Home Study Program Module 9
Property Investor Guide

Wealth Creation Dynamics

Learn how to **drastically** advance **your** financial future.

by Philip Sigglekow

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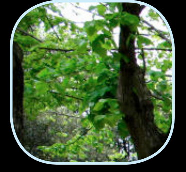

Welcome

Module 9
Property Investor Guide

Welcome to module 9 of the Wealth Creation Home Dynamics Study Course - Property Investor Guide.

This module is number 9 of 24.

Each module is presented in the same layout and contains exercises that you can do in your own time.

The benefits of participating in this Home Study Course are:-

- You progress at your own pace.
- You can study in the privacy of your own home.
- You can ask questions regarding the course at questions@apin.com.au

We hope you enjoy the Wealth Creation Home Study Course.

Best regards,
The team at APIN

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A Vested Interest

Today, many people are aware of the need to address their future security by investing in an asset venture. Determining where to invest is a serious matter, as the monetary outcome is linked to investors' future living standards. The public have a vested stake in the investment markets, and this has created a great deal of interest and concern. The media continually speculate and debate the topic, particularly focusing on where to invest and which of the asset sectors is the most profitable form of investment. The constant comparing of the various asset sectors has made investing seem like a daunting task, leaving the average person feeling overwhelmed and confused.

First-time investors should not be caught in the debate as to which asset class is better, as each has its advantages and disadvantages; they have different risk and return profiles and their performance is determined and measured by completely dissimilar factors. Take for example property and shares. Residential property values are primarily affected by supply and demand, with some sway from the domestic economy. We all need somewhere to live, and the amount of suitable land is finite, so residential property essentially commands a built-in value.

On the other hand, share values are highly liquid parcels of a company, and to some extent company performance, market sentiment, and their relative scarcity determine their value. When a company is performing well and investors are confident about the economic outlook, share prices generally rise and vice versa.

This example illustrates that there is no definitive reason to choose one asset class over another. Instead a more balanced approach should be taken to your investment portfolio, that of investing across the various asset sectors.

Compared with most other forms of investment, it is said that the property asset sector has a relatively high ratio between security and income yield. Other positive attributes of property investment include:

- **Security** - 'Bricks and mortar' provide a certain sense of security, i.e. it is tangible.
- **Control** - You are not as dependent on the abilities and decisions of others, and you can choose the extent of your involvement and do as much or little as you like.
- **Stability** - Historically, the value of property has seen a gradual and steady rise.
- **Return on Investment** - One can be assured of a steady annual return that is not as subject to fluctuations in value as some other assets.
- **Demand** - There is an ever-growing demand for property because people will always need somewhere to live.

Property investment has positive and negative aspects. The drawbacks are considered to be the high entry and exit cost, and its perceived illiquidity. Others may consider these drawbacks to be actually an advantage, contributing to a more stable and secure market. Speculators may be deterred from the market, contributing to a more solid platform for investors. There are ways to address these drawbacks and thus minimise their impact. For example, owning a property increases your borrowing potential and allows you the option of a credit line. This means that in cases of emergency, you have access to a liquid source of cash flow.

This is not to say that investing in property should be the sole option for you. A financial service provider (FSP) can give you a balanced portfolio by looking at your overall investment needs in the context of your personal goals and financial situation. From this information, they can recommend what proportion of your income and capital should go towards each asset class. They can also provide information and advice regarding shares, managed funds and so forth. In terms of property service provision, an FSP can locate properties, provide property information, illustrate investment scenarios and assist investors in the buying process.

We have briefly discussed the investment debate, showing that there are opportunities for returns in both the share and property investment sectors. For example, the suitability of an investment depends on your risk/return investor profile among other things.

The next section, 'Entering the Property Investment Market', outlines the decisions you should make before selecting your investment property. It discusses the timing of your purchase, what type of investment properties you should consider, and the issues involved when buying off the plan.

Exercise

What factors affect Property Values?

What factors affect Share Values?

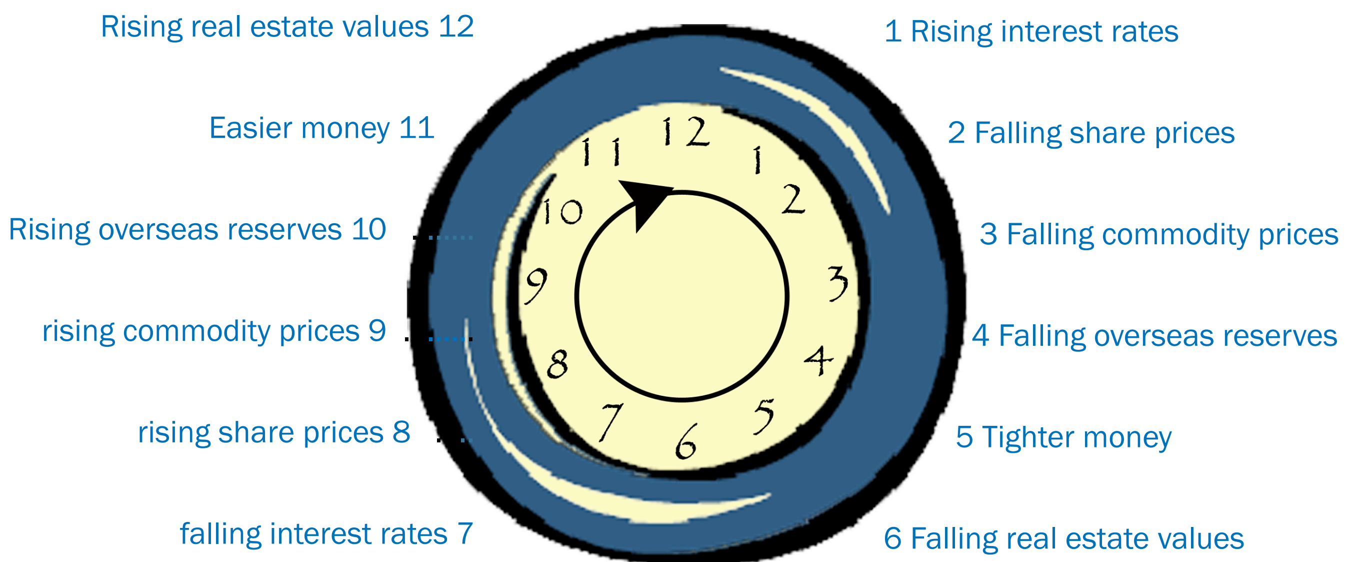
Timing

When is the right time to buy an investment property?

