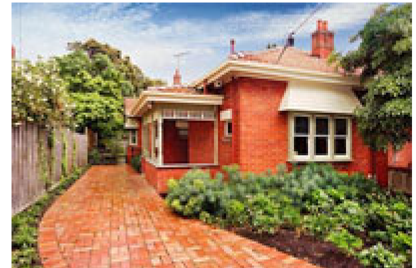
GOLDEN GATE FINANCE

Making your home a rental

It's called the six-year rule and it's so commonly bandied about that it has its own folk law. We look at the issues that will affect you if you decide to rent out your home.
The first major point of the six-year rule is that you cannot apply it until after you've lived in the house. Factors the Australian Tax Office (ATO) considers relevant in determining if you have lived in a house include your address on the electoral roll, where your family resides, whether utilities are connected in your name and where your personal effects are kept.
Assuming you've lived in the home, you can rent it out for up to six years at a time and continue to give it your main residence exemption.
Of course during this time you cannot exempt another property as your main residence even if you're living in it. Couples are only entitled to one main residence between them. If you move back in after renting the property out for six years and then move out and rent it again you're entitled to another six years and so on.



If you vacate the property for more than six years in a row you can still use the six-year rule to exempt it for the first six years.
Let's assume you have "property one" which you've lived in since you purchased it and "property two" which has been a rental property since you purchased it. Due to urban renewal that has just begun around property one, you expect it to make better capital gains and earn a better rent than property two. So you decide to move from property one into property two. By leaving your main residence exemption with property one, in six years' time you could sell it and not be subject to any capital gains tax (CGT) on it.
If you ever sell property two you will be subject to CGT on it for the period you owned property one. You can move your main residence exemption across to property two as soon as you have sold property one. You don't have to move back into property one before you sell it, nor do you have to justify to the ATO why you arranged your affairs that way, it is your choice.
You don't have to decide which property is covered by your main residence exemption until you prepare your tax return for the year you sell property one. If you intend to live in property two for the rest of your life, the sleeping CGT liability on it will never bother you or your heirs.
If property two is your main residence when you die it makes no difference that at some time in the past it was rented. Your heirs are still entitled to all the CGT concessions that would have applied if it had been your main residence all the time you owned it. This means they pay no CGT if they sell it within two years of your death, or, if they keep it, their cost base is simply the market value at the time you died.
Another name for the six-year rule is the absence rule. If you are not absent, you are not entitled to use it.
So if you rent out part of your home, for example a granny flat or rooms in the house, the six-year rule cannot apply. Instead your main residence exemption is limited to the part of the property you use personally. If this is the first time you've earned income from your home, it will cause your cost base for your whole home to be reset at the market value at the date it first started earning income. This can be the case even if you are just renting out a room in your home.

Scenarios
There is a case of parents who bought a family home but only ever stayed there when on holidays in Australia. They worked overseas and their adult children occupied the house. The parents could not give it their main residence exemption as they were considered to be residing overseas for all of the period of ownership and as their children were over 18 but not on the title deed, they could not cover the property with their main residence exemption either.

As you can see from the above it's not hard to wind up with some CGT applicable to your home. But while CGT may apply, keeping good records can help you minimise its effect.

Section 110-25 of the Income Tax Assessment Act 1997 applies to properties purchased after August 20, 1991. The CGT cost base for these properties includes holding costs, such as interest, repairs, rates, insurance and land tax that are not otherwise deductible.

It's important to note that holding costs cannot be used to create a capital loss. Holding costs increase the cost base before it is apportioned between exempt and non-exempt days so the holding costs while you are living there can reduce the gain incurred while you are not.
This is best explained by way of an example. Let's assume a family lives in a house for 10 years and rents it out for 12.
The house costs them about $5000 per year in holding costs. During the 12 years it was rented they claimed a tax deduction for the holding costs so they cannot be used to increase the cost base but the holding costs while they lived there can.

Assume the property originally cost them $100,000 including purchasing costs such as stamp duty. After deducting selling costs, they received $200,000 from the sale. Their cost base would be $150,000 (100,000 + ($5000 x 10 years)) after adding in the holding costs for the 10 years they lived there. They have made a gain of $50,000 which is divided by the 22 years they owned it and multiplied by the six years it was not covered by their main residence exemption. So only $13,636 ($50,000 / 22 years x 6 years) of the gain is not exempt.

After applying the 50 per cent CGT discount they are only taxable on $6818. Note, this would not be the case if they first rented the property out after August 20, 1996. Main residences that are first rented out after August 20, 1996 automatically have their cost base reset to the market value at the date they are first rented out.

