BUILD CONFIDENCE, MINIMISE RISK AND CREATE PEACE OF MIND

AUSTRALIA WIDE

THE LANDLORD MINDSET

7 Keys to Buying and Managing Residential Investment Property

GEORGE ASTUDILLO

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The Landlord Mindset
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Preface

As a real estate professional for the past twenty-five years I have seen many investors from all walks of life become despondent and fearful investing their money in property.

The major fears can be boiled down to three concerns: cash flow, losing their hard-earned savings, and the fear that things will go majorly wrong.

Through my business I can only help a limited number of investors that share a similar ideology and are within an appropriate distance. The reason I have written *The Landlord Mindset* is to help anyone who is working hard to create a financial future through property, regardless of where in Australia they live.

I believe that the greatest tool to create confidence is knowledge. Being able to seek advice from someone you trust and who has done it successfully before can be very reassuring. I hope this book becomes that for you.

Introduction

Creating wealth is no longer a daydream; it's essential.

If you retire at sixty-five or seventy, yet live to eighty-five, you will spend fifteen to twenty years without an employment income.

According to the Association of Superannuation Funds of Australia (ASFA), the benchmark cost of living for a retired couple owning their own home and living a comfortable lifestyle is $58,784 per annum. Yet the current aged pension, with all the trimmings, is only $33,982 per annum.

In short, if you're relying on the pension to see you through your retirement, you can expect to struggle.

A carefully-planned nest egg is critical to your future and can make a real difference between struggling to make ends meet and the joy of a secure retirement.

And, having been in the property market since the mid-1980s, I believe that property is the most reliable investment to secure your financial future.

Why?

1. Strong capital growth

The number one reason people invest in property is to create capital growth, a nest egg for the future. According to RP Data, Australian property prices have shown an average annual growth of 8.5 per cent since 1980. Over the same period of time, inflation has averaged around 4.6 per cent. This means that just by holding on to property you are increasing your wealth faster than inflation. More millionaires have been created through property than any other form of investment.

2. Easy to borrow funds for the purchase

Finance for the purchase of a property investment has never been easier to obtain. Borrowing money from a bank or lending institution means you can buy an investment property sooner, and reap the benefits from the capital growth and rental for longer.

3. Strong demand for rentals

Over the last few decades, Australia has experienced strong demand for rentals, with vacancy rates typically less than three per cent, and even less than one per cent in some capital cities. This means that with a sensible leasing strategy you can expect to find a tenant very quickly.

4. A safer choice

Over the years, investing in property has been shown to be a safe choice. While there have been fluctuations in property prices, values have, over the long term, increased strongly. The major risks in property come from short-term speculation, where timing your exit is critical.

5. Tax benefits

The Federal Government has provided many incentives for investors in the form of tax benefits, from negative gearing to depreciation allowances, which assist with owning an investment property.

6. Easy to add value

Improvements to your property will add more rent and capital value. Many of these improvements are relatively inexpensive and easy, yet can make a huge impact. Magazine articles and television shows on property improvements have never been more popular with help, advice and ideas so easily available.

7. Easy learning curve

Learning how to invest in property is much easier than most other investments; there are no difficult formulae or company balance sheets to understand, and researching property values and rental prices is reasonably easy. Within a short time you can be as knowledgeable as any real estate agent in your area.

8. Borrow against equity

There is no need to sell the property to realise its value. You can use the increased equity in your investment in many ways, including purchasing additional investment properties.

9. Bricks and mortar

Unlike other investments (shares, term deposits, managed funds) where your investment is represented as numbers on a page, property is tangible. You can touch it, drive past it and decorate it in the style and taste of your choosing.

10. Ability to minimise risks

With many landlord insurance packages available that will cover you for fires, tenant damage, loss of rent and more, it is very easy to minimise the risks of your investment.

But what if it all goes wrong?

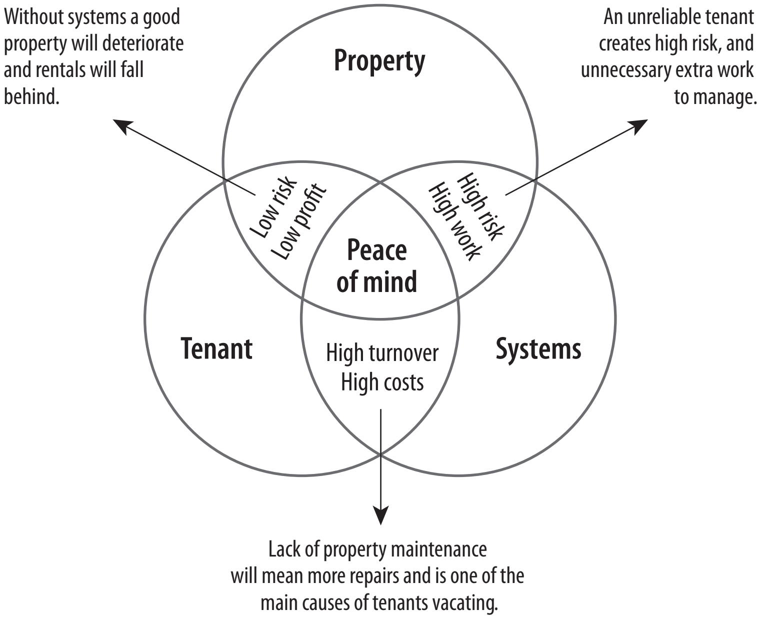
We've all heard the horror stories – friends and family who have lost money and sleep because of bad tenants or poorly managed investment properties. Many investors are forced to sell because of poor returns, continuously having to outlay huge sums on repairs, or rents not keeping up with mortgage payments. While this bad news sells newspapers, what you don't often hear are the success stories – the ones about savvy investors who manage to avoid or solve these problems.

How do they do it? They have found the sweet spot between a well-maintained property, a reliable tenant and effective systems (or a good property manager) where everything runs harmoniously and profitably.