"It is never the wrong time to buy a property". However, that statement comes with a caveat in that it is only true provided you pay the right price for a property. The right price is the real market price, but you may ask what the real market price is? This is a much harder question to answer than it appears. In our view, the real market price is the price at which you could sell the property to another person within a reasonably short period of time. The last part of the caveat is important because it stipulates that the market will generally desire your purchase. The lowest risk approach to this latter point is to stick to property that the majority of the population would desire.

Furthermore, remember your investment should last for a property cycle (seven to ten years) or more. Markets will slow and boom, so the longer the term of your investment, the better your chances will be of achieving the attractive long-term total returns available.'

Property Cycles: The average length of a property cycle is said to last between 7 and 10 years in which the following pattern may occur:



BOTTOM OF THE RECESSION

(This cycle was compiled by the London Evening Standard from an examination of trade cycles over a period of 150 years).

Timing property cycles when entering the property investment market is important for speculators and short-term property traders. For long-term investors, fluctuations are marginal over time.

Another important point to consider is that there is more than just one property cycle. Because property is location specific, i.e. different cities have different demographics, population growth rates, land boundaries and so on that all affect the supply and demand for property, you need to look at individual cycles and assess how various markets are performing. Even within individual cities there is a high degree of variability. A way to assess your position is to see whether the properties you are considering cater for a growing or declining demographic market.

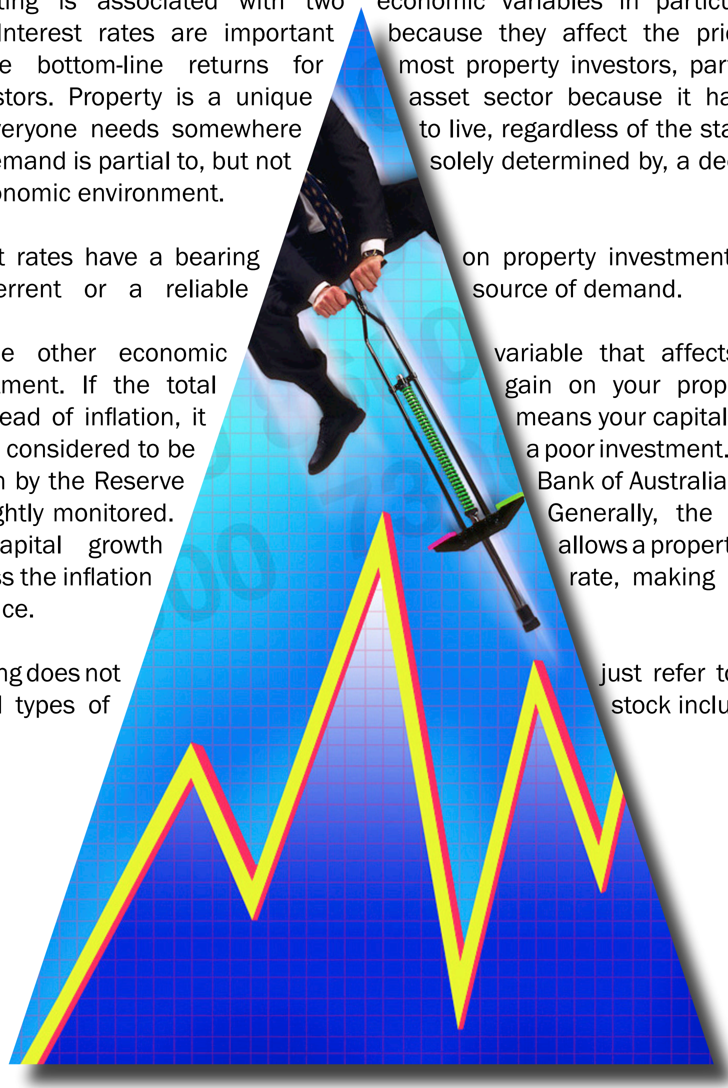
The Economy

Property investing is associated with two economic variables in particular: interest rates and inflation. Interest rates are important because they affect the price of debt, which determines the bottom-line returns for most property investors, particularly the higher leveraged investors. Property is a unique asset sector because it has a base level of demand, ie. everyone needs somewhere to live, regardless of the state of the economy. For example, demand is partial to, but not solely determined by, a declining interest rate in a slowing economic environment.

Overall, interest rates have a bearing on property investment, but they are not always a deterrent or a reliable source of demand.

Inflation is the other economic variable that affects returns on your property investment. If the total gain on your property investment is not keeping ahead of inflation, it means your capital is diminishing, and your property is considered to be a poor investment. However, the target rate for inflation by the Reserve Bank of Australia is between 2% and 3%, and it is tightly monitored. Generally, the addition of rental return and capital growth allows a property's total investment return to surpass the inflation rate, making property a popular investment choice.

Property investing does not just refer to residential stock. It relates to all types of stock including industrial.



Choosing Your Investment

Property investing does not just refer to residential stock. It relates to all types of stock including industrial warehouses, commercial offices, serviced apartments, units and houses. For a person entering the property market, residential property is perceived as the most preferred investment option because there is seen to be an underlying demand.

The next question to ask is what makes the best investment, a house or a unit? To quote Residex: 'Houses in capital growth terms do generally outperform units by about 1.5% to 2% per annum. However, it must be recognised that it costs more to maintain a house than it does a unit. Furthermore, the land tax bill on a house will probably be higher. It is also possible to identify areas of the city where houses perform more poorly than units do. When there is low capital growth, the rental return will generally compensate for the low capital return to some extent.

Therefore there is no hard and fast rule. However, it is wise to stick to some very basic principles when it comes to buying a property. The best property investment will:-

- Be purchased at or below market value.
- Have a value that is affordable for most of the population, ie. its value will probably be close to the median value of properties in the area in which it is located. This means there will be a large market for it when it is sold.
- Be subjected to expenses that are moderate.
- Be in a good position, ie. close to transport and amenities such as schools, shopping centres and parks etc.
- Have some desirable attribute that makes it unique in some way. This attribute will ensure that when there is an oversupply of properties, the investment will not be as adversely affected as it will be unique from other properties. Properties that have a special view or are in very close proximity to a significant public amenity fall into this category.

With today's social demographics and lifestyle preferences, people are tending to favour units, townhouses, villas and terrace-style accommodation. This is a specific type of investment where the investor needs to know how strata titled properties work.