In the example above, the holding costs incurred after the reset cannot increase the cost base because they would have been claimed as a tax deduction and the holding costs before the reset are now disqualified.

Nevertheless, the six-year rule would apply to exempt half the time it was rented out. So if, say, the market value was $140,000 and after deducting selling costs they netted $200,000 on the sale, they have made a gain of $60,000 – half of which is subject to tax as they had rented it out for 12 years straight so could only use the exemption for six years. They also qualify for the 50 per cent CGT discount so the taxable gain would be $15,000.

If your cost base is reset to the market value when your house first produced income but you move back in, make sure you keep a record of all your holding costs from that point onwards as they can be used to increase the reset market value cost base.

Note, all of the above is only applicable to properties purchased after September 19, 1985. CGT does not apply to properties purchased before that date unless they change hands or significant money is spent on them.

Source: CPA

GOLDEN GATE FINANCE

Aussies expect family help for first home

Many Australians expect to tap into some form of family support to finance their first home purchase, despite indications an inheritance may not be enough to secure a mortgage.
While financial independence still remains a goal for most people, a recent survey found 32 per cent of people had factored in inheriting some of the value of their parents property as part of their repayment strategy.
The survey - conducted by the Mortgage Industry Association of Australia (MIAA) and BankWest - also found a quarter of the 842 respondents were relying on some form of family assistance to buy their first property.

"Mortgages are much larger in absolute terms than they've ever been before and housing prices are much more expensive," MIAA chief executive Phil Naylor said.
"Sixty-nine per cent say that saving a large enough deposit is holding them back from buying a home.

"This is a reassuring sign that they are responsible when it comes to entering the market and prefer to demonstrate their saving abilities before committing to a mortgage."

Fifty-two per cent of Australian would like to own a home without any strings attached and plan to finance their purchases without having to rely on family support.
But for many, financial independence is a very expensive dream.

Despite concerns about financial overcommitment, 64 per cent of first home buyers believe home ownership has more advantages than renting while 60 per cent expect to enter the market within the next three years.

MIAA said most lenders looking to approve a mortgage still examine a homebuyer's ability to meet repayments when working, not the ability to utilise inheritance or family assistance.

The survey also found 89 per cent of first home buyers were excited about the prospects of renovating to their taste, 75 per cent looked forward to feeling financially secure and 68 per cent wanted to have a stable family home.
Meanwhile, 17 per cent were considering buying an investment property before buying the family home.
Source: AAP

GOLDEN GATE FINANCE

The pros and cons of rental guarantees

What's in store for apartment investors when the rental guarantee runs out? Marc Pallisco finds out.
According to most real-estate agents, Melbourne's apartment market has decelerated from the heady heights of the late 1990s. As such, developers have been forced to devise new methods to maximise existing demand, with the goal for many being to achieve enough pre-construction sales to make the development profitable.

One concept that has gained popularity in recent years is the rental guarantee.
Here, a developer promises a purchaser a guaranteed rent - typically for a period of one to two years - to help make the investment more attractive to buyers and their lending institutions.
Coupled with stamp duty savings and depreciation benefits, developers have used rental guarantees cyclically since the late 1980s, to help start projects that may not have otherwise got off the ground.

Rental guarantees are also used by student and tourist accommodation providers, who take management of the leasing and outgoings and pay an owner a weekly rent.
One such investment currently on the market is the Enterprize Hotel in Spencer Street. Promising a 6.5 per cent return, the building owner is offering studio-style suites from $164,000, leased back to the hotel operator for three years.
Nearby on the corner of Spencer and La Trobe streets, a similarly sized apartment, without a rental guarantee or indeed a tenant, was asking $145,000.
So what does the extra money buy you?
According to Enterprize Hotel marketing agent Carlo Rosetti of Melbourne Business & Investment Corporation, it buys security.
"Rent will be paid into the investor's bank account immediately after the property settles," Mr Rosetti says. "Investors buy the security of knowing rent will continue to be deposited into their bank accounts for the next three years."
In the case of the Enterprize Hotel, the rent received would cover most banks' minimum mortgage repayments, leaving buyers with an asset that virtually pays for itself for at least the next three years.
But it's what could happen at the end of those three years that property valuers say should send alarm bells to potential investors.
"If a deal sounds too good to be true, it usually is," says Richard Bowman, principal of Ernst & Young Advisory Services in Melbourne.
Mr Bowman says that in most cases, particularly related to off-the-plan apartments, the guaranteed rental is factored into the initial purchase price of the property, which is often higher than market value.
This is reflected in bank lending criteria, which usually requires investors to have deposits of up to 40 per cent to finance a rental guaranteed investment.
"Lending institutions will usually strip out the rental guaranteed component of an investment such as this, and value on a vacant possession basis," Mr Bowman says. "They will then add the value of the rental guarantee to the property for however number of years that guarantee is offered."
He says in many cases, the amount of rent received drops once the rental guarantee period has ceased.
Buyers' advocate and director of Morrell & Koren David Morrell says "people get sucked into rental guarantees, not thinking about what will happen when the rental guarantee falls over".
Mr Morrell points to the number of inner-city apartments sold with rental guarantees when the market started to falter earlier this decade. "When market conditions are strong, rental guarantees are not as prevalent. "(Lower-grade) properties have to have a twist to make them digestible to the market."

