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## Common Questions - Property Investment

### **What if I have no deposit for an investment property?**

What you mean is that you have no cash deposit. Cash is not really necessary when you have equity in your own home. Having sufficient assets against which to borrow is all that is required and in this way, you can borrow the full amount plus all the additional costs.

### **Is property investment still OK if inflation is low?**

It's not so much the absolute capital growth rate that is important, but rather the growth relative to inflation. With capital growth historically averaging between 2% and 4% over and above inflation, even if inflation were to fall, I would still expect property to perform at this level above inflation. In America, where annual inflation has been slightly lower at around 6%, property growth has averaged more than 8% per year, which is still that couple of percent above inflation.

Everything needs to be put in true perspective and if inflation, and consequently capital growth, is lower relative to everything else, property should still be better than any other form of investment. Furthermore, interest rates would have to fall, reducing the cost of the loan to such an extent that the overall rate of return (above inflation) on the property investment should remain about the same.

### **We own our own house but want to borrow money against this house to build a bigger and better house in which to live. We would still like to keep the one we're living in now as a rental property. Is the loan tax deductible?**

The short answer is no, the loan is not tax deductible. This is a classic situation in which many property owners find themselves when they first decide to upgrade. Assessing whether interest on a loan is tax deductible depends on the *purpose* of the loan – not the *collateral* for the loan. In this case, the purpose of the loan is clearly to build a new home and not for the purpose of producing income. This situation is a double loss. Not only would the interest on the loan not be tax-deductible, but the rent from the investment property would be taxed at the highest marginal tax rate.

A simple solution could be to sell the first home and put the proceeds into the new home; you would then borrow to buy a rental property, using the equity in the new home as collateral. The interest on the loan would then be tax-deductible and instead of paying tax, a tax refund would more likely result.

However, there may be alternatives. For example, if the first home had been bought in the wife's name only, the husband could borrow the money to buy the property from his wife, and she could put the money she receives towards the new house. A legally binding contract is needed, and stamp duty must be paid, however, the tax benefits may far outweigh the transfer costs. I would

recommend that you check with both your solicitor and accountant before you attempt any transaction of this nature.

### **What if the mortgage company goes bust?**

You have their money so you cannot lose it in the same way as if the company has yours. The title of the property is in your name and at all times you have legal ownership. The mortgagee has no right of claim to your property – unless of course you renege on your mortgage agreement. The only claim is on the money borrowed, not your property. Another financial institution may take over the defunct company or you may have the slight inconvenience and expense of refinancing elsewhere.

### **How do I pick the best area for capital growth?**

Although it is human nature to want to find a bargain in an area of great capital growth, I believe it is false economy to spend a huge amount of time searching elsewhere for gems that are probably buried in your own backyard. It is virtually impossible, and really unnecessary, to gauge just where the most valuable suburbs will be in the future. It is far more important to find an area that you know well rather than try to guess the area that has maximum capital growth potential. History has shown that reasonably well-located property should follow the pattern of around 10 to 11% capital growth over the long-term. If your property achieves better than this, it's more likely good luck than good selection. Rather than spending weekend after weekend driving from one side of the city to the other, you can maximise your returns and better manage your investment by organising your finances in the best possible way and ensuring that you pay only fair market value in an area around your home with which you are familiar. Of course, this may not always be achievable, particularly if you live in an expensive suburb and you find that you have to go further a field to find suitable rental property.

### **What if interest rates rise?**

I personally recommend fixed-interest loans. If the rates rise, then you are insulated against rising repayments. On the other hand, if rates fall you should still be smiling. Have you noticed how low interest rates are usually followed by an increase in property prices? Also, if variable rates do rise, you are buffered by the tax refund.

### **Won't there be a glut of vacant properties when everyone discovers the advantages of owning rental property?**

Firstly, let me remind you of the number of people who take any step towards becoming financially independent – there's such a small percentage of the population in the running to buy rental property. Secondly, people have been renting property since time eternal, and with more than 30% of the population renting, and this percentage increasing, tenants will not disappear overnight. There should always be a pool of tenants looking for rental accommodation and it's up to you to make your property most desirable.

Supply and demand in rental properties is cyclic and vacancies can and do occur from time to time. However, the baker doesn't expect to have customers in his shop every minute of the day from early morning until night and having a property vacant for a time is par for the course. But there are

certain things you can do to keep this time to a minimum. Choosing the right property in the first place helps and well-located, well-maintained properties with reasonable rents attract more tenants.

### **I've been to several banks and they all say I can't afford an investment property. Where do I go from here?**

It's quite common to find people turned down for a property investment loan, even though they feel sure they can afford it. Don't be disillusioned if your first approach to a bank is unproductive. It's up to you to prepare a budget and an assets/liabilities statement to not only assure yourself that you can do it, but also to assure the financier. In some cases, the financial institution won't have taken the tax refund into account, and this can make all the difference. Don't stop at the first "no". The great American baseball Babe Ruth failed to get to first base just as many times as he hit a home run. Continue until you find a manager who will listen.