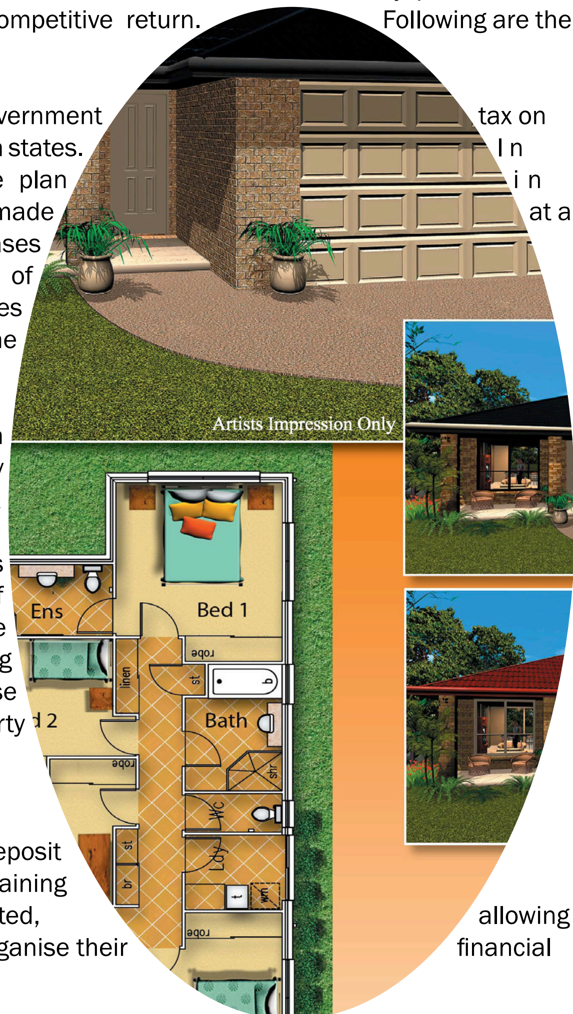
When selecting an investment property, the total investment return per annum is your key indicator. In a short-term letting market, the rental returns are higher, so a much higher vacancy rate should be accounted for. The cost of holding the property during these periods may cause financial strain on the landlord. However, the astute investor will allow for these vacancies by either having a high cash flow from a job, or borrowing extra money as a reserve.

Buying Off The Plan

Properties that are yet to be constructed provide investors the opportunity to 'buy off the plan'. As the term suggests, buying off the plan means entering into a contract to purchase a property prior to its construction.

Essentially, you select and purchase a property from the developer's floor plans. Buying off the plan has become a popular method of buying investment property. There are many reasons to consider buying new residential property off the plan, some of which include a lower entry price into the property market, good capital growth and a competitive return. Following are the perceived benefits of buying off the plan.

Stamp duty Deferral - Stamp duty is a State Government tax on the transfer of property. It is charged in all Australian states. In most states, the advantage of buying off the plan in terms of stamp duty is that payments can be made at a later date. In New South Wales, off the plan purchases allow stamp duty to be paid within 15 months of the exchange date unlike established properties where you have to pay within three months of the exchange date.



'Lock in' a price for your property - You can 'lock-in' the purchase price of the property today, while one to two years down the track the value of your property may grow relative to market movements. Often, property values increase during the period between buying off the plan (signing the contract) and the date of the development's completion. Buyers are benefiting from rising property values because the purchase price is locked-in at exchange, although the property is worth more at the time of settlement.

Delayed settlement gives you more time to save a deposit - A 5%-10% cash deposit or a 'deposit bond' is all you need to buy off the plan. The remaining balance is paid when the development is completed, allowing the investor 12 months or so to maximise and organise their financial affairs. Buying off the plan can offer you:

- More time to save money for future mortgage repayments,
- The opportunity to save a larger deposit,
- A time delay between exchange of contracts and the completion of construction therefore, you have time to shop around for the best loan and, if necessary, sell existing property,
- A better opportunity to borrow more money, as most banks allow investors to borrow on the current market value of their property at settlement.

You can make suggestions regarding finishes, floor plans and interior style - Purchasing off the plan gives you the opportunity to sometimes put forward any suggestions you may have regarding design and finishes.

Significant tax savings - Off the plan purchases of new residential property may qualify for greater depreciation tax savings than those available on existing buildings, if purchased for investment purposes.

Building warranty - Since the 1989 Home Building Act was introduced, properties now come with a building warranty. In most states the warranty is seven years. This applies if the building is constructed by a registered builder.

Wider selection in the development/s - Buying off the plan does not limit your options in terms of variety, ie. The location, price and style etc. Investors have the option to choose from a wide variety of properties.

Generally, property investors and owner-occupiers consider buying off the plan to be risky because they cannot see the finished product. To motivate buyers to purchase properties early, developers sometimes price apartments off the plan at a discount to market value.

Following are the drawbacks to buying off the plan and ways to reduce their impact:

1) Unlike the purchase of a completed dwelling, the contract of sale will lack certainty relating to the finished product.

- The contract will usually have a list of inclusions and finishes, often of a very general nature, with provision for substitution and variation. Usually, the developer will stipulate that if the schedule of finishes is altered, they will be replaced to a similar effect and quality. The buyer can compare the list of inclusions and finishes with a view to having a list attached to the contract which is as detailed as possible.

- Apart from the lot plan, the buyer often has no real sense of the design layout, finished product and how it will function separate from, and in conjunction with, common areas of the building. This uncertainty is reduced by the introduction of architectural floor plans and site layout plans, level by level. Given the possibility that floor plans may be altered during construction, we suggest that you mention the floor layout with your solicitor prior to exchange, i.e. the positioning of the walls, kitchens, bathrooms and so forth (Taking into account the developer's reputation for craftsmanship can substantially reduce the aforementioned risks. Inspecting properties the developer has completed is a good idea).

2) There are a number of ways to ensure the developer repairs any defects there may be with a property. Before exchange, your solicitor may be able to negotiate the insertion of a holding costs clause in the contract prior to exchange. If the defects have prolonged the vacancy rate, it is reasonable to ask the developer for some form of assistance for the holding costs of the property. Another option is to nominate a longer settlement period after registration of strata so that the repairs can be completed by the time you have to settle.

3) The contract will usually stipulate that the vendor has to build 'substantially' in accordance with plans attached to the contract. Often the only plan attached is a draft strata plan with an outline of the Lot measurements. The contract includes provision for the seller to be able to vary the measurements, and sometimes the location of the Lot, without the buyer's consent. The buyer needs to be aware that any reduction in area or location could affect the final value of the unit, and that a permissible reduction in area could occur wholly in one particular part of the Lot, such as the living area or car space. This is why it is important to have a good solicitor who will negotiate and stipulate that the property is not to pass a reasonable agreed area. It also gives the developer some flexibility in building and planning long-term projects. For any work over the agreed area, the solicitor may be able to negotiate a reduction in price, if it is worked out by floor space per square metres or the option to rescind the contract.

