



THE FINANCIAL PLANNER AS A PROPERTY ADVISER

McMasters' Advisers' | July 2011



The Financial Planner as a Property Advisor

The Financial Planner as a Property Advisor is one of a series of technical manuals specifically created for financial planners running fee for service practices. These manuals help establish the financial planner as the client's primary advisor, the point of first contact on all business questions and the advisor who facilitates other advice and professional services as needed.

McMasters' Advisors believe businesses are the best investments and that advisors should routinely recommend their clients buy or start businesses, or further develop existing businesses, wherever a client is suited to this, by inclination, personality or training. The extra economic benefits, improved tax planning and, hopefully, the CGT free profit on the ultimate sale of the business mean this is an option clients cannot afford to overlook.



McMasters' Advisers' head office

Clients who are in business have a greater need for the advisor's extra services, and in the new fee for service world it's all about providing extra services. That's where the extra fees come from. A client who is in business has a greater need for a financial planner's skill and experience, including risk insurance planning, income tax planning, debt planning, estate planning, superannuation planning and, of course, investment planning.

The average business client is worth five average non-business clients.

McMasters' Advisers is dedicated to helping advisors develop the skills needed to develop a competent business development advisory capacity as part of their financial planning practices. McMasters' Advisers believes financial planners should be their clients' primary business advisor, with a broad knowledge of all relevant areas, and the capacity and inclination to bring in other specialist advisors including accountants and solicitors where appropriate.

The Financial Planner as a Business Advisor uses the literary device of John, the financial planner, to examine the major financial planning issues connected setting up, running and selling a business in Australia. It works at two levels. The first level is an overview of the technical issues and the second level is a case study in how to set up and run a successful financial planning business.

The Financial Planner as a Business Advisor cross-refers to the other McMasters' Advisers' manuals. Internet links connect these manuals at appropriate points.

I trust you find "The Financial Planner as a Business Advisor an instructive educational experience that improves your understanding of this essential field of expertise for successful financial planners.

Yours faithfully

Terry McMaster

Chairman

McMasters' Advisers





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PART 1 WHY PROPERTY

McMasters' Advisors encourages its advisors to encourage their clients to invest in property.

It defies belief that most AFSL specifically prohibit advisors from advising on property, unless it's dressed up as a financial product. Property, particularly the family home, is the most valuable asset owned by most people, yet it does not get a mention in most statements of advice, even those which on their face claim to be comprehensive and all embracing, covering all aspects of a client's financial profile.

McMasters' Advisors has always encouraged advisors to encourage clients to invest in property. It's because we believe it is in your client's best interests, and hence your best interests.. It's also because it is what clients want. There is a huge demand for quality property advice. This has been particularly the case since many clients lost confidence in equities during the GFC, and will become more particularly the case once the new Future of Financial Advice reforms kick in on 1 July 2012.



If you really do put your client's fortunes before your own, you will make sure you are advising on property by 1 July 2012, and that all statements of advice at least consider this essential investment.

By the way, advising on property is a great way to grow your practice. Your clients will love it. It's what they want. And in a fee for service environment it is what they are prepared to pay you for. Up-grades to the family home. New family homes. Homes for kids. City homes for country folk. Negative gearing strategies. Advanced gearing strategies. Residential, office, retail, industrial and even farming properties all have a role to play.

If you want to make friends with your clients, show them a way to extend or renovate their home without incurring non-deductible debt. It's often possible, and just takes a little care and skill in managing their finances.

If you want to keep your client show them how high tax bills can be reduced through safe and low risk gearing strategies.

If you want a twenty year relationship, with annual fees for annual services for each of those twenty years, get your clients started now on building a diversified property portfolio across all states and all property classes.

If you want to build a profitable, sustainable and valuable practice, take the time now to learn more about how property works and how property advisory services can help you to help your clients.





PART 2 RESIDENTIAL PROPERTY

The Investor's home as an investment

The family home occupies a special spot in the Australian psyche. At about 70%, our home ownership rates are amongst the highest in the world. And the home ownership rate is easily higher than this if just Investors are considered. Since the Second World War there has been an explosion in home ownership: cheap land, new building materials and methods and government policy combined to see most able to afford at least some sort of a home somewhere. Something their forefathers only dreamt about.

The family home also occupies a special spot in the Australian investment history. It is the highest earning asset class, with an average annual return of about 16% compounding in the 20 years to 31 December 2003 (source: ASX Annual Investment Report June 2004). That's the average: in some regions and suburbs, particularly those that Investors usually live in, the average annual return is even higher than this.

Like most other people, some Investors would not have accumulated any wealth at all if it was not for their regular principal repayments and the steady rise in their home's value over the years. Most Investors can attribute most of their wealth to their family home.

Our advice to Investors always says "own as much home as the bank will let you, as soon as you can. And then pay the loan off as fast as you can". The Investors who followed this advice did very well. We doubt that this is going to change much in the next ten years, despite events so far this year. We still think Investors should buy as much home as their bank will let them. And then pay the loan off as fast as they can.

Rising home values are traditionally good for politicians. The wealth effect trickles over to increased confidence and increased consumption, which makes re-election more probable. Normally governments like home prices to increase. But lately it seems there is almost a conspiracy amongst the various levels and arms of government are combining to deliberately hose down the residential property sector. The federal government and the Reserve Bank have both talked up interest rate rises to talk down house prices. The NSW state government changed stamp duty rules and the Victorian state government jumped in with changes to the auction rules. Henry Kaye and his mates helped things along too. All hopes are that the “over heated” market heads for “soft landing”, as the lingo goes.

The conspiracy has worked and home prices have soft landed by as much as 10% since January 2004. And now our view in July 2004 is, as the salesmen say, “now is a good time to buy”. The market has over-reacted. There is no real reason for the price falls. What has really changed? The economy is stronger, there are more jobs, and there is a greater ability to pay than ever before. The population is growing. Certainly the basic psychology of home ownership has not changed: people still want to live in and own nice houses, and they are prepared to pay to do it. It's a status thing as much as anything else.

We think homes will cost a lot more in 2010, and 2020, than they do in 2004. Investors should be fattening their residential property portfolios while everyone else is thinning theirs out.

What are the trends?

Despite our overall positivity, it does seem that the rate of home ownership is in fact declining. But its not declining nearly as fast as the population is increasing. Department of Family and Community research on trends in home ownership indicates that the overall rate of home ownership has declined marginally in recent years. This appears to be due to:

- (i) the population aging, and moving into alternative accommodation;
- (ii) the traditional family unit breaking down and a correlating increase in single parent families and group households, which tend to rent rather than own;
- (iii) an increase in the average age of first home buyers, due to the higher cost of housing, increased participation in post secondary education and training, HECS debts and the trend to later child bearing.

The decline is only marginal, just two or three percentage points over more than 20 years. But there does seem to be a permanent change in Australia's home ownership profile since the early 80's.

What are the advantages of home ownership?

The most important advantage of home ownership is more of a psychological advantage than a purely financial advantage. It's the nesting instinct. It explains why young couples spend so much time getting the house ready, turning it into a home, before the first baby arrives. It's a territorial thing. This is your space and your home is your castle. It provides a sense of permanence and control which is important to overall psychological happiness.

And it avoids the psychological disadvantage, the perceived social stigma, attached to not owning your own home. Do not under rate this one. Perceived social status is a big factor in why people buy in Brighton or Double Bay.

Residential properties, and the loans used to buy it, are a great way to save. Many people, Investors included, would not save a cent if it was not for the principal component of their home loan repayments. And later, when the home is paid off, the owners save rent.

The home is usually CGT free. The principal residence is excluded from the capital gains tax net, by dint of social policy and political survival. Improvements to the home are usually CGT free too: it can be that a \$100,000 improvement creates \$150,000 of value. And that extra \$50,000 is tax free.

For older people the home is outside the assets and the income test for the old age pension. And increasingly reverse mortgages are being used to access some of the large amounts of equity in the home during old age without having to sell it. Reverse mortgages turn homes into tax free reservoirs of wealth, a superannuation alternative, to smooth consumption over a person's expected life span: they build up the reservoir during their working years and run it down in their retirement.

From time to time governments create benefits for homeowners, such as the first home buyers grant and the NSW stage government stamp duty concessions (although one can argue that these inflate home values by greater amounts, thereby making home ownership harder, not easier).

What are the disadvantages of home ownership?

Property values can go down as well as go up. However, for most people this has not been a problem. People who bought homes in the six to 12 months to July 2004 may have dropped a few bob. But they are the only ones. And it's a fair bet that if they keep their bottle and stay in the market prices will recover and they will eventually be ahead. Remember, short term is five years, medium term is five to ten years and long term is ten or more years. Six months is nothing.

Property can be expensive to buy and hold. Acquisition costs include stamp duty (work on 5% of the cost), bank fees, solicitors' fees and titles office costs. Holding costs include council and water rates (which do produce some benefits), interest, increasingly, land tax, maintenance and repairs and real estate agents' fees. These can be significant and are often ignored when people calculate the gains made on their homes.

Critics of home ownership normally list opportunity cost on foregone investments and a lack of diversification and hence a higher risk than otherwise may have been the case. But historically this has not been the case: property is the top performing asset class so there is no opportunity cost. And the lack of diversification has been the homeowners' advantage: who wants to diversify into a lower earning asset class?

One disadvantage the financial planners do not normally list relates to the opportunity cost of other investments that may have been geared. For example, if a investor chose to put a deposit on a positively geared commercial property costing, say, \$1,000,000 rather than an equal deposit on a new home costing, say, \$500,000, then ten years down the track the investor would probably have been better off with the commercial property. But it's not a fait accompli and it does depend on the assumptions you make about the relative price movements in each asset

class. One commentator has been saying for years that he thinks investors will be better off renting their home and investing in the share market. One day he will be right. Let's hope his wife does not leave him first.

Critics argue that residential property is an illiquid asset. This has never really been a problem with Investors: they have high, stable, secure and long income streams and cash flow is rarely a concern. It has been even less of a problem in the last ten years or so as equity access loans, ie debt facilities linked to the value of the home, have allowed Investors to cash out some of the value of their home, whether for consumption purposes or for other investment or business purposes.

Who should own the home?

For asset protection purposes an investor should not normally own his or her home, if at all possible. If the investor is married to a person who is not in a litigation exposed occupation, the Investor's spouse should own the home. This simple strategy will be effective against the entire world should the investor become embroiled in patient litigation or similar troubles. But for family law purposes it does not have any effect: for obvious reasons nominal ownership is ignored here.

If the Investor's spouse is also in a litigation exposed occupation, it can also make sense to buy the home through a family trust, and lease it from the trust. This can be a very safe way to own a home, but the principal residence CGT exemption will not be available on any capital gain. Whether this is an issue depends on whether there is a capital gain, whether it will be realized, and what the trust's tax profile is like when that happens. In many cases giving up the uncertain future benefit of the principal residence CGT exemption may be a small price to pay, particularly when the certain and immediate tax benefits of interest, depreciation and other holding costs are taken into account.

Sometimes when both spouses are in litigation exposed occupations, but one is not as exposed as the other, it can make sense to have the home owned by the lesser exposed spouse. For example, if a male O&G specialist working sixty hours a week is married to a female GP working 16 hours a week, it makes sense to own the home in the female investor's name. This is because statistically speaking she faces a far lower risk of patient litigation than her partner.

Asset protection is a complicated area and it is discussed in more detail in chapter 18 of this book. Specific legal advice should be sought before implementing any asset protection strategies.

Deductions for the home as a place of business

Once it was common for Investors to practise from rooms attached to their homes. The home was a place of business as well as a domicile, and the costs connected to the home as a place of business were deductible for taxation purposes. These costs included a portion of the interest on any loans used to buy the home, usually calculated on a floor space basis, a portion of the running costs such as the rates, electricity and so on. It also included depreciation of any plant and equipment to the extent it was used to produce income.

When considering whether the surgery was a place of business the ATO considered whether:

- (i) the area was clearly identified as a place of business;

- (ii) the area was not suited or easily adaptable to private or domestic use;
- (iii) the area was used predominately for business purposes; and
- (iv) the area was regularly visited by patients.

Generally speaking we advise Investors against claiming occupancy costs connected to the home, such as interest and rates, because of this CGT disincentive. The home is basically broken into two assets for for taxation purposes and, only one, ie the bit not used as a place of business, is exempt from CGT.

Deductions for home offices

Investors can claim deductions for home offices.

To be honest, there is not much in these deductions and it is usually not worth the bother of complying with the ATO's substantiation rules. There is one exception to this: sometimes the depreciation claim available on plant and equipment can be significant. Desks, tables, book cases, chairs, computers, 'phones, faxes and similar equipment can easily exceed \$20,000 or more. This amount is spread over the useful life of each asset, and this can easily add up to a deduction of say \$2,000 a year.

The ATO cannot tell an investor how much he or she can spend on a particular item of plant and equipment: so that nineteenth century oak partner's desk that you have always wanted can be depreciated if it is actually used just for professional purposes. The family home has a special place in the Australian psyche, and deserves a special place in this book. Rightly or wrongly for most people the family home is the most valuable asset and investment they will ever own. It is also the asset, probably the only asset, which produces warm emotion and fond memories, and exerts a significant influence over the family's day-to-day happiness.

Investors are not exceptions to this phenomenon.

This value of a home is measured not only in financial terms, but also in emotional and familial terms. The quality of the family home is an important variable in determining the quality of family life. This is not to underestimate the importance of other factors. Obviously lots of other things are pretty important to. But generally speaking, the better the family home the better the quality of family life. This is particularly so for those who spend the bulk of their time in the family home, such as mothers and young children.

This part of the chapter looks closely at some of the issues surrounding the family home. Is it worth owning a home? If so, who should own it, who should buy it, how it should be financed, where it should be located, and when it should be sold, if at all.

This part of the book also looks closely at whether you should own more than one home, ie live in one and rent the other out to tenants, and whether and how an investor can help a child own his or her own home faster.

Is it worth owning a home?

From time to time various heads pop up saying that the Australian obsession with the family home is financially damaging and that most people would be better off owning a parcel of shares or other investments rather than

their home. One such head belongs to Phil Ruthven, of IBIS Business Information and a noted commentator on financial matters. Ruthven has said publicly that most people will be up to \$300,000 better off by renting a home rather than owning one. His argument is based on the observation that historically the investment performance of homes has lagged behind that of the other major asset classes, most notably Australian shares and international shares.

There is some concern as to whether this is right. It appeared to be right, up to the end of 2000. But since then local and international share markets have been in a spin whereas residential property, at least in Sydney and Melbourne, has boomed, with 2001 seeing average gains of about 30% in some parts of town. By mid-2004 the best performing major asset class over the last twenty years in Australia has been residential property.

But who knows how long this will last for. Markets are fickle things and perhaps home prices are about to dive and share prices are about to soar. Perhaps the traditional pre-2000 relativities are about to reassert themselves. Perhaps Australian shares and international shares will be better performers over the next ten years.

This may happen. But if it does we do not think that this change the basic wisdom in an investor owning his or her own home. Buy it and pay it off as soon as possible to minimize the effect of non-deductible debt, and then borrow in a tax-deductible format to acquire other investments. These should emphasize the investor's own practice but also consider the other major asset classes as appropriate and in line with their own risk return profiles and financial profile.

One great advantage of the family home, and the family mortgage, is that it forces Investors to save. Debt repayment is a form of saving. Every month at least some principal is paid back to the bank. We prefer to see it paid back as fast as possible, since debt on a family home is not tax deductible and is therefore very expensive. But even a small amount of principal repayment is better than none. Many respected commentators have wondered whether the average person would save anything at all if they did not have a home loan. The answer is that they probably would not.

Another advantage of the family home is that the increase in its value is tax-free. Family homes are not subject to capital gains tax ("CGT"). This means that provided certain conditions are met any profit on the sale of the family home will be outside the capital gains tax rules.

Family homes provide a nest for the family. The psychological value of a home of your own, however humble, is huge. Home ownership is an irresistible force: have a chat with someone over age 25 who does not own their own home and ask them what they want the most. Nine times out of ten it will be their own home. And if they have kids it is ten times out of ten.

Who should own the home?

Often the worst aspect of falling into financial trouble is the loss of the family home. This is normally the aspect of financial trouble that causes the most angst and pain. It often destroys marriages.

If this sounds extreme, ask yourself how your spouse would feel if, for whatever reason, you lost the family home as a result of your business or investment activities. How would things go after that? It might not be the end of

things but it is unlikely that you would just laugh and shrug it off. It would probably rank after the death of a close relative as the worst thing that could happen to you, and the most stressful.

For Investors the threat of patient litigation is always present, at least to some extent. Professional indemnity insurance might yield some relief, but there is always a concern as to whether this adequately covers the situation. Recent reports about the state of some insurers have added to the angst. Many are now rightly wondering whether professional indemnity insurance premiums mean much at all.

For these reasons taking time to consider how the family home is owned and how it is financed is typically time spent well. You do not know when or how it might pay off.

Should your spouse own the family home?

If you are an investor, and your spouse is not. And your spouse is not otherwise exposed to a risk of being sued by a dissatisfied customer, then you should seriously consider having your spouse own 100% of the family home.

And probably all other valuable assets for that matter.

If you do not own something you cannot lose it. So if your spouse owns your home and you become involved in a medical negligence matter your home will almost certainly be safe and well beyond the reach of any of the courts.

In fact, ignoring medical indemnity insurance, not having any assets may be the surest way to make sure you do not get sued. It would be negligence on the part of the plaintiff's legal advisors to encourage legal action if it was clear that there was no prospect of you being able to pay. No more blood in the stone, so to speak.

The Family Law Act ignores nominal ownership between spouses. So it does not matter whose name the home is in should the marriage break down for any reason. Arranging things so that your spouse owns all the marriage assets will not prejudice an investor if the investor's marriage breaks down.

So if you are married and are considering buying a home also consider whose name it should be in. It is likely that it is not the investor's name.

But take care if you are in a relationship with someone and you are not married. Unmarried couples are not covered by the Family Law Act and arranging things so that your partners owns the home will probably greatly prejudice the investor if the relationship breaks down.

What if you are not married or if your spouse has a risky occupation?

In 1987 the Full Federal Court considered the case of a surgeon who had a specialist practice based in a Victorian bayside suburb and:

- (i) on the advice of a solicitor brother-in-law and a real estate agent father-in-law, (he married well) purchased a family residence in the name of his and his wife's family trust;
- (ii) the family trust then rented the family residence back to the surgeon and his wife on normal terms and conditions including a market value rent;

- (iii) the family trust then returned the rental income as assessable income in its annual income tax return and claimed all of the costs incurred in respect of the family residence as tax deductible losses and outgoings (these outgoings including interest, rates, repairs, depreciation and garden maintenance); and
- (iv) a net loss of about \$12,000 was incurred and this was in effect claimed as a tax deduction against the other income earned by the trust (this income was mainly comprised of service fee income derived by providing services to the surgeon).

For tax purposes this meant the surgeon ended up paying more than \$6,000 a year less in income tax than if had he and his wife owned the family residence in their own names. Remember this started in 1978, when a dollar was worth a lot more than it is in 1995.

