PROPERTY LADDER REALTY
SALES - MANAGEMENT - INVESTMENT
P: 07 4035 3044 | F: 07 4035 3077
www.plrealty.com.au | 128 Aumuller Street, Cairns QLD 4870

Special Edition

6th May 2012

Dear Owners and Investors,
I was asked a very similar question by two different people in the past two weeks. This answer has been buzzing around my head, and if I don't get it out and on paper it will continue to buzz and annoy me. You have to remember that my answer is based on my understanding of the rules - you will need to get your Accountant to advise you on your personal situation and confirm everything. I will try to explain it as best I can, I hope I do alright as it is very complicated to explain.

Being a property investor, is totally different to being a home owner. When you look at buying an investment - it is pretty much about numbers, potential and what benefit it can bring to you via tax deductions and long term capital growth. Ramon and I still do have one golden rule - irrelevant of how cheap it is. We ask ourselves, if we had to live here would we? If the answer is no, then how can we expect a tenant to pay us good rent to live there?

Now your own home is totally different. This is where you come home to each night, where your family lives and grows up, where you have to be happy and comfortable. You still need to be sensible and not buy something that is overpriced, never going to appreciate in value or fall into the trap of over capitalising. Finding the balance between keeping the investor and the emotional side in balance is sometimes difficult. Blurring the lines between an investment and your home is easy to do - and one of the areas where the biggest mistakes are made.

These two particular people both have houses in Cairns. For both it has been their home, so it has an emotional attachment. They have done the gardens, made the improvements and in one case built it from scratch. For this exercise today, I will just concentrate my writing for the couple with the house in Redlynch which is now a rental property. This couple is now renting a house down south, but is contemplating buying or building their home.

At the moment, their house in Redlynch is still technically their "principal place of residence". They have lived in it, and because they haven't bought something else to live in for tax reasons it will continue to be their principal place of residence. This means that the property can be rented, and they can claim the rental deductions as if it were a normal investment property. If at some point in the next six years, if they choose to sell it whatever capital gain they make will be tax free - as if they were selling their own home.

This capital gains benefit will continue on for the next six years whilst it is a rental property. If they at any time move back into the property during this six years, then move out again - the six year capital gains free period starts again.

The couple I am writing about are our clients, but I don't know their exact financial situation, so I am only making guesses on the figures used below.

Now in this couples situation, they have a fairly low mortgage on the property. This means that the property is pretty much neutrally geared. It will not add to the tax burden of this couple. Any expenses, improvements or other costs associated with this property are tax deductible, and once you take into account depreciation this couple may actually receive a tax benefit.

In the other case, he has completely paid off the property. If we now go to rent this property out - he will actually increase his taxable income - and have to pay more tax.

At the moment the house in Redlynch is a debt, but it is what I would call a good debt. It is holding a property that is bringing in income, and long term will appreciate in value. It is also giving the couple a tax benefit each year and if it continues to be their "principal place of residence" then it is also continues to be capital gains free.

Whilst they have no other principal place of residence, it continues to be a good investment. It may not necessarily be the one they would choose to buy for investment purposes but keeping it makes financial sense. Any property investment is better than none.

Now this couple is looking to buy or build in the new town they have decided to call home.
When this happens, a few things will happen
They will loose the Capital Gains benefit on the house in Redlynch and it will be transferred to the house they will be living in.
They will have to take a loan for the house they are going to build/buy - this will be a substantial loan for the full amount of the purchase, less any deposit they have
They will use the equity from their original house to secure the lending
This new debt will be a "bad debt" - it won't bring them in income, it won't give them tax deductions but it will be Capital Gains Free
The new loan will be non tax deductible - the purpose of the loan is to buy a house to live in and not for investment purposes - so it isn't tax deductible
The loan repayments on the new house will have to be paid for with after tax dollars

Let’s assume that the house in Redlynch is worth $400K as at when they buy their new "principal place of residence". At this point their new house will take over, and the house in Redlynch will then become a straight investment property. I don't know what the property has cost them as far as land and building, so I will guess it is $200K. My understanding of the capital gains tax is that the gain they have made between the $200K and the $400K that it is valued at as of today is all capital gains free. From this amount onwards, it will become capital gains applicable.

Let’s now assume that they continue to keep this property in Redlynch as an investment property. In the mean time they have a big mortgage on their own home that is costing a lot of after tax dollars. They keep both properties and in two years time they go to sell the house in Redlynch as the market has increased. To make it interesting let’s say they can get $600K for the house.

This is my understanding of the tax implications.
The cost of the house and land was $200K
The value of the house as at when they bought their new home in 2012 was $400K
The sale of the property in 2014 in Redlynch achieves $600K - I am not going assume it is a clear $600K after all outgoings to keep the numbers easy
The couple has actually made a profit on the property of $400K, but only $200K of this is capital gains applicable.

If they own the property 50/50 and the capital gains rules are the same, then 50% of the $200K is capital gains free. They have earned $50K each, without having to pay tax.
Of the remaining $100K this is split equally between the two owners.
Each owner will have $50K added to their taxable income, and they will have to pay tax at that rate.