Reliable Tenant: A troublesome tenant can make your life an expensive misery and you'll end up spending most of your time chasing and worrying.

Well-Maintained Property: A property that is not in the best condition will ultimately cost more in repairs, while your tenants will eventually tire, become upset and move out.

Effective Systems: Without the right systems in place, problems will become more expensive and more difficult than they need to be. Routine inspections and rent reviews need to be systematised or they will ultimately cost you money in lost income.



No matter which area(s) are giving you headaches, the solution is simple – go back to the fundamentals so you can enjoy the fruits of property investment and avoid the pitfalls.

Learn the fundamentals

There are fundamental principles that make managing property safe, easy and rewarding. Think of it as a business – your property is the product and the tenant is your customer.

The fundamentals in this book apply to any type of residential property, whether it's a studio apartment or a waterfront mansion. The key principles remain the same – finding the right tenant for your property, avoiding the wrong one and managing the tenancy process.

So what are these fundamental Keys?

1. The landlord mindset

As with any business, the main focus is to generate income and grow your asset, but you don't want to be up all night worrying about it. This is why it's important to have a plan and stick to it, a plan that includes your goals, budget and risk profile. Your focus and emotions play a huge role in the investment process, and this section will teach you how to keep your focus on your goal, and not let other people's agendas sway you from your plan.

2. Do your research

Once you know your investment goals, you need to figure out which property will help you meet them. Here we cover location, property types and the market cycle – by knowing the options available you can get them right from the start.

3. Buy the right property

Not every property is a good investment – in this section you will discover the ground rules for buying an investment property, including what you need to have organised before you make an offer, dynamics that will impact the sale price, and how to buy a property at auction or by private treaty.

4. Present your property

Appearances and first impressions are vital to success. Before you begin marketing, you need to make sure your property ticks the boxes that tenants are looking for. Presentation is more than skin deep – safety issues, low-maintenance appliances and cleanliness can make a real difference to both your bottom line and your peace of mind.

5. Start marketing

Choosing the right tenant will eliminate many issues and go a long way towards keeping you on your set path. The wrong tenants, on the other hand, will side-track you. It's this waste of time, energy and money that you want to avoid.

Here you will learn marketing and pricing strategies to attract tenants, as well as an effective tenant application process to help you select the right tenant for your investment.

6. Choose a tenant

Choosing the right tenant is the backbone of a healthy and worry-free investment. You'll discover how a tenancy application is designed to uncover all the information you need to know about the tenant and how you can go about verifying the information. You'll also learn about the documentation you'll need as required by legislation, as well as to protect your interests.

7. Manage your property

Once you have good tenants, it's important to keep them, and keep them house-proud. Here we'll look at the systems you'll need to create to help you monitor the condition of the property and the tenancy. That way there'll be no surprises, and you'll be ready for anything.

These fundamentals are organised on a chronological basis. However, property management is also a cyclical process, as tenants don't stay forever. Sooner or later you will need to find a new tenant, 'update' an old one, or may even start all over again with a new property. Feel free to start at any page that is relevant to your current position in the cycle and go from there.

The thing to keep in mind is that even if you already own an investment property, it's important to review all seven keys from the beginning every time the property becomes vacant.

If this is the first time you have taken an educated look at your investment property, it would be a good time to make sure it's the right fit. Many investors reach the unfounded conclusion that property investment is not right for them, rather than realising that they are persevering with the wrong property. This is also relevant if you are planning to use your existing home as a rental property.

Once you are satisfied that your property is the right fit, the other keys will help you make sure it is always looking its best, create a proper marketing strategy, choose the right tenant and ensure you have systems in place to keep things running smoothly.

Basic assumptions

Before we get started, you should know that there are a few concepts that underpin this book.

First, the focus is primarily on residential property. While some of this content may also apply to commercial property, that's not the main purpose of this project.

Second, I firmly believe that a successful investment property is founded on harmony and good will. This is why this book is not about winning at the expense of someone else but shows how a win-win strategy is good business and provides peace of mind in the long run.

Third, although property law and taxation is covered in some detail, this is not designed to be a text book on those subjects. Please make sure you take advice from a qualified accountant and a solicitor who know your particular situation before you make any decisions.

Finally, while information has been provided on legislation on a state-by-state basis, this is not intended to be a comprehensive book on legislation. It is designed to show the variations between states in the way the landlord-tenant relationship is addressed. It is also important to remember that legislation changes from time to time.

Are you ready?

This book is designed to give you a thorough understanding of how to ensure your investment property provides sustainable, consistent and trouble-free income.

As well as the financial benefits that come from property investment, there are other rewards, such as the satisfaction of knowing that your property offers a great lifestyle to tenants who will cherish it as their home.

My hope is that reading this book will give you a clear idea of the mechanics of property management, which will enable you to have more control over your investment and your future.

Over the following pages, we will cover the concepts and ideas that will help you formulate a plan to achieve exactly this outcome.

So, are you ready to get started?

THE SEVEN KEYS

KEY 1

The landlord mindset

Property investment isn't just numbers on a page. It is about the transactions between a tenant and a landlord, often conducted through a property manager. It involves people communicating and negotiating with other people. And this can easily become personal. As human beings, every transaction we make is to some degree emotional, reflecting how we like to be thought of and how we like to be treated.

The issue with this is that your emotions can create biases that are totally unrelated to the decision you are about to make. Feelings produced from a stressful event can and will influence your judgement on later unrelated matters. Likewise, feelings of being attacked or taken advantage of, whether rightly or wrongly, can influence the way you react and communicate. Heightened anxiety will have your mind looking for defensive solutions, and these solutions may not be appropriate for your circumstances. This is particularly dangerous if the anxiety has evolved from perceptions that have not been clearly verified.

The advertising industry has been manipulating our emotions for years to get us to buy things we don't need. They play on our fears and desires, 'pressing our buttons' to make sales.