Investors should also conduct research into the developer's ability to honour the rental guarantee after the property is purchased, Mr Morrell says.
"Developers don't have to lodge any documentation to a government body for an investment of this type," he says. "What happens if a builder goes broke?"
For the past 10 years, Mr Morrell has been lobbying against developers using rental guarantees to attract investors. He argues that real-estate agents and developers proffering rental guarantees have no legislative right to do so under the Corporations Act, and is taking the fight to the Australian Securities and Investment Commission to rid this kind of carrot being waved to unsuspecting purchasers.

A satisfied customer
The owner of this Malvern apartment was paid rent even when there was no tenant.
Carol Stack (pictured) appears to have survived her rental-guaranteed investment unscathed. In January 2000, Ms Stack had first choice of a six-unit apartment development in Childers Road, Malvern.
Her payment of $290,000 bought a two-bedroom unit with courtyard from developer the Benson Property Group.
Ms Stack negotiated a rental guarantee period of 18 months, six months longer than the period the developer had advertised. For this period, the developer agreed to pay Carol $330 a week, equating to a rental return of 6 per cent. That rent dropped to $260 a week when the rental guarantee ended.
According to Ms Stack, the timing coincided with an influx of new rental properties that presented towards the end of Melbourne's property boom.
At a market rent of $260 a week, the investment showed a 4.6 per cent return on the purchase price, which Ernst & Young Advisory Services principal Richard Bowman says is consistent with the market range achieved for most apartments.
On top of that, the suburb of Malvern recorded an increase in median apartment value over that period, which saw Ms Stack pocket some capital gain. Had she invested in some of the inner-city suburbs she was being shown at the time, the increase in property value might have been lower.
Ms Stack admits she was surprised by the drop in rent but was satisfied with the investment, which paid her rent even during a period when her property was vacant.

How it can go wrong
A developer is marketing a new project of 50 apartments in the inner city for $400,000 each.
However, the market is considered oversupplied and the apartments' true value is only $320,000.
Market rent for an apartment of this type, and in this area, is $350 a week. At a purchase price of $400,000, the investor's return is 4.5 per cent.
Rental guarantees allow developers to manipulate these numbers.
To make an investment offer a return of 6 per cent - well above the average of most other investments - the developer will offer the buyer a guaranteed rent of $460 a week, paid for the next two years.
Once a buyer signs a contract, the developer will lease the apartment at the highest possible market rate - and make up the shortfall for a period of two years.
Assuming an apartment leases for $350 a week, the developer will make up the extra $110 a week.
The developer can afford to do this because they have been paid $400,000 for a unit that's only worth $320,000.
When all the apartments in this project are sold, the developer has pocketed an extra $4 million simply by promising rental guarantees.
If the development is to be financed, the developer has enough pre-committed sales to get finance from the bank, plus the financial responsibility of the apartments has now been handed to the investor.
When the rental guarantee period ends, the apartment owner has to find tenants in the open market.

Under the developer's guarantee, the investors were earning $24,000 a year. Assuming they now receive $350 a week, their annual return from the apartment is $18,200.
The investor's returns have fallen from 6 per cent to 4.5 per cent overnight - and it gets worse.
A fall in income reflects a fall in the apartment value.
If the investor decides to sell, they find themselves competing with developers selling new units with guaranteed 6 per cent returns.
At $350 a week rent and a 6 per cent return, the apartment is now worth only $305,000 on the open market. Their income has fallen $11,440 a year and the value of their investment has fallen $95,000.
Generic example cited by David Morrell of Morrell & Koren Buyer's Advocates.

You can share the above information with your family members, relatives, friends and colleagues.

However, if they would like to receive our Property & Finance Matters directly, please just ask them to send us their names and email addresses.

Our email address at Golden Gate Finance is: info@goldengatefinance.com.au