### **Most people seem to emphasise position, position, position. Should I buy prime residential property?**

Property in prime locations does experience strong capital growth, perhaps slightly higher than normal, however the real return cannot be measured by the growth alone. There is not much point in purchasing a property one street back from the main shops if you have borrowed money using a principal and interest loan over 10 years with an interest rate of 18% and the property is so run down that nobody wants to rent it. I believe that property that is well-located, properly financed and properly managed will outperform property selected on the basis of position alone.

### **What if real estate prices stagnate?**

Holding onto the house for at least 10 years should ensure a buffer against any cycles in the market. It's important to keep sight of long-term goals and not be distracted by any short-term hiccups. What happens to property values from one Christmas to the next should not concern you and although property can be cyclical, history shows that around 10% to 11% growth can be achieved long-term. More importantly, long- growth has performed at several percent above inflation. term property

### **Are units better than houses?**

There is not a simple yes or no to this question. There are many financial factors to be considered as well as personal preferences. Houses may, and I say may, experience better capital growth because of the higher land content, but the maintenance could be higher and the yield (rent/value) could be lower. So in the longer term, the overall returns from units could be the same as for houses. Also, it's a case of horses for courses and the different tenant profile in some locations predetermines the suitability of houses, units or flats. Around the city centre, units or townhouses may suit the young professional couples whereas in the suburbs, young families might be more attracted to houses.

### **Do I have to get deeply involved if I invest in real estate?**

No! Real estate is only the vehicle for building wealth – a means to an end and not the end itself. The great thing about property investment is that you can do as little or as much as you want to. You can do all the maintenance and bookwork yourself, or you can employ someone to do it all for you. The returns from property can be so great that you can afford to pay to have all those things done that you don't like doing or don't have time for – they're tax deductible anyway. A good property manager helps and he can do most things from paying the rates to arranging for the shower to be fixed or making insurance claims if necessary. The degree of involvement is entirely up to you. While doing everything yourself can increase your overall returns, weigh up the real cost in terms of family life and your peace of mind.

### **Shouldn't I buy up-market real estate as an investment if I can afford it? Won't I get better capital gains?**

Quite possibly you could get greater capital gains but the real rate of return in the long-term could be the same as, or lower than, a property in the lower end of the market. Just because a property valued at \$100,000 might generate rent of \$160 per week, it does not mean that a \$500,000 property will rent for \$800 per week. The rental market can only bear so much and in buying more expensive property, the market will dictate the rent you can command. Also there will be fewer people who can afford to pay the higher rent, so this will limit your choice of tenants. Another consideration is that the upper end of the property market is much more volatile and timing of the purchase becomes more critical.

### **I have \$300,000 in equity in my own home. How much can I afford to borrow to buy more property?**

It's not just a case of how much property you have to borrow against. It's just as important to consider your ability to service the loan. I have known people who own several million dollars worth of prime rural land, but because their income is limited, they are not capable of borrowing very much at all. No matter what the value of your properties, when it comes to borrowing money, we are generally limited by cash flow.

### **My wife and I live in a house worth \$300,000. Would I be better to sell and buy a cheaper property in which to live and use the excess money to buy rental property? Or should I stay put and borrow against my home to buy more?**

Economically speaking, you should downgrade and put the excess into rental property where you will be able to have more property working for you. However, when you are deciding just how much you want to invest, it's important to take personal considerations into account. You could live in a tent and own 10 investment properties or you can live in a mansion and have nothing else. Somewhere between the two extremes you'll find a happy medium.

## **I don't seem to have much spare money as it is now. How am I going to afford to buy an investment property?**

If you have already made the commitment to pay for necessities first and luxuries last, then the only remaining stumbling block is more of a perceived problem than an actual problem. Too often, we think of an investment property in the same light as our first home. This being the case, we tend to see only the interest payment as creating an enormous burden. But your contribution to the interest bill, remember, is after the tenant and the taxman have paid their share, and what's left may be as little as \$80 in the first year – and it gets less over time as the rents increase. In addition, section 221D of the Taxation Act may help you to improve your initial cash flow through reduced PAYE tax instalments which means you don't have to wait up to two years for your tax refund.

## **My wife isn't keen on the idea of buying an investment property in my name only. Is there an alternative?**

There's not much point in putting a negatively geared property in joint names when the wife is not working, just in case of a marital break up. It is most tax advantageous to buy the property in the name of the highest-income earner. If you are at all worried about divorce, get a solicitor to draw up a written statement as to the equitable division of all your assets, regardless of title of ownership. This may only cost a small amount, compared to the thousands of dollars of potential tax savings.