However, sometimes our negative buttons get pressed accidentally, and this creates unnecessary reactions that slow down or even stop negotiations, making communication angry and aggressive.

Property investment needs to be treated as a financial endeavour that is regulated by two types of principles: business principles and personal principles. There are certain business principles that, if understood and followed, will result in better returns and lower risks. And there are your own personal principles that guide the way you conduct yourself – your moral compass. Following these principles will help you be a more effective investor.

How can you do this? Develop a landlord mindset, where you can manage your emotions and see things as they really are, even in the face of someone else's difficult behaviour.

This comes down to:

- Being very clear on your financial and lifestyle goals.
- Understanding your limits, especially relating to your budget.
- Understanding your risk tolerance.

With this clarity, you'll be able to create an investment plan and maintain the discipline required to carry it out.

Your goals

Why are you investing in property? What's your agenda? Do you want to build a retirement nest egg? Are you looking to create enough rental income to allow you to pursue other interests? Or do you want an income that will allow you to travel?

Knowing your goals gives you something to aim for, a path on which you can measure your progress and ultimate success. It will also help you stay on track when other people's agendas conflict with yours.

The two main categories are 'lifestyle' and 'financial'.

Lifestyle goals

Money gives us the opportunity to create the lifestyle we desire – adventure, security, luxury or just the freedom to do whatever we wish.

Your choice of lifestyle goals may influence your choice of investment property. If you seek freedom or travel, you may want to look for a property that is low maintenance and can be easily managed.

Keep in mind that low-maintenance investment properties are always desirable. The less you, or your agent, need to do to keep things at their best, the fewer things can go wrong and the better the property will perform over the long term.

Do you want to buy a yacht, new car or new home? Do you want to retire early?

Take a few moments to write down your lifestyle goals.

Next, think about when you would like start your new lifestyle.

Financial goals

Your financial goals make your lifestyle goals concrete by having a clear end date and being measurable.

For example, if your goal is to have enough money when you retire, then you need to know when you are planning to retire (end date) and how much money you need to have by then (measured).

The same goes for each of your other goals – what are the end dates and how much will you need to achieve them?

Take some time to research your lifestyle goals and how much they will cost. Searching online will give you enough basic information to get started; you can then further refine your goal with a financial planner or other adviser in the future.

Once you have an end date for each of your goals and their approximate cost, you can use that as the foundation of your property investment plan.

For example, say you want a retirement income of $100,000 per annum. You will need to have a property portfolio earning a net income of $100,000 per annum by the time you retire. This could be one property or many, depending on your strategic plan.

Creating a plan with annual budgeting is how you can break down the main goal into manageable steps that has measurable check points along the way.

What level of involvement are you planning to have?

While we'll be covering how to choose a professional property manager later in the book, it's important to be clear on your intended involvement before you consider the type of property to buy, simply because your level of involvement will have a direct impact on whether or not you achieve your lifestyle goals.

There are four basic ways to manage your property.

1. Complete do-it-yourself

This means you will handle all aspects of managing the property, from finding and screening the tenant to handling repairs and all of the accounting.

The most useful skills in property management are common sense and a willingness to understand and compromise.

If you wanted to do it yourself, the main issues you would encounter are understanding the tenant's rights, your obligations as a landlord and applicable documentation. Fortunately, the legislation in most states has been written in an easy-to-understand format that is very clear.

Apart from understanding the applicable legislation, however, you would need to make time available when problems arise. Repairs, particularly emergency repairs, need to be acted on quickly. Problems that come up may involve many hours negotiating and possibly time at tribunal hearings. These events are generally unplanned and will require you to have a flexible timetable. As a result, this level of involvement may be inconvenient for particular lifestyle goals, such as if you were to travel six months of the year.

The two main benefits of this style of management are having complete control over your investment and saving on agent fees.

2. Do-it-yourself management plus outsourcing to an agent

This level of involvement is the same as the first except you outsource some tasks.

Finding a tenant and attending to the initial documentation are the most common tasks that DIY landlords hire an agent to assist with. The minimum fee for finding a tenant is usually two weeks' rent and there are many agents that offer this service.

With other management tasks, most agents have an 'all or nothing' approach and it may be difficult to find an agency that will take the time to assist unless you are prepared to enter into a management contract or provide a sizeable remuneration.

The benefits and problems of this level of involvement are the same as the first level of involvement, with some agent fees.

3. Professional property manager under your supervision and control

This is where you engage a professional property manager to do the work and they report back to you for all approvals. You make all the decisions and they carry out the tasks. They are responsible for complying with all relevant legislation, finding a tenant and managing the property. When a problem arises, they contact you for instructions.

They, in effect, become fully responsible for ensuring all aspects of your investment are taken care of, with clear communication before and after completion. Their fee is fully tax deductible.

Usually, contact is made by phone or email and the property manager handles all contact with the tenant. If you plan to be away for any length of time, you can leave authority for a third party to be contacted.

Keep in mind that you still need to manage the agent.

4. Professional property manager with clear written parameters

Sometimes, a landlord has no available time for anything other than an emergency and engages a property manager to undertake all tasks within certain parameters. The property manager then has authority to undertake these tasks and report back to the landlord on completion.

The property manager can authorise repairs up to an agreed value, review rents as appropriate and negotiate with the tenant.

This type of arrangement can be risky and should only be entered into with clearly-documented monetary limitations and with a highly reputable and trusted agent.

Most investors start with a level-three involvement and slowly allow things to evolve to a level-four arrangement. As time passes, they tend to take less and less of a hands-on interest and rely more and more on the agent.

However, while there are many good agents out there, most of them are overworked and find it hard to keep up with emergency issues, let alone make time for proactive tasks. Under these circumstances, important activities that are essential to maintaining a healthy investment are overlooked or rushed. If it's not urgent, it doesn't make it to the top of the 'to do' list, so a satisfactory level-four arrangement may not be possible with some agents.

