When does it make sense to turn your home into investment property?

Before you decide to convert your current home into a rental property, there are serious financial and tax considerations that you need to take into account. **Margaret Lomas** explains

Choosing to keep the home you are moving from may result in a great loss of useful tax deductions – deductions which can often give you the extra cash flow you need to repay debt and so gain equity, and leveraging power, much sooner

So, you have made the decision to move out of your home, buy something new to live in, and rent out the home you are moving from. Have you made the right decision? And if so, what do you need to do to your present financing arrangements to ensure that they become tax effective and, more importantly, remain within the tax laws?

Too many people undervalue the importance of getting this all right, and I see many investors who end up in trouble with the Tax Office because they made claims which they simply were not allowed to make.

There are many considerations to make when initiating this kind of move – from whether you are actually making the right financial decision right through to ensuring that your structures are correct and you are making all of the tax claims you can. Here is a guide to help you through the minefield.

Is it right financially?

You have decided to move from the house you live in for any one of a number of reasons. It could be that you are being transferred with work, but think you may be coming back again to the home you are vacating.

You may have decided to upgrade to a bigger and better property for yourself, and because you like the one you are moving out of so much, believe it will make a good investment. Or, you might be moving for a number of reasons, but just cannot bear the thought of letting go of the house you have known and loved so much. Let's put all these reasons into perspective to be sure that you are operating from your brain, and not from your heart!

Temporarily vacating

If you leave your principal place of residence with the intention of returning at some time in the future, the six-year rule will allow you to vacate, rent it out, make claims for income and expenses, but avoid capital gains tax in the future once you ultimately sell.

As the name of the rule implies, the maximum amount of time you may be absent is six years, after which any sale would attract capital gains tax, at the current discounted rate, on a pro rata basis for the amount of time the property was a rental.

You may move back in and then move out again, and a new six-year period will commence. This rule is of particular use to people who are in employment which may require them to be itinerant, but who wish to move back home again at some time in the future.

To apply the six-year rule, there are a number of conditions:

1. The property must have been your main residence from the time when you acquired it
2. The property may not have originally been a rental
3. If you move out for longer than six years, you may be entitled to a partial reduction in CGT

The main reason why you would elect to maintain your home while being away is because you specifically want to move back into that property, not necessarily because you think it will make a good investment.

Moving on or up

Often people become so attached to the house in which they live that they simply cannot bear to sell it. They may have decided that they need a bigger home, or a residence in a better area, or they may be permanently leaving town to establish roots elsewhere. However, they simply cannot part with the property they are moving from for a number of reasons – it holds too many memories, they believe it is a 'good' investment' or they want to use that property to commence their investment portfolio.

From both a financial and emotional perspective, this may or may not be a good idea, for the following reasons:

1. Financially you may be upside down

If you are in the position where you have paid a lot off your debt, and are planning on using the equity you have built up to leverage against and raise the funds you need to move into your new principal place of residence, you are likely to be topsy-turvy from a financial perspective. The property which is about to become your investment property will have a small, tax deductible debt, while the property you are about to move into will have a large, non-tax deductible debt. Take a look at the following example:

Brad and Sarah own a home valued at $300,000, on which they owe $100,000 with an interest rate of 8.5%. They can achieve $18,000 in rent a year. They want to move into a home valued at $400,000, and the loan will also be at 8.5%. Ignoring purchasing costs in the following examples, their circumstances will look like this:

Current owner-occupied

Property value:	$300,000
Current debt:	$100,000
Equity:	$200,000
Rental income:	$18,000
Interest on loan:	$8,500
Other costs:	$2,000
Gain for the year:	$7,500
Tax @ 30%:	$2,250
Net to Brad and Sarah:	$5,250
New home value:	$400,000
Interest on loan:	$34,000
Net cost: (new loan interest less net rent)	$28,750

It is far better for Brad and Sarah to take advantage of the capital gains tax-free status of the existing owner-occupied property, sell it, and then use the proceeds for a deposit on their new property, and only raising a smaller debt to buy it.

Then, once they have moved in, they can use the equity which they have transferred to the new owner-occupied property to leverage back into a different investment property, with a 100% fully tax deductible loan.

The results, ignoring selling and purchasing costs, would be as follows:

Proceeds from sale:	$200,000
Loan for new home:	$200,000
Interest on new debt:	$17,000
Loan for new investment:	$300,000
Interest on loan:	$25,500
Other yearly costs:	$2,000
Income from rental:	$18,000
Gross loss from rental:	$9,500
Tax break @ 30%:	$2,850
Total costs to Brad and Sarah:	$23,650

it needs to possess, as I've outlined in my latest book*. The areas we choose to live in do not always possess those characteristics, because the places we make our home depend on other things – being near family or work and living in an area we are comfortable with.

The best areas to invest in may well be areas which you would not choose for your own place of residence. It is highly likely that the property you are moving from is not located in the very best area in which to invest at that time Far better to liquidate, avoid all of the financial and emotional issues, and start again with a property that is ripe for investing.

