Your questions answered

Using a trust to reduce tax

Q I was told that you can write off interest payments on a rental property against your income even if the property is bought in a trust. This scenario only applies to a property investor trust and not the normal family discretionary trust. Is this correct?

A You can structure your affairs so that a hybrid trust (property investor trust) purchases the investment property in its trustee's name. It does this via funds from related party cash contributions and by issuing units in the hybrid trust to a related individual who has taken a loan out in their own name and contributes the proceeds into the trust for units in the hybrid trust as consideration. A portion of the rental profit will be distributed to the unit holder each year as a trust distribution and the unit holder will then write off the interest on their loan against this income in their individual tax return. In a normal discretionary trust the trustee would take out the bank loan and the interest deducted on this loan in the trust will result in a loss carried forward in the trust and starving yourself of the cash flow generated by the tax benefits of negative gearing. *– Pat Mannix*

Money Matters

Q We own an investment property but are still living in a rented apartment saving for a bigger deposit to buy our first home. While waiting for that right property to come up I transferred our savings into the investment loan in order to reduce the shortfall temporarily. I intend to withdraw that extra repayment when I'm ready to buy the first home to live in. If I do so would that affect the interest being deductible? Are there any other implications? I'm a sole trader if that matters.

A When you withdraw the money to purchase your new home the interest on that portion of the loan won't be deductible because the money borrowed was used to purchase a non income-producing asset. It would be better not to redraw but to get a fresh loan for your new house. At least with the loans separated you can concentrate on paying off your home loan first. *– Julia Hartman*

MEET THE PANEL

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New to property

Q I'm 23 and am researching to buy my first investment property towards the end of the year. I'll have a $20,000 deposit and would like to borrow $230,000 to buy an apartment near Melbourne CBD or a little further out. It seems however that all the calculators say I can only borrow about $110,000. I have a stable income of about $45,000 per annum and very little living costs as I live on an army base. I guess I'm asking if my circumstances would allow me to borrow more.

My second question is whether I would be able to find something positive cash flow in this range, as I live in Sydney and would have my stepfather looking after it.

A I have done some checking for you and it would seem that you would have a maximum borrowing capacity of $245,000. This considers that your expenses are low and you are a single person. There are some other considerations you must make, however. Firstly, if you are buying an apartment for $230,000 and you have only $20,000 deposit, you would need to borrow around $222,000. This is because you will have stamp duty on the purchase of $9300, stamp duty on the loan of around $1000 and about $2000 in conveyancing costs. At 96 per cent of the value of the property, you will struggle to find a lender who will provide this high a loan to valuation ratio, and if you do you will also have the additional costs of lender's mortgage insurance of around $1500 to $2000. So you see your proposal has more complications than just your personal borrowing capacity. You will need to either save more, or look around for a cheaper property. There are still many parts of Adelaide which have excellent prognosis for future growth and which are accessible for prices around $150,000. Your total costs would be lower (around $6000), leaving you with $14,000 as a deposit. Saving just $1000 more will give you a 10 per cent deposit, lower your lender's mortgage insurance premium and greatly increase your chances of obtaining a loan.

As for your second question, positive cash flow is hard to find at the moment as prices in so many parts of Australia have taken off. Since rent returns are slower to respond, it will now take a period of stabilised values for those rent returns to catch up and for positive cash flow property to once again appear. In the meantime, try to find property where rents have been stable for a while but where the economy is good and the population is growing.This increases tenant demand and rents grow faster and after a short while your cash flows will improve.

Your stepfather shouldn't be looking after this property for you anyway unless he is a property manager. The after-tax cost of a professional manager far outweighs the great risks you take when you try to manage a property yourself.

– Margaret Lomas

Which way to turn

Q I have about $600,000 equity in my property and earn just over $100,000 per year. Should I use a cash deposit or purchase against my equity? Would a newer property be better? Is freestanding better than a body corporate complex? And would an investment property be a good tax benefit to me? I'm 43 years old.

A When you talk about your existing property, I assume you mean your family home. Before you consider buying a property purely for investment purposes, you should pay off any remaining debt on your home. Debt on your home isn't tax deductible; it is more expensive debt than debt on an investment property, so the faster you pay it off, the better for your hip pocket. Once you've paid off the debt on your home, you can leverage off the equity to buy an investment property. From an investment point of view, it's not important whether the property is a freestanding house or an apartment. What matters is the quality of the asset – the location, floorplan, degree of structural soundness, land value, and access to amenities and public transport. A negatively geared investment property may help reduce your overall tax bill. I suggest you speak to an accountant who can review your broader financial position and provide you with the appropriate advice.

– Mark Armstrong

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