Budgeting

Before you start looking at properties, a budget and careful planning will save a lot of anxiety later on.

Good budgeting is relevant to two stages of the property investment lifecycle:

1. The purchase of the property, and
2. Annual income and expenditure.

The two are equally important. How much you borrow will also have a significant impact on your risk management and potential profit.

Purchase costs

Planning your budget for the purchase of an investment property includes more than saving for the deposit. Other costs include:

- **Stamp duty –** This varies from state to state and represents a significant cost when buying property. The rates operate on a sliding scale based on the purchase price of the property.
- **Loan costs –** These may include registration fees, the application fee, valuation(s) and stamp duty on the mortgage.
- **Conveyancing –** A conveyancer, often your solicitor, advises you on the transfer of the title of the property (meaning the transfer of ownership) from one person/party to another. Apart from their fee, other costs include title searches and registration fees.
- **Mortgage insurance –** If you are borrowing more than eighty per cent of the purchase price, this insurance covers the lending institution in the event that you default on the loan and the sale proceeds of the property aren't enough to cover the loan.
- **Council rates, water rates and strata fees –** These need to be reimbursed to the previous owner for any payments made past settlement date.
- **Improving the presentation –** Great presentation is essential to finding the right tenants, so ensure you have budgeted

appropriately and won't be tempted to scrimp because the purchase has taken most of your funds.

These all make up the total purchase price of a property and need to be allowed for when saving a deposit and considering loans.

Taxation structure

While not one of the initial expenses, understanding how to use taxation to your advantage is essential to achieve the best returns, and this starts by considering which form of ownership will bring you the best tax benefits. Consult with your accountant to work through the various options that will best suit your needs.

Individual

Investors usually buy in their own name as this has low set-up costs and is easy. The net profit, after expenses, derived from your property is added to all your other income such as wages, interest and dividends to calculate your overall taxable income.

When two or more individuals buy a property together, it can be either in 'joint names' or as 'tenants in common'.

Joint names

Joint names is where all parties named on the title have a full interest in the property. In the event that one of the individuals dies, their interest in the property is automatically passed on to the other surviving owners of the property and it does not form part of the deceased's estate. A married couple would normally purchase property in joint names. Keep in mind the tax implications are shared equally.

Tenants in common

This set-up allows for the interest in the property to be apportioned in any manner the individuals agree to. The interest in the property can now be sold or left in a will. Your tax benefit/liability is now set according to your share of the property.

Self-managed superannuation funds (SMSF)

More complicated and therefore more expensive to set up and manage, SMSFs are, however, an effective way to use your accumulated superannuation money. The non-concessional contributions (as in after-tax contributions) are capped at $180,000 (as of 2015), but you are allowed to 'bring forward' a further two years, making a total of $540,000 in contributions. Superannuation funds can now also borrow for the purchase of property, making them very popular. However, losses cannot be used to offset your personal income in the same way as negative gearing.

Discretionary trusts

A family trust also has higher set up and running costs but allows for good asset protection, particularly if the trustee is a company. However, losses cannot be used to offset your personal income in the same way as negative gearing.

Companies

The benefit of purchasing through a company is that the tax rate is fixed at thirty per cent. There is no capital gains tax discount available and losses cannot be used to offset your personal income in the same way as negative gearing.

When it comes to choosing the best taxation structure for your circumstances, your best resource is your accountant. And, in all cases with taxation, it is imperative to keep a complete record of all purchases and transactions.

Income and expenditure

It would be crazy to start a business without a financial plan. Buying an investment property is no different.

Many investors live month to month, using the rent to pay the mortgage and expenses. In some months there's money left over and in some months there's not enough. To some it's all a surprise.

By knowing what your expenses are and when they are due, you can prepare yourself for the unexpected.

The expenses

Council rates

Council rates are assessed annually and are usually sent out in July and due in August. Most councils will allow you to pay them in quarterly or monthly instalments.

Water rates

There are two components to water rates, which are paid quarterly:

- Water service – This is a charge for the delivery of water; and
- Water usage – Representing the actual amount of water used.

Strata levies

If your investment is strata (a form of ownership for multiple dwellings in buildings and subdivisions), Company Title or part of a larger holding, you will be required to pay levies. The levies are usually paid quarterly and comprise three parts:

> **Sinking fund –** This is a forecast or estimate of funds needed to cover major capital costs associated with the common property, such as replacement of carpets in foyers and corridors, lifts, roofing, fencing, painting and more. Funds collected in the sinking fund accumulate in a savings account (earning interest) until needed.

> **Maintenance –** The day-to-day expenses of maintaining the common property such as cleaning, lighting, gardening and general ongoing repairs.

> **Special levies –** These are raised by the Owners Corporation for expenses that are generally of a one-off nature, meaning they are unforeseen or need to be brought forward and cannot be covered by the sinking fund. Examples are storm damage and major equipment failure.

Land tax

In most states, payment is due forty days after receiving your assessment, which is sent between mid-January and April. If you make full payment, you receive a small discount; otherwise you can make three payments thirty days apart.

Management fees

A property manager will charge a percentage of the rent collected as the fee for managing your property. This is deducted from the rent collected and should appear on the monthly statement.

Postage

Property managers also levy a postage charge of around ten dollars per month. This covers the postage for monthly statements, notices to tenants, telephone calls and more.

Leasing fees

If the property is vacant, the property manager charges a separate leasing fee for finding a tenant and this is deducted from the initial rent paid by the new tenant.

Lease preparation fees

Property managers charge a lease preparation fee whenever they prepare a new lease or lease renewal.

Marketing expenses

The fees for photography, signboard, Internet marketing and other methods used to attract a tenant.

Insurance

Landlord insurance is usually payable annually. You can, in some instances, elect to pay monthly, however, it will cost more.