An experienced solicitor acting for the buyer will point out the issues and risks associated with buying off the plan.

They will also endeavour to reduce the risks by negotiating contract terms in the buyer's favour as much as possible.

Now that you know more about timing and what type of stock to invest in, you need to understand what constitutes a good property investment in terms of selection and strategy.

The Art of Property Investing

Property is a unique asset sector, and there are many factors that contribute to effective property investing. The art of property investing requires that you understand the factors that make a property a worthwhile investment. Essentially, the skeletal answer can be found by looking at the property investment process. The investment process is an evolving one whereby the property investor is shifts from being a beginner investor to a buyer to a landlord and so forth. Accordingly, varying your perspective and coordinating your approach to property and finance factors makes for successful property investing.

To begin your investment, you need the right financial structures in place. Your financial service provider (FSP) can address this. You then need to look at the factors that make the property a profitable venture. There are essentially two factors that drive property gains and make up an investor's total investment return: capital growth and rental return. The combination of the two makes property an excellent investment source, as you do not need high levels in both for an investment to be profitable. With higher capital growth properties, rental yield may be low, while other properties might have high rental income yield and low capital growth.

People close to retirement may prefer higher yielding properties as a source of future income; whereas a couple with very different incomes might buy properties in different names to take advantage of different growth/yield combinations. It is important to calculate your overall returns by adding the growth and rental yield instead of isolating the two when assessing your investment property's performance.

Realising a property's total investment return allows you to make a more informed decision about which property best suits your financial goals and investment needs. To assess a property's likely investment returns, you need to evaluate the likely capital growth and return.

You need to ask yourself, how can I assess the capital growth before the growth has actually occurred? Historical figures play a vital role in establishing recent performance of an area however the future is not always like the past and these figures may in many instances be misleading.

Locating the right property and purchasing it is only the beginning of the property investment process. Effective property investing requires good property management and tax planning. Once you have purchased your property, the next phase of the investment process involves shifting your perspective to incorporate a landlord mentality. This requires you to assess what factors maintain your asset's viability. Good property management involves the upkeep of your property and resolving tenancy issues. Tax planning is the financial basis of maintaining property as a worthwhile investment.

One of the most important aspects of property investing is your investment strategy. Successful property investing involves holding your property over a long time frame. The ability to manage and hold property is an acquired skill.

entering the property investment market 2

Discipline and the ability to organise your financial affairs are two important characteristics that a property investor should have.

Investing in property is not a short-term endeavor. Anything short-term is considered trading. Short-term trading (unlike long-term investing) magnifies the risks of external variables such as market movements that are beyond a person's control. A long-term property investment strategy gives you the opportunity to build your wealth portfolio appreciably without being affected by short-term fluctuations in the economy, which is normally a prominent factor when investing in any asset sector.

The art of property investing is a combination of all the aforementioned factors, from selection to strategising financial and property specifics. Understanding the logistics of these components will enhance your skills and knowledge base and place you in an astute investor category.

Factors such as demographic trends, new government initiatives, changes to infrastructure, proximity to, and, availability of services are some major indicators of future capital growth. For example new planning initiatives for a suburb may entail a new road network, new school and/or high and consistent population growth, all of which will increase demand and hence value of homes in the suburb leading to high capital growth.

Rental return is the other factor making up total investment return. By conducting research, an investor can find out the rental return on a property from local real estate agents. For properties that are not yet built, an investor can obtain rental estimates when buying off the plan. However, just by looking at a property, one can personally judge its rental appeal and observe the extent of its allure to a potential tenant. A good property should also accommodate the tenant's needs by being in close proximity to services, including transport, retail services, schools, restaurants, recreational activities, business districts and so fourth.

Good returns on property investments can be found in every state. By varying your property investment portfolio, you can take advantage of the differences in location variables. For example, different cities may be at different stages of the property cycle, allowing the investor to take advantage of that difference in that state; buying properties in different states may minimize land tax, as each state levies taxes on property owned in them; also properties in different areas may have tax advantages stemming from travel.

In any investment undertaking, you need to do a certain amount of research to accumulate information and first-hand knowledge of what you want to buy, and gain an understanding of the risks and benefits associated with that purchase. Many suggest the research involved for a beginner investor in around six months.

Exercise

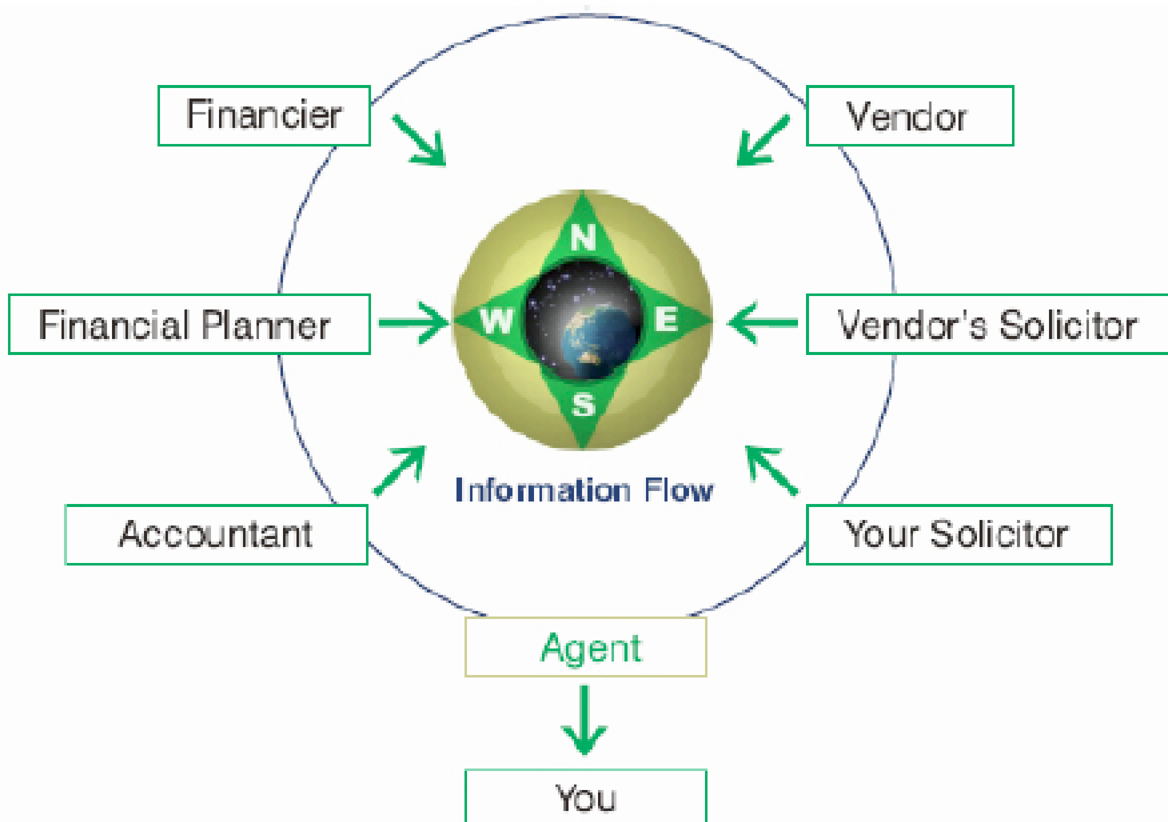
Name some attributes of a good property investment:

What are some of the advantages and disadvantages of buying "off the plan":

A Step In The Right Direction

Investors should be educated on the steps of the overall property investment procedure, so that rather than being led, they are involved in the process. The buying process can be quite daunting. However, if you are actively involved in the buying process, the experience will be more enjoyable for you.

The buying process involves a few individuals, as you may well be aware. When purchasing an investment property, besides you there is a financial planner, a financier, an accountant, a vendor, a vendor's solicitor, and your solicitor.



Financial Services Provider

A financial service provider (FSP) is considered to be one, some or all of the following: a financial advisor, financier, financial planner and/or accountant.

Financial structures
Discuss with your FSP how you are going to structure your loan and leveraging, i.e. negative or positive gearing and so on.

Helpful Hint
Ask about lines of credit to see if they are a viable option for you.

What is a deposit bond?

When a person or entity enters into a contract to purchase residential property in Australia, it is common practice for the purchaser to lodge a cash deposit of up to 10% of the purchase price with the vendor's solicitor. This secures the purchaser's obligations, and gives the vendor (the seller) a fund that they can claim if you fail to complete the transaction.

A deposit bond is a convenient way to purchase a property without needing to arrange a large cash deposit or sell an investment that may mature at some point in the future. An insurer issues the deposit bond to the vendor for all or part of the deposit required.

Before issuing a deposit bond, the buyer needs to satisfy the insurer that they are financially able to complete the sale and pay the full deposit amount on settlement. The loan pre-approval is subject to verification of income and a satisfactory valuation of the property to be purchased. Once the prospective buyer locates the ideal property and signs the purchase contract 'subject to finance approval', it takes 14 days to obtain a valuation and approval for a loan. It is deemed the quickest way for a buyer to secure a property.

If the purchaser fails to complete the purchase of a property and has used a deposit bond, the vendor or the holder of the deposit bond has the right to present it to the insurer and claim the full amount. The insurer will then seek reimbursement from the purchaser for any monies paid, plus any other costs and expenses.

Essentially, a deposit bond enables the purchaser to defer their 10% deposit until settlement. However, it does not remove a purchaser's obligation to pay the deposit amount to the vendor at settlement.

Deposit bonds can be used to purchase residential properties in all states and territories in Australia. The cost of a deposit bond is usually determined by the value and term of the bond. It is usually a one-off fee, which is paid prior to the bond being issued.

In summary, a deposit bond is a popular deposit option because:

- It costs less than borrowing a cash deposit.
- It is a quick and efficient way of arranging the deposit for the purchase of a residential property, particularly if the purchaser has not sold their current property or needs to sell investments to raise the required funds.
- Obtaining a deposit bond is generally a fast, uncomplicated process that ensures the property purchase is ‘locked in’, and leads to a faster exchange. It is particularly useful when purchasing properties off the plan.

(The information pertaining to deposit bonds was sourced from various deposit bond institutions)

Solicitors and Accountants

CONVEYANCING

Conveyancing is the transfer of the right to ownership of a property from the seller's name to the buyer's name. A solicitor usually handles the conveyancing in the property investment process. The typical process is outlined below.

Once you put a property 'on hold' (take a property off the market), a contract is sent to your solicitor. Your solicitor will then explain the standard terms and conditions of the contract to you, along with any special conditions that are included. They will go through your obligations and rights as a purchaser under the contract, including your implied rights under various legislations.

Your solicitor will check warranties such as proper insurance in relation to building and construction, and make sure that you have evidence of finance approval before exchange. They will discuss mortgage documentation implications, too.

Your solicitor will also, depending on the property being purchased, suggest required pre-purchase repairs, which may include a survey report, strata records inspection, building and pest inspection reports.

Your solicitor may organize a 66W Certificate. This extinguishes your cooling off rights; i.e. you wave your right to a five-day cooling off period. Some purchasers agree to a 66W with a vendor, who may hold the property for a longer period so that your solicitor can do the property checks.

It is important to mention gazumping in relation to the period up until exchange. Gazumping is when a vendor agrees to sell the property to you, but then sells it to someone else, usually because they have been offered a higher price.

The faster the contracts are exchanged, the less chance there is of being gazumped. After the exchange of contracts, your solicitor will raise requisitions on title. This is a set of questions asked of the vendor in relation to the property.

Your solicitor will then conduct a number of government department searches to make sure the property is not affected by any adverse circumstances. For example, will check with the local council, State Rail Authority, Road Transport Authority, Sydney Water, the Electricity Commission, Energy Australia, Environment Protection Authority and the Department of Education. Once contracts have been exchanged, your solicitor will ensure that the plans are registered if you are buying a strata titled investment. Your solicitor will check that the registered strata plans are not significantly different to the draft strata plans contained in the contract. Once registered, a strata number will be issued, enabling your solicitor to draw up a stamp duty transfer, amending the contract to include the strata number, and advise the financier involved.

Before settlement, your solicitor will confirm with the Office of State Revenue whether or not your property is encumbered with land tax obligations.

ACCOUNTANTS

Your accountant may have a checklist of requirements in relation to your investment purchase. Keeping your accountant informed of any investment information compiled by you including reports, valuations, depreciations and so forth will assist them in advising on the following:

Contract Name
It's important to consult your accountant or financial planner as to whom should be the ultimate legal owner of the property, i.e. single, joint ownership, company or a trust. Depending on your status, ask your accountant which would be the most favorable option.

Income Tax Withholding Variation
Ask your accountant if it will suit your needs to lodge an Income Tax Withholding Variation Form. Once lodged and approved with the Australian Taxation Office, it enables your employer to deduct less tax from your pay, instead of a lump sum credit at the end of your tax year. This form takes into account your gross earnings and deductible expenses with respect to your investment property. This is a cash flow consideration. The purpose of this is to ensure that the amounts withheld during the income year best meet your end of year tax liability.