Let's assume with this $50K added to their income for the year, they are at the tax rate of 45 cents in the dollar each - they each will have to pay $22,500 capital gains tax.
They will give the tax man a total of $45,000 in Capital Gains Tax between them.

In this two year period they haven't received as many tax benefits as possible for the Redlynch property simply because the debt that is owing on the property is low and the rental income is high. In this same two year period, their home loan for their house is high and they have no tax benefits at all on this debt.

I will go further and assume that their new house is going to cost $400K - roughly the same as what their house is Redlynch is worth.
Let's assume that they have a loan of only $100K on the house in Redlynch - this gives them a great equity base of $300K
Let's assume they do get a mortgage for their new home for $400K but don't sell the Redlynch house.

Based at 6.5% interest only for $400K they will pay $26,000 per annum or $500 per week just on interest - all of this is after tax dollars! They have a big "bad debt loan"
Let's now assume they do sell the house in Redlynch and bring the equity down to their new house and only have a mortgage of $100K.

Based at 6.5% interest only for $100K they will pay $6,500 per annum or $125 per week on interest - again after tax dollars. They now have a small "bad debt loan"

This couple will still have the same level of equity. Their new house is worth $400K but they only have a mortgage of $100K - so they have $300K equity.
They can now go to the bank and use this equity to buy another investment property.
The new loan for the investment property will be for the full purchase price and all of this loan will then be a big "good debt loan".

I am a big believer in keeping property long term and not selling. There are times when this isn't always true, and you have to make the judgement on what is best for each of you individually. In this particular case, the couple needs to somehow transfer the equity from their original home to their new home so their level of "bad debt" is a low as possible or nil, and their "good debt" is as high as possible. I know there will be other legal ways around transferring this equity between the homes, but I don't know of them except to sell the property and buy another.

Ahhh, feeling much better now that is off my chest - so to speak.
Many of you have investment properties here in Cairns, but don't actually live here. Apart from this email, if you want to be kept informed I do post things on Facebook each day. They are normally links to the local newspaper to let you know good things that are happening here.

It is really difficult to explain just how different it feels since the beginning of 2012. There isn't one single thing that has changed to make it better, here are some of the small things
Cairns Base Hospital has a $445 million upgrade that is well under way. This project will continue for the next two years
The Mount Sheridan Shopping Centre extension is happening - love driving past it in the morning to see all those tradies cars filling the car park.
The main tenant for this centre will be Kmart.
The Home Maker Centre is also being constructed.
The main tenant for this centre will be Masters.

Both of these tenants will be big employers not just within their stores but all the associated industries they engage.
The new State Government has given many confidence that things will get back on track.
There is talk of $40 million of State money being spent on dredging the inlet.
If this happens - it means more cruise ships coming into Cairns - which means lots more money being injected into the economy.
More flights internally are being added - Tiger now flies direct between Melbourne and Cairns.
Talk of adding a direct flight between Cairns and Asia.
A new local council was elected on the 28th April - one with business sense. Hopefully it won't be long before we start to see things move again.
Talk of expanding our Naval Base - this means a huge boost to our economy.

On the rental side, the actual vacancy rate has dropped and I personally think it won't be long before we start to hear about a "rental crisis" in Cairns. You know this is on the cards when the Cairns Post had an article yesterday about the vacancy rate dropping
http://www.cairns.com.au/article/2012/05/05/217871_real-estate.html

As at today we have a total of three properties that are for rent.
One the tenant gave notice which is due to expire on Monday. He left paying $200 per week and we have new tenants moving in early next week that are going to pay $220 per week. The owner gets $20 a week extra and nothing needs to be done to the unit.

The next is one of our units - the unit I cried about after seeing it vacant. Ramon is busy pulling up the 30 year old lino and carpet, ripped out the kitchen and is repainting it. This tenant was paying $220 per week and once we are finished we should get $250 as it is so close to the city.
The last is a tenant that won't leave for another week. She is paying $220 currently and we have it advertised at $250 per week. I did have one inspection yesterday and will wait to see if they come back with an application. We may have to drop the rent slightly to get it filled immediately, but we should get this owner some extra money for doing nothing to the unit.

You all know I am a big softie, and this weekend has been the day I have been looking forward to as an investor - but dreading as a property manager. I have been going through all the current tenant’s rents and working out where we can increase them. I will be writing to each of you about your properties with my thoughts on what we should do. It is such a difficult one - I need to increase the rent as the costs have gone up, I need to make it so the tenant will stay at the new rent so it can’t be that high - unless of course we don't mind if they move on. In this case we put it up more and if they stay then it is a bonus for us all.

We have some units in Whitfield that are our personal units. There are five in the complex. We have renovated the inside of all of them now - repainted and new floor coverings. We haven't done the kitchens or bathrooms as this stage. At the peak of the market we were easily renting these for $250 per week each. At the low of the market we struggled to get $200. Right now we have one at $230, two at $200 and two at $220 per week. I was going to increase the lower ones only slightly, but then when I searched the available rentals I found that if they left I could potentially get $240 - $250 per week.