The ATO challenged the arrangement and the matter ended up in court. Ultimately the Full Federal Court found that, although the relationship was in a sense familial and produced a number of benefits for the doctor's family, there was nevertheless a very strong commercial basis and flavor to it. Therefore, and on balance, the arrangement was effective for taxation purposes and did not fall foul of any special anti-tax avoidance rules contained in the Income Tax Assessment Act.

The rental income derived by the trustee of the family trust and paid to it by the doctor was assessable income under ordinary concepts of income. As a result, a deduction was able to be claimed by the trustee of the family trust for the various losses and outgoings incurred in earning that income, including interest on the loan used to buy the family residence, rates, repairs, garden maintenance and similar types of losses and outgoings.

Why did the Full Federal Court find this way?

First, there was evidence that the arrangement was strongly motivated by a desire to put the family residence beyond the reach of future creditors of the investor, (including the Federal Government, in the event that Probate Duties were to be reintroduced). This had been the advice of the solicitor brother-in-law and the real estate agent father-in-law and the surgeon had genuinely acted on that advice.

Second, the Court found that reducing the amount of income tax paid on the family trust's income was to some extent at least a motivating factor, and that familial thoughts were well in mind when the arrangement was put in place by the surgeon. However, on balance the arrangement was motivated mainly by commercial considerations and was quite explicable to ordinary business and investment practices.

Accordingly, the Court found that the arrangement was effective for taxation purposes. This was so even though one of its goals was to reduce an income tax bill by claiming a tax deduction for the (net) costs connected to owning the family home.

There is a lesson in this for every investor. If you are not married or if a spouse has a risky occupation, then a family trust may be the right spot for the family home. Once it is there it is beyond the reach of future creditors or potential litigants, (except where the investor, through the trustee, grants a security or charge over the assets owned by the trust).

From a taxation point of view, not only does this mean that you can buy more family home for your (after tax) dollar and you can therefore typically benefit from higher capital gains as residential property values increase over time, it also means that the family home is in a safe haven and is protected from most creditors should something go wrong in the future.

The downside to owning a home through a family trust is that the CGT principal residence exemption only applies to natural persons and does not apply to assets owned by trusts. This will only be an issue where the home is located in an area that is expected to have significant capital gains.

Family trusts, family homes and the Family Law Act

Trust based structures and arrangements are generally ignored for the purposes of the Family Law Act. The Federal Court, which oversees the Family Law Act, has sweeping powers to ignore any legal structures or arrangements put in place to defeat the purpose and intention of the Family Law Act. The Federal Court habitually uses these powers.

Transferring the family home to a family trust controlled by one party will almost certainly have no effect for family law purposes should a dispute arise between the parties. The Federal Court will simply ignore it.

Family trusts, family homes and capital gains tax

One disadvantage of owning a family home through a family trust is that trusts do not get the benefit of the principal residence exemption for capital gains tax purposes. Normally a family home is subject to this exemption so that the disposal of the family home does not give rise to capital gains tax computation. This is often quoted as being a problem and a reason for not owning a family home in a family trust. On closer consideration this may not be a problem in some cases because:

- (i) capital gains tax is only paid on half the capital gain if the home is actually sold (assuming it is held for more than a year). There is a strong argument that homes should be owned for a minimum of at least ten years, and should not be sold even if the investor wants to up-grade, but instead should be retained and rented out as an investment property;
- (ii) family trusts are generally tax efficient vehicles for owning appreciating assets and for deriving a capital gain on their sale, as any beneficiaries who have little or no other taxable income can be the object of a distribution of capital gain and pay little or no income tax on that capital gain distribution; and
- (iii) even if some capital gains tax is eventually paid in respect of a capital gain derived by the trust on the sale of the family residence, being beyond the reach of potential plaintiff litigants is a small price to pay for security of mind and for the very significant income tax benefits enjoyed in the earlier years.

What if I already own a home in my name?

If you already own your home in your name, it may be expensive to transfer it to a trust as stamp duty will be payable (although this may still be the recommended course of action). But if you are married and you co-own

your family home you could consider transferring your interest in it to your spouse/partner (presuming he or she is not exposed to a risk of litigation or to business or investment risks).

You should get legal advice before you transfer your home to a non-married partner. Spousal transfers are subject to stamp duty in all states except Victoria.

Spousal transfers are generally very cheap to complete from the point of view of solicitors' fees. This is because the normal checks on a transfer of land do not have to be completed (we presume your spouse won't sue you if something goes wrong with the transfer!). Where a bank has a mortgage it will have to adjust its security to allow the transfer to go through.

If you have just bought a family home and do not wish to sell it, you could instead consider transferring your interest in it to your spouse now and file away the idea of a family home in a family trust for reference if you decide to move to something more suitable to your future needs.

When should you sell your home?

There is really no answer to this question. However, as a general observation we believe too many investors are too ready to sell their homes, particularly when considering upgrading to a new home.

More than once we have seen an investor quickly put his or her home on the market for sale the day after they sign up for a new home (and, amazingly, they have often taken the advice of the agent who sold them the new home. Strangely, he thinks it is a great time to sell, even though he has just sold to them.) More than once we have seen the investor regret that decision within 12 months, as property values continue to return their long term average of more than 10% pa.

Investors are well advised to at least consider never selling their homes, even when buying new ones. Just rent them out through a reputable agent and let time do the rest. Those Investors who have done this have almost always benefited significantly after a few years have passed, even though the first few months may be a bit tight.

What if the investor lives where homes are not expected to appreciate in value?

People who live in capital cities tend to think that home prices always go up.

But this is not always so. In some places prices do not go up much at all. For this reason we routinely recommend that country Investors own at least one residential property in either Melbourne or Sydney. The historically poor performance of rural residential property and the incredible increases in Melbourne and Sydney prices mean this is a must, for both investment and lifestyle reasons. It's a standing recommendation to all country Investors.

To explain why, it is simplest to recount the experience of one rural investor who bought a home in North Fitzroy in the early 80s using 100% borrowed funds. The property was rented to arms length tenants for about ten years under a classic negative gearing strategy. The tenant and the ATO basically paid for the property, while its market value rose and rose and rose. The investor chose to pay the investment loan off as quickly as possible, which is always the way to go with any investment or business loan.

By the early nineties the home's value had doubled and the original debt was (virtually) gone. The eldest of the three children came to study in Melbourne and moved into the house. It became a student house, with rooms rented on a monthly basis and a kitty for handling common costs. The child pocketed the money from the other students and used this for her own living costs: this was in line with an ATO ruling that says board is an offset to a private and hence non-deductible cost, and is not assessable income.

The parents could not claim tax deductions for the property, since it was no longer producing rent. But this did not matter as the interest cost was negligible and not worth worrying about. Interest rates were dropping too.

The child was the object of trust distributions from the parents' family trust, since she was over age 18 and did not have any other assessable income (the board being in effect tax-free under the ATO ruling).

Over the next few years the other two children arrived and took up rooms. This meant the board from the other students dropped off, but this was more than offset by the saving in living costs and convenience achieved by the family having a Melbourne base. It also meant the children could live together and that the parents had a place to stay when they come down for a weekend. The north Fitzroy house really became the family's Melbourne home. And three children over age 18 without any other assessable income meant the Investor's family trust became particularly effective during these years.

The children are now young adults in their mid to late twenties. They all still live in the North Fitzroy home and their parents visit every few weeks. Each of the children has bought their own home elsewhere in Melbourne, and is letting it out, so a tenant and the ATO is paying it off for them too.

The North Fitzroy purchase has stood test of time. Not only has it stacked up as an investment on its own, it has also had definite lifestyle advantages. The children have been able to stay together in a secure and pleasant house, and mum and dad have visited whenever they wanted to. This has given the children a real head start in buying their own homes years ahead of schedule, and therefore thousands of dollars cheaper.

It also means that if the parents decide to retire to Melbourne they have a ready-made home (sans kids I hope!) that was bought at 1980 prices, not 2002 prices.

Too many country Investors discover that for all the economic advantages of practicing in the country, the downside of being outside of the major residential property markets can be great after a few years. This can make a return to city practice, particular Sydney and Melbourne, a very expensive option and one that for some is becoming too costly.

Homes for children

The Federal Government provides a grant for first homebuyers.

Investors with children over the age of 18 should seriously consider encouraging their children to use this grant to buy their first home. Coupled with a guarantee from mum and dad, the grant can allow young people to enter the

property market much earlier than otherwise meaning they can buy properties at 2004 prices rather than, say, 2005 prices.

An example may help explain. In the early 80's when still a student I was amazed when a friend told me he had just bought a four bedroom home in Northcote (an inner northern Melbourne suburb, reasonably close to Melbourne University), even though he has was still a full time student and had never worked (except for the usual round of part time and vacation jobs). He was from Ballarat (ie rural Victoria), and his father had "encouraged" him to apply for the first homebuyers' grant and use it as a deposit on the house. He lived in one room and the other three rooms were let to other students, in the classic student house model. The cash from the other three rooms more than covered the loan repayments and the father's guarantee meant there was no problem getting the loan.

The property was sold last year, un-renovated, for about \$450,000, tax free, city views included. On one view the Federal Government gave my friend \$450,000. Not a bad result from an initial investment of nil. (I confess to not being impressed by this "Rich Dad Poor Dad" stuff. I just wish my dad was his dad! What a great set of genes!)

Seriously, this is a strategy to consider for adult children, particularly those in the age range 18 to about 25, who have probably not yet entered the property market, but wish to do so. It allows them to enter the property market perhaps five years or more before they otherwise could, which probably means a serious and permanent headstart in the wealth accumulation stakes. It also means they can do this off their own bats, adding to their sense of dignity and achievement (and meaning they are less likely to cost you money in the future!).

The cash from the room rentals is considered by the ATO to be an offset to domestic costs, rather than assessable income, and hence is tax-free. There is an ATO ruling to this effect. Overall it is a very good strategy, and one that should particularly appeal to country Investors where mum and dad often seriously subsidize the children's living costs: this was my friend's situation back in the early 80's.

The only real downside is the risk that the property may fall in value and mum and dad become exposed under the guarantee. But this is a manageable risk and one most can live with. This risk is there any way, and the grant in effect mitigates some of this risk.

It's never too early...

A recent meeting with an investor highlighted the effect of time on residential property investments, and the power of gearing to increase returns many times over.

The investor finished her medical training in the early 80's. She was not earning much in the early days and took on an extra session a week, every Thursday night, in an outer suburban practice. Her friends thought her a bit excessive, and her parents thought her a workaholic. None of them could understand her. University was grueling, so why not kick up your heels a little before the next phase of your life starts?

The pay was good and she easily saved an extra \$100 a week. It was left intact in a separate bank account that she never touched.

Three years later she and her new fiancé were looking to buy their first home. They checked their finances and found they had none, except for the \$100 a week, which by now had grown into \$15,000. This was just enough for a deposit on a nice town house in an unfashionable beachside suburb. The loan was scary: \$100,000, and even on two incomes it seemed they would be working forever. So all of her salary was paid on to the loan. They had to beat it as soon as they could.

Time ran and housing prices rose. So did her income. Soon the \$100,000 debt was almost gone and the unit almost owned. But circumstances changed (as they always do) and something bigger was needed. "Sell the town house", the parents and friends all said, "and buy yourself something bigger. Get a new car too." But the investor had other ideas. Instead she kept the town house and plunged head first into another bucket of debt, borrowing \$300,000 to buy a new home just around the corner, with a big yard for the kids.

She let the town house and applied all the rent to paying off the loan. And she kept paying all her salary on to the loan as well. Melbourne housing prices continued to rise and the beachside areas suddenly became more fashionable. The debt equity mix was looking pretty good, so they borrowed again and bought another property.

The recession came and went, and interest rates increased then fell. It was not all plain sailing but the investor never really doubted that her strategy would work: borrow against the security of the existing properties, pay all rent back to the bank, pay the second salary to the bank as well, and let time do its work on the value of the properties.

The investor and her husband now have a property portfolio that's worth more than \$3,000,000. Each house is well tenanted and has excellent future prospects. Cash flow is good. There is no financial stress.

But the big pay off came just before Christmas. Unexpectedly, her husband was retrenched. Prospects for retrenched bank managers are not excellent. But in this case rather than being a financial catastrophe, retrenchment was (almost) welcomed. He is now spending more time on their properties. Has spruced a few of them up and has identified a couple of potential good buys. Sometimes you have to stop working to start making money.

The investor's story is, sadly, unusual. It's also simple and straightforward. All she did was work hard, forgo some current consumption, borrow money, buy quality assets and let time do the rest. And it all started with a small part-time job twenty years ago.

And now, at age 59, the investor is financially secure for the rest of her life. And so are her kids and grand kids. Buying her first property at age 40 was the best move she ever made.

How does residential property rank in the investment stakes?

A report released by ASX in early June 2004 shows that up to 1 January 2004 residential property is the highest performing asset class in Australia over each of the last ten years and the last 20 years, achieving an annual compound rate of return of about 13% and 14.5% respectively in each of those periods. Since 1 January 2004

residential property has slipped back a bit, and international shares and Australian shares have moved forward a bit, but not so much as to overtake the long term dominance of residential property.

But whether it stays there or not our view is that an investor should own one or two residential properties other than the family home purely for their intrinsic investment merit. Investors who borrowed to buy residential properties one year, five years, ten years or twenty years ago have by now done very well.

We believe investors should be overweight in residential property.

Investing in residential property

Property is a tangible asset, bricks and mortar, something you can see and touch. It exists. It is there. This is a big reason for its popularity. The residential property market is more stable than the share market. Investors are less likely to panic and rush to sell based on short term considerations.

The investor has more control over property than shares. The investor can add value to by renovating or rebuilding. Residential property rents usually increase in line with inflation.

There is steady demand for good rental properties in most areas. If the landlord is prepared to meet the market in terms of rent then he or she will almost always find a tenant, and the Sunday papers horror stories are not that common in the real world: most tenants take reasonable care of the property and some take great care, treating it as if it was their own.

Some banks lend all or even more of the purchase price, which means capital is not a barrier to entry and almost guarantees a steady supply of potential purchasers when you come to sell.

On the down side, residential property is illiquid, which means it cannot be easily and quickly converted to cash. You cannot sell the laundry. A house or unit may be slow to sell in a sluggish market. But normally an owner can borrow against the property and this removes some of the liquidity risk.

The entry price tends to be high. The median price for both Melbourne and Sydney homes is more than \$500,000, even after allowing for the dip in values in the first 6 months of 2011.

There are many costs connected to buying and holding residential property. Stamp duty, solicitors' costs and bank fees all take their toll: allow 7% of the purchase price. And often the already low rental yields are all but eaten up by costs such as rates and repairs, even before interest is considered. Which highlights that residential property is a capital gains play: people buy residential properties expecting them to go up in value. And the Australian tax system favors capital gains over other forms of income, not taxing unrealized gains and only taxing half of that gain when it is realized (assuming the property is held for more than 12 months).

Evaluating an investment property

Its not just location, location and location, its also timing, timing, timing.

Consider proximity to facilities such as schools, shops, public transport and work places. These can all be important for potential tenants as well as potential purchasers.

Never forget quality. This is crucial. The nature of the materials and the quality of the workmanship both make a big difference to the finished product, and its re-sale value years down the track.

The building must be appropriate to the market. For example, one bedroom trendy apartments may not work in a new family orientated growth area, and a four bedroom family home may not work that well in the middle of the café scene.

But the basic question is this: can you see the property increasing in value? Remember residential rental yields are very low and the only way you will make a dollar is by the property's value increasing.

Have a look at www.jpp.com.au, the website of James Property Advocates, for detailed information on what you should look for in a residential property investment.

A word of warning on apartment developments

The last few years have seen a trend to inner-city apartment living. All we can say is that there are apartments and apartments, and great care should be taken if you intend to go down this road. Problems abound. These range from the quality of the workmanship, over-supply issues, body corporate management issues, noise and privacy issues and views being damaged as new projects come on line.

In some cases commissions of more than 10% are being paid to the selling agents, which sadly includes many accounting and financial planning firms.

Officers from the National Australia Bank recently told us that they would not lend more than 70% of their assessment of market value (which is usually less than the amount paid) and certain developments were off the lending list altogether due to serious concerns with the quality of the underlying work.

Think seriously before buying an apartment. It is a lot safer to buy something that comes with its own piece of land.

ATO eyes landlords' claims

The ATO will closely scrutinize landlords' claims for rental property deductions during the 2004/5 income tax year.

Pilot studies have discovered serious discrepancies in about 85% of claims. The discrepancies include claiming deductions for:

- (i) initial repairs, when they are really capital in nature;
- (ii) improvements, such as bathroom and kitchen renovations, when they are really capital nature;
- (iii) interest that is not related to the rental property;
- (iv) say, 11/12s of the cost of a rental property in a holiday area that is not genuinely available for rent for eleven months of the year;
- (v) the full cost of travel to interstate locations and not apportioning some of the costs to private purposes.

Property owners who sell investment properties without declaring a capital gain will be subject to particular scrutiny: it is pretty hard to have not made some profit as a landlord in the last 20 years. Depreciation is also high on the agenda. Residential property owners are well advised to engage a quantity surveyor to prepare the property's depreciation schedule. It is well worth the cost to make sure the deduction survives an ATO audit.

The ATO expects to raise several billion dollars of extra tax from this project.

Capital gains tax on the family home?

The CGT principle residence exemption has long been a cornerstone of the Australian taxation

system. There is no basis in public finance theory for this exemption: a gain on the value of the family home is no more or less an increase in “betteroffness”, ie income, than a gain on a rental property. Why should the owner of the rental property pay more tax than the owner of the principal residence in similar circumstances?

The answer is, of course, connected to politics. And hence the family home is sacrosanct.

Or is it? The NSW State Government’s recent stamp duty changes are in effect a capital gains tax on the family home. And the possibility of a more formal and widespread CGT in the family home was raised at the national summit on housing affordability when. Judy Yates, Associate Professor of Economics at the University of Sydney, said that nearly \$21 billion in tax revenue was foregone every year due to the principal residence exemption. It’s hard to see a change under a Liberal government. But would a Labor Government see things differently? Would CGT on luxury homes fit in its agenda?

Of course it is already possible for gains on the sale of a home to face income tax. Consider a person who buys a block of land, builds a home, lives in it briefly for a few months and then sells it at a profit, which is what was always intended. It is quite possible that this gain has to be included in assessable income under current law, as part of the taxpayer’s ordinary income, and without the benefit of the 50% CGT discount factor.

Are you thinking of buying residential property? A note for July 2004

Interest rates have risen, auction clearance rates have fallen. The median price of homes in Melbourne dropped in the March 2004 quarter for the first time in three years. Prices in the luxury market are particularly depressed. Real estate agents are valiantly talking things up and no one is going to the hot house buyers’ seminars any more.

Now could be a good time to buy.

Residential property is one of the top performing asset classes over the last ten, twenty and even thirty years. After businesses, it is the main driver of wealth in Australia. Residential property is a funny asset class. It does not behave the way other asset classes behave. It’s not driven by economics. It’s driven by emotions: lifestyle aspirations, social consciousness, perceive social standing, success, greed, fear and a myriad of other emotions impact the buy sell decision. An increase in interest rates creates fear and a more than proportionate response, skewing the dynamics towards the buyer. And there is no objective market price, as there is for say shares. The buy sell negotiations are personal and there is

plenty of room for psychology. People will sell good assets for bad reasons over the next few months.