The main reason why you would elect to maintain your home while away is because you specifically want to move back into that property, not necessarily because you think it will make a good investment

Brad and Sarah are $5,100, or almost $100 a week, better off by selling their old home and buying a different investment property. Add to that the fact that this $5,000 per annum will buy them equity (or exposure which allows them to buy more property sooner) and the fact that both properties, the old owner-occupied and the new one are CGT-free, then this clearly becomes the better strategy.

2. Emotionally it may be the wrong choice

If you want to hold on to that property because you love it so much, then I have two things to say.

Firstly, if you love it so much, you will not be able to bear watching what others do to it. You will not be able to become emotionally detached, which is something that all investors need to be. You will be needlessly driving past and worrying about how your treasured home is being treated.

Secondly, if you do love it so much, why are you moving? It can't be that good if you are thinking of leaving it!

3. Investment-wise, it may not be the best you can get for your money

For a property to become a viable investment, there are 20 major qualities

Important considerations

If you have decided to keep the property you are moving from, and you are certain that is the best choice you can make, you must make sure that the existing loan and the structure in which you have purchased is suitable too. Be sure that you attend to the following issues:

The loan

The loan that you have in place will probably be a standard owner-occupied home loan. These days, there are not really special investment loans per se, and the existing loan will most probably be suitable to become the 'investment' loan. Be careful, however, that:

- If the loan is a line of credit, and you are about to raise a new debt for a new owner-occupied property, you should not use the line of credit on what has become the investment property to park your income and so offset interest. You want any interest offsetting to occur on a personal, owner-occupied debt rather than on a tax deductible investment debt
- If you do maintain the debt on what will become the investment property as a line of credit, be careful not to deposit funds into it which you subsequently draw-back to use to pay personal expenses or to buy personal items. If you do, the amount you draw back will be considered 'personal use' (even if you originally deposited additional funds) and you will lose tax deductibility status on that portion of the loan. This then also makes apportioning interest at tax time very time consuming and difficult, and this could increase your accountancy costs
- You establish an exact loan balance as at the time the property becomes income producing. This then becomes the full amount of the investment loan. The original loan amount, current as at the time you purchased the property, is not relevant
- If the debt is a principal & interest loan, you may wish to convert it to an interest-only loan if you are going to take out a non-tax deductible, owner-occupied loan on another property. This is because you want all repayments of any principal to be made to a non-tax deductible, personal loan. Once you no longer have personal debt, it is fine to begin repaying investment debt by making principal & interest repayments
- You ensure that you separate this existing, now tax deductible investment loan completely from the new, owner-occupied loan you obtain to buy your new home. Combining the loans into one is asking for trouble from the Tax Office and it is crucial that tax deductible debt be quarantined from non-tax deductible debt
- You understand tax law when it comes to making deductible claims in loan interest and fees

Structure

Typically, when you buy an owner-occupied property with a spouse or partner you will become joint tenants. This is because you are both going to own and live in this property and, most likely, in the sad event of your untimely death, you would want your share to fall automatically to your partner.

When we buy property as an investment, and that property has a negative cash flow, often we employ the tax effective strategy of having only one party of the couple's names appear on the title, usually the higher income earner. This then allows that one person to make all of the tax claims and, since

they are often in a higher marginal rate of tax, they get more tax back.

If you are moving out of a property on which you have already reduced a lot of debt, that property may be positively geared – that is, the income exceeds the total expenses. If this is the case, the property should only be in the name of the lower income earner, since tax must be paid on any gain made.

Choosing to keep, instead of selling, the home you are moving from may result in a great loss of useful tax deductions – deductions which can often give you the extra cash flow you need to repay debt and so gain equity, and leveraging power, much sooner.

The ultimate cost of retaining a property which does not obtain the best tax advantages possible could be far greater than it seems at first glance, especially if it results in you missing out on tax benefits which could otherwise allow you to gain equity more quickly and so buy more property, sooner. While it is impossible to work out the cost of this 'lost opportunity', it could ultimately run to tens of thousands of dollars of lost tax deductions and exposure to a growth market.

Depreciation

Generally, we would not have a depreciation schedule prepared for a property that we owner occupy, since we have no access to claims for loss of value on any property which does not produce an income.

If you are moving from an owner-occupied property which will then become income-producing, it is vital that you engage the services of a quantity surveyor who can estimate the present value of the building, fixtures, fittings and furniture. Even if you have the original costs of these items available to you, a quantity surveyor will be able to provide you with the value as at the time the property becomes income-producing.

You are then able to claim any balance of building claims (so the remainder of the '40 years since construction' claim period) and the loss in value of the fixtures, fittings and furniture for their new 'effective lives' from the day the property becomes income-producing. These items can bring substantial tax breaks, and so this is an important step to take.

Conclusion

I have rarely seen an owner-occupier who is better off retaining the home they are vacating as an investment. The only circumstances that I could see this as being an advantage would be if you were able to absolutely confirm that the area in which the property is situated really is about to do marvellous things in terms of growth. Then the resulting gain from capital growth will far outweigh the losses you see from being in a worse cash-flow financial position.

Since no one has a crystal ball, then this would all be just speculation anyway, and this strategy may be costly to you in the long run.

Be sure that you are being commercial in your approach, and recognise when your emotions are making the decisions for you. If you really do intend to upgrade, transfer or start a new life elsewhere, cut all ties and let someone else enjoy that home you have grown to love so much. **YM**

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