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Accounting • Taxation • Business Services

About Tax

A FRIENDLY TAX NEWSLETTER FROM MANU GUPTA

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IN THIS EDITION

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PLANNING POINT

WHY KILL YOUR GOLDEN GOOSE?

A number of clients have asked me this question – *"My investment property is now positively geared and is making me pay more tax. Should I sell it off?"*. This question is coming across more often now with rising rents and relatively low interest rates.

To these clients I narrate a version of an age-old story, the story of the goose that layed golden eggs. I tell them *"You have a goose that gives you golden eggs and promises to do so day after day, provided you share a small part of it with the tax office. Why kill your golden goose? Wouldn't you rather make more money getting those golden eggs over time and some day selling the goose at a price much higher than today? All you need to be prepared to do is share your benefits with the tax office."* The message goes across quite effectively i.e. if your investment is positively geared and is expected to generate future capital growth there is no reason why you should sell it off!

Unfortunately, too many of us treat our investment plans as a means of saving tax rather than generating wealth, including even some financial planners. If it wasn't so, I fail to see why would anyone sell or buy those 'tax effective forestry investments'!

TIP! *Tax saving should never be the first reason to buy, hold or sell an investment. Key objective should be to generate wealth. Maximising tax benefit should be one of the means towards generating wealth.*

MAKE YOUR MORTGAGE WORK FOR YOU

Going by the great Australian dream of owning a house and paying it off as soon as possible, we tend to buy our first home, create equity in it and then sell it off, thus generating wealth, tax-free! Some would rather keep the property as investment and buy a better, bigger home to live in. This is where some of us make a big tax blunder.

Consider the example of a young energetic and proactive couple who;

1. Bought their first home with a loan of $250,000.
2. In 5 years, paid off loan down to $50,000.
3. In the fifth year, redrew the $200,000, used it as deposit to buy a new home and converted the first home into investment.

	Loan I (P+I)* Home 1	Loan II (P+I)** Home 2
Year 0 First Property (Val $300,000)	$250,000	
Year 5 (reduced to)	$50,000	
Redrawn	$200,000	
Loans after redraw and new purchase (Val $500,000)	$250,000	$300,000
Year 5 after new loan	$250,000	$300,000
*Good Loan	$50,000	NIL
*Bad Loan	$200,000	$300,000

* P – Principal I – Interest. Good Loan – Tax deductible loan. Bad Loan – Non tax deductible loan.

At the end of the 5th year, they intend to claim interest on $250,000 for the year against the rent, hoping for a healthy tax refund. Sadly though, they are told by their accountant that this is not possible because $200,000 of the loan fails the 'purpose test'. ***Interest on a borrowing needs to pass the 'purpose test' to be able to be claimable as tax.*** This test states that interest is deductible in tax if the borrowing was made to invest in an income-producing asset.

In the above example, the Tax Office considers that the original loan which was used to purchase the 'now income-producing investment property' has been reduced to only $50,000. The $200,000 paid into the loan over first 5 years has reduced the original loan. Its redraw has created a new loan, the purpose for which is to fund the 'now new primary residence', which fails the purpose test.

Thus our young professional couple ends up with a total borrowing of $550,000 (over two properties) with just $50,000 of this being tax deductible. Worse still is that the first property is now positively geared and thus making them pay more tax.

TIP! *Imagine if the loan account was a Line of Credit facility with every pay-cheque treated as repayment of original loan and every redraw for home expenses considered as new personal bad loan. One might end up with a loan largely the same over the years, yet most of it being non tax-deductible.*

How could we have changed the situation? By using the concept of 'offset accounts'. An offset account is a savings account which sits alongside a loan account (without reducing the loan account balance). It ensures that the interest you pay is calculated on an amount net of loan less offset account balance. Thus if on a given day your Loan account balance is $200,000 and your offset-savings account balance is $30,000 you would pay interest on only $170,000. This thus works exactly like a redraw facility account, in some situations even better!

Check out how a simple offset account works wonders for our young couple;

	Loan I (Interest Only)	Offset Account I	Loan II (Interest Only)	Offset Account II
Year 0 First Property (Val $300,000)	$250,000	-	-	-
Year 5	$250,000	$200,000	-	-
Move Offset across, for deposit on new property (Val $500,000)	$250,000	$0.00	$400,000	$100,000
Year 5 After New Purchase	$250,000	$0.00	$400,000	$100,000
Good Loan	$250,000		NIL	
Bad Loan	NIL		$300,000	

Changes made:

1. Convert all loans to interest only, even if it is used for principal place of residence.
2. Set up an offset account and put all savings in the offset account.
3. As the balance of offset account increases, interest charged on loan will decrease, further helping you save more and build your offset account.

4. Aim to bring the offset equal to your loan account. This practically means your loan is paid off, without actually paying it off.

Results achieved:

1. Loan I stays unchanged over the years. So when first property is converted into investment property, the whole of $250,000 remains a ***good tax-deductible loan***.
2. Funds from Offset Account I are easily drawn and used as deposit for second property loan. Any surplus is kept in Offset Account II ***to ensure minimum non-tax deductible interest is paid***.
3. As compared to the earlier situation, ***Good loan is increased to $250,000 and Bad loan reduced to $300,000***. Total loan remains the same!
4. If for any reason the couple needs to move back into first property, offset funds are moved back from Offset II to Offset I thus maximising good loan and minimising bad loan.

Conclusion:

Whether you borrow for owner occupied or investment property, it is critical that a proper tax plan is prepared and executed to ensure you make your mortgage work for you! If any of you have similar plans or find yourself in a similar predicament, feel free to contact us for possible solutions.

TIP! *The above strategy works best for people having the discipline to save. For those who need a reason for forced savings, principal plus interest loans is probably a better option.*

NEWSFLASH

M G Arthur and Associates is organising Audit Insurance covers for its clients through AIB Insurance Brokers. This insurance largely covers a client towards certain professional fees in case of a query, review or audit by ATO or any other State or Federal revenue agency. For further information please write to amsha@mgarthur.com.au

TIP! *One might conclude we don't need this strategy if we don't change our residence into investment property. Even when we might think we wouldn't need to change our main residence, life is uncertain. Many at times we have to move suburbs or cities because of kids attending a particular school or for better job prospects. If we don't plan for those times now, we might be in the above situation with a huge 'bad loan' and a taxing positively geared property!*