Now could be a good time to buy.

It takes nerves of steel to buy when the market is down, fully aware that the market can go down further before it comes up again. Contrarian investment strategies take guts. But that's where the money can be made. Residential property is a very long term investment: you should be at least working on a ten year time horizon, if not twenty years. And well located properties in good condition will prove to be very good investments over that time frame. Who cares what happens in the first three months after you buy?

Think of your children: a key recommendation to our Investors is to have as many residential property investments as you have children. The idea is that the family is the relevant economic unit and it is hedging itself against runaway prices in the future. Much better to buy today at 2004 prices, and then have a tenant and the taxman pay it off for you, than it is to buy at 2014 prices, and watch your kids slave under a non-deductible mortgage.

There is a body of thought that places this as a much better head start than a private school education. Who knows? But it is food for thought.

Think of your tax bill. The property obviously has to stack up as an investment, with the key criteria being location and condition. But once that is ticked off the heavy tax benefits can make the investment sing. The maths of the matter are that most heavily geared residential properties break even on cash flow once the tax break is factored in. This means only modest increases in prices translate to large percentage returns on investments.

I stress buying residential property is a ten to twenty year proposition though. And be prepared for prices to go down before they go up again. Take your time and evaluate the proposal carefully before you commit. Get expert advice if you think it is needed. There is an abundance of good quality information at your local book store, and one good website we can recommend is James Buyers Advocates at www.jpp.com.au. This site contains heaps of useful information about buying residential property and if you are stuck for time and are unsure of your skills in this area, you can do worse than speak to Mal James about your options.

One tip: always buy residential property in your own name or your spouse's name and "and or nominee". This gives you 14 days as of right to insert a nominee, such as the trustee of a family trust, into the contract without setting off double stamp duty. The estate agents are familiar with the process here and will have the extra forms for you to sign as nominee easily at hand.



PART 3 COMMERCIAL PROPERTY

The roles of property in the financial planning process

In financial planning theory, property, in all its species, was traditionally regarded as a low volatility and hence a low risk asset, with an expected return, therefore, somewhere between the cash rate and the average return on equities.

The introduction of property into a portfolio was thought to reduce risk without having a significant effect on expected rates of return, particularly as past price patterns indicated that property prices and equity prices do not have a high positive price correlation. If equity prices were falling, there was a good chance that property prices were increasing, but there was no guarantee of this.

As often happens, in recent years at least this theory has not been supported by the facts.

In recent years property has emerged as the highest earning asset class. This, together with its low price volatility and general stability has made it a very popular, in fact probably the most popular asset class. Who knows if this will continue in the future?

Most investors own their own home, and therefore have an automatic exposure to residential property. Many have one, two or even more residential rental properties. Usually these have been very good investments. Commercial property is, however, very much a separate asset class and separate exposure to it is generally recommended. This recommendation stands on its own, and is soundly supported by the facts: it does not

depend on a risk reduction/diversification argument posited by the traditional theorists. Commercial property, in its various forms, has generally been a very good investment and will probably continue to be a very good investment.

Property and risk minimization

Property tends to have much less price volatility than other classes of investment. This means that property has the effect of stabilizing an investment portfolio and hence reducing the risk in it.

What is commercial property?

Commercial property can be defined as any property other than property used for residential purposes. Therefore it includes shopping centres and malls, strip retail stores, farms, tourism assets, offices, factories, some sporting facilities and medical and dental surgeries. By defining commercial property as “any property other than property used for residential purposes” we emphasize purpose over form, so the traditional Investors surgery in a converted residence is included as commercial property rather than as residential property, even though it may still have a potential function as a residential property.

“Commercial property” is therefore a broad term covering a wide range of property types. These types have quite different risk/return characteristics and will follow different trends and cycles, further compounded by geographic factors. For example, it is not unusual for rural land in South Australia to increase in price after a good grain cropping season at the same time that sugar cane plantations in Queensland are dropping in value.

Tourism assets, rural land sporting facilities are generally not owned by Investors, and the remainder of this discussion will exclude them and focus on the more familiar offices, factories and shops, ranging from small local facilities to the huge CBD and industrial zone complexes.

Returns from commercial property

Returns from commercial property comprise rents and capital gains (or losses).

Commercial property rents are generally high relative to residential property rents. An article in the Age newspaper on Tuesday 22 January 2003 noted that the national average yield (ie rent as a percentage of value) appeared to be about 7%, and was expected to fall during 2003. Falling yields mean rising values, since value is an inverse function of yield.

Capital gains tend to be less than for residential property. Exceptions can occur, as can losses, but generally the capital gain is determined largely by the inflation rate, since this tends to determine rent increases. If a property's annual rent increases by 3% then, all things being equal, one would expect its value to increase by 3% too. But things are rarely equal, and this will be reflected in the change on yield. As indicated above, value is an inverse function of yield, so falling yields mean higher values and rising yields mean lower values.

Yields are determined by a number of factors, some apply to the general economy, some apply to the property's location, some apply to the type of property and others apply to the particular property. The factors include:

1. General economic conditions. Favorable GDP forecasts normally mean that businesses will need space;
2. Local geographic/demographic conditions. For example, the new ring road in Melbourne has led to higher values in the surrounding suburbs, due to their increased accessibility, and the expansion of a shopping mall will lead to lower values in local retail strip shopping facilities; and
3. Matters relating to the property itself, including the length of the lease, the timing of rent reviews, whether the lease allows for automatic increases, and the financial strength of the tenant.

An example may help explain how commercial property is valued. Assume that a factory in a high demand area was bought in 2000 for \$2,000,000, on an annual rent of \$200,000, reflecting a 10% yield. Since then the rent has increased 9%, and is now about \$218,000. The local commercial real estate agents say that similar properties are now selling on yields of 8.5%.

The situation is as follows:

	2000	2003
Rent	\$200,000	\$218,000
Yield	<u>10%</u>	<u>8.5%</u>
Value	\$2,000,000	\$2,564,705
Percentage increase in market value		28%
Percentage increase connected to rent increase	9%	
Percentage increase connected to change in yield	21%	

The following paragraphs summarize the major types of indirect property ownership. In each case the value of the investors' interest in the property will by and large be determined by the above factors and relationships.

Why should clients invest directly in commercial property?

Investors should invest in commercial property because it is an asset class generates high returns with relatively low risk. This risk can be diversified down by investing in a mix of commercial properties, whether by owning multiple properties or by owning indirect property, through listed property trusts, certain managed funds and property syndicates.

Over the last 20 years commercial property returns have averaged more than 10% per annum, and in the last ten years it has been the second highest performing asset class, second only to residential property and well ahead of both international shares and Australian shares (source ASX June 2004). In the ten years to 1 January 2004 it averaged a bit above 10% per annum and in the twenty years to 1 January 2004 it averaged 12% per annum (with international shares also hitting 12% per annum over this period.)

If commercial property comes second to residential property, then why own any commercial property? Why not only own residential property?

One reason is that commercial property usually generates higher income yields than residential property. Rental yields of 7% or more are not unusual, and rental yields of 10% are encountered as well, whereas residential

property yields are normally closer to 3% (with occasional exceptions in less popular areas). And with commercial property the tenant pays the outgoings (rates, repairs etc), not the owner, so there are lower cash outgoings as well. Higher yields and lower outgoings mean cash flow positivity even with high levels of gearing. That is more cash comes in than goes out, even before the tax advantages are considered. Many geared commercial properties don't just cover the interest on the loan but they also cover the principal repayments as well.

This compares very well to residential property, where the cash flow effect is usually negative. One month after the investor settles the purchase of a residential investment property, cash flow is down compared to what it was before; whereas one month after the settlement of an industrial property, cash flow is up compared to what it was before.

Each purchase of a residential property reduces the Investor's ability to service the loan on the next residential property investment; whereas each purchase of an industrial property increases the Investor's ability to service the loan on the next industrial property investment. This of course ignores capital gains: historically residential property has achieved significantly higher capital gains than commercial property. Obviously investors buy residential property with medium and long term capital gains in mind: why else would you borrow at 7% to buy an asset earning 3% rent? The answer has to be an expected capital gain in five, ten and twenty year's time.

But expected capital gains down the track are pie in the sky if an investor cannot meet the loan repayments in the meanwhile. Another reason why investor should consider owning commercial property is diversification. Studies show that diversifying across asset classes reduces risk. It boils down to not putting all your eggs in one basket: if you have all your wealth in one asset class your fortunes are 100% determined by that asset class's performance. But diversification is a two edged sword: it reduces up-side risk as well as reducing down-sized risk. Warren Buffet has said something like "put all your eggs in one basket and then take really good care of that basket". It all depends on the individual Investor's risk tolerance profile, and most prefer some diversification.

Commercial property usually has much longer leases than the residential property. Lease terms of five years, with options for a further five or ten years at the end are unusual. This creates more security than residential property, where terms are usually for no more than a year. Most residential property tenants see themselves as renting short term, whereas a business in a well located retail strip, or a manufacturing plant with specific features, will want to secure their own goodwill by obtaining security of tenure. This means they want the certainty attached to a long term lease.

Diversification from residential property to commercial property makes particular sense when the cash flow positivity of commercial property is considered: this positivity creates a cash flow buffer that takes away some of the stress of residential property prices falling. Often we suggest Investors build up a portfolio of two or three residential properties, plus their own home, and then diversify into commercial property. Another residential property may have created too much strain on the practice's cash flow, whereas a commercial property instead adds to cash flow and alleviates some of the strain caused by the existing residential properties.

Why don't more Investors invest directly in commercial property?

There is a strange reluctance for investors to invest directly in commercial property, at least other than in the practice premises. And if the practice premises are a converted residential property it is apt to behave more like residential property than commercial property anyway.

A common reason for not holding commercial property seems to be a lack of information. Most text books barely touch the topic, dedicating a few paragraphs, at most, to the topic, and normally centering on the risks connected to it rather than its benefits. A recent review of the academic training requirements for financial planner's shows that direct ownership of commercial property is not covered at all, and neither is residential property. These are amazing omissions: the training processes for Australia's future investment advisors and financial planners omit the two best performing, most commonly owned and highest dollar value asset classes.

When asked if they would consider owning commercial property most Investors immediately observe how risky it is and how an owner can easily end up without a tenant. Maybe 5% of commercial property falls into this bracket. For example, experienced valuers have observed that the historical vacancy rate for commercial property in the Moorabin industrial belt, in Melbourne's southern suburbs, is less than 4%. This includes a lot of tin sheds that an astute investor would not think twice about. It is actually less than the average vacancy rate on residential property. Like residential property, it all depends on which property, and following the mantra "location, location, location" will not take you far wrong.

One valid reason for not owning commercial property relates to the high entry prices. Ten years ago it was not uncommon to see factories valued at \$500,000 generating rents of \$50,000 per year, or rental yields of 10% per year. These were great buys. Nowadays inflation and price increases, partly driven by a substitution effect out of residential property, mean \$2,000,000 is closer to the mark as an entry point for higher yielding properties, and the top yield is likely to be closer to 8% or may be 9%. Not every client can come up with the 30% equity needed to buy such a property, meaning \$600,000 of owners' equity plus \$1,400,000 of debt. \$600,000 is a pretty high barrier to entry, and bars most people, including most Investors, from entry.

Another valid reason for not owning commercial property relates to its lack of liquidity. Commercial property can be hard to sell. It's a supply and demand thing: there are fewer potential buyers than there are for other asset classes and there is no established "clearing house" as there is for the share market. It is not unusual for there to be a delay of as much as a year from the time the decision is made to put the property on the market, and the ultimate receipt of the purchaser's cheque.

The high entry prices may be overcome by co-ownership and the lack of liquidity can be overcome by arranging bank debt access facilities, like those routinely available on borrower's home.

Commercial property also attracts transaction costs such as stamp duty. Work on an average of about 5% for stamp duty, except for Queensland where the top rate is 3.75% (transition rules apply, with lower rates for lower value ranges). Land tax can also be an issue, especially where the land value is high relative to total value (although it is tax deductible, which means it not quite as bad as it may first seem).

An example

A client bought a factory in Moorabbin Victoria for \$2,000,000 including stamp duty and other transaction costs. It is leased at \$160,000 or 8% yield for the next five years. The tenant pays all outgoings including land tax (on a single holdings basis). The tenant is stable and has operated from the site for more than 20 years.

The bank lent the investor 70% of the total cost of the property and the client contributed a further \$600,000. The interest rate is 7.0% pa. The term of the loan is ten years.

The maths look like this:

Rent	\$160,000
Less interest (ie \$1,400,000 times 7%)	<u>\$98,000</u>
Net rents	\$92,000

The net rent of \$92,000 represents a return of about 15% on the investor's \$600,000. If an unrealized capital gain arises each year of, say, 3% (ie. about the inflation rate) then this generates a further 10% return, taking the total return on the Investor's investment to about 25% pa.

Of this 25% return, 10%, ie. the unrealized capital gain, is not taxed, and about 3% is sheltered from tax by large depreciation claims and similar items. This makes the investment very tax effective.

The investment is cash flow positive. This means it generates more cash than it costs to hold it. This excess cash is paid back to the bank, and the debt will be eliminated in about 8 years time. In fact the investment is so cash flow positive that it is also repaying all the principal due on the loan.

The big risk is that something will happen to the tenant, or that for some reason the tenant will not renew the lease at the end of the current lease. This means a big part of the due diligence is finding out about the tenant and forming a view of the "lettability" of the property if for any reason it became vacant. A valuer's report gave comfort here, indicating that historically the Moorabin area had experienced only a 4% vacancy rates, and the vacant properties tended to be the lower quality older properties. Local real estate agents confirmed this view.

Not all commercial properties behave this way. The more fashionable retail areas sell on much lower yields. Historically these have been as low as 5% to 7%, but recently have fallen as low as 3% to 4%, as investors flee the stock market and fail to realize that retail property is an entirely different beast. A substitution effect from a hot, if not over-heated, residential property market may also be at work here. It's hard to see how commercial properties bought at these yields will ever perform as investments. These buyers have paid too much.

There are many traps in the commercial property market. There is a risk that an attractive yield will cease when the current lease ends, and the proud owner will be left with an un-leasable, and hence worthless, property. A property is only as good as its tenant and the key to buying commercial real estate is the concept of "future maintainable rent", ie not the current rent, but the rent that could realistically be achieved if the property was placed on the market tomorrow. This is the rent you should do your sums on.

Negotiating the actual purchase of commercial real estate can also be a treacherous process. It is a good idea to engage someone else to do the evaluation and purchase negotiations for you. It is a tad presumptuous to think that a novice property investor can out-negotiate a seasoned full time real estate agent. Time and time again we have seen the asked for price fall significantly once a professional buyer gets involved.

Indirect investment in commercial property

Lack of knowledge, and perhaps confidence, the high entry price, low liquidity, and fear of losing a tenant often mean that direct investment in commercial property is in the too hard basket. This does not mean that Investors

cannot invest in commercial property: the market provides a variety of ways for Investors to overcome the difficulties of direct property investment, and these are generally described by the catch all term “indirect investment”.

Methods of investing indirectly in commercial property include:

- (i) managed property funds;
- (ii) listed property trusts;
- (iii) unlisted property trusts;
- (iv) co-ownership and property syndicates; and
- (v) property securities trusts including index funds.

Each of these is discussed in turn in the following paragraphs.

Managed property funds

A managed property fund is a large unit trust run by a manager and supervised by ASIC that invests in property. Mixed managed funds may also hold a large amount of commercial property. Investors can acquire fractional interests in the properties held by the trustee by acquiring units in the trust from the manager or some other person. Ownership will entitle the investor to a fractional share of the net rent, including any tax benefits, and a fractional share of any net capital gains or losses on the underlying properties.

Managed property funds are relatively liquid, although sometimes there are restrictions on the unitholders' rights to cash out in a falling market. Entry prices are as low as \$1,000, overcoming the problem of a high entry price for direct commercial property, and risk is diversified by the manager directly owning a variety of properties and often also holding other indirect property assets.

The main difficulties associated with managed funds are the high commissions and management fees. The fund managers claim these are justified by the superior investment performance. There is no evidence to show that there is superior investment performance, however the other advantages of managed property trusts does help justify these fees.

Listed property trusts

Listed property trusts (“LPTs”) are property trusts that are listed and traded on the stock exchange. The first LPTs started operations in the early 1970s. Total funds now exceed \$40 billion, with significant growth occurring in the last ten years.

Some commentators say that LPTs should be treated as an equity investment, on the grounds that technically they are a share investment and there is a strong positive price correlation with the broader equity market, which they estimate to be about 70%. Other commentators say that they are just another form of property investment and therefore should be included as a property investment when determining asset classes. Both groups of commentators are right.

Recent years has seen a significant increase in the size of the LPT market, backed by strong investment performance, in the face of a generally weak Australian share market, saw large growth in this sector. There are more than 50 LPTs listed on the Australian Stock Exchange with total assets of more than \$40 billion dollars and LPTs now comprise the fifth largest market sector on the Australian Stock Exchange.

Because it lists on the ASX, the LPT needs to provide information to the market as and when it becomes available. This introduces a level of accountability for the individuals managing the LPT that you just don't see in non-listed managed funds. This accountability allows the investor to be much more informed about the goings on in their fund, giving back some of the control that they would normally give up in employing a fund manager. It also encourages the fund manager to keep their management fees as lean as possible – in LPTs they are answerable to the share market, which is typically a more sophisticated investor than the people who invest in unlisted managed funds. The sharemarket will readily punish an LPT that it thinks is too expensive.

Shares prices tend to be quite volatile, with prices rising and falling by relatively small amounts often within the same day. The volatility of the share market can be due to one of two broad things: the performance of the underlying asset (usually a company) and the desire of the market to own that asset. This second form of volatility is often termed market sentiment and often it is just that – sentiment. LPTs tend to experience less of the first type of volatility, making movements in their price more vulnerable to sentiment. The ASX estimates up to 40% less volatility in LPTs than in the rest of the market.

But while the absence of regular changes in the underlying asset make LPTs less volatile than the rest of the share market, the effects of market sentiment make LPTs more volatile than typical property assets. This introduces some opportunities for the investor: they can seek to buy LPTs during a period of normal downward movements, reasonably confident that the downward movement will be corrected.

By normal downward movement we mean the movement in price created by market sentiment. Changes to the underlying nature of the asset being invested in (such as a commercial property become dated due to technological improvements) are 'abnormal' and should not be responded to without careful consideration.

What this all means is that an investor who is keeping a watching brief on LPTs should take note of downward movements in the unit price. Where the movement is happening without there being any significant change in the underlying assets of the LPT, the downward movement is probably due to market sentiment. This will often signify a good time to buy.

How are LPT unit prices determined?

LPT unit prices are determined by the same market forces that determine the price of any listed security. Theoretically the unit price is equal to the market value of the underlying properties less any debt, divided by the number of units on issue. This is known as "Net Asset Value ("NAV"). In practice market price rarely matches NAV and will be more or less than NAV depending on the market's assessment of the LPT's prospects. Relevant factors include:

1. the LPT's income yield, ie what is the percentage of net income plus capital gain to the property's current market value, relative to some benchmark such as current interest rates;

2. expected rental growth and capital growth, which largely goes to the quality of the underlying properties and the strength of the LPT's management team; and
3. general economic conditions.