Smoke alarm inspection

In some apartment buildings the Owners Corporation will arrange an annual testing of all smoke alarms and the cost is covered by your levies. Otherwise it is your responsibility to ensure smoke alarms are working and, in the case of battery-operated smoke alarms, provide new batteries. There are companies that will inexpensively undertake the responsibility for you.

Repairs

It's wise to put away some funds to allow for unexpected repairs. Even if you have prepared the property perfectly prior to the tenant moving in, there is often something that goes wrong or malfunctions.

Maintenance

If your property has expensive landscaping or a pool, it makes sense to keep the maintenance under your control and allow for it in the rent. Often, to reduce costs, the tenant changes the maintenance schedule or uses a cheaper gardener or pool cleaner, to the detriment of the property.

Loan repayments

With a realistic budget, you can appraise the effect that the size of your monthly repayments has on your profit and affordability.

Do you need to pay GST?

Rent from residential property is classed as input-taxed income, meaning there is no GST on residential property rent. So, although you will still be paying GST on most of the expenses involved in owning an investment property, you cannot claim any GST credits.

Rates for water, sewerage and council are exempt from GST, as are loan interest charges.

Purchasing a brand new property, however, *is* subject to GST. The builder or developer will be registered for GST as they are effectively running a business and the costs are regarded as legitimate business costs. Therefore, they will be claiming GST credits and then charging GST on the sale of the property. The GST is built into the price and you are not able to claim the GST as a credit in most cases.

Claiming your expenses on your tax

When it comes to budgeting, a key part of your planning will involve what you can expect to claim on your taxes. As far as taxation is concerned, there are three types of property expenses to consider:

1. Expenses claimable in the same financial year;
2. Expenses claimable over a number of years; and
3. Expenses that can be added to your cost base for capital gains tax purposes only.

Expenses claimable in the same financial year

Many expenses can be claimed as a tax deduction in the year they are paid, including:

- Loan costs, such as:
  - ~ Bank charges
  - ~ Interest
- Repairs[1]
- Maintenance[2]
- Cleaning
- Electricity and gas
- Garden maintenance
- Pool maintenance
- Insurance

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1 It's important to be clear on the difference between repairs and renovations, because while repairs can be claimed in the same financial year, renovations must be claimed over a number of years. According to the Australian Tax Office (ATO), repairs are 'work to make good or remedy defects in, damage to or deterioration of the property'. The ATO considers an item repaired if the repair relates directly to wear and tear. So, for example, while repairing a burn on the carpet with a patch is a repair, replacing the entire carpet is a renovation.

2 Maintenance is treated in a similar manner to repairs and renovations. If the maintenance is 'work to prevent deterioration or fix existing deterioration', it can be claimed in the same financial year.

- Security
- Smoke alarms
- Pest control
- Statutory costs, comprising:
  - Land tax
  - Water rates
  - Council rates
  - Body corporate fees
- Tax-related expenses
- Management and marketing:
  - Agent fees
  - Lease preparation costs
  - Advertising
  - Stationery, postage and telephone
- Bookkeeping and accounting fees
- Legal costs for evicting a tenant and the associated court costs
- Travel expenses

Before we move on, it's important to address the ATO's stance on travel expenses. Regardless of where your property is located, the ATO will allow you to claim travel expenses for the following:

- Getting the property ready for new tenants (keep in mind that this does not include the first tenant);
- Property inspections;
- Repairs and maintenance, including gardening and cleaning;
- Collecting rent; and
- Meeting with your property manager regarding the property.

Travel expenses that can be claimed include travel to the property by car, train or air, together with accommodation. If the property is overseas, you must keep a travel diary that details which activities were leisure.

Take care here, as the ATO requires a high level of substantiation to show that the primary purpose of your travel has been to attend to the property rather than holiday/leisure.

Expenses claimable over a number of years

Expenses claimable over a number of years include loan expenses, depreciating assets, renovations and capital works.

Loan expenses

When purchasing your investment property, only the expenses relating to the loan, or mortgage, can be claimed as a tax deduction. All other purchase costs such as legal fees and title searches cannot be claimed. However, they can be used when calculating the cost base of your property for capital gains tax (CGT) purposes.

If these expenses (including the establishment fee, valuation fee and stamp duty) are more than $100, they need to be spread over a five-year period (or the term of the loan, whichever is shorter).

Depreciating assets, renovations and capital works

The ATO regards depreciating assets as a long-term cost of ownership.

There are many items in a property that will, over time, deteriorate. The ATO has calculated the effective life, in years, of these items and will allow you to claim a deduction over that period of time.

There are two main types of depreciation claims: those for capital works and those for depreciating assets.

Capital works are improvements to the property that are of a structural nature and fixed to the property. For example, kitchen and bathroom renovations, paving and driveways, built-in cupboards, clothes lines and fences are regarded as capital items (but note that not all capital works are included and care should be taken here).

Capital works include the initial cost of building, but not the cost of the land. When buying into any brand new building, you are entitled to claim all or a portion of the construction costs.

Equipment and appliances are depreciating assets and include such items as kitchen appliances, carpets and other floor coverings, window finishes, air-conditioning units, alarms and pool equipment.

When you buy a new property, a list of these costs, known as a depreciation schedule, should be available from the property developer, identifying the cost of every item that can be claimed.

On older properties, there may still be items that you can claim depreciation on. You can commission a quantity surveyor who specialises in preparing depreciation schedules to draw up a schedule for you.

Depreciation can reduce your taxable income by a significant amount. In fact, if you are in a high-income tax bracket, buying a brand new property can give you very high and immediate tax advantages.

Expenses that can be added to your cost base for CGT purposes only

Some expenses can only be added to your cost base for the purpose of establishing your capital gains tax (CGT) liability.

CGT is a tax based on the profit made from the sale. For a property purchased after 20 September 1985, it is calculated on the difference between what you paid for the property (cost base) and what you sell it for.