## **Am I better off buying one property for \$200,000 or two for \$100,000?**

Generally, it is better to buy more property at the cheaper price, but this depends entirely on the area in which you are buying. A \$200,000 property in the inner city may be the bottom quarter of the market in that area, whereas a \$200,000 property in a provincial town would probably be a mansion. In the former case, a \$200,000 property would be OK but not so in the latter for a number of reasons. Firstly, a property in the lower end of the market has a higher rental yield, which results in a better cash flow. Secondly, the lower rent should attract more tenants. Thirdly, if you wish to sell on your retirement, there's more flexibility in selling one small property rather than one large one. And finally, if you're selling, property in the lower quarter of the market should attract other investors as well as first-home buyers, so there should be more potential purchasers.

## **Should I avoid timber houses because of the extra maintenance?**

As an investment, timber houses can be just as good as brick houses. Usually they are cheaper than a brick equivalent, which may compensate for their maintenance later. Or if it is a very old house, it is quite possibly in a good position, being closer to the town centre – in which case, it may be more attractive to tenants or experience slightly greater capital growth that again compensates for the maintenance. But don't try to do all the maintenance yourself if you don't enjoy it. Too many landlords try to do everything themselves, instead of using tradesmen.

## **I've spent a long time looking for a good property but I seem to keep missing out on the real bargains. How long should I look before buying an investment property?**

It's my opinion that the "once in a lifetime" bargain comes along about "once-a-month". However, try to remember the real costs in chasing a bargain. If you are investing longer-term, there's no need to spend six months of your valuable weekends in a real estate agent's car chasing that elusive bargain. Time heals all wounds, and so long as you pay fair market price (a little homework should determine what this value would be), you should still achieve sound capital growth. Don't buy the first property you come across, but on the other hand, don't go out with any preconceived ideas of what makes the perfect investment property because you'll spend a year looking for something that may not exist. Spend at least a month familiarising yourself with values in your area, so that when you do find that "right" property, you'll immediately recognise it.

## **With an interest-only loan, when do I actually get to own the property?**

While it is true that, with an interest-only loan, there is a perpetual debt on the property, you retain title to the property at all times. Whether you ever get to "own" the property outright is irrelevant. What is important is your equity in the property and how fast it increases over time. Eventually the debt will be insignificant compared to the property value. Reducing the principal reduces the interest claimable and you'll then pay tax on the rent. So why pay it out? The only loans you should pay out while you are building wealth are those that are not tax deductible – such as the loan on your own home or car.

## **What if a consumption tax (Goods and Services Tax – GST) is introduced and personal tax rates are cut. Will this affect property investment?**

Initially, the value of most commodities will rise causing an increase in property values. This is because both land development costs and building materials will increase, directly affecting property values. Longer term, although the tax effectiveness will be marginally less, everything is relative and all other tax-advantaged investments will be similarly affected. If residential property outperforms all other investments now, then there is no reason to expect that this will be any different with a consumption tax.

## **What if negative gearing is abolished?**

The government has already made the mistake of abolishing the right to claim interest losses from rental property against other income. The turmoil in the rental market that occurred when investors took flight was so great, that it was reintroduced within two years. I believe the government is unlikely to make the same mistake twice. But in the unlikely event that it does, I wouldn't expect the change to be retrospective and it would be a matter of adjusting the debt to balance the rental income.

## **Will they ever get rid of the capital gains tax?**

Revenue from the capital gains tax is now firmly entrenched in the government's budget. Since it was introduced in 1985, billions of dollars have been collected as a direct result of the tax and to remove it now would mean drastic cuts to sensitive areas such as education and health. For this

reason, I believe it is here to stay. However, it is not the bogey it is made out to be and it should not really affect long-term investors. If you don't sell, you don't pay and because it applies only to gains above inflation, it is usually minimal if you do sell in the long-term. The tax was intended to encourage long-term investment and discourage short-term speculators – and this it does very effectively.

### **Why hasn't my accountant told me everything about investing in property?**

When you go to the garage for petrol, does the mechanic come running out to suggest that your brakes need checking or that it's time for a tune up? We probably expect too much of accountants. They should be able to answer all of your questions competently, but don't expect them to be creative in guiding your wealth creation program. Accountants are usually specialists in their area of expertise – accounting. They will expertly complete the tax forms for you after you have provided them with all the figures. They are usually not specialists in property investment and should never be relied on as such. However, there are some accountants who do specialise in property – and even have some rental property of their own.

### **We seem to be in the middle of a recession. Is it still a good time to buy rental property?**

The herd mentality of the population is such that everyone buys when everyone else is buying and sells when everyone else is selling. (Statistics show that most investors bought in the midst of the last property boom when interest rates and property prices were at their highest!!) Successful investors look on a downturn in the economy as a great time to buy and they then take all the necessary steps to ensure that they are able to hold long-term to reap the rewards of future recovery.

### **Should I buy a property in partnership with a friend?**

Usually, this is one sure recipe to lose a friend. If the investment is worthwhile, do it yourself. Different people will have different ideas on investments. However, if it is the only way that you can afford to get started in property investment, then have a go, but beware of the pitfalls.