Because LPTs are traded on the ASX they are more liquid than their unlisted trust counterparts. In practice virtually all LPT units can be bought or sold in real time through the usual broker channels and liquidity is therefore very high.

Most LPTs are taxed as "collective investment vehicles". This means they are not taxed on their net income provided all net income is passed on to the unitholders. Instead, unitholders are assessed on their share of the LPT's net income, adjusted for depreciation and building allowance deductions.

LPT Gearing

Many LPTs will borrow from banks and other financial institutions as a way of increasing funds under management and improving investor returns. The average level of gearing is about 30%, and this has risen in recent years due to low interest rates widening the gap between the cost of money and the expected return from investing that money. LPTs are not permitted to gear more than 60%, which is a relatively low level of gearing of the LPT holds high grade properties.

If an investor borrows to invest in an LPT with, say, 50% gearing then the total investment is very heavily geared. There is gearing on gearing. This is great if property prices rise, but disastrous if property prices fall.

How do you invest in LPTs?

Investors can invest in LPTs via their normal stockbroker, or via a prospectus for a new listing. Dividends reinvestment plans for existing LPT holdings are another way of expanding holdings: the dividend is still assessable income, but normally is acquired at a small discount to the market.

Unlisted property trusts

Unlisted property trusts ("UPTs") are similar to LPTs except, as their name suggests, they are not listed on the Australian Stock Exchange. Because they are not listed they are generally less liquid than LPTs. UPT units are bought and sold via the manager, ie a management company appointed by the unit holders to manage the UPT's affairs including the transfer, issue and redemption of its units and the maintenance of all unit holder records.

An unlisted property trust's unit price will be set by the manager and should be equal to the market value of its assets less any relevant debt divided by the number of units, less a manager's fee for handling the redemption or transfer of units.

Unlisted property trusts suffered set backs in the late eighties and early nineties when record high interest rates and dropping demand for property saw most UPTs suffer serious liquidity problems. Things got so bad that many UPT managers froze redemptions and some UPTs were shut down altogether, leaving most of their former unit holders seriously bruised.

Memories of these liquidity problems haunt the sector and most UPTs now have strategies in place to deal with a repeat of those circumstances. In many cases UPTs have evolved into hybrid securities where significant amounts are invested in LPT shares, as well as direct property. The LPT investments are underpinned by property but, since the shares are traded on the Australian stock exchange, are far more liquid, which in turn makes the UPT a more liquid investment.

Private property syndicates

The high entry price for commercial property means they are often bought by pooling the resources of more than one investor.

At the basic level, for example, four Investors may club together to buy a surgery costing, say, \$1,00,000. Each of the Investors put up, say, \$100,000 of their own money (possibly borrowed from their bank against the security of their home) and then borrow the remaining \$600,000 from a separate bank secured solely against the surgery and the three owners' personal guarantees.

The Investors then rent the surgery back to their practice entities. The net rents are then used to pay the interest and repay the principal. The repayment of principal and capital gains over time create value for the Investors.

An advantage of this arrangement is that each of the three owners has been able to access an investment that may have been beyond them individually. Risk has also been diversified, particularly if more than one property is bought using this method. As a practical matter for asset protection purposes the Investors will probably not own the surgery themselves, and will instead use a trust based structure or may be own their interest in the surgery through their spouses.

Further up the scale is the small property syndicate. Provided certain conditions are met a small number of investors may combine to buy one or more properties without having to satisfy the Corporations Act and the Financial Services Reform Act rules regarding licensing of responsible entities, prospectuses, product information statements and so on.

At the top end of the scale are the full-blown property syndicates businesses. These businesses must satisfy a host of onerous and expensive rules regarding the information they give investors and how they run the syndicates. These rules are designed to minimize the risk of fraud or other improper practices and are administered by the Australian Securities and Investments Commission.

The Age newspaper on Saturday 12 June 2004 stressed the attractiveness of small commercial property syndicates in the range \$5,000,000 to \$20,000,000, and noted that syndicates are now responsible for more than one third of the properties being purchased on the market.

A number of good operators regularly bring reasonable offers to the public. A few years ago income yields as high as 10% plus capital gains were not uncommon but these have become few and far between and 8% is now a far more likely outcome (although some will quote higher average rates "over the life of the syndicate").

The major players include the Austgrowth Group, Centro Properties, Teys McMahon; Landmark Corporation, Challenger International and Macquarie Bank. Information regarding these companies and others is easily obtained over the internet.

The normal approach is for the operator to source a likely acquisition, perhaps acquiring an option to buy it exercisable during a specified period, and to then arrange for a group of investors to buy the property. A deed or memorandum will specify the various rights and obligations of the investors. In most cases the deed or memorandum specifies that the syndicate will last for a fixed period of time and will be limited to holding the specified properties. Each month each unit holder receives a pro-rata share of the net rents received by the syndicate, and at the end of the period the property is sold and the receipts distributed between the unit holders.

Some syndicates operate for a fixed term and some stay open ended. Some syndicates buy just one property and others enable the operator to buy more suitable properties as they are identified. Liquidity is the big drawback. Investors usually have to wait until the end, although some operators create informal secondary markets where, for a fee, they match up prospective buyers with prospective sellers.

Property syndicates involving retail investors are subject to heavy regulation under the Corporations Act. This creates an extra cost that is in effect paid for by the investors.

Property security funds

A property security fund invests in a wide range of property type investments. For example, it may own units in a number of LPTs and UPTs, participate in a number of property syndicates and even own shares in companies connected to the property industry, such as Lend Lease and Westfield.

A PSF will function very much like an equities trust: the manager will constantly research opportunities in its area and, when those opportunities are expected to beat a pre-set benchmark, will invest an appropriate amount. The manager will usually select a wide range of investments to diversify returns and reduce risk and to ensure liquidity is appropriate.

From the point of view of an investor, PSFs:

- 1 create exposure to a variety of different properties and managers;
- 2 require only a small minimum outlay, typically about \$1,000;
- 3 have high liquidity: redemption is usually virtually immediate; and
- 4 have an efficient tax structure that allows the tax benefit of depreciation and building allowance write offs to pass through to the end investor.

Property security index funds

These funds apply the principles of indexing to the commercial property industry. This way they achieve an average rate of return and diversify risk by indirectly holding a very wide portfolio. This portfolio is designed to produce the same results as the market sector it is based on.

Our enthusiasm for indexing share investments extends to the commercial property section. Investors who are unable or unwilling to hold direct commercial property or specific indirect commercial property are well advised to consider property security index funds.

Issues connected to co-ownership of a commercial property

Many clients have questions concerning issues connected to co-ownership of a commercial property. To answer these questions we take the specific example of four GPs buying and developing a new surgery, but its content is generic and applies just as much to non-medical persons and non-medical properties.

Co-ownership of commercial properties is becoming more and more of an issue with clients. Investors are becoming more aware of this asset class and, aware of the high entry price, are often combining together to co-own property that may be beyond their reach as individuals. This is usually a good move but there are no guarantees and we recommend clients consider all proposals very thoroughly before proceeding with them.

Which structure?

The best structure is a company as a trustee of a unit trust or a hybrid trust, with the level of debt in the trust controlled so that the property will be cash flow positive and the trust will have a net income for income tax purposes rather than a tax loss. A diagram is attached showing this structure.

Why is this the best structure?

This is the best structure because:

- (i) it is income tax efficient. There are no problems with losses being locked up, and therefore not available to the owners, and there is no taxing point until the net income has flown through to the ultimate beneficiary, usually a low tax rate relative or possibly a company
- (ii) it is capital gains tax efficient: the 50% CGT discount on the sale of assets after 12 months applies, and this CGT exempt amount can be paid out to the unit holders without a further tax charge;
- (iii) it is easy and cheap to admit new owners and to exit old owners. This can be done either by a transfer of units from the old owner to the new owner or can be done by an issue of new units or a cancellation/redemption of old units. There is no stamp duty on these admissions and exits (subject to one exception) whereas if the owners held the property in their own names there would be a stamp duty charge, and a more cumbersome and costly transfer process, each time a new owner was admitted or an old owner exited. The exception arises where the so called land rich company rules (which also apply to trusts) apply, ie where the net value of the land in the trust is more than \$1,000,000 and there is more than a 50% cumulative change in ownership: separate legal advice should be sought if a proposed transaction could trigger this rule; and
- (iv) it is easy to administer. The trust has its own bank account and runs its own profit and loss statement and balance sheet. There is no mingling of funds, apart from the distribution of net income. The trust will register for GST if its rent income is more than \$50,000 a year, and it will have its own ABN and TFN. It will lodge its own income tax return each year, and the trustee company will lodge an ASIC return and pay an ASIC fee of \$200 per year.

But it is possible that another structure can be better suited to a particular project.

How much does a trustee company and a unit or a hybrid trust cost to set up and run each year?

It usually costs about \$1,800 to set up a company and a trust. If a hybrid trust is used there is also a separate stamp duty charge of \$200. The annual accounting costs depend on the time taken to prepare the accounts and the tax returns. These are largely determined by the number of transactions that occur. It's safe to assume that the accounting costs will be at least \$1,000 a year.

There is a \$200 annual ASIC fee.

How is the debt structured?

Most commercial properties are bought and held using debt.

There are a number of different ways to structure the debt, and each has advantages and disadvantages. Our usual preference is to have the unit holders contribute equity of 30% plus transaction costs, including stamp duty, which really comes out of their own resources or borrowings against other assets they hold, such as their home. This makes the total equity contribution about 37% of the purchase price.

This is contributed to the trust as capital, in return for an issue of units. So, if the total cost of the property is \$1,000,000, including stamp duty, and there are four unit holders, then each unit holder would contribute \$92,500 (ie \$1,000,000 times 37% divided by 4). This \$92,500 would be paid into the trust before settlement, and the trustee would use this capital receipt of \$370,000, plus the \$630,000 of borrowings, to settle the purchase of the property.

Technically the unit holders are issued with units at the time their money is paid in. But as a practical matter the paper work to record the issue of units would not be completed until the trust's first set of accounts and tax return is being prepared. This is because there are usually a few other transactions which impact unit holdings and it is simpler and cheaper to wait and see how the dust settles, and then document them all in one go, rather than have a series of paper chases during the year.

We have chosen equity of 30% (plus stamp duty) because the larger banks will normally lend 70% of the market value of a commercial property without any collateral security other than directors' guarantees. This means the four owners/unit holders can buy and hold the property together without having to give cross securities over each others home and other assets. Each of the four owners may borrow this equity of 30% (plus stamp duty) if they wish to. They just cannot borrow against the security of the new property. It is not unusual for an owner to borrow their share of the owners' equity, in this example, \$92,500.

Who should be the unit holder?

If the investors have family trusts, then the family trusts should be the unit holders. This is because they enable the trust's net income and net capital gains to be distributed on to the Investors' family members or other related

persons. Family trusts are discussed in detail a number of our memoranda, and you should contact us if you need copies of these documents.

If an investor does not have a family trust then a spouse can be considered, presuming the spouse faces a lower tax rate and is not in a risky profession or occupation. Or they could consider using a hybrid trust deed and distributing net income and net capital gains to family members or other related persons direct from the hybrid trust. Hybrid trusts are discussed in detail in a number of our memoranda and you should contact us if you need copies of these documents

Self-managed superannuation funds should not be unit holders.

What will the profit and loss look like?

By limiting the amount of debt in the trust one can maximize the prospects of having net income in the trust, and not a tax loss, for taxation purposes. This is important because a trust cannot distribute a loss, and losses in trusts can create problems elsewhere. It is simplest and safest to structure the debt so that the prospects of a loss are, if not eliminated, at least minimized.

This means the trust's profit and loss statement might look like this:

Income		
Rent		\$80,000
Less Costs		
Interest (\$630,000 times 7%)		\$44,000
Depreciation		\$10,000
Rates		\$ 2,000
Repairs		\$ 2,000
Other		<u>\$ 2,000</u>
		<u>\$60,000</u>
Net income		\$20,000

This will be distributed equally to each of the four unit holders, that is, they will be required to include \$5,000 as assessable in each of their tax returns. How this is taxed will depend on each unit holders' own tax profile.

How does the tax distribution differ from the cash distribution?

The potential cash distribution to each unit holder is \$7,500. This is because depreciation, which is a negative in the net income calculation, is a non-cash item and therefore does not reduce the amount of cash available for distribution. \$10,000 divided by four is \$2,500, which means potentially extra \$2,500 cash is available to each

unit holder. This extra \$2,500 is tax-free. Whether the actual cash distribution is \$7,500 per unit holder is another thing. The trust will presumably have to repay the \$630,000 borrowed. The actual cash distribution will be reduced by the amount of borrowings that are repaid each year.

The unit holders will have to show \$5,000 as income in their tax returns irrespective of whether they receive it. This is because this is what the tax law says. Sometimes unit holders get upset because they are paying tax on income that they have not received in cash. This can create cash flow problems but they have to remember that the value of their units will go up by an amount equal to the shortfall. So they are still in the same position overall.

Which bank?

It's not a bad idea to choose a bank which none of the investors has any other borrowings with. This way there is no risk of the Investors' private affairs being tangled up with the practice premises. This may seem excessively cautious, but we can remember the late 80's and early 90's and there were definitely problems like this: Dr Smith's own bank lent him money for his own investments and also lent money to the property trust, of which he owned one quarter. When property prices fell, and the 70% security was no longer there, the bank was able to pump up the interest rate on both the property and Dr Smith's other investments and businesses, and there was nothing he could do about it. His partners were all in the same boat.

If possible, use a different bank for your co-ownership exercises.

We are often asked "which bank is best?", and the answer is they are really all the same. You should choose the bank which offers the lowest interest rate. With commercial property lending the concept of service does not really apply. Once the loan is in place and the property is settled its just automatic pilot, and automatic repayments, for the term of the loan. So the answer to this question is "the one with the lowest interest rate."

What if someone wants to leave?

An investor wanting to leave the investment is not an unusual event. If there are four Investors in a group, and one leaves every five years, that means there is an average stay of 20 years. That's a pretty stable investment. This means that everyone needs to be up-front at the beginning about this issue and make sure everyone knows what will happen. The procedure for someone leaving should be set out in an agreement (see below) and should be something like:

- (i) transfers to related parties can be done any time without the consent of the other unit holders; but
- (ii) transfers to non-related parties can only be done if a procedure is followed, and this procedure will involve:
 - (a) offers to the other unit holders to sell to them at market value, in their proportions; and
 - (b) if any unit holders fail to take up the offer to buy, those units are then offered to the other unit holders in their proportions; and
 - (c) if after three months the offer is not accepted the units can be sold to other persons.

In practice this type of procedure tends to be superseded by negotiation and discussion between the parties.. The fact that the unit holders' agreement prescribes a set procedure does not mean that it has to be followed to the finest detail, if all the unit holders agree to this.

How are renovations dealt with?

It is not unusual for a commercial property to be renovated. This may be at the time the premises are bought or it may be much later.

The renovation issues are much the same as the ownership issues. However, if equity has been built up (ie borrowings re-paid and/or values have increased) the bank may be prepared to lend 100% of the renovation cost. But if this is not the case the unit holders may have to contribute a further amount to create additional equity to allow borrowings for the renovation to proceed. The unit holders may be able to persuade the bank that the renovation will add net value, ie increase value by more than the renovation cost. But we have found banks normally take a more conservative view and if anything discounts the value back.

The rent should be increased post-renovation to reflect the increased value. This will create cash flow for the trust that can be used to service the renovation debt.

What's hot in commercial property?

In July 2004 several sectors of the Australian commercial property market are running hot. And the retail sector is running the hottest of them all. Retail spending is at all time high and there is nothing to suggest that this is going to change in any way. The average weekly expenditure of Australian households in the 80 biggest malls is nearly \$30 and growing. It's not feasible for investors to own malls directly (at least as far as we know) so it's the retail trusts if you want to access this area. Trends are important: internet shopping has fizzled in the pod, the larger players are looking hard offshore, so hard that Westfield is now the largest player on the world stage, and the only real worry is a significant number of planning approvals for new centres: perhaps more than 20 around Australia, which must dilute the market to some degree.

Bulky goods is a particular growth story in the retail category. BIS Shrapnel's Bulk Goods Property 2003-2008 Report says this sector grew by 10% in 2003. Strong net immigration and a strong first home owners' property market means this is not going to change in the short term. Homemakers want all the mod cons and they want them now. So anything with the likes of Bunnings, Mitre 10, Harvey Norman, Megamart or Dick Smith makes a lot of sense.

The Canberra property market just keeps getting better and better. It's vacancy rate has fallen to less than 3%, forcing rents up. The Federal Government needs more office space each year, and this will not change for some time. The Adelaide property market also has prospects, having its own needs and being largely quarantined from international forces. Adelaide is off the radar of the bigger players, leaving good quality stock with attractive yields for smaller investors. But stick to occupied A grade stock. This is where the promise is: the empty B and C grade stock may well stay empty for ever.

Melbourne's suburban light industry zones show good promise, particularly where they are

close to arterial roads, have container access and three phase power and gantry cranes.

The proximity to desirable living areas means these will stay in demand for a long time yet. These units are idea for distribution centres as well as smaller head offices.

In Sydney the growth is centred around the city fringe and in the South, showing the highest rental returns in the state, although rent free incentive periods are increasing in the city fringe area.

Property or shares? And which ones?

We generally prefer our Investors to invest long term in the share market or the property market or both. Short term buying and selling just introduces a whole bunch of extra transaction and taxation costs, and to be done well it needs to be treated almost like a full time job. Without this sort of commitment it is really just gambling.

Between these two asset classes, the question “property or shares” is one that most intelligent investors ask. The answer depends very much on who you talk to. Those with vested interests in the share market tend to prefer shares. Those with vested interests in the property market tend to prefer property.

So, what do we say? What is our answer to the question “property or shares?”

We say: “invest in both shares and property”. Over time they tend to do as well as each other, with the added feature of often performing differently, perhaps even oppositely, at any point in time.

Broadly speaking, the property market tends to perform in shorter, larger, sporadic bursts while the share markets accumulates more incrementally (and with smaller steps backwards and forwards in the process). We all know the recent experience in the residential property market, where for the five years to the end of 2003 the median house price in Melbourne and Sydney rose by about 100%, and by much more in some suburbs. Over the same period, the All Ordinaries Index (AOI) of the Australian Stock Exchange rose by around 27%.

But before you decide that this means that the property market is the place to be, remember that most property pundits will tell you that between 1990 and 1997 there was little growth in the median house price in the capital cities. Just 20% over the period is about right – perhaps not even keeping track with inflation. Between 1990 and 1997 the AOI rose by 73%. Therefore, when you smooth out the cycles, between 1990 and 2003 the sharemarket rose by about 120% and the residential property market did about the same. Of course, there are other property markets, but our point is made: both markets have merit and Investors should invest in both if they are to maximize long term investment performance.