If you have owned the property for less than twelve months or you are operating through a company, the full amount of the capital gain is taxable and becomes part of your taxable income for the year. If you have owned the property for more than twelve months, tax is payable on fifty per cent of the capital gain for individuals, partnerships and trusts, and on 66.67 per cent of the capital gain for complying super funds.

When purchasing your property, the only expenses that can be claimed as a tax deduction are those relating to obtaining the loan (establishment fee, title search and mortgage documents). However, when selling your property, to reduce the net capital gain, you can add your other costs to the purchase price, otherwise known as establishing a cost base. These expenses include legal fees, stamp duty on the transfer of title and all ancillary costs relating to the presentation, renovation and cleaning of the property prior to the first tenancy agreement being entered into.

From the selling price you can deduct the costs of sale including agent's fees, advertising and legal fees. This results in a lower capital gain (from the ATO's perspective), meaning that there is a lower amount on which you need to pay tax.

Losses can be carried forward to offset another capital gain in another year but they cannot be used as a deduction to offset your current income tax. There is no time limit on how long you can carry this offset forward.

CGT does not apply to your principal place of residence. When renting out your home, you may be exempt from CGT if it is rented for a period of less than six years.

Example budget

The example budget on page 34 refers to a property with the following parameters:

Property value	$650,000
Interest-only loan amount	$300,000
Interest rate	5.88 per cent
Rent	$650 per week

The property is professionally managed and was purchased in March the year prior.

This type of investment would be considered neutrally geared (meaning not making a profit or a loss) and is typical of a low-risk recent purchase. Over the next few years, as rents increase, we would forecast a healthier return and some capital growth.

To work out your own budget:

1. Make a list of your expected expenses, including the amounts you would expect to pay for each (some research online will help you get a rough idea at this stage). These expenses may include:
   - Council rates
   - Water rates
   - Strata levies
   - Land tax

- Management fees
- Postage
- Leasing fees
- Lease preparation fees
- Marketing expenses
- Insurance
- Smoke alarm inspection
- Repairs & maintenance
- Loan repayments

2. Determine how often you will need to pay these expenses – which are weekly, monthly, quarterly, half yearly and annual?
3. In a table, like the one on the opposite page, make a note of the months in which you'll pay each of these expenses. The monthly ones will be every month, while quarterly will be every three months, and so on.
4. Add a row to add up the total expenses each month. You'll see that in some months expenses can be much higher than in others, and may even be higher than the rent received.
5. Add a row for your expected income, or rent.
6. Subtract the total expenses from the rent each month to determine your expected monthly profit.
7. Create another column with your annual totals to determine your expected profit, or loss, for the year.

Allow some funds for the unexpected and remember to compare this budget with actual costs to make sure you are still on track to your goals.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Totals
Income	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**2,172.62**	**26,071.43**
Council rates		327.16			327.16			327.16			327.16		1,308.64
Water rates			172.05			172.05			172.05			172.05	688.20
Strata levies	546.50			546.50			546.50			546.50			2,186.00
Land tax													
Management fees	108.63	108.63	108.63	108.63	108.63	108.63	108.63	108.63	108.63	108.63	108.63	108.63	1,303.57
Postage	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	120.00
Leasing fee													
Lease preparation fees			66.00										66.00
Marketing expenses													
Insurance			465.00										465.00
Smoke alarm inspection			100.00										100.00
Repairs													
Repairs & maintenance	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	
Loan repayments	1,498.19	1,353.21	1,498.19	1,449.86	1,498.19	1,449.86	1,498.19	1,498.19	1,449.86	1,498.19	1,449.86	1,498.19	17,640.00
Total	**2,263.32**	**1,899.00**	**2,519.87**	**2,214.99**	**2,043.98**	**1,840.54**	**2,263.32**	**2,043.98**	**1,840.54**	**2,263.32**	**1,995.65**	**1,888.87**	**25,077.41**
Profit	-90.70	273.62	-347.25	-42.37	128.64	332.08	-90.70	128.64	332.08	-90.70	176.97	283.75	994.02

How much should you borrow?

The amount you borrow to finance your purchase will play a big part in your budgeting, where the more you borrow, the higher your loan repayments will be as a part of your ongoing expenses.[3]

In a highly geared purchase, your loan repayments may push your total expenses to exceed the income you derive from renting the property. In other words, your investment will make a loss. In this scenario, because there isn't enough rent to cover the expenses, you will need to cover the shortfall from your savings or income from other sources to keep the investment afloat.[4]

The advantage of high gearing is that while your tenant is paying the bulk of the loan repayments and expenses, any shortfall can be used as a deduction to your personal income tax, as the ATO allows the full amount of the loss to be claimed as a tax deduction against your other income. This loss can even be carried forward into the next tax year if you have not earned enough income to absorb it. In the meantime, you still benefit from the total growth in the value of the investment.

To see how this could be a useful tool to increase wealth, we'll look at a simple example.

You purchase a property for $200,000 with a deposit of $40,000 and an interest-only loan of $160,000. The costs of purchasing the property (loan fees, stamp duty, legal expenses and so on) are $12,000.

3 In property and other investments, borrowing is also known as 'gearing'. A highly geared purchase means you are relying on a high level of borrowings.

4 Negative gearing is when expenses are greater than income, where only the interest you pay on any borrowings is treated as an expense, not the repayments on the principal.

Over the next five years, because the rent is insufficient to cover the expenses, you need to contribute a total of $10,000 of your income to the loan after claiming all available tax options.

Using the average annual increase in property prices over the past thirty years of eight and a half per cent, after five years your investment property would be worth around $300,000.

Your financial situation after five years would be:

Costs	
The deposit	$40,000
Purchase costs	$12,000
Total annual losses over five years	$10,000
Total outlay (money invested)	***$62,000***

Assets	
Value of property	$300,000
Less loan amount	$160,000
Equity	***$140,000***

Notice that the equity in the property (value of the property less the loan) increased from the initial deposit of $40,000 to around $140,000.