GST
GST is only payable on newly constructed residential property, purchased after 1 July 2000. It is not payable on residential dwellings that existed before that date. The vendor will be liable to pay GST on the date is generally on settlement, which y 10% of the property's value. The vendor is responsible for collecting GST and remittance to the Australian Tax Office, and hence this should be dealt with in the purchase contract. Hence the purchase price on the contract should include GST. Generally, if the contract says the sale is a taxable supply and GST is payable, you should check that the price is GST inclusive, you should check with your professional advisers as to your entitlement to a tax credit.

Ask your accountant for further information regarding GST on new residential property and if the margin scheme is applicable to your property.

Property Management

Locating a good property management service is just as important as choosing the right property. A well-researched process can help you locate and purchase a great investment property. However, the benefits of your timely purchase can be compromised within one year if the property is managed poorly. There is a lot involved in good property management. Assuming any property management agency will automatically achieve this for you is an unnecessary risk to your investment return.

The property manager you choose can make the difference between a dream investment and a nightmare experience. A lack of property management skills and servicing can result in poor tenant selection, continual rental arrears, poor property maintenance, wanting landlord communication, extended vacancy periods, unfavorable results at Residential Tribunal hearings, and so forth. When selecting an agent to manage your property, there is a range of criteria to consider.

Many believe that the local agent is ideal for carrying out the management of the property, and to some extent we agree. After all, they have the least distance to travel to make inspections and are in the right place to locate interested tenants. However, this approach may not be appropriate for the astute investor who has more than one property in different localities. In this case, choosing a local agent each time would lead to multiple agents.

There are potential tenancy issues investors need to consider when renting out a property. They should be aware of the processes in place that deal with unfavorable tenancy scenarios.

Rent in Arrears
If the tenant decides that they do not want to pay the rent, the landlord has very few options with no immediate solution.

The following procedures must be followed to recover rent and evict the tenant:

- Day 14 - The tenant must be 14 days in arrears before a termination notice can be issued.
- Day 15 - The termination notice can be issued on the 15th day. The tenant must be given 14 days from the date of the termination notice to vacate the property.
- Day 29 - A further four working days must be allowed for postage.
- Day 33 - If the tenant has not vacated the premises by this time, an application must be made to the Residential Tribunal at a cost of $26 plus any managing agent costs.
- Day 47 - It usually takes 14 days before a hearing date is obtained.
- Day 54 - It often takes seven days before the case is heard. If the tenant pays some rent before the hearing date, it is likely the Tribunal will make an order to allow the tenant to stay in the property and the lease to remain on foot. The tenant is usually given a repayments schedule that enables them to pay back the rent.

If the tenancy is terminated, you can claim the bond, which is worth 28 days. But you may be up for cleaning costs, repairs, letting fees and advertising costs. If the tenant refuses to leave the premises, you will need to reapply to the Tribunal for an order to remove the tenant, and this order will need to be served by a sheriff. Once again, this will cost to the landlord.

As you can see, it can take up to 54 days or more before a landlord can recover any rent. At best, that may only be 28 days worth of rent. The Tribunal does not have the power to recover the loss of rent. To do this you would need to apply to the local court using the Tribunal order, which must be served by the sheriff. If the tenant has not provided a forwarding address, the sheriff will not be able to serve the court order. The onus is on the plaintiff to inform the sheriff as to the location of the tenant.

Denied Access

The tenant can refuse you or your property manager access to the property to perform an inspection. In this case, the only action available is to apply to the Tribunal for an order to gain access. This can take weeks, during which time the tenant could abandon the property, leaving it in a damaged state.

Abandoned Premises

It usually becomes apparent that a property is abandoned when the rent falls significantly in arrears and there is no response to any attempt at communication. In this case, the landlord must apply to the Tribunal for an order to classify the premises as abandoned. The onus is on the landlord to prove this, which would entail evidence such as witness statements, notices of gas, telephone and electricity disconnection and so on.

Any possessions that the tenant has left behind, that are of value, must be removed and stored by the landlord at the landlord’s expense. Within seven days, the landlord must provide written notice to the tenant and publish the notice in a statewide newspaper. After 30 days, the landlord can auction the goods to recover the storage, removal and sale costs incurred. The balance must be given to the tenant if they so request. Often the sale of abandoned goods does not recover the costs incurred by the landlord.

Strata Titled Investments

Strata title is the most common system under which one block of units is divided among several owners. Some of the property is owned individually as ‘lots’, and some of it is common to all the owners. Essentially, owners hold a certificate of title for the unit and a certificate of title for the common property (stairwells, lifts, laundries, lobbies etc).

The basis of strata title is the strata plan; a type of floor plan that shows the position of each lot on each floor of a building. The strata plan must also provide a schedule of unit entitlements. The allocation of unit entitlements should reflect the relative values of the lots at the time of registration. Unit entitlement also determines the voting rights attached to each lot, and the proportion of operating costs of the strata scheme payable.

Common property is the land and areas not contained in a particular strata lot. The common property becomes the custodial property of the Owners' Corporation, a committee of all the owners who manage the property as a whole, sometimes called the body corporate. The role of the Owners' Corporation is to 'control, manage and administer the common property for the benefit of the proprietors.'

The owners pay set fees each year to the owners' corporation to cover the maintenance of the building and the upkeep of all the common areas, such as the stairs and garden. The two main levies are called the administrative fund and the sinking fund. The administrative fund levy covers the day-to-day operating costs for things such as cleaning of common property, lawn maintenance and insurances. The sinking fund levy is for long-term maintenance items and includes such renovations as painting, rewiring, re-carpeting or guttering.

The Owners' Corporation maintains a strata roll, which is a record of the details of the proprietors and others who have an interest in the lot, such as mortgagees and lessees. All owners have voting rights with regard to the management of the strata scheme. The right to vote at meetings depends on whether the owner is recorded on the strata roll.

The strata scheme is regulated by by-laws that govern the conduct of proprietors and occupiers, noise, parking and so forth. There are model sets of by-laws contained in the Act. An owners' corporation can choose any one of these sets of by-laws or they can write their own. The by-laws are then registered and recorded on the Certificate of Title of the Common Property. By-laws can be added, amended or repealed by a motion of the owners' corporation.

A by-law remains ineffective unless:

- a notification has been lodged with the Registrar General within two years of its passage;
- the Registrar General has recorded it on the certificate of title of the common property.

Strata title provides a means to resolve disputes. The Strata Titles Commissioner and the Strata Schemes Board of New South Wales administer the Act and play the role of arbitrator when disputes arise.