How to decide

The individual investor’s decision then as to which to invest in will be decided by the characteristics of each type of asset. Broadly speaking, the property market requires larger amounts to be invested. Shares can often be bought in small bundles of a few thousand dollars. Property needs to be purchased in larger bundles of hundreds of thousands of dollars.

This can be prohibitive, especially if the investor wants to diversify within their investment portfolio. This might mean that the investor would need more than one property to satisfy his or own investment criteria.

In addition, various sub-types of property investment require varying levels of management. For example, managing a residential investment property is relatively easy: just engage a reputable local real estate house to manage the property for you. Tenants know to go to estate agents to find a property, so they will find a tenant fairly easily. If they can't, you can just drop the asking rent by a small percentage. The agent will also collect the rent, pay certain expenses and arrange minor repairs for you. For this you will ordinarily be charged about 7% of the rent received for the property. Normally it is a pretty good deal.

Many clients know McMasters' are big fans of commercial property. A problem with commercial property is the high entry point. The higher rental yields, 9% and above really only kick in at about \$2,000,000. Ten years ago it was \$1,000,000, but a substitution effect from the residential market has increased demand in the lower price ranges and lowered average yields. For this reason it is not uncommon for smaller investors to club together to invest in commercial property as co-owners, and even in small informal property syndicates. Well chosen and well run commercial property can provide significant returns, the decision to go into it should only be made by an investor confident that they can earn a decent return that repays the extra work involved.

Indirect property

The term "indirect" essentially refers to the presence of an investment manager in some shape or form. Thus, indirect property investment is often made via a managed property fund. Normally, we advise against the use of managed funds – we like to see Investors retaining control over their investment funds, and are not convinced that the typical investment manager can justify their fees.

There is one potential exception to this general rule for us though. Listed property trusts. A LPT is a unit trust which is traded on the ASX. As the name implies, a LPT invests in property assets, and thus investors are able, via an LPT, to use the advantages of the stock market to invest in property.

Because it lists on the ASX, the LPT needs to provide a good deal of information to the market as and when it becomes available. This introduces a level of accountability for the individuals managing the LPT that you just don't see in non-listed managed funds. This accountability allows the investor to be much more informed about the goings on in their fund, giving back some of the control that they would normally give up in employing a fund manager. It also encourages the fund manager to keep their management fees as lean as possible – in LPTs they are answerable to the share market, which is typically a more sophisticated investor than the people who invest in unlisted managed funds. The sharemarket will readily punish an LPT that it thinks is too expensive.

Shares prices tend to be quite volatile, with prices rising and falling by relatively small amounts often within the same day. The volatility of the share market can be due to one of two broad things: the performance of the underlying asset (usually a company) and the desire of the market to own that asset¹. This second form of volatility is often termed market sentiment and often it is just that – sentiment. LPTs tend to experience less of the first type of volatility, making movements in their price more vulnerable to sentiment. The ASX estimates up to 40%

less volatility in LPTs than in the rest of the market.

But while the absence of regular changes in the underlying asset make LPTs less volatile than the rest of the share market, the effects of market sentiment make LPTs more volatile than typical property assets. This introduces some opportunities for the investor: they can seek to buy LPTs during a period of normal downward movements, reasonably confident that the downward movement will be corrected.

By normal downward movement we mean the movement in price created by market sentiment. Changes to the underlying nature of the asset being invested in (such as a commercial property become dated due to technological improvements) are 'abnormal' and should not be responded to without careful consideration.

What this all means is that an investor who is keeping a watching brief on LPTs should take note of downward movements in the unit price. Where the movement is happening without there being any significant change in the underlying assets of the LPT, the downward movement is probably due to market sentiment. This will often signify a good time to buy.

In April 2004, a merger was announced between two of Australia's most prominent LPTs (Westfield Trust and Westfield America Trust) and one of Australia's largest companies, Westfield Holdings. This created some specific volatility in the LPT sector which was almost entirely related to market sentiment. None of the assets changed in any marked way. The only thing that changed was how much people wanted to own them.

What questions should a INVESTOR ask before joining a property syndicate?

There is nothing better than a robust review of all the materials including compliance with the Corporations Act, and checking out the viability of the underlying property or properties. But more specifically, some good questions include:

- (i) what happens if the syndicate is oversubscribed? Is your money returned, in all or part, or is it held for another investment?
- (ii) what happens if the syndicate is undersubscribed? Does an underwriter or some other person make up the short fall? Or does the bank step in with a loan?
- (iii) is the syndicate limited to one property? Or will it acquire additional properties? If it will acquire additional properties, what sort of properties will they be and who decides whether they should be bought? How will they be paid for? Will syndicate members receive priority in any further capital raisings?
- (iii) will the syndicate borrow money, at the beginning or later on? If so, from whom will the money be borrowed, and who makes the decision as to how much is borrowed?
- (iv) How long is the lease? Are there any guarantors? Is the property able to be leased easily if for any reason the tenant fails and the lease payments are not made?
- (v) Is there an exit strategy for investors? Is there a buy back facility or a secondary market in the syndicate?
- (vi) What is the syndicate leader's track record in commercial property and other business and investment areas? Do you trust them?



PART 4 DEBT AND PROPERTY

Introduction

We have never seen a self-made millionaire become wealthy without using debt. We have also never seen a self-made bankrupt go broke without using debt. Debt is a two edged sword: it can create wealth or it can destroy wealth. Most investors use debt intelligently and enjoy the wealth it creates. Whether it be increasing equity in the family home or a rental property or a geared investment in shares, unit trusts or other securities, most investors have enjoyed an increase in their wealth and much of this has sprung from the judicious and sensible application of debt.

The high cost of living and high marginal tax rates make it hard to accumulate wealth from personal income alone. Superannuation, mandatory and voluntary, helps. But even double-digit contribution rates are insufficient to accumulate wealth, except over a very long time. Most people are not prepared to wait that long, ie until retirement, to enjoy the benefits of wealth.

Borrowing to acquire appreciating and income producing assets is the solution.

Tax deductible debt: the investor's friend

Debt is the investor's friend. Most investors who have borrowed money to acquire investment assets have ended up much better off as a result. This is because historically each of the major asset classes has produced returns

significantly greater than the cost of borrowing to acquire and hold them, ie the interest rate. Most investors who borrowed money over the last twenty years to buy good quality diversified assets have done very well. This is even before the tax benefits are factored into the equation.

In the long term, which we define as being twenty years or more, it is very probable that the rate of return on each of the major asset classes will exceed the interest rate.

The basic benefit of a geared investment, that is, that the return on investment is normally greater than the cost of investing, is enhanced by a number of features. These include:

- (i) most geared investments have some owner's equity in them. Therefore not only is the rate of return greater than the cost of funds, but that greater rate of return is earned on a larger capital base;
- (ii) most geared investments produce at least some unrealised capital gains. Unrealised gains are not taxed until they are realized. And when they are finally realized are only 50% taxed provided they are held for more than one year. Warren Buffet calls this tax deferral an interest free government loan, and he is pretty much right;
- (iii) tax benefits may exist if the assessable income (which does not include unrealised capital gains or half of any realized capital gains on assets held for more than a year) is less than the allowable deductions; and
- (iv) sometimes tax benefits can be enhanced by intelligent use of depreciation, repairs and pre-paid interest arrangements.

Investing in a diverse range of assets is a good idea when gearing. Diversification reduces risk. Do not have all your eggs in one basket. By investing in a number of different assets and a number of different asset classes one can reduce the risk of specific asset values falling, and, in particular, reduce the risk of them falling below the debt, so that owner's equity is wiped out. How much, or how little, diversification there is depends on the Investor's own expectations of performance and attitude to risk.

Remember that diversification also reduces up-side risk, ie the probability of the asset increasing in value by more than the average. It is all a question of judgment and expectations.

Experienced financial planners and investment advisors can also work through these issues to help you better understand your risk return tolerances and preferences. We suggest you do this.

Despite the need for these cautions and comments, it is clear that those Investors who borrowed money to gear sound investments over the last ten years or more have by now mostly done very well. Many wish they had geared more investments. Those investors who lost money on geared investments tended to sell too quickly. They did not fully appreciate that property and shares investments are long term, (ie at least ten years,) and a year or two of poor performance does not mean that they should be sold. Other investors just made poor investment decisions. Thankfully, these tend to be in the minority, and it is rare for all of a Investor's investments to perform poorly. Normally it is just one or two. Diversification is the key here, reducing the prospects of being left with just one or two poor performing assets.

It is very hard for anyone to accumulate significant wealth without taking on at least some debt for some time. The amount of debt taken is a matter of personal choice, and reflects an underlying view of, and attitude towards, risk. But as a general proposition, over the last ten years, investors who borrowed to acquire sound investments

did a lot better than those who did not. This general proposition applies to young investors in their early years of practice, say up to age 35, middle aged investors in their “peak-cost years”, say between age 35 and age 55, and to older investors who were starting to wind back their professional commitments.

Looking to the future, then, it is likely, therefore, that investors who take on debt to acquire more investments will accumulate more wealth than those who do not. And those that take on more debt than most will accumulate more wealth than most. Sadly there are no guarantees that this will be the case, and each person has to make their own decisions. What is good for one person may not be good for another. But as a general proposition, investors who borrow to invest will probably do quite well.

Borrowing to Invest

If you need more encouragement, or perhaps convincing, that Investors should be borrowing more, shout yourself a copy of Noel Whittaker and Paul Resnik’s book “Borrowing to invest: the fast way to wealth: a user’s guide for borrowers”. No one could ever accuse either of the two authors of lacking conservatism, and they each have elder statesman standing in the financial advising community.

Published by Simon and Schuster in July 2002, paragraph 1 of chapter 1 reads:

“Are you prepared to use other people’s money to build a better life for yourself. Have you stopped to think about what will happen if you don’t? Chances are you would never own your own home. Every mortgage is, after all, built on someone else’s money. And, unless you are heir to a fortune, it’s just as likely that your years in retirement will be years of watching the dollars.”

This paragraph, and the title of the book “Borrowing to invest: the fast way to wealth”, gives you a good idea of their basic thesis. But we recommend you read the rest of the book to find out what else they have to say.

In her book “Personal Finance for Dummies” well known and well regarded financial journalist Barbara Drury explores similar thoughts when she writes:

“Many people still fee uncomfortable about borrowing money to invest, a practice referred to as gearing. Yet the same people cheerfully borrow to the gills to buy their own home because they understand that the only way to own such an expensive asset is to use other people’s money.

Borrowing to buy growth assets, such as shares or property, and using your own cash or equity in your home as a down payment, helps you increase your returns. You make a profit as long as the investment returns (income plus capital gains) are greater than your interest payments. Say you have \$10,000 and borrow another \$10,000 at 8% interest to buy shares with a dividend yield of 4%. The dividends of \$400 cover your interest payments but you stand to make double the profit when you sell the shares because you bought twice as many shares as you could have done with your own money.

Gearing can substantially increase long-term investment returns, but it magnifies the potential risks as well as the potential rewards. If you choose to gear into shares or investment property, invest in a diversified portfolio of high quality assets that have the best chance of producing solid capital growth over the long term. Never gear to invest in speculative investments, or to avoid tax.”

An investment is negatively geared if its income is less than the interest incurred on any amounts borrowed to acquire it. An investment is neutrally geared if the income derived from it is (roughly) equal to the interest incurred on any amounts borrowed to acquire it. And, similarly, an investment is positively geared if the income derived from it is greater than the interest incurred on any amounts borrowed to acquire it.

The investment may be property, whether residential, retail, commercial or industrial, shares or similar securities in listed or unlisted companies, or managed funds or indexed funds. Each of the major asset classes is suited to geared investment strategies.

The word “geared” is chosen because of its engineering connotations: the idea is that with correct gearing or leverage a result can be obtained that is better than that obtained without gearing. This is usually achieved by expanding the practitioner’s asset base and allowing time to run, and capital gains to accrue, which more than compensate for the deficiency in cash flow caused by the interest being greater than the income.

This technique usually works. But there is no guarantee that it will. It all depends on the quality of the underlying investment. And a word of caution is appropriate: the gearing works in reverse too. The effect of any drop in value will be greater too, and it is possible that the practitioner’s equity in an investment can be wiped out as a result of this phenomena.

An economically rational investor will be prepared to negatively gear an investment if the expected after tax return, including capital gains, is greater than the expected after tax cost of holding the investment. The after tax return will usually be made up of two things; one, the income from the investment (ie rents, dividends, or distributions, depending on the investment, and two, the increase in value, or capital gain, over time. The income can usually be predicted with reasonable certainty. The capital gain is the wild card. No one knows the future, so the best one can do is expect a capital gain. This is where investing becomes an art rather than a science; expectations will be the critical issue.

The Australian Master Financial Planning Guide provides a useful example showing how gearing engineers a greater return for the investor:

“An investor has several options, based on an initial investment amount of \$40,000.

- investing \$40,000 as an ungeared investment;
- investing \$80,000 as a geared investment with borrowings of \$40,000; and
- investing \$120,000 as a geared investment with borrowings of \$80,000.

Assumptions:

- income from the investment is 4%
- capital growth is 5%
- interest on borrowings is 7%

	Ungeared	Geared	Negatively Geared
Equity invested	\$40,000	\$40,000	\$40,000
Borrowed	Nil	\$40,000	\$80,000

Total invested	\$40,000	\$80,000	\$120,000
Income received	\$1,600	\$3,200	\$4,800
Less interest paid	Nil	\$2,800	\$5,600
Net cash flow	\$1,600	\$400	\$800
Capital growth	\$2,000	\$4,000	\$6,000
Total return	\$3,600	\$4,400	\$6,800
Equity invested	\$40,000	\$40,000	\$40,000
Return on equity invested	9%	11%	13%

The example shows that the more the investment is geared the greater the return on equity invested, assuming amongst other things, capital growth of 5%. Investors should realize that the assumed income levels and capital gains amounts are very conservative: the long term historical earnings rates are actually much higher than a total of 9%. Most Investors who geared investments over the last 20 years got much better results than this.

Quite responsibly, the author goes on to show "what would happen if the market value goes down by 5% rather than increasing by 5%". The revised table then looks like:

	Ungeared	Geared	Negatively Geared
Equity invested	\$40,000	\$40,000	\$40,000
Borrowed	Nil	\$40,000	\$80,000
Total invested	\$40,000	\$80,000	\$120,000
Income received	\$1,600	\$3,200	\$4,800
Less interest paid	Nil	\$2,800	\$5,600
Net cash flow	\$1,600	\$400	\$800
Capital growth	(\$2,000)	(\$4,000)	(\$6,000)
Total return	(\$400)	(\$3,600)	(\$5,200)
Equity invested	\$40,000	\$40,000	\$40,000
Return on equity invested	(1.00%)	(9.00%)	(17%)

We have never seen a wealthy person who at some stage has not taken on at least some debt for business or investment purposes. We have also never seen a bankrupt person who has not taken on at least some debt as well. It is clear that debt is a two edged sword: it can increase investment returns and it can reduce investment returns.

It is best to keep to sensible debt levels, manage interest costs and to favor higher income yielding investments if the downside of debt is to be avoided.

The Australian Master Financial Planning Guide says that:

"An investor should only make a negatively geared investment if:

- *the investor has secure and permanent income from other sources sufficient to cover living expenses and all other requirements as well as the shortfall under the negative gearing;*
- *where the gearing arrangement or borrowing includes a liability to make margin calls in certain circumstances, the investor can satisfy the margin calls by supplying further security or by payment from other sources to avoid the possibility of a forced sale (keep in mind that the economic conditions that lead to the need for a margin call will, almost certainly, mean that any forced sale will be at depressed prices and will lead to a significant loss to the investor);*
- *the investment is made on the understanding that it will be retained for at least five, preferably, ten years or longer;*
- *the investment and borrowing have sufficient flexibility to cover events such as death, disablement; major illness or redundancy. The first three of these would normally be covered by insurance or superannuation benefits and redundancy could be covered by an employer pay out. However, even in these circumstances the negative gearing arrangement ... may need to be terminated. Check whether this can be done without incurring penalties and with the flexibility to avoid suffering loss through a forced sale of the asset;*
- *there is flexibility to cover changes in circumstances, such as a transfer overseas (where the tax advantages may not apply) or divorce; and*
- *the taxpayer can take full advantage of the tax deduction. Negative gearing normally works best for investors on the highest marginal tax rate but may be of less value to low tax rate or non-tax-paying investors."*

The author then warns of the danger of negatively gearing into an already geared investment, such as a listed company or a property trust. This increases both the up-side risk and the downside risk even further.

Handy hints for getting the money

Research the costs before you sign the contract. Make sure you know the interest rate, the principal repayment rate, the administration costs and the penalties for early repayment.

Shop around. The first offer is unlikely to be the best offer. Remember that Investors are good risks so make sure you get an offer that reflects this. Look for a bank that offers special deals for Investors. Most do. The AMA has done a great job negotiating a special deal with the CBA and most of the other banks will match it or more if pushed to do so. The banks know that Investors have virtually a nil delinquency rate on debts, and this means more money can be lent at lower rates while still maintaining overall profitability.

Some finance brokers specialize in Investors and other medical personnel. We have generally found them to be quite good. Their rates are as competitive as the banks and their service exemplary: perhaps they are more aware of their exposure to bad word of mouth advertising!

Make sure that your finance application is clear and to the point. Support it with recent accounts, company searches, business plans and similar documents where necessary. These materials are best included as

appendices to the main application as they may cloud the message you are trying to deliver. If the loan is for business or investment purposes, stress this, as it may be relevant if the ATO questions the deductibility of any interest claimed on the loans down the track.

Ensure that your finance application shows all repayments can be met out of your existing and expected business cash flows. If asset sales are contemplated in the short or medium term then say so, as this is very relevant to your capacity to service the debt. Financiers may not be impressed if the repayment of principal depends solely on the sale of the object investment.

Do not borrow too much. Most banks work on a debt to equity ratio of about 70:30. But in working out the value of your equity they discount historical cost by factors representing their expected resale experiences. Take account of these discount factors before you commit yourself to a transaction. Ensure that your finance application includes all relevant materials. This should include all financial information that does not favor your application. If something goes wrong later on and the bank finds out that you withheld certain information then, to say the least, tempers could rise.

Keep the communication channels clear. If something does go wrong, tell the bank straight away. This is important because banks do base their recovery actions on how they perceive the borrower to have behaved. Trust is very important with banks. If your word is your bond then you will get much better treatment if an unexpected situation arises. For example, time and time again we have seen banks extend an existing facility over the 'phone without any extra security when an investor has asked for it, whether it be to use as a deposit for a new property or whatever. Because trust has been established the banks will come to the party and help you out where needed. Open and honest communication is the key to building this sort of a relationship, and once it is created, don't waste it!

The banks will be extremely reasonable if you are reasonable with them. It is therefore important to play with a straight bat at all times.

Handy hint if you are borrowing to buy property

If you are borrowing to buy property consider making your offer subject to finance from a specified branch of a specified bank in a specified time, say a month. If something goes wrong you will probably not lose your deposit. Also, if you change your mind within the specified time frame then you may be able to "arrange" for your finance application to be refused. This means that you can get your deposit back. But make sure that the finance condition specifies which bank and even which branch of that bank. If you do not do this you may find the vendor arranging finance for you through a lender that normally you wouldn't go anywhere near.