I don't want all of the tenants to leave at one time, but I do need the rents to go back up to help cover the increased costs. The investor in me says - increase them all to $240 and if they leave so be it. The softie side of me says that is a big increase for them. The renovator side of me came out and said - increase it but not so much because I am in retirement and don't want to pull the painting or gardening clothes on again.

P : 07 4035 3044 | F : 07 4035 3077
www.plrealty.com.au | 128 Aumuller Street, Cairns QLD 4870

The internal struggle went on for some time yesterday afternoon and the decision has been made to increase all the rents up to $230 per week. One will get no increase so she will be happy, two of them will only get a $10 a week increase which shouldn't bother them too much but the two that get the $30 per week increases won't be happy on Tuesday. Out of this I am going to guess one will probably leave - and if she does then we have a chance of actually getting a higher rent.

As a general indication of the rents
Bedsit Units - fully furnished $150 per week for the last three we rented. The next one we get notice for I will try for $160 and see what happens.

One Bedroom Units - fully furnished - $170 per week. I actually haven't had many of these come vacant in 2012, so it could be higher. It will depend on the location and style of unit.

One Bedroom Town House - fully furnished - $180 - 185 per week. These are bigger than the standard one bedroom unit. Traditionally we have only been able to achieve $5 per week more for the town house, but for some reason we are getting alot more.

Two Bedroom Units - fully furnished - $210 to 220 per week. These are the ones in Palm Trees, Scotsdale and City Park. The demand is getting much higher for these as they are big, affordable and close to everything. The ones that are closer to the city we do get slightly more - just because the tenants can walk to the city.

Duplex - unfurnished - $250 per week. If the owners are prepared to allow pets, then the demand is huge. People want their pets but can't afford a house so a duplex is the next best thing.

What we all have on our side is the fact that no building has occurred in Cairns for at least five years. The properties we have are the basic construction units that are clean, tidy, close to the city and very affordable. They haven't built any of these since 1995 - yet our population has essentially doubled. I will agree that it has been tough for the past five years, but now I think the tide is starting to turn and we will see in the next 12 - 24 months good rental increases. We still need to balance this with getting 52 weeks rent for you.

Recently we had a house to rent out in Edge Hill. It is a really nicely renovated house, with a huge back yard that is fully fenced. The owners will accept pets so that immediately puts $20 per week onto the rental. It is only a two bedroom house, although very big, it is still only two bedrooms. Whilst it was being finished off, we were cheeky and had it advertised at $350 per week - not an enquiry. We knew we missed the mark so we dropped it down to $330 per week - oh the flood gates opened and the phone and email went made.
I have been doing this a very long time, and can work out a lot about the people on the phone.
I will show those that I believe will be right for the property - and do this as quickly as I can.
We got two great enquiries on Wednesday morning - we showed them at 6pm and 6.30pm that night. By the time I drove home I had an application on my email from one, and at 8am a text to say the other had faxed theirs to the office. Although both were good applicants, one was just better than the other and on Friday night he was in our office with the money and moving in!
We could have rented the house for $350 per week, but this could have taken us another two weeks to find the right person. In the mean time this means no rental income for the owners. Sometimes it is better to drop that extra few dollars to get it rented.

To finish this email off I will tell a tenant story or two.
Last night the dreaded tenant ring went off on my mobile. It was 8.30pm on a Saturday night. It was a lovely lass we have in a unit. She apologised that she was calling so late, but she had only just realised that the rent payment didn't go through and wanted to let me know that she had just sent two weeks rent through. I did notice on the arrears list she was a few days behind, but she is such a good tenant I didn't worry. I knew it would be fixed. I must be scary if she called me that time of night!

We have a couple that live in a block of units we own that happens to be right next door to our office. It has been a constant battle with them on the rent, and the junk they have lying about the outside of the unit. What is annoying is that each time I see him, he has a can of drink in one hand and a smoke in the other. They sit out the back smoking most nights and this faces our office - they are a bit like a volunteer security guard as they tell me when things go wrong.
On Monday night at about 11.45pm my mobile went off, but the general ring as the number was blocked. I thought I was going to get one of my funny escort calls as I haven't received one for a while. It was this young man telling me that he has heard a huge crash at the office and then when he went around to investigate a huge Islander man came running out from the side of the house. He wasn't going to go in, but wanted to let us know. We do have security screens around the entire property and it is pretty secure. I looked at Ramon and he knew that if we didn't drive in to have a look, he wasn't going to get a wink of sleep as I would be tossing and turning worrying about if they had gotten in.

We don't take in the Mercedes SLK to any of our properties because, well, it just isn't right to turn up in a flash convertible to a rental property. We figured we would be safe as by the time we got there it would be 12.30am and no one would be around. We got there and the gate was wide open - armed with not much more than a flash light, we went in the front door and opened all the lights and doors. I would say he had come in to the yard try and find somewhere to sleep or to pee and knocked something over. Just as I was breathing a sigh of relief our tenant wanders over - yes drink in one hand, smoke in the other and very red eyes (not that I am saying he had smoked something else before). I don't think he even noticed the car. I thanked him for keeping an eye on the property and assured him no one had gotten in.

I hope you are all happy and well in your world.

Linda