Exercise

What is a Deposit Bond and what are the benefits of using one as a deposit?

What are some of the possible tenancy issues facing property investors?

Tax Deductions

As highlighted in the previous section, the benefits to property investors are those tax deductions received from expenses incurred. Tax deductions are split into two categories: revenue cost and capital cost.

Revenue costs are incurred from earning rental income, and are classified as cash or non-cash. Cash deductions, like interest rates and expenses, are deductible at the time the cost is incurred. Non-cash deductions such as depreciation and borrowing costs are claimed annually regardless of whether or not you paid out any monies in a particular year.

Capital costs are any funds used for the purchase of, sale of, or improvements to an investment property. Buying and selling costs are not directly deductible against income. These costs can only be attributed towards calculating the Capital Gains Tax (CGT) payable once the property is sold. Regarding the improvement category, there are shades of grey as to what constitutes a repair that is tax deductible now. Otherwise, if it is noted as a capital improvement, it will need to be taken into account in the CGT if the property is sold. A capital improvement is understood to be any work on the property that returns it to the condition it was in when you bought it.

It is tax-effective to carry out repairs towards the end of the financial year. Since you cannot claim on improvements immediately, it is a good idea to take out a loan because you can claim the interest.

Typical tax deductions are:

- All materials that helped you in your investment decision such as newspapers, manuals, books, magazines, videos, audio tapes, computer software, seminars, consultants, courses, conferences, etc

- Borrowing costs including all those fees associated with the loan. For example, the establishment fee, searches, valuations, registration, solicitor, mortgagee and broker fees, solicitor's mortgage insurance, mortgage stamp duty, etc. The borrowing costs can be deducted over five years or the term of the loan whatever period is the least amount of time.

- Council rates and charges such as water rates, sewerage, garbage collection, registration fees for flats, etc. Properties are often purchased in the middle of a rate period and are apportioned according to the date at which the vendor and the purchaser settled. The amount paid by the vendor is tax deductible.

- Property and contents insurance. It is also possible to claim your personal life insurance if your financier insists on making it a condition of the loan. Public liability and mortgage insurance are also tax deductible.

- Interest on loans. Any interest on loans used to finance improvements that generate income such as paint; carpets and furniture are deductible from your assessable income, even if they are taken out to pay for improvements that are classified as non-deductible expenses.

- Legal expenses. The majority of legal expenses are of a capital nature relating to the property not the tenant and therefore are not tax deductible. Although the cost of evicting tenants is deductible, disputes over the lease agreement are usually sorted out well before legal action is necessary.

- Property agents' fees and commission. Agents' fees for letting and managing the rental property are tax deductible and can vary between 5% and 20% of gross rent depending on the agent and whether or not the property is for holiday letting. Remember that the fee is tax deductible, and that it is based on the rental income, not the property value.

- Lease costs. Expenses incurred from the preparation of the lease by your property manager are included in the first week's letting fee.

- Stationary/Postage. File all receipts for office materials and postage. These deductions are based on the proportion used for business.

- Travel expenses related to the management of your properties, such as travel to interstate inspections and body corporate meetings. Airfares, accommodation and meal costs should be entered into your diary and receipts filed. If you combine a holiday with your inspection, the proportion spent between business and private time needs to be calculated.

- Land tax varies depending on the state. You can jointly own a few properties (this even excludes your own home) with your partner before you exceed the tax-free threshold.

- Vacancy. Proof that you have actively advertised for a new tenant ensures that you will be able to claim all the expenses during the term of the vacancy.

- Fire levy. This may be collected by local governments or as a separate account levied by the states.

- Cleaning costs that are not covered by the bond of a departed tenant.

- Quantity surveyor's fees. A quantity surveyor prepares schedules for depreciable fixtures and fittings as well as the building. Quantity surveyors usually know the latest in tax law, rulings, determinations and common trade practices.

Depreciations

Tax depreciation for an investment property allows you to depreciate certain parts of the building, including plant & equipment (now referred to as depreciating assets) and the structural components (capital works). This applies to commercial, industrial and residential property.

As your investment depreciates (deteriorates or loses value) due to wear and tear or age, the tax act allows you to write off this amount against your income.

The value at which the item is depreciated comes under two distinct types of ‘allowance’: capital works and depreciating assets. Capital works is based on the actual construction cost of the building. The building allowance is either 2.5% or 4%, depending on the date of construction, type of building (residential, industrial, retail, commercial), and if it is a short or long-term letting. To claim 4% allowance, the tax act states that the property must be either a hotel, motel or guesthouse with more than 10 bedrooms; or a building that contains more than 10 apartments, units or flats, available for short-term accommodation. Residential, commercial or industrial property that was constructed between 1985 and 1987 also qualifies for the 4% allowance.

Depreciation on assets is available where capital expenditure has been incurred on ‘plant and articles’; the rate of depreciation is based on the effective life of that item. For depreciating assets, the value at which the item is depreciated is based on what the taxpayer actually paid for a particular item.

There are two methods by which assets are depreciated; these are the diminishing value method (DV) and the prime cost method (PC). The diminishing value method provides a more accelerated depreciation over the first 10 years, as opposed to the prime cost method, which provides a more even distribution of the depreciation benefit.

The DV method will continue until the value of the asset reaches zero, whereas the PC method will continue for a period of 10 years only. An accountant should be consulted in relation to the method that best suits the taxpayer. Once you select a method, you must stick to it; you cannot alternate between methods.

In summary, the new system has removed accelerated depreciation. Now the depreciation of plant items is based on their effective life. The old immediate deduction for items costing less than $300 has also been abolished. The Australian Tax Office has brought in a low-value pool for items less than $1,000. The Australian Tax Office has ruled that this low-value pool is to be written off at half the rate, or at 18.75% in the first year and 37.5% from then on.

Two types of depreciation reports may be provided. These are the Indicative Tax Depreciation Schedule and the Final Tax Depreciation Schedule. An indicative report is only preliminary and should be used as a guide when selling or purchasing property; the Commissioner of Taxation does not accept it. The final report is more detailed, covering property specifics; you can submit it to the Commissioner of Taxation.

In summary, the preparation for depreciation schedules: offers attractive tax incentives for the property owner; may be used as a marketing tool when selling the property; may be submitted and is accepted by the Commissioner of Taxation should the investor be subjected to a tax audit; and, all fees are fully tax deductible.

Helpful Hints

Many developments now contain gyms, swimming pools, lifts, barbecues, car park lighting, fire pumps, electronic security and so on. These are all part of what is referred to as 'common property'. A unit owner owns a proportion of this common property and is therefore entitled to claim a portion of it as part of the depreciation against their capital income.