Handy hints for income tax time

Consider choosing a facility such a fully drawn advance, or using a supplementary form of finance such as an overdraft, that allows you to prepay interest. Pre-paid interest is generally tax deductible in the year it is pre-paid, provided that the pre-payment period does not extend for more than thirteen months.

Remember that borrowing costs, including stamp duty and legal costs on the loan contract are tax deductible over the shorter of five years or the term of the loan.

Non-deductible debt, i.e. debt that is not connected to a business or an investment activity is the most expensive debt. Every \$1.00 of interest takes up almost \$2.00 of pre-tax income. For this reason it is a basic tax planning strategy to pay off expensive non-deductible debt as soon as possible and to defer paying off cheap deductible debt as long as possible.

For example, if you have a home loan of \$200,000 and an investment loan of \$200,000 it makes sense to pay off the home loan at twice the usual rate and to pay nothing on the investment loan.

How do you convert non-deductible interest to deductible interest?

There are a number of ways to convert the non-deductible debt to deductible debt, that is, debt that is connected to a business or an investment activity.

One simple technique is best illustrated with an example. An investor may have a share portfolio of say \$200,000 built up over the years without using debt. The investor is contemplating up grading the family home to get a few extra bedrooms and a bigger back yard. The problem is the up-grade will cost at least \$300,000 and the investor does not have it. He will have to borrow it. But interest on a home loan is not tax deductible. What can be done? Well care is needed, but one solution involves the Investors wife borrowing \$200,000 from a bank to buy the shares from her husband. The husband then uses the proceeds of sale to help pay for the new home. This also has the advantage of moving valuable assets out of the Investor's hands, something that should be a standing recommendation for anyone who can be sued by a patient.

Capital gains tax needs to be considered, and this can normally be dealt with. Stamp duty was once an issue but ceased to be on 1 July 2001 when stamp duty on share transactions was abolished as part of the Federal Government's GST deal with the states.

Another technique involves transferring business assets or investments to a spouse using investment loans and using the sale proceeds to pay off non-deductible debt.

Handy hint if you have more than one loan

Separate your financiers. For example, consider having your home loan with the ANZ, your business loan with the NAB and your credit card with Westpac and do not let them have cross securities. Each bank should have security over just one asset. Although this sounds messy if something goes wrong it will be a lot harder, if not impossible, for each bank to tie up the various securities provided to them.

We are seeing a lot of this lately. An investor may have an investment loan with say the NAB, and as part of the security documents both her practice company and service trust have granted the NAB a floating charge over all their assets including future assets. The investor may be interested in acquiring share or other securities under a margin lending arrangement. It can be a good idea to arrange for the shares to be bought in a new and separate trust that has not granted a charge to the NAB and to use a margin lender other than the NAB, say BT Australia. This means the investors other assets are not at risk if the share portfolio gets in trouble, and vice versa. In most

cases the extra time and trouble created by this strategy will be a waste of time. This is, of course, the best outcome.

Handy hints for choosing the type of finance: what are the options

Pick the right type of finance for different purposes. Different types of finance suit different borrowing needs. For example:

- (i) commercial hire purchase may be appropriate for a purchase of plant and equipment costing \$60,000 where you are putting up \$30,000 yourself. This will maximize your depreciation claim and allow you to include your equity in the plant and equipment in other finance applications;
- (ii) some lease contracts (lease contracts classified as "operating leases") do not have to be shown in your business' balance sheet. This can help show a good financial position to other financiers;
- (iii) an overdraft may be appropriate for funding your practice outgoings in February, as the effect of your two-week holiday in January kicks in, or for funding other short term dips in cash flow or unexpected outgoings. But overdrafts are expensive and if they look like becoming permanent then you should consider converting them to a cheaper and more long term type of debt; and
- (iv) an overdraft, being an inherently short term form of debt, is not appropriate for acquiring "long term" assets such as practice premises except where the debt proportion is very small and/or is expected to be paid back very quickly, say within twelve months.

Handy hint: let someone do the work for you

Use a consultant who is experienced in dealing with banks and who can represent your interests competently. The consultant should have a good handle on both the accounting and legal aspects of your practice.

Consider using a finance broker. They are in touch with the market all day every day and normally can get you a better deal than anyone else can. The financier pays them, not you, so their services will not cost you any more.

Try to minimize the time that you spend yourself dealing with the banks: this is time better spent in your practice. You can't bill for time spent talking to your bank manager, or for time spent worrying about what you are going to say to him.

How to manage debt

Debt is a fact of life for most investors.

Debt may arise as a result of starting a practice, buying into a practice, buying a home or acquiring investments. It requires careful management and control if it is not to become a cause of financial loss and pain rather than a powerful wealth creation tool.

Unless you are born with the silver spoon firmly in your mouth, there is normally no choice but to borrow to acquire assets that have any significant value attached to them. It is hard to save up \$300,000 to buy a home. By the time you do the children will have grown up and you will probably prefer a retirement home anyway.

A controlled amount of debt, used intelligently, can have a great influence on the quality of your life and on your net wealth position. It allows you to acquire assets otherwise outside of your reach and to benefit from holding these assets values rise and as the debt is gradually repaid over an extended period of time.

By the same token, whenever we see a client in financial trouble, we normally also see a stack of debt standing behind him or her. The misuse of debt is easily the greatest cause of financial pain we know of.

So what should you do?

Basically, be careful. A number of simple rules need to be observed when dealing with debt if you are to avoid being financially hurt. These are:

- (i) don't deal with the fringe players. Deal only with the major trading banks. Yes, they have their moments, but generally they are keen to get the medical profession's business and will even offer special discounts on normal lending rates. Shop around. You will be surprised what you will be offered. investors are almost always good credit risks, so make sure you are not dealing with the shark end of the market, because you certainly do not have to;
- (ii) remember that debt has to be repaid out of after tax dollars. A loan of \$300,000 may not sound like much, but it will require almost \$600,000 of pre-tax income to be repaid. This applies to all debts, not just private debts;
- (iii) similar to (ii) never borrow without a clear plan for repaying it within a specified time. Debts can be repaid by fresh borrowings, by selling an asset, by cashing out superannuation fund benefits (conditions apply) and by harnessing the practice's cash flow properly. Sometimes a combination of these methods may be used. Each repayment method has its place;
- (iv) never borrow to enter into tax planning schemes such as pine plantations, film investments and primary production schemes. Yes, your tax bill might go down, but that doesn't help you pay the interest or the principal on the loan. Half a loss is still a loss: income tax advantages cannot turn a bad investment into a good investment: they half the pain they do not eliminate it. There is still pain;
- (v) always pay off non-deductible debt (eg., debt on private credit cards and debt used to buy a home). These are the most expensive forms of finance because the interest has to be funded out of pre-tax dollars. Avoid them wherever possible: always borrow so that the interest is tax deductible;
- (vi) conversely to (v), pay off deductible debt last and where borrowings are required borrow in a form that is tax deductible even if the ultimate use of the funds is private. Most self-employed Investors are able to do this. For example, a family trust can borrow money to pay out an unpaid distribution to beneficiaries and the beneficiaries can use the cash for their own purposes. The trust will be able to claim a deduction for the cost of the interest. There are many other ways of achieving the same goal; and

- (vii) consider consolidating all of your debts into one facility and with one lender. This normally lowers both the interest cost and the administrative effort connected to the debts. If things are really out of hand think about extending the loan for say, five extra years. This may take the pressure off a bit and let you get back on your feet. If for any reason assets are at risk it can be a better idea to keep your financiers separate. For example, lease equipment from someone other than your bank.

When should we use negative gearing to reduce a tax bill?

This is a frequently asked question. The answer is "never". Only borrow money to buy an asset if the expected before tax income plus the before tax increase in the asset's value exceeds the before tax interest costs and other costs connected to buying and owning the asset. In other words, the expected return must exceed the expected cost of the investment.

This means that the expected before tax gross income plus the expected before tax capital gain must be greater than about 11% per annum before a rational investor would borrow to buy an income producing investment. A rate below 11% and you will lose money.

How much higher above 11% you should go depends on your perception of the risk implicit in the investment proposal. The answer to this question is essentially subjective, but, as a guide we wouldn't proceed under about 15%. Without such a margin it's just not worth the effort. Your time will be better spent in your practice. If this base condition is not met, it doesn't matter that the net loss on owning or holding the investment is tax deductible. A loss is a loss. All the tax benefits in the world will not change this. You will be better off paying income tax and putting what's left of your money in the bank.

This does not mean that one should never borrow to acquire appreciating assets. This can be a strategy. But the basic rules of investing must be satisfied if you are going to be better off as a result of doing this.

Sources of debt: What are the options?

This part of the book sets out an overview of the most common forms of finance used by Investors to fund their investment activities.

The overdraft

The common bank overdraft is a simple concept.

It is like a bank account, but instead of you being owed money by the bank, you owe money to the bank. The amount that you owe fluctuates over time as cheques pass in and out of the account. Interest is almost always fully tax deductible: this is so even where a private or non-business cheque is written. The revolving nature of the overdraft means that the Commissioner of Taxation is not able to trace through the overdraft account to apportion interest between deductible and non-deductible purposes.

Bank overdrafts tend to be at a high rate of interest. At the moment 8% or more is quite common. You also have to factor various bank charges into your assessment of the cost of the finance. These can easily add another 1% or more to the cost of the overdraft.

The overdraft has the advantage of being flexible and this means that you only pay for the money that you use for the time that you use it. Normally banks require a first mortgage over real estate to secure amounts lent under overdraft facilities. The better the security, the lower the interest rate.

Overdrafts can be useful for prepaying certain deductible practice expenses, including interest due on other debt instruments and paying deductible contributions, prior to 30 June each year. The interest on these amounts will be deductible.

Bank overdrafts are a sensible way of funding most small to medium medical practices and are frequently used by Investors.

Term loans

Term loans are the next most common form of finance used by Investors. Most practices will have them from time to time. Term loans are simply a loan for an agreed period of time. They can be interest only or principal and interest, and they can be a fixed interest rate or a variable interest rate. Some have hidden administration costs and others do not.

Term loans can only be repaid early without penalty if the interest rate is variable. If the interest rate is fixed the bank loses if the loan is paid out early. This loss is almost always passed on to the customer.

Small term loans can be a suitable way to fund a small to medium medical practice and are a good way of funding property investments and share investments. The rates charged can differ greatly from bank to bank and it can pay to shop around. A number of the larger banks offer special deals to Investors (this means that you get a nice bag of goodies and, most importantly, a discounted interest rate).

But be shy of changing banks just because one is offering an interest rate a percentage point below the others. Ask how long this will last for, and what happens when the facilities are reviewed: will the discount continue then? We expect that the answer will be "no".

Term loans can be used as "cocktails" to create flexible debt packages that achieve personalized financial goals. For example, an investor who owes \$400,000 on a loan used to buy a property could structure the debt as follows:

- (i) \$300,000 fixed interest only for five years; and
- (ii) \$100,000 variable interest and principal for five years.

This combination means that the investor can be reasonably certain of the net cost of the finance for five years (since three quarters of the interest charge is fixed) and can make sure that a significant amount of debt (ie \$100,000) on the variable interest loan) will be paid off within five years. Some principal can be repaid early without penalty if this is desired. At the end of the fifth year the remaining debt (\$300,000) would be refinanced

with the same bank or a new bank in line with the market conditions and the Investor's circumstances at that time.

Margin lending

Margin lending is a relatively new form of borrowing, and one that has rapidly become quite popular with Investors interested in buying shares and certain other securities.

A margin loan is a loan provided by a bank or other financial institution to facilitate the purchase of shares or other securities approved of by the margin lender. Normally a margin loan will be for between 60% and 70% of the value of the shares, with just the shares providing the security for the loan.

If the value of the shares falls below the 60% or 70%, then a "margin call" is payable within an agreed time, to bring the debt: equity ratio back inside the agreed proportions, or else the margin lender will sell some shares and use the cash proceeds to repay all or part of the debt.

Paul Clitheroe writes in Making Money that:

"Borrowing to invest can certainly magnify the returns from the share market if times are good. But margin lending also magnifies the risk of investing in shares and is not something I could recommend for first time investors. It is more suited to investors comfortable with a higher degree of risk who can pay the interest and who have the capacity to meet any margin calls, should they occur."

Some commentators are concerned that should there be a significant fall in the market, leading to calls and forced sales by margin lenders, that this will in turn create selling pressure leading to further falls in the market.

We are generally fans of margin lending: it is a relatively cheap and simple way of financing shares and other securities. But the interest rate does tend to be a little higher than the home loan lending rate. So if possible we prefer investors to finance their shares and other securities using a home loan facility rather than margin lending. That extra 05%, expressed as a percentage of the gap between the interest rate on the loan and the earnings rate on the shares can be significant, and really adds up over time.

Bank bills

Bank bills were once a very common form of finance, particularly for large and medium sized property transactions. However, they have become less common in recent years as banks have tried to switch customers to other forms of debt on amounts below \$500,000 or so to avoid the high costs of administering bills.

Bank bills are generally a cheap form of finance, with a cost (discount rate) tied to the bank's prime interest rate plus an administration fee.

There is no interest payable on a bank bill. The bank makes its money by discounting the bill, that is, by lending you an amount of money that is less than the amount of money that you have to pay back to the bank.

For example, a \$1,000,000 bill for a term of six months at 10% interest per annum will mean that you receive a cheque for an amount of \$950,000 on, say, 1 January but you will have to pay back an amount of \$1,000,000 on

June 30. The amount of \$50,000, being the amount that you have to pay back less the amount that you received, is called "discount".

Bank bills are normally discounted over a period of 30, 60, 90, 120 or 180 days. We are not aware of bills being discounted for longer periods. Normally the bill will be "rolled forward" by the bank at the end of the discount period with little difficulty.

Where a bank bill straddles two financial years the discount must be spread over the two financial years on a days basis. For quite a time there were some concerns amongst tax advisors about the correct taxation treatment of bill discount that straddles two financial years. But the Full Federal Court in the Coles Myer Finance Ltd Case has now put these to rest.

Banks bills do not have a built in repayment program. The absence of this facility can be problematic, particularly over periods when interest rates rise and asset values fall. You can find that you owe more than you own. Bank bills are administratively complex but are normally cheaper than, say, an equivalent overdraft. They are more suited to funding a larger property transaction and are not appropriate to fund the day-to-day activities of a medical practice.

Finance leases

Under a finance lease the lessee in effect borrows an amount of money equal to the cost of the asset being leased. The lessor owns the asset but the lessee is able to use the asset provided that the lease payments are made on a regular basis and (particularly with larger leases) the asset is properly housed, maintained and insured.

Finance leases are normally used for plant and equipment and furniture and fittings purchases. This includes motor vehicles.

The advantage of a finance lease is that all payments made under the lease agreement are tax deductible, being in the nature of a lease rental. This is so despite some part of the payments being in substance a repayment of part of the principal amount borrowed to buy the asset.

The taxation advantages of leases can be overstated though: most items of plant and equipment can now be depreciated over either a three or five-year period: the principal amount becomes deductible as depreciation over a short period of time anyway. In the case of a four-year lease of computer equipment, the cost of the equipment would have been depreciated over three years anyway: here a lease would be tax inefficient.

Most lease contracts provide for a residual payment at the end of the lease term. If this residual payment is not made possession of the leased asset will revert to the lessor. In most cases the lessee will make residual payments. Lessees should consider not making the residual payment if for any reason the market value of the leased asset falls below its residual value.

The Commissioner has released guidelines for the minimum term and residual payments for leases. These guidelines must be satisfied if he is to accept that the finance contract is a lease and therefore that the lease rentals are deductible losses and outgoings for income tax purposes.

The minimum acceptable residual values as a percentage of cost are:

Depreciation Rate Bands					
Term of Lease	20%	15%	10%	7.5%	5%
Year 1	60%	64%	67%	68%	70%
Year 2	45%	52%	60%	62%	65%
Year 3	30%	41%	52%	55%	60%
Year 4	15%	30%	45%	50%	55%
Year 5	Nil	19%	38%	45%	50%

For example, if you buy a computer using lease finance over three years, the ATO will only accept that the lease rentals are deductible if the residual value is not less than 30% of the amount of the cost of the computer.

Normally leases do not require any additional security. The leased asset provided sufficient security. However, financiers normally will not enter into lease contracts with companies without directors' guarantees. Larger contracts or contracts for unusual (and hard to sell) plant and equipment may require collateral security.

The luxury car depreciation rules do not apply to lease contracts: this makes leases particularly attractive for purchasing cars with a cost of more than about \$56,000. All lease rentals, including those connected to the cost above the luxury car limit will be deductible.

Commercial hire purchase

Commercial hire purchase contracts are functionally similar to lease contracts. They are typically used to buy plant and equipment and furniture and fittings, including cars. But, conceptually, a hire purchase contract is quite different to a lease contract. The borrower borrows money to buy the asset and is the owner of the asset. This means that the borrower is able to depreciate the asset for income tax purposes. The payments made under the hire purchase contract are a mix of principal and interest, and the amount of deductible interest will be calculated using the "rule of 78" method. The principal component of the hire purchase payments will not be tax deductible.

Commercial hire purchase will be more attractive than a lease where the borrower has some equity in the asset being financed. This is because the cost of the asset will be depreciable under a hire purchase contract, including the owner's contribution, even though only part of this amount is financed using debt. However, under an equivalent lease contract the lessee's contribution will not be depreciable because the lessee will technically not own the asset. Only an owner can claim a deduction for depreciation.

Mortgage originators

The last few years have seen the rise of "mortgage originators". These firms now provide a real alternative to traditional bank finance. Companies such as Aussie Home Loans and RAMS now account for a significant share of housing finance in Australia.

Investors who have dealt with these companies report well on them. They seem to provide a good service. They are able to provide lower cost finance because they do not have to support the infrastructure of the larger banks. They just organize loans: they are not the principal lender. The principal lenders are larger merchant banks that are attracted by the security and low administration costs of this type of finance.

Finance brokers

It can be a good idea to ask a broker or some other independent person to arrange your finances for you. This saves you time dealing with lenders and saves you money because in most cases the broker can get you a better interest rate. Normally using a broker does not cost you anything because the lender pays the broker, not you.

Interest charge checkers

A number of firms have entered the personal and small business financial market as interest charge checkers.

Often staffed by retired bank managers, they use precise interest rate calculations to identify interest charge errors and bank charge errors. Small amounts add up, particularly if there is a pattern of overcharging. The firms collect the refunds for you. From what we have seen these groups offer a good service and Investors should use them if they believe they have been overcharged on interest or other bank charges.

Some good software packages are available that do the checking for you.

Why consumer credit is not good for you

Credit cards are typically used to purchase consumable goods and services. Consumable goods and services are those that fall in value over time. People using credit cards to buy such goods are usually reducing their net wealth.

Some consumable goods and services are unavoidable. Food, shelter, clothing, health etc are all things that people need to purchase. They are often referred to as 'non-discretionary' consumable items, as the buyer does not really have the discretion to decide whether or not to make their purchase. The purchases have to be made.

Some consumable goods and services are avoidable. These tend to be items where the person will not 'suffer' if they don't have them. They are often referred to as discretionary consumable items, as the buyer does have choice as to whether they make their purchase. These items are also sometimes referred to as luxury items.

