

# September 2005 Newsletter

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## Trading Places –To sell or not to sell?

*Are you planning to upgrade your current home, should you sell it or keep it as an investment property? This is the question most people ask themselves at least once during their lifetime.*

The first home that people purchase is generally not going to be their home for the rest of their lives. Firstly, it is difficult for first home buyers to purchase a large property that will service their future needs, especially in Australia's capital cities. Secondly, people's preferences and requirements change, particularly when couples start a family. Inevitably, the time comes when people are faced with the decision of whether to sell their existing property or retain it and rent it out as an investment property. In fact, the average family come across this decision three or four times in their lifetime.

I recently wrote a detailed article about this topic for Australian Property Investor magazine (which you can download below). Below is a summary of this article.

### The first and most important question

The most important question you need to ask yourself is, will your existing home make a good investment property? A home will not always make a good investment property. You need to consider two main factors.

Firstly, you need to consider the quantum of rental income and the likelihood of vacancy. How much demand will there be for your property? What percentage rental yield can you expect to achieve and how does that compare to the average for your area? Secondly, you need to consider the likelihood of your property increasing in value in the future.

These are the most important factors, because

there is no point hanging onto a property that is not going to perform well and might be vacant half the time. You may consider enlisting the assistance of a suitably experienced investment property advisor to help you with this assessment. An investment property advisor will be able to advise you if your existing property will be a good future investment. They should be able to justify their opinions and recommendations with data, and by citing fundamental factors as to why your property is, or is not, a good investment. By fundamental factors, I mean things like location to schools, transport, new infrastructure, etc. This could prove to be very valuable advice, because retaining an underperforming investment can significantly retard a person's wealth creation activities.

### The tax implications

When people purchase a home, a common strategy is to repay as much of their home loan as possible. Of course this is a good strategy – you should always try and repay non-tax deductible debt as soon as possible. However, doing so will deny your ability to claim a tax deduction in the future. A common misconception is that you can redraw or re-borrow the home loan before you rent the property out. That is, if you had a home loan for \$250,000 and you repaid the loan down to \$100,000, some people think that you can redraw the loan up to \$250,000 and then claim the interest on the \$250,000 as a tax deduction. This is incorrect. The Australian Tax Office (ATO) treats every redraw as a separate loan. Therefore, in determining if your loan will be deductible or not, you will have to look to the purpose of the redrawn funds. For example, if you redraw the loan back up to \$250,000 (i.e. redraw \$150,000) the ATO will look at what purposes the \$150,000 funds were used for. If you used this money to contribute to the purchase of your next home (i.e. a purpose that does not produce taxable income), then the loan will not be deductible.

Consequently, one of the downsides to retaining your existing property and purchasing a new one is that you may have proportionally more non-deductible debt. Continuing with the example above, assume that the person purchases a new home for \$600,000 (and retains their existing \$450,000 property). They will need to borrow approximately \$640,000 to purchase this new property (including stamp duties and other costs). They can borrow 100% plus costs, because they can use their

existing property as collateral security. Therefore, they will have two loans:

- Tax deductible investment loan for \$100,000; and
- Non-tax deductible home loan for \$640,000.

It would be more tax effective if this situation was reversed (i.e. if the tax deductible loan was higher than the non-deductible loan).

### Rebalancing tax-deductible debt

There are a few things you could do to rebalance your investment debt. One strategy is to sell your existing property to your partner or another entity such as a family trust. For example, if your existing property was in the male partner's name only you could sell it to the female partner after you have purchased the new home. The female partner could borrow 100% of the investment property plus costs, say \$475,000. Therefore, after repaying the \$100,000 loan you would have \$375,000 to repay off the home loan. Once this transaction has been completed your loan balances would be:

- Tax deductible investment loan for \$475,000; and
- Non-tax deductible home loan for \$265,000 (i.e. \$640k - \$375k).

There are many issues that you need to take into account when undertaking a transaction like this. Some of these issues are discussed in the full article (download at the end). In addition, I talk about some products that you can use to preserve the tax deductibility of loan balances so that you can avoid this potential problem.

### How much equity do you need?

Lenders will assess your borrowings from an aggregate position. Therefore, you can use the equity in existing properties as security for the new property

(and borrow 100 percent). Remember, you can borrow up to 80 percent of a property's value before you have to pay for mortgage insurance. You can borrow up to 95% of a property's value (up to a maximum loan amount of \$1 million) but you will have to pay for mortgage insurance. The full article sets out steps to calculate your borrowing capacity.

### Selling gives you more deposit

Selling your existing home and therefore liquidating the asset into cash will give you a greater purchasing power. The reason for this is because most lenders will only lend a certain percentage of a property's value (normally less than 100 percent). Therefore, if you don't have a lot of equity in your existing property and you don't want to pay for mortgage insurance, then selling might be your only option.

### Think about your options

As the saying goes, hindsight is a wonderful thing. Forward planning is even better. Thinking about how long you will occupy your home and its future use can make a tremendous difference to the products and loan structure that you use. This loan structure can, in turn, have a huge effect on your tax position. If you take one thing away with you after reading this article, it should be to recognise the real value of forward planning coupled with professional loan structuring advice. Sometimes simple and seemingly unimportant decisions can turn out to have more significant consequences in the future.

**Full Article:** A more detailed article about this topic was written by Stuart Wemyss and was published in the September issue of Australian Property Investor (API) magazine. API is Australia's leading property magazine for home buyers and investors. You can subscribe to API by visiting: [www.apimagazine.com.au](http://www.apimagazine.com.au).

To download the full article visit: [www.prosolution.com.au/articles/trading.pdf](http://www.prosolution.com.au/articles/trading.pdf)

## Interesting Fixed Rates

The mortgage market is still very competitive: there are some interesting fixed rates on offer at the moment.

Fixed 3 years:	Westpac - 6.49%
Fixed 5 years:	Heritage - 6.69%
Fixed 10 years:	Westpac - 6.99%

## Free Investment Booklet

We have published a free booklet titled 'Six Critical Steps to Ultimate Investment Property Finance' which discusses loan structuring, which products to use when, hidden costs and how to measure them, etc. If you would like your free copy just email your name and postal address to [info@prosolution.com.au](mailto:info@prosolution.com.au).