So, after five years, your investment of $62,000 (the deposit of $40,000, the initial purchase costs of $12,000 and the $10,000 in expenses over five years) is now worth $140,000.

This equates to an annual compound rate of return of around eighteen per cent.

This can be a good strategy if your income is highly taxed and, in a rising property market, the capital growth is well worth the extra outlay.

However, in a falling or stagnant market, where there is no capital growth, there is no benefit at all – negative gearing is just an expense. While the loss is certain, the capital growth is only potential. So in times when property prices are stable or falling, you may suffer the double whammy of a loss on income *and* a loss on the value of the property.

Depending on your income and marginal tax rate, the tax benefit will range from zero per cent to forty-seven per cent of the loss. So, even though the loss is claimable, you still have to pay the difference (or the residual loss after tax deductions) from your after-tax income. If you receive little or no income, most or all of the losses will need to be paid from your savings.

When a property is vacant, there is no rental income to help pay the monthly costs of the mortgage and outgoings. This adds a lot of pressure to find a tenant.

In one example, as a result of the recent Global Financial Crisis, property prices in Europe have plummeted by as much as forty-five per cent. It is likely that European investors with highly geared property investments now face the prospect of having to service loans that are greater than the value of their properties.

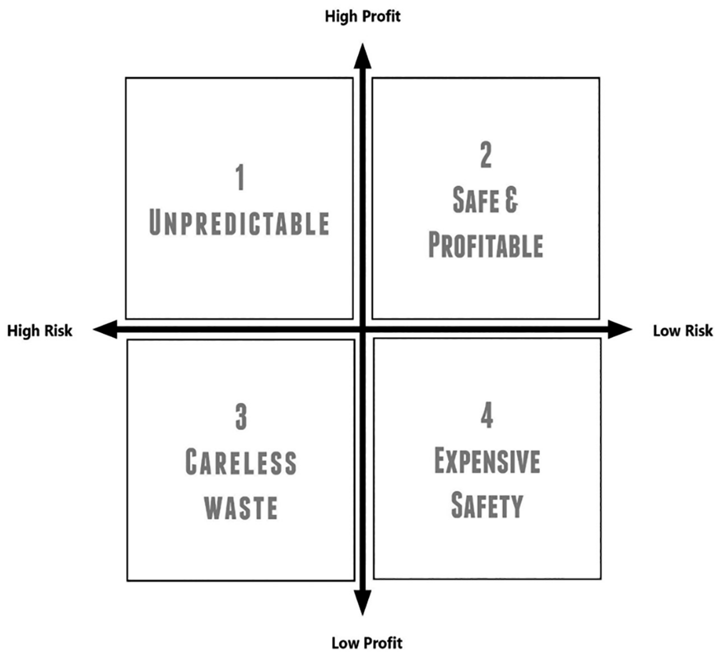
Additionally, there are only so many negatively geared properties you can afford to carry. By contrast, when they are positively geared, you have more flexibility.

The lesson is, when it comes to gearing, think carefully about the benefits based on your income level, the performance of the property market and how long you intend to hold the property. If this is a lifetime investment, then temporary dips will even out over the long term.

Once you've decided on a loan amount, the next step is to speak to a bank manager or a mortgage broker.

A bank manager is tied to the bank's lending policy, so there may be times when he won't be able to offer you the best deal. A mortgage broker, on the other hand, is not tied down to one lender so can source funds from a number of lenders and find you the best deal being offered at the moment. Either way, it's good practice to talk to both and use one against the other to negotiate a better rate. When comparing loans, keep in mind that other costs such as monthly fees, set-up costs, valuations and lender's mortgage insurance can be quite significant.

Your risk profile



Like all successful endeavours, building wealth through investing in property needs careful planning. Which strategy you use will depend on how comfortable you are with taking risks.

An investor with low tolerance for risk will need to be cautious and utilise a strategy based on security, whereas an investor with a higher tolerance can be more aggressive with their choice of strategies.

The common rule for all investors is that a higher risk factor deserves a potentially higher reward.

There are a number of factors in determining how comfortable you are with risk:

- Your general attitude – are you a 'glass half full' or 'glass half empty' sort of person?
- Your current personal circumstances. For example, a twenty-five year old, single man may have a higher capacity for managing risk than one with a family with five children, who has more to lose.
- Your current skills and knowledge, or access to skills and knowledge you can trust. Everything is easy when you know how.

Once you have an understanding of the level of risk you are comfortable with, you can then decide on strategies that are within your level of tolerance. Stress and pressure are experienced only when events take you beyond your comfort level.

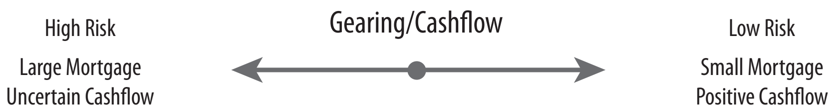
In many relationships, risk tolerance differs, creating friction. One person will be seen as 'reckless' while another will be considered to be 'putting the brakes on everything'. By understanding each other's levels of risk tolerance, you will be able to find common ground.

Risk tolerance will also need to be taken into account when seeking property advice. There is no point paying for advice that you may consider too aggressive or too cautious.

Strategies revolve around a number of characteristics. Whilst each individual characteristic may seem insignificant, watch that the cumulative level of risk created by all your choices is still within your risk tolerance.

Cashflow

The more you borrow, the higher your expenses, which results in less net income. This can add enormous pressure if a tenant moves out and the property becomes vacant for any length of time or if unexpected repairs are required.

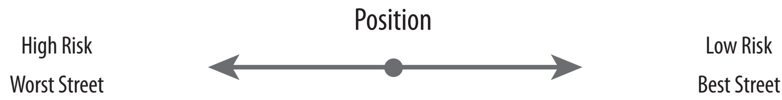


Quality of the property

The better the features, presentation and overall feel of your property, the better quality tenant you will attract. The better the tenant, the more secure your property and income.