Whether or not an item is discretionary or non-discretionary, the fact that they are consumable means that they reduce the purchaser's net wealth. The good or service is worth less once it has been bought. For non-discretionary items, this reduction in wealth is valid. Indeed, in many ways it is to fund these purchases that wealth exists in the first place. But for non-discretionary items, the buyer should be aware that the purchase reduces their wealth.

When the purchase is made via a credit card, and the buyer incurs interest on the debt, then the price of the purchase becomes even higher. This increases the negative effect on net

wealth.

It should be noted that not all credit card purchases attract interest. Most cards allow an interest free period. If the user of the card pays back the amount of the purchase before the interest charges are applied, then they do not pay interest. However, only 30%² of credit cards are repaid within the interest free periods, meaning that 70% of credit card users pay interest.

Consider a purchaser who buys a TV for \$1,000 using a credit card that charges 17% pa interest. Once the TV has been bought, its second hand value would probably halve. Thus, the TV immediately falls in value to \$500. If the buyer takes a year to clear the credit card, then the purchase price of \$1,000 attracts \$170 in interest. Thus, the total price is really \$1,170. The day after the purchase, the buyer owns an item now worth only \$500, for which they have paid \$1,170. Their net wealth has been reduced by \$670. Long term the value of the TV will continue to fall, meaning that the effect over time is even greater reduction in net wealth.

The impacts of these borrowings on net wealth are of obvious importance to the financial planner. As a general rule, clients need to know that credit card interest usually reduces their net wealth, especially over the long term, while financing to purchase a property will typically increase their net wealth, again especially over the long term



PART 5 WHAT DETERMINES THE VALUE OF AN INVESTMENT PROPERTY?

Dinner parties abound with theories about what determines the value of a property.

But for a land economist the answer is decidedly simple: expected future net cash flow adjusted for inflation determines value.

Expected future cash flow comprises rent and capital gain on ultimate sale to a third party. Most investors do the sums intuitively rather than a formal calculation, but if you can use discounted cash flow methodologies to assess properties for purchase. An example of DCF analysis for a rental property is set out in appendix 1. In summary, the expected future net rents plus the expected future capital gain, discounted for inflation, are computed, and if this amount is greater than the required purchase price, the investment should be proceeded with, and the greater the excess the better the investment is expected to be.

But the land economist's cold clinical analysis does not really satisfy our question. It's just a calculation, not an explanation. To really understand what determines the value of a property one needs to look much further, and to enquire into a whole range of factors relating to both the individual property and the wider macro-economic environment. These factors, particularly when they require forecasts, are inherently subjective. This is where the art takes over from the science: a good property investor can see the future and accurately assess the state of the market five, ten and, we would stress, even twenty years down the track, and make astute decisions now.

Location, location, location...

Location is clearly a critical factor in valuing a property.

Location determines desirability. Desirability determines price.

In the case of a residential property, identical houses in two different suburbs will have different values, reflecting the premium or cache attached to each, and even in the same suburb identical houses may have different values, reflecting subtleties of view, access, proximity to services and the character of neighbouring properties.

In the case of non-residential property, the same phenomenon holds. Identical shops in two different suburbs may have significantly different values, reflecting these same factors as residential property, perhaps with lower weighting, and also reflecting the related concept of “rentability”, which ultimately comes down to supply and demand, that infinite list of subjective circumstances which determines why an enterprise wants to be in a certain location, rather than an alternative location, and how much it is prepared to pay to be there.

The issues become even more complex as one moves from an inter-city analysis, ie comparing Bondi to Campbellfield in Sydney, to intra-city analysis, say Bondi to Bermagui. In many ways the properties are not comparable and they are simply in different markets.

What makes for a good location? Three factors can be identified, being:

- (i) its economic base and demographic features, including local aesthetics, population and, we stress, expected future population growth;
- (ii) an element of monopoly, in the sense of something that cannot easily be replicated elsewhere, a coveted “prime location”, but think about what will be the “prime” location in twenty years time, and consider investing in emerging prime locations;
- (iii) zoning and town planning controls enforced by state and local governments

Residential property and location

The local economy is a major variable here. Northern NSW and southern Qld in 2011 represent historically good buying, with costs down by 30% over the last three years due to a combination of the GFC, floods and the high \$A deterring in bound tourism and sending domestic tourism offshore to Thailand and other Asian destinations. The larger the city the less risky the local economy is. Smaller regional centres can be 100% dependant on one or two industries, or even employers, and show appropriate volatility: this is another reason to be careful with boom time mining towns.

Immigration is important. 100,000 or so new arrivals to Melbourne keep values simmering even when interest rates are up and economic news is not good. The immigrant attitude is significant too: very home aspirational with the economic means to achieve these aspirations.

As noted above, subtleties of view, access, proximity to services and the character of neighbouring properties, and changing patterns over time, generate value variations both within suburbs, between suburbs and between cities and regions.

Don't forget plain old fashioned snob value. Why else does what was once a little corner of Elsternwick jump 10% in value when re-zoned as Brighton? It's the postcode, stupid.

Office property and location

Are the offices convenient to residential areas? Commute time is more important each year. What are the alternatives like? Being close to cafes, gyms, child care facilities and schools help too: it's all about the location working for the residents.

The long term trend to increased tertiary industry and overall economic growth create demand for offices outside of the major cities, ie Melbourne, Sydney, Brisbane, Adelaide and Perth. The Federal Government's Broadband Network project and improving communications technology will make city centres less and less relevant in coming decades. Smaller offices in areas adjacent to fashionable suburbs with easy access to the city and airports will do well.

The two speed economy, ie the booming mining and support industry compared to the moribund traditional industry is not apparent: offices are well priced around Australia in all industries

Retail property and location

The drop in bricks and mortar retail sales does not portend well for retail property, since it is the bricks and mortar in the equation. The internet and satiation with physical goods and services and an increasing tendency to spend discretionary dollars on services and experiences are relevant here. But it's the fringe dwellers that will feel the pain and the classic prime locations will remain just that, ie classic prime locations.

An opportunity exists to pick the classic prime locations in areas of increasing population growth and gentrification, ie the waves of movement in higher spending higher income workers.

Synergistic tenancy mixes are important. But malls and larger shopping centres are off the radar for most investors: too big and too risky. The classic main street shopfront will always have a tenant...

Fashionable shopping strips in fashionable suburbs will do better than others.

Industrial property and location

Here it's all about easy access to major traffic pathways and ease of access to major destinations. Prices have increased alongside new major road infrastructure projects in the major cities. Town planning is important, particularly for heavier industrial uses.

Light industry close to preferred living spaces makes great sense in our post-industrial Australia.

Macro-economics is very important. Witness the plight of Shepparton's fruit industry (ie SPC) as cheaper imported fruit is allowed into Australia, with the perfect storm of a record high dollar making exports harder than ever. This flows through the local economy into the industrial property market. Excessive dependency on one or two main industries or even one or two main employers is always a problem. As a general rule, the closer to the

large, diversified city, the lesser the risks since there are more potential tenants and uses for the property if the current tenant gets into difficulty.

Risk

Risk may be defined as the possibility, or probability, that the actual outcome will differ from the expected outcome. This means there is good risk and bad risk, since actual outcomes may be better or worse than expected outcomes. Good risk is often called “up-side” risk and bad risk is often called “down-side” risk.

Down-side causes the most problems and it's what we look at in this manual.

Most commentators nominate three main types of risk. These are:

- (i) market risk, which effects all properties in a particular market;
- (ii) financial risk, usually connected to finance risk; and
- (iii) property specific risk, normally connected to locality, building and tenant.

Market risk

Market risk generally refers to macro-economic variables applying broadly to all properties, or types of properties, within a certain market or sub-market.

Examples include the risk that a major employer will downsize or even abandon a particular region, which can significantly reduce property values across all classes of property. On the up-side, the arrival of a new major employer in a particular region often leads to higher property values across all classes of property as new employees bid up prices and economic benefits flow on to related industries and service providers, possibly including extra government services such as schools, transport and health.

Market risk also encompasses wider national or state trends, such as rising unemployment rates or changes (often by stealth) to state land tax charges and similar costs. But unemployment rates and land tax charges can fall too. In 2010/11 a rising Australian dollar was forcing down property values in traditional tourist locations such as the Gold Coast, the Sunshine Coast and far north Queensland.

Financial risk

Financial risks are risks connected to property loans.

Typically they include the risk of rising interest rates and the risk that a fixed term loan will not be extended at the end of the term.

In the GFC the Australian Government acted to significantly lower interest rates, to stimulate spending and to take pressure off property owners. Owners with good tenants actually experienced better net cash flows throughout the GFC period, another example of up-side risk at work.

Financial risks are guarded against by not over-borrowing and generally being prudent in financial dealings. Most property failures are more connected to greed and over-ambition, and poor judgement, than uncooperative lenders.

Property specific risks

Does the building have rising damp? Termites? Asbestos? Concrete cancer? All necessary permits? Any illegal extensions? Noisy neighbours? Will the zoning laws change? Is the tenant about to go broke? Is the council about to remove the parking spaces to create extra roadway?

How do you guard against these risks? You cannot eliminate them but you can minimise them by taking care and exercising “due diligence”, is not a defined term and generally refers to the process by which a person verifies the circumstances connected to a property (or other asset) before acquiring it. In the context of real estate, the golden rule is to not trust anything you are told by the seller’s agent. The seller’s agent is not the buyer’s agent and does not owe the buyer a duty of care or a contractual duty, other than a duty not to mislead or deceive. Verify everything.

Verification may include:

- (i) building inspections by qualified personnel;
- (ii) pest inspections and other specific inspections;
- (iii) using a buyers’ advocate, (strongly recommended on larger purchases, but make sure they do not charge too much!);
- (iv) careful research on the fundamentals;
- (v) solicitors to vet leases and make sure all is in order;
- (vi) talking to other selling agents about other properties to get a better feel for the market;
- (vii) internet research.

Building obsolescence

Valuers assess the depreciated value of a building by identifying, quantifying and assessing “building obsolescence”, in the sense of its appropriateness to current uses and expected future uses. This lack or appropriateness, or obsolescence, does not happen overnight. Rather, it sneaks up over the decades so what was once, in 1980, a beautifully appointed and elegant office building will be completely inadequate for use by a government department in 2012.

Building obsolescence occurs when the expected cost of an up-grade exceeds the expected benefit of an up-grade, and is not directly connected to age. A 100 year old building may be wonderfully appropriate to its tenant’s uses and expected future uses. A 10 year old building may be the opposite, empty, and need of a good tearing down

Obsolescence must be managed, with constant re-investment back into the building to ensure it remains appropriate to current and expected future uses. A building’s value will otherwise fall, since future tenants will not be prepared to pay as high a rent for a building that is not as appropriate to their current or future needs.

The concept of building obsolescence applies to all forms of property, ie residential, retail, office and industrial, and is normally connected four sub-species, being:

- (i) physical obsolescence;
- (ii) functional obsolescence;
- (iii) economic obsolescence; and
- (iv) in more recent years, many say, sustainability obsolescence.

In his book “Australian Property Investment and Financing” Patrick Rowland provides a useful practical table summarising building features and obsolescence. It is reproduced here:

Property use	Building feature	Signs of obsolescence
Residential	Number and size of rooms, age, durability, style, facilities and fittings.	Lack of second bathroom, games room, or home theatre, unsecured parking, lack of air-conditioning or lifts in a block of flats.
Offices	Functional floor plate (position of internal columns, window mullions and corridors) natural light, views, finishes to entrances and lobbies, quality of air conditioning, telecommunications and IT services, availability of car parking.	Awkward floor plan, cramped foyer, slow lifts or a low green rating.
Retail	Width of shop front(s), finishes to shopping mall, lighting and temperature control.	Poor pedestrian circulation, tired appearance, water penetration, insufficient on-site parking or inferior customer facilities.
Industrial	Truss Height, wall cladding, floor loading, loading docks, (natural) lighting, ancillary offices and/or showroom.	Inconvenient internal columns, insufficient height for pallet or other storage, insufficient office space.

Creative capitalism

Behind every new development is an obsolete older building. Its capitalism at is most creative.

Most buildings eventually outlive their economic usefulness and are be demolished, and a new building is put up in their place. This is what happens when the expected cost of an up-grade exceeds the expected benefit of an up-grade, ie a building is obsolescent.

It's out with the old and in with the new.

Property and taxation

This part of “The Financial Planner as a Property Advisor” manual looks at the tax benefits and costs connected to owning a property. It is intended to communicate a general understanding of the main issues and an appreciation of the tax efficacy of holding property as a long-term investment.

The Australian tax law contains many special property features that combine to make owning property a very tax efficient experience.

The first feature relates to capital gains. Australian tax law only assesses capital gains when the property is a disposed of (or is deemed to be disposed of, which we discuss later) and not each year as it is held. When the property is disposed of, assuming it has been held for more than 12 months, only half the capital gain is assessed to income tax at the owner's current marginal tax rates. And usually the investor controls the time of disposal, and can arrange the ultimate sale in a period when the owner has little other taxable income or is even income tax exempt.

(This, incidentally, highlights why property should always be a long term investment, twenty years or more: it means there is no tax charge on the major component of total return, ie capital gain. This benefit compounds and compounds over the years and creates a huge advantage for long term property investment over alternative short term investment strategies.)

This feature opens the door to excellent tax planning strategies. For example:

- (i) a financial planner may buy office premises in her self-managed superannuation fund for say \$1,000,000, and pay a high rent to the fund, say \$100,000, and enjoy excellent unrealised capital gains each year. These capital gains will not be assessed to income tax until and if the SMSF sells the property, and if this done after she starts her pension benefits there is not tax at all on the capital gain. The rent is economically similar to additional superannuation contributions, and is only taxed at 15% in the SMSF's hands, but is deducted at up to 46.5% in the tenant's hands, this creates an annual tax benefit of \$31,500 [ie \$100,000 times (46.5% less 15%)] in the financial planner's hands every year and accelerates her asset accumulation strategy in a very tax efficient way; or
- (ii) an employee accountant may buy a residential property as an investment for \$1,000,000, and rent it to an arms length tenant at say \$30,000 a year, or 3% rental yield. The accountant can claim the rental loss, ie the excess of interest over rent, plus other deductions such as repairs, depreciation of plant and equipment and building allowance against his salary income, whereas in reality the property has made a profit, since it had increased in value by more than the after tax rental loss, is has experienced a capital gain. But this capital gain will not be assessed to income tax until and if he sells the property, which he probably will not do until he has retired and has no other assessable income, so the final tax charge will be minimal.

Understanding the tax principles behind these two strategies, and others like them, is essential to being a competent property advisor.

Some basic tax questions

The tax questions for every potential property acquisition include:

- (i) how will capital gains on the property be taxed?
- (ii) what “non-cash” deductions are available, including depreciation and building allowance claims?
- (iii) is the interest on any borrowings tax deductible?
- (iv) can any losses incurred on holding the property be offset against other taxable income?
- (v) who, or what, should own the property, considering land tax and stamp duty issues as well the tax treatment of losses and any future capital gains?

Advisors must be able to answer these questions if they are to competently advise clients on property investments.

Some basic tax principles

Taxpayers pay tax assessed on their “taxable income” which is defined as assessable income less allowable deductions. Assessable income is a broad concept and includes amounts that are income under ordinary concepts, such as rent, and amounts that are deemed to be income under specific provisions in the income tax law, such as net capital gains on the sale of assets.

Allowable deductions includes costs that are deductible under ordinary concepts (the general principles of deductibility) because they are connected to the production of assessable income, or more broadly are connected to an assessable income producing business, and are not private or domestic or capital in nature. Interest is an example of such a deduction. Allowable deductions also includes amounts which are not deductible under ordinary concepts but which are made specifically deductible under a specific provision of the tax law, such as depreciation of plant and equipment and building allowance claims.

(In some cases a loss or outgoing may be deductible under the general principles of deductibility and also be specifically deductible under a specific provision of the tax law. Rates and repairs are examples of such deductions. A taxpayer can only claim the deduction once, and not twice, in circumstances like these!)

Tax payable is determined by applying the relevant tax rates to the taxpayer’s taxable income. The resident Australian income tax rates (before Medicare Levy) for 2010/11 are:

<i>Taxable income</i>	<i>Tax on this income</i>
0 - \$6,000	Nil
\$6,001 - \$37,000	15c for each \$1 over \$6,000
\$37,001 - \$80,000	\$4,650 plus 30c for each \$1 over \$37,000
\$80,001 - \$180,000	\$17,550 plus 37c for each \$1 over \$80,000
\$180,001 and over	\$54,550 plus 45c for each \$1 over \$180,000

It's quite common for person's taxable income to be above \$80,000, which means they pay 37cents for every extra, or marginal, dollar of income. This phenomena drives the concept of negative gearing: for a tax payer in the 37% tax range every dollar of negative gearing loss produces a tax benefit of 37 cents (plus Medicare levy), and for a taxpayer in the 45% tax range the every dollar of negative gearing loss produces a tax benefit of 45 cents (plus Medicare levy).

These tax benefits can be seen as a second rent cheque: a reduction (or refund) of tax connected to ownership of the property and forming part of the economic return or reward for owning the property. This is actually a key point to understand: a large part of the attraction of property derives from its income tax efficacy and the tax benefits of negative gearing. Historically these tax benefits have driven the Australian property market, particularly the residential property investment market, where the low rent yields translate to relatively higher negative gearing losses.

The taxation of capital gains on property

Most investors are assessed to income tax on any gain on the disposal of a property under the special rules applying to capital gains in Part 3-1 and 3-3 of the Income Tax Assessment Act 1997.

(Occasionally someone will say a gain on the disposal of a property is taxed as ordinary income or as part of a profit making scheme or undertaking or, more probably, a loss on a property is deductible against other income and is not a capital loss in the net capital gain computation. This is in fact quite unusual, and there is every probability that someone is wrong. It is quite rare for a gain to be taxed as ordinary income or as part of a profit making scheme or undertaking, and it is certainly not a simple matter of choosing to be one or the other. It should always be assumed that the property is subject to the capital gains rules unless specific legal advice to the contrary has been obtained.)

The capital gains rules are quite complex and contain many unusual definitions and special provisions designed to capture unusual circumstances. In the interests of clarity and brevity, and improved understanding, we will ignore many of these definitions and special provisions and focus on the practical day-to-day scenarios encountered by financial planners and their investor clients.

Relevant acquisition dates

There are three sets of dates for acquiring CGT assets. The date the asset is acquired determines whether the asset is subject to CGT and, if it is subject to CGT, what computation rules apply.

Date	Summary of rules
Pre 20 September 1985	Generally not subject to CGT
20 September 1985 to 20 September 1999	Subject to CGT with indexation of cost base or an exemption, whichever gives a better result.
Post 20 September 1999	Subject to CGT, with an exemption

(The exemption applies to assets held for more than 12 months and is 50% for individuals and trusts and 33% for superannuation funds. There is no exemption for companies.)

A property is acquired or disposed of in the period the contract is formed, ie usually when the sale contract is signed. This will typically be 30, 60 or even 90 days before settlement. It is common for settlement periods to straddle 30 June, and this often confuses the consequential CGT computations.