Property allowance specialists who provide a tax depreciation schedule on your investment property analyse the property for the purchase price at the date of settlement. If you renovate or remove some structures, you change what you originally purchased, and this may significantly change your original depreciation allowances. It pays to have your property analysed before committing to additional capital expenditure.

New apartments, townhouses and units offer higher depreciation on depreciating assets (plant and articles).

This is mainly due to the fact that they have new fixtures and fittings and the combination of a full building allowance, which further maximises the taxation benefit. However, effective life may be reduced on account of the second-hand condition of the plant. The value of plant can be depreciated on the basis of what the taxpayer paid for it, and not what it cost to originally install.

Reports should contain a detailed tax depreciation schedule that itemises each individual asset contained within the property, and covers a depreciation period of 40 years, rather than the first 10 years as some companies provide.

You should not purchase property solely for the tax benefits. Capital gains and cash flow should be the main goals, as virtually any investment property will provide substantial tax benefits to its owner.

Depending on the type of investment property held, certain tax deductions can be obtained. For example, body corporate fees usually apply to unit complexes and vary greatly according to the value and age of the building, and the facilities, in relation to administrative and sinking funds. Your accountant should be able to distinguish between a capital cost and revenue cost within the fund.

For short-term letting properties such as holiday unit complexes and serviced apartments, tax deductions can include:

In-house video recorders - an expense most likely incurred in managed holiday complexes where each unit is connected to cable television and has a network of telephone systems, both of which are usually leased on a monthly basis.

Replacements - Holiday houses and units are usually let fully furnished, and items such as crockery and bed linen can be claimed at the time of replacement. The initial installation may be capital. However, on-going charges are considered expenditure.

Different tax deductions apply to different investors. If you own multiple properties you can include accounting fees and land tax under the general business section of your tax return. Also, some people treat property investing as a business and devote much attention to it. There are tax deductions if you are running property from a 'home office' or place of business. Expenses in conjunction with that, such as advertising, travel allowance, repairs and maintenance can be claimed. Other tax deductions may include electricity, gas, and pest control, gardening and mowing. Although these services are generally considered to be the tenant's responsibility, they are tax deductible if you have paid for them.

Selling Your Property

Discharge of mortgage. A mortgage that has been registered on the Certificate of Title that secured your loan has to be discharged at the time of settlement. A fee is paid to the lending institution for attending the settlement and discharging the security of the loan. A fee is also charged for preparing the discharge of the mortgage document, and there is a government fee for registering the discharge of mortgage on the Certificate of Title.

Capital Gains Tax (CGT). This is usually the largest expense involved in the selling of property. The contracts are usually exchanged on the date the property is acquired and not on the settlement date.

Helpful Hints
Legal expenses that include the purchase or disposal of your property, costs of resisting land resumption, and defending your title to the property are non-deductible. However, they may be used as part of the CGT calculation when the property is sold.

Agents' fees or sales commission should be taken into account when calculating any CGT liability or profits derived from the sale.

After the sale of a property, the borrowing costs can be claimed in the remainder of that year. If the property is refinanced or sold, the fees for releasing the mortgage or any penalties are fully tax deductible in the same year.

Keep records of anything that will affect your capital growth in the future. These include the purchase contract, legal costs, stamp duty, conveyancing costs, and receipts for repairs and improvements. All records must be kept for five years after the sale of an investment property to support your CGT calculations.

Cancel any insurance policies taken out on your investment property. Insurance companies should forward you a refund calculated on a pro-rata basis.

The GST is payable on most selling costs associated with all types of property, new or old. For example, solicitor and accountant fees, advertising costs and agent's commission. Make sure that anyone you engage the services of provides you with an ABN. If you don't, the Australian Tax Office will expect you to apply the maximum tax rate in your payment to the service provider and forward the withheld tax to the Australian Tax Office.

The following information was obtained from the Australian Taxation Office (ATO):
Capital Gains Tax (CGT) is a component of income tax that applies to certain types of assets that you buy and sell for a profit and loss. It affects your income tax liability because your assessable income includes any net capital gain or capital loss you made for the income year.

Capital Gains Tax

CGT is only payable when you sell or give away your property. There are stages when it is time to sell property. For example, when retiring, you may need to balance the debt so the rent from your properties becomes your primary source of income. When deciding whether to sell a property, it is important to consider the implications of CGT.

Minimising the impact of CGT can be achieved by selling properties over a period of years. This spreads the CGT so that most of the taxable capital gains fall within the lower tax brackets. Or you could sell the properties in the name of the lower income earner who has incurred the least capital growth. You could also sell the properties when your income is at a low level, such as when you completely retire.

Alternatively, you could make your taxable income lower by paying a year's interest in advance. Individuals, partnerships and trusts receive a 50% CGT exemption on investments held for a minimum of 12 months.

The important dates are the date of the purchase contract and the exchange date of the contracts when sold. Calculating the taxable gains is determined by the initial price you paid for the property and any acquisition and disposal costs directly related to the purchase and sale. Acquisition cost examples are solicitor's fees, stamp duty, registration of title, loan/establishment fees, valuation fees, mortgage insurance and stamp duty on mortgage insurance. Disposal cost examples are agent commissions, accountant and solicitor fees, advertising costs used to find a buyer, and discharge of mortgage. The change in ownership is usually recognised on the date the contracts are exchanged.

Maintain good records of any property transactions over the term of ownership to avoid missing out on expenses that add to the cost base, and in turn, lower your CGT liability. These records help substantiate your calculations of the cost base to the tax office if they carry out an audit.

Due to the nature of CGT, properties need to project capital growth well above the inflation rate (in contrast to properties with a healthy rental return and little prospect of appreciating in good time). An appreciation rate of 2.5%+ per annum in the first few years is a fair benchmark to measure the success of the net return of investment. This is another important reason to research and be able to identify properties that are going to perform to your expectations, especially under the current tax system.

Ask yourself if the potential gains outweigh the costs of selling. High capital growth with no provision for indexing of inflation against the growth is half the story. CGT is calculated on the full capital gain regardless of inflation. Therefore your investments need to grow at a rate that at least doubles the inflation rate to receive rewarding equity.

Exercise

For this exercise, assume you own an Investment Property that is a brand new 2-bedroom unit in a large complex with a lift and swimming pool. List some of the tax deductions you would be able to claim:

Assume, you decide to sell this unit 10 years later with a profit of $200,000 before any agents fees, etc. What costs are involved in selling this unit?

final reflections

What key points have you learnt from this module?

You are ready for the next module.