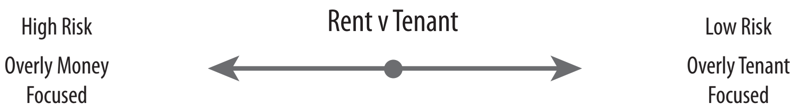
Position/location

Is your property in the best street or worst street of your area? Is it adjacent to power stations, industrial premises or transport hubs?



Profit v tenant

An overly-cautious investor will sacrifice rental income for the sake of the security of a good tenant, whereas an aggressive investor will risk losing a good tenant for the sake of a higher return.



Insurance

All savvy investors know that landlord insurance is essential. Make sure you have adequate cover for your actual needs and that you're not paying for cover on items that are not relevant to you or your property.

Landlord insurance – manage your risk

Nobody knows what's around the corner; situations change, and good tenants can also change under specific circumstances. People break under the pressure of divorce or lost employment and this can cause unimaginable damage. However, you don't want the events in your tenants' lives to adversely impact on yours.

Landlord insurance is your investment property safety net and should be considered a 'must have'. It will protect you, your family and your property from potential financial difficulties, thereby lowering your investment risk.

However, looking for the appropriate insurance cover can be time-consuming, as each insurance company has its own combination of what it covers, what it doesn't and the limits of the cover. Take your time deciding – you don't want to find out you are not covered when you need it most.

Landlord insurance cover may include the building, contents, events, loss of rent and public liability.

Building

Building insurance covers:

- Replacement cost of the building;
- Demolition and removal of debris;
- Locks and keys; and
- New structures to comply with all statutory requirements.

If you own an apartment, the Owners Corporation, or company if it's a Company Title, owns the building it is in. They are responsible for the building insurance, which you pay through your quarterly fees. Wallpaper and paint may not be included and should be allowed for in your contents cover, together with other items added separately, such as air-conditioning, lighting and flooring.

'Under insurance' is where the cover you have purchased isn't enough to cover the full amount of any damage. This can result in a proportionally lower payment by the insurance company, even for lesser claims. The insurance company could argue that if $500,000 is the appropriate building insurance cover and you have only covered for $300,000, you should cover the difference and they will only pay sixty per cent of the costs/claim.

Contents

Contents insurance covers:

- Carpet and other flooring
- Light fittings
- Window finishes
- Manchester and linen (if supplied)
- Any furniture itemised in the tenancy agreement
- Kitchenware cabinets and appliances
- Bathroom vanity, cabinetry and shower screens
- Tap ware
- Tiling, paint and wallpaper
- Household goods such as gardening equipment
- Washing machines and dryers
- Potted plants
- Portable pools, spas and equipment

In an apartment, make sure you know which items are not covered by the strata building insurance so that you can include them in your own insurance. In the event of fire elsewhere in the building, your unit may be affected by smoke and water damage, possibly needing new paint and carpet, or at the very least cleaning.

You do not need to take out contents insurance for the tenant's belongings, nor can you insist they do so.

Events

There is a wide variety of events that can be covered, including:

- Accidental loss or damage
- Malicious damage
- Theft
- Fire or explosion
- Lightning
- Earthquake
- Riot or civil commotion
- Water damage – leaks, rain, floods and tsunamis
- Oil heater leakage
- Accidental glass breakage
- Storm or rainwater
- Electric motor burn out
- Impact from aircraft, trains, automobiles, space debris, satellites, falling trees or branches, TV antennae, satellite dishes or radio masts

Make sure you get the cover you need, and check the policy exclusions carefully. For example, some policies do not cover:

- Accidental damage caused by the tenant[5]
- Theft by the tenant

5 In these cases you'll need to seek compensation from the tenant.

- Damage by the tenant’s pets
- Tsunamis or other actions by the sea or rivers

Loss of rent

This covers you for loss of rent in the event that the property is not habitable and cannot be leased due to any of the events listed above.

It also covers any rent default by the tenant. However, there are usually conditions attached to a rent default claim, so check the conditions carefully. Also check the policy for how long the insurance company will pay for loss of rent as well as the default period before a claim can be lodged.

Beware, on some policies you are only covered for loss of rent if the tenant is in a current, unexpired, fixed-term tenancy agreement – you are not covered if your lease has expired and is now a periodic tenancy agreement. This adds unnecessary risk, as it’s not always possible to have a tenant continuously sign a new tenancy agreement.

Public liability

This relates to your legal liability as the owner in regards to an event at your investment property which results in death or injury to other people or damage to other people’s property in or at your investment property.

Consider a minimum public liability cover of no less than twenty million dollars.

Chapter summary

- To be an effective property investor, you need to have a landlord's mindset. This is the ability to make investment decisions based on business principles and personal principles.
- Your goals are a key part of this mindset, as they give you something to aim for as well as a way to measure your success.
- You also need to know your budget, both a budget for the purchase of the property and a budget for the running costs (income and expenditure).
- Many of these expenses can be offset against your personal income for tax purposes.
- Part of your budgeting is knowing how much to borrow, and whether a negatively geared property is the right strategy for you.
- A key part of the landlord mindset is understanding your risk profile and the profiles of those partnering with and advising you.
- Insurance is the best way to mitigate risk.

Action steps

1. Be clear about the goals for your investment property, both financial and lifestyle.
2. Understand the workload your level of involvement will entail.
3. Create a clear budget, including:
   - Purchase costs
   - Expected income (rental yield based on researching similar properties in the area)
   - Expected expenses
4. Decide how much you are prepared to borrow, considering the amount of interest you will need to pay each month, and whether those payments will be sustainable in the long term.
5. Get clear on your risk profile, and work within that to determine your property strategy.
6. Talk to your accountant to work out the best tax structure for your particular situation.
7. Research the various insurances available for your investment – it is best to be ready before you buy.

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