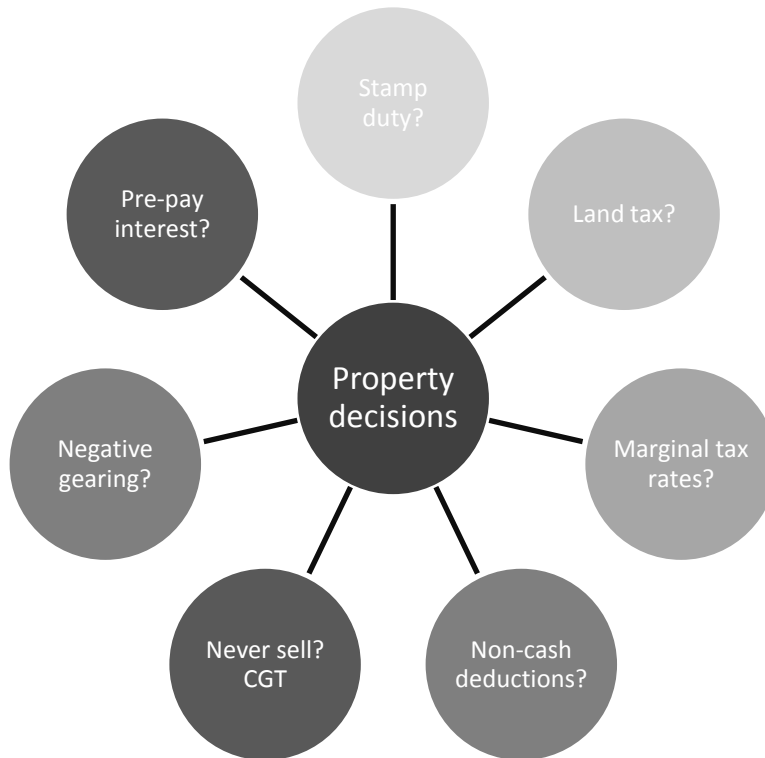
The concept of a CGT event

A property is disposed of if a “CGT event” occurs. CGT events are summarised in section 104-5 of the ITAA97 and, in the context of real estate, include:

- (i) the disposal of an asset: CGT event A1
- (ii) the use and enjoyment of an asset passes before title passes (as may happen under a terms sale contract): CGT event B1
- (iii) the end of a CGT asset, for example in a bushfire or flood: CGT events C1 to C3

Cost base

The cost base of a property includes the price paid for it, the transaction costs connected to the acquisition (eg stamp duty), the transaction costs connected to the disposal (eg selling agents commission, and conveyance costs) and costs connected to holding it which are not deductible against rent income (eg interest on a block of land held for re-sale and not for rental purposes).



This table summarises the main sources of property income and property deductions in Australia.

Income	Source
Rent	Assessable as derived (ie normally when received) under ordinary concepts of income.
Net capital gain	Assessable under section 160O ITAA
Lease premiums	Assessable as derived (ie normally when received) under ordinary concepts of income.
Lease inducement payments	Assessable as derived (ie normally when received) under ordinary concepts of income.
Deductions	Source
Interest	Deductible under general principles when incurred, ie when the borrower is required to pay it, even if it is not paid
Borrowing expenses	Deductible under section 25-25(1) ITAA97 over the shorter of the term of the loan or five years, on a days pro-rata basis
Mortgage discharge costs	Deductible under section 25-30 ITAA97
Repairs and maintenance	Deductible under general principles when incurred and also deductible under section 25.10 ITAA97
Payments for failure to make repairs	Deductible under general principles when incurred and also deductible under section 25.10 ITAA97
Council and water rates	Deductible under general principles when incurred and also deductible under section 25-75 ITAA97
Land tax	Deductible under general principles when incurred
Insurance	Deductible under general principles when incurred
Bank charges	Deductible under general principles when incurred
Real estate agent management fees	Deductible under general principles when incurred
Body corporate fees	Deductible under general principles when incurred
Legal costs: lease document expenses	Deductible under general principles when incurred and under section 25-20(1) ITAA97
Legal costs: existing tenants	Deductible under general principles when incurred
Advertising for a tenant	Deductible under general principles when incurred
Courses, magazines, books and subscriptions connected to rental income	Deductible under general principles when incurred
Accounting and bookkeeping fees	Deductible under general principles when incurred and under section 25-5(1) ITAA97 as tax related expenses

Travel expenses connected to the property	Deductible under general principles when incurred to the extent the true purpose was connected to the property
Insurance premiums	Deductible under general principles when incurred
Advice connected to the on-going management of the property (but not its initial acquisition)	Deductible under general principles when incurred
Quantity surveyor's report for depreciation and building allowance claims	Deductible under general principles when incurred
Telephone, stationery, internet connections, postage and similar costs	Deductible under general principles when incurred
Gardening and lawn mowing costs	Deductible under general principles when incurred
Security costs	Deductible under general principles when incurred

Case study of negative gearing

It may be useful to introduce a simple case study.

John is an employee financial planner on a salary of \$180,000. He expects a bonus of \$50,000 in the 2012 year, placing him well and truly in the top tax bracket. John wants to create an investment portfolio to support him and his partner once he retires, and any tax benefits will be a welcome plus.

John borrows \$500,000 to buy a two-bedroom townhouse in Melbourne's inner eastern suburbs and rents it to a tenant at a rent of \$18,000 a year. The property is 100% geared at 7% interest, or \$35,000 a year, and incurs other costs of \$2,000 a year.

The negative gearing analysis is shown here:

Purchase of property								
Purchase price	\$476,190							
Additional costs (%)	5%							
Total cost	\$500,000							
Cost of purchase consist of								
Equity contribution	\$0							
Amount to be borrowed	\$500,000							
Interest rate (on borrowing)	7%							
Economic Assumptions/Other Information								
Rental yield	3%							
Annual rent increase	4%							
Depreciation term (years)	5							
Depreciation estimate	\$60,000							
Building allowance estimate	\$250,000							
Rates and other outgoings	\$2,000							
Tax rate (taxpayer)	46.50%							
Investment analysis								
	Year 1		Year 2		Year 3		Year 4	
	Tax	Cash	Tax	Cash	Tax	Cash	Tax	Cash
Gross Income								
Rental income	\$14,286	\$14,286	\$14,857	\$14,857	\$15,451	\$15,451	\$16,069	\$16,069
Less costs								
Rates and other outgoings	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
Interest expense	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000
Depreciation expense	\$12,000	\$0	\$12,000	\$0	\$12,000	\$0	\$12,000	\$0
Building allowance	\$6,250	\$0	\$6,250	\$0	\$6,250	\$0	\$6,250	\$0
Tax benefit	\$0	-\$19,048	\$0	-\$18,783	\$0	-\$18,506	\$0	-\$18,219
Total deductions/cash out	\$55,250	\$17,952	\$55,250	\$18,217	\$55,250	\$18,494	\$55,250	\$18,781
Taxable amount (loss)/cash deficit	-\$40,964	-\$3,666	-\$40,393	-\$3,360	-\$39,799	-\$3,042	-\$39,180	-\$2,712
Tax benefit of tax loss	\$19,048		\$18,783		\$18,506		\$18,219	

Does not take into account inflation
Depreciation & building allowance are non cash deductions

In summary, the town house costs John about \$3,666, or 0.73%, a year to hold, on an after tax basis.

It's a good bet that the property will go up by more than this each year. The inflation rate is 3%, or \$15,000, and the average increase in town house prices over the last ten years has been more than 6%, or \$30,000. So realistically, and conservatively, John will make on average in the long run at least \$11,334 (ie \$15,000 less \$3,666) and may be as much as \$21,334 (ie \$30,000 less \$3,666) each year. And this amount is not taxed until John sells the property, and even then (after 12 months) only half the capital gain will be included in John's taxable income computation.

John intends to hold the property for the very long term, at least 20 years, as a core asset in his portfolio. Realistically it will not be sold, if at all, until he is in a much lower marginal tax rate, or even a nil tax position.

The concept of a repair - What is a “repair”?

The tax law does not define a “repair” and there has been a long line of cases between taxpayer landlords and the Australian Taxation Office. “What constitutes a repair is a question of fact and degree and each case having regard to the appearance, form, state and condition of the particular property at the time the expenditure is incurred and to the nature and extent of the work done to it: Taxation Ruling TR 97/23. There is no strict definition and the courts have said “repairs should be given its ordinary meaning and have in effect provided guidelines for what is and what is not a repair, including:

- (i) the concept of restoring an asset to its original condition, in terms of functional efficiency, without improvement, dominates the cases. In the context of property repairs this is a useful concept to bear in mind with period properties: costs connected to getting the property back to its original condition and functionality are prima facie repairs. This may include for example, re-blocking, re-wiring, re-plumbing, re-stumping, re-roofing and re-painting a property;
- (ii) a repair involves the replacement or renewal of a part of an item, rather than the replacement of the entire item. A substance approach should be taken to identifying what is a part of an item and what is an entire item, and there can be genuine cases of disagreement. For example, in one case a roof was found to be part of an item, ie a building, and not an entire item on its own account;
- (iii) initial repairs are seen as being capital in nature and not deductible, particularly where the owner paid a lower price than otherwise to acquire the asset. There is no definition of what is “initial” but many interpret it as 12 months.

In the context of income producing property it makes sense to not complete any “repairs” in the first 12 months (unless they are clearly connected to fresh tenant damage) and to concentrate on getting the property back to its original condition and functional efficiency without replacing the entire structure and making sure some significant parts of the original remain.

Spreading the repair program over a number of years is a common sense precaution. As a practical matter a large repair completed in one tax year is more likely to attract ATO attention than the same repair completed over two or more tax years. Separate the repair program from the improvement program. Have different contractors complete any improvements, preferably in a later tax year than the repairs.

Pay attention to the paper trail. Make sure all third party correspondence such as quotes and tax invoices created by consultants, tradesmen (and even banks if finance is needed) speaks of “repairs”, as the concept is explained above, rather than “improvements” or entire replacements.

Depreciation of plant and equipment

The decline in value rules are contained in the Uniform Capital Allowances System in Div 40 of the ITAA97. Broadly speaking these rules allow a deduction each year for part of the capital cost of depreciating assets used to produce assessable income, such as rent from a property.

“Depreciation” as a word no longer occurs in the tax law. The current phrase is “decline in value” and this phrase corresponds with the accepted meaning of depreciation, ie the decline in value of an asset over its expected effective life. We will use the word “depreciation” here as

Depreciating assets includes air conditioners, hot water systems, heaters, carpets, curtains, blinds, light fitting, stoves, hot plates, lifts.

The cost of depreciating assets is the amount paid to acquire them, and any later costs paid to get the asset into a usable position or condition. This cost is claimed as a tax deduction over a number of years, loosely based on the concept of effective life.

Cost can be allocated in one of three ways:

- (i) low dollar value items costing less than \$300 can be claimed straight away;
- (ii) the prime cost method where the cost of the asset is spread evenly over its effective life; or
- (iii) the reducing balance method where the cost of the asset is deducted by applying a fixed percentage to the written down value, so that the amount of the deduction falls each year over its effective life.

As a general rule most property owners would prefer the reducing balance method. This is because it produces a larger deduction in the earlier years, and this enhances the tax planning aspects of owning the property.

Effective life may be determined by the owner, based on reasonable wear and tear and assuming normal maintenance. Or effective life may be determined by the Commissioner of Taxation as explained in extensive rulings published on the ATO website from time to time.

Building deductions

Division 43 of ITAA97 allows a deduction for the cost of buildings and certain structural improvements, usually at 2.5% a year, based on an assumed 40 year effective life.

Non-cash deductions are good deductions

The cost of depreciating assets and buildings may be difficult to estimate where a property is bought for a global sum and no details of the cost of the different items are provided. Here it makes sense to engage a quantity surveyor to inspect the property and to prepare a detailed asset report for you.

The annual depreciation deduction and the annual building deduction do not involve cash payments. They are what are often called “non-cash deductions”, in the sense that although cash is paid at the start to acquire the

asset no further amounts are paid in subsequent years. This increases the tax efficacy of the property, by increasing allowable deductions, and hence decreasing tax payable, without any reduction in cash.

It's not unusual for these claims to exceed \$30,000 a year on a \$1,000,000 property, and that equates to extra tax benefits of up to \$13,950 cash a year.

Getting the depreciation claim and the building deduction claim right are an important part of managing the property and maximising its tax efficiency.

Land tax

Land tax is a cost connected to the ownership of land. It does not apply to principal residences or land used for primary production, but applies to all other land. Land tax is assessed on an annual basis, as determined by land held at 31 December in the preceding year. It is based on the unimproved value of the land, as determined by the local municipality valuation process. These values are normally up-dated each year. The amount of land tax you pay is based on the total unimproved value of all the land you own (excluding exempt land) in the relevant state. Land tax rates are progressive, and increase proportionately as total land value increases.

Land tax is assessed on a state by state basis and land owned in other states is excluded from each state's computation. Some investors take advantage of this by spreading their holdings across more than one state, thereby minimising or even eliminating land tax. It is assessed on a per person basis. This means there may be planning opportunities connected to the choice of person to own the property. But other factors, including income tax, planning issues and asset protection issues also impact this decision.

Special rules apply to trusts in Victoria and NSW.

Land tax is deductible if the property is used to produce assessable rental income or is used in an assessable income producing business or other enterprise. It is often overlooked in the property selection process: its progressive nature often means investors get a rude surprise a year or so after they buy the next property, not realising it has bumped them up into a higher land tax rate.

Land tax can be a political issue. Politics is one reason why principal residences (ie the family home) and primary production land (ie the farm) are exempt. It's not unusual for political activists to even form one policy parties connected to land tax reform, as you can see from the "Land Tax 2010 Coalition website: www.landtax2010.com.au.

Land tax rates, explanations and details are published on each state revenue office's website, and we refer you to these resources and note that land tax rates and details change over time and the clients' specific circumstances should be considered before any advice is given.

Compare State Land Tax



Use this [land tax estimator](#) as a guide to compare land tax between the various states.

The below information was sourced from the requisite land tax offices in each state. They do not account for "Trusts" situations, which may attract different rates in some states.

LAND VALUE	RATE OF TAX
Less than \$25,000	Nil
\$25,000 to \$349,999	\$50 plus 0.55% of value above \$25,000
\$350,000 to \$749,999	\$1,837.50 plus 2% of value above \$350,000
\$750,000 and over	\$9,837.50 plus 2.5% of value above \$750,000

TASMANIA NEW LABOR SCALES	
LAND VALUE	RATE OF TAX
Less than \$25,000	Nil
\$25,000 to \$349,999	\$50 plus 0.55% of value above \$25,000
\$350,000 and over	\$1,837.50 plus 1.5% of value above \$350,000

New South Wales

Land tax is calculated on the combined value of all the taxable land you own. The land tax threshold for 2009 is \$368,000. Your land tax assessment is calculated on the combined value of all the taxable land you own above the threshold. The rate of tax is \$100 plus 1.6 per cent of the land value between the threshold and the premium rate threshold. From the 2009 tax year, a new premium land tax marginal rate of 2 per cent will apply for taxable land value above \$2,250,000.

Western Australia

LAND VALUE	RATE OF TAX
0 - \$300,000	Nil
\$300,001 - \$1,000,000	0.09 cent for every \$1 over \$300,000
\$1,000,001 - \$2,200,000	\$630 plus 0.47 cent for every \$1 over \$1,000,000
\$2,200,001 - \$5,500,000	\$6,270 plus 1.22 cents for every \$1 over \$2,200,000
\$5,500,001 - \$11,000,000	\$46,530 plus 1.46 cents for every \$1 over \$5,500,000
\$11,000,001 and over	\$126,830 plus 2.16 cents for every \$1 over \$11,000,000

Queensland

LAND VALUE	RATE OF TAX
0 - \$599,000	Nil
\$600,000 - \$999,000	\$500 plus 1 cent in each \$ more than \$600,000
\$1,000,000 - \$2,999,999	\$4,500 plus 1.65 cents in each \$ over \$1,000,000
\$3,000,000 - \$4,999,999	\$37,500 plus 1.25 cents in each \$ over \$3,000,000
\$5,000,000 and over	\$62,500 plus 1.75 cents for each \$ over \$5,000,000

South Australia

LAND VALUE	RATE OF TAX
0 - \$110,000	Nil
\$110,001 - \$350,000	30 cents for each \$100 or part \$100 over \$110,000
\$350,001 - \$550,000	\$720 plus 70 cents for each \$100 or part \$100 over \$350,000
\$550,001 - \$750,000	\$2,120 plus \$1.65 cents for each \$100 or part \$100 over \$550,000
\$750,001 - \$1,000,000	\$5,420 plus \$2.40 for each \$100 or part \$100 over \$750,000
\$1,000,001 and over	\$11,420 plus \$3.70 for each \$100 or part \$100 over \$1,000,000

Victoria

LAND VALUE	RATE OF TAX
0 - \$249,999	Nil
\$250,000 - \$599,999	\$275 plus 0.2 cents for every \$1 over \$250,000
\$600,000 - \$999,999	\$975 plus 0.5 cents for every \$1 over \$600,000
\$1,000,000 - \$1,799,999	\$2,975 plus 0.8 cents for every \$1 over \$1,000,000
\$1,800,000 - \$2,999,999	\$9,375 plus 1.3 cents for every \$1 over \$1,800,000
\$3,000,000 and over	\$24,975 plus 2.25 cents for every \$1 over \$3,000,000

Stamp duty

Historically stamp duty was a tax levied on documents. Documents had to be impressed, or stamped to be legally effective, and the government imposed a fee, or a duty, for doing this. The Australian Government does not charge stamp duty, but each Australian state and territory does, and stamp duties on transactions, particularly land transactions, now accounts for a major part of each jurisdiction’s annual revenue.

Each state has different stamp duty rates and scales, but all scales are progressive, in the sense that there is an increasing percentage applied as value increases, subject to an overall cap or limit. Each state also has excellent state revenue offices and you should refer to these websites for details of stamp duty payable on purchasing land in each state.

Dutiable value NSW	
Not more than \$14 000	\$1.25 for every \$100, or part, of the dutiable value
More than \$14 000 but not more than \$30 000	\$175 plus \$1.50 for every \$100, or part, by which the dutiable value exceeds \$14 000
More than \$30 000 but not more than \$80 000	\$415 plus \$1.75 for every \$100, or part, by which the dutiable value exceeds \$30 000
More than \$80 000 but not more than \$300 000	\$1290 plus \$3.50 for every \$100, or part, by which the dutiable value exceeds \$80 000
More than \$300 000 but not more than \$1 million	\$8990 plus \$4.50 for every \$100, or part, by which the dutiable value exceeds \$300 000
More than \$1 million	\$40,490 plus \$5.50 for every \$100, or part, by which the dutiable value exceeds \$1 million

Nomination clauses

It is common for a purchaser to include a clause like “John Smith and Betty Smith and or nominee” in a purchase contract. Advisors should take great care with nomination clauses, because in some states in some cases the nomination of a third person to be the ultimate purchaser may comprise a further conveyance of the land at strict law, and give rise to a further stamp duty charge.

This means two lots of stamp duty are payable on what is in effect one purchase of a property.