping clients with refinancing investment loans, we will often suggest including a small buffer of $5,000 to $10,000 in their investment loans. For example, if a client has an investment property worth $400,000 and a loan for $200,000 we would suggest that the client apply for a loan amount of $210,000 (or more) when refinancing. The client can then use the extra $10,000 to pay for ongoing property expenses instead of paying these expenses with their other (salary or rental) income. Their income can then be put to better use, such as repaying non-deductible (home loan) debt.

Seek advice

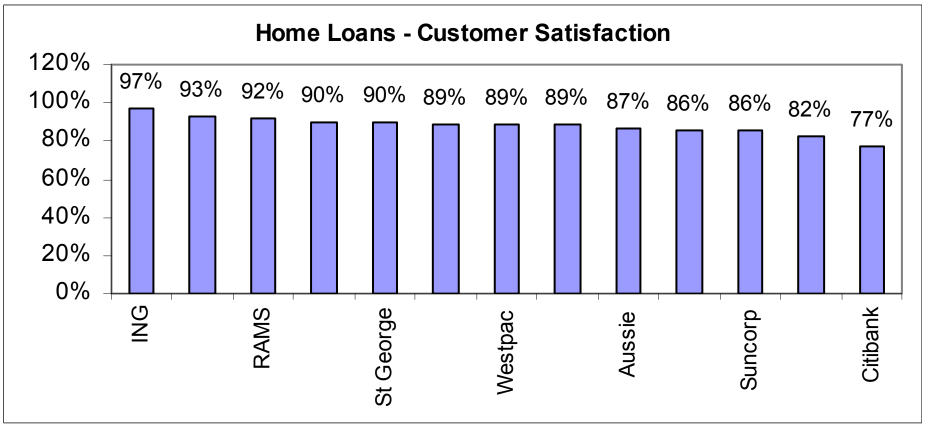
An inadequate loan structure that you set up today may come back to bite you sometime in the future. Therefore, there are two things you must do. Firstly, you must give some consideration to your future property ownership plans. Secondly, you must share these plans with an experienced and qualified mortgage broker, so that they can consider the appropriateness of the products and loan structure you choose.

You must also seek advice from a qualified accountant to confirm the tax treatment and consequences of certain products and loan structures, before acting on any advice or information in this article.

Any questions about this article? Email us.

Customer satisfaction

Results for the latest Nielsen Media Research, Financial Institution Customer Monitor survey are shown below. The survey covers the last 12 months for owner occupier loans (dated February 2005).



NSW State Budget

The NSW government recently announced changes to stamp duty concession which become effective in August 2005 in the State budget. Previously, NSW did not charge mortgage stamp duty on loans that are being refinanced (as long as borrowers and security are unchanged). However, the NSW State government will now charge mortgage stamp duty on loans that are refinanced and that are over $1 million. Stamp duty will not be charged on the original loan amount or the first $1 million, whichever is lower. Therefore, if you refinance a loan for $1.5 million the mortgage stamp duty will now be $2,000.

Mortgage insurers change policies

When property owners borrow over 80% of a property's value they have to pay for Lenders Mortgage Insurance (LMI). This is not only an extra upfront cost, but the borrowers also have to meet the mortgage insurer's (which are external to the lenders) credit policies. In the past, mortgage insurers used to lend up to 95% of a property's value up to a maximum loan of $500,000. If you need to borrow over $500,000 then the maximum they will lend is reduced to 90%. This policy was becoming outdated, especially with the current property values in Sydney. The mortgage insurers have recently announced a change in policy, where they will now lend up to 95% of a property's value up to a maximum loan amount of $650,000. This will allow borrowers to purchase a property for up to $684,000 and only need to contribute $64,000 (plus the cost of mortgage insurance) in their own funds. Previously you would need a deposit of $98,000 to purchase property for $684,000.

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