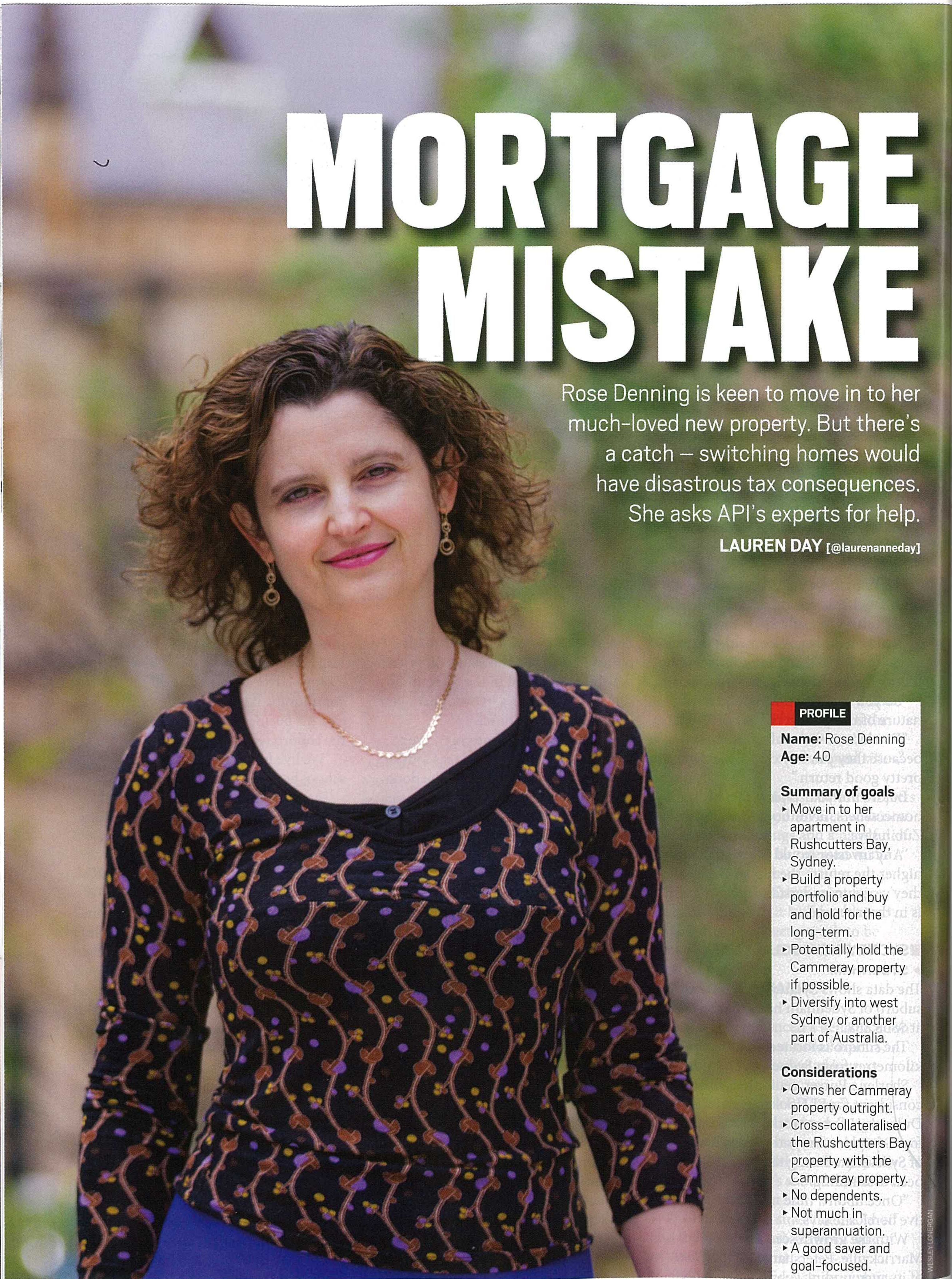

MORTGAGE MISTAKE

Rose Denning is keen to move in to her much-loved new property. But there's a catch – switching homes would have disastrous tax consequences. She asks API's experts for help.

LAUREN DAY [@laurenanneday]

PROFILE

Name: Rose Denning
Age: 40

Summary of goals

- Move in to her apartment in Rushcutters Bay, Sydney.
- Build a property portfolio and buy and hold for the long-term.
- Potentially hold the Cammeray property if possible.
- Diversify into west Sydney or another part of Australia.

Considerations

- Owns her Cammeray property outright.
- Cross-collateralised the Rushcutters Bay property with the Cammeray property.
- No dependents.
- Not much in superannuation.
- A good saver and goal-focused.

WESLEY LONERGAN

Imagine buying your dream home only to realise days later it doesn't make financial sense to live there.

This is exactly what has happened to 40-year-old Rose Denning*, who just bought a 57-square-metre two-bedroom apartment in one of Sydney's trendiest and most beautiful suburbs, Rushcutters Bay. The apartment is small but the lifestyle on offer is one Rose has always dreamed of – close to the harbour, cafés and restaurants. It also has easy access to Rose's workplace and is among some of Sydney's finest homes. The apartment itself is in a quiet street and even has its own parking, which is a big bonus in this busy part of town.

But we're getting ahead of ourselves.

To get to the bottom of Rose's predicament, we need to go back to the start. She bought her first property and principal place of residence in Cammeray back in 2008. It was just as the GFC hit, but that didn't stop this determined and passionate property lover.

Rose paid $395,000 for the 67-square-metre one-bedroom apartment in Sydney's leafy Lower North Shore area, and then went about paying off the loan as quickly as possible.

Rose doesn't have any dependents and is single, and so acknowledges that she doesn't have many expenses. But it was mainly hard work and sacrifices that enabled her to be debt-free within a few years. More recently, as the Sydney market boomed, Rose realised she longed to move to the eastern suburbs. It's an expensive area, but beautiful and convenient.

Unfortunately, with so many people attending open homes and prepared to pay premiums, Rose jumped into her second purchase without seeking advice first. She now realises it was a bit of a mistake. Not the purchase itself, of course, just the way the mortgage was set up.

The problem is that Rose found her slice of Rushcutters Bay and snapped it up in haste, forking out $656,000. She took out a 95 per cent loan, then added mortgage insurance and stamp duty on top, so the loan on this property is actually $683,000. To get the deal across the line, the property was cross-collateralised with her Cammeray pad.

But the main issue is that Rose bought this property as an investment, rather than a principal place of residence, even though she plans to move there.

The joy of 'getting in' to the eastern suburbs was short-lived when her accountant told her she would pay thousands of dollars in tax if she were to keep her Cammeray property and rent it out.

The 'problem', even though it's probably one many investors wish they had, is that the Cammeray property is paid outright, so would be heavily positively geared and probably rent for around $550 per week.

"Since the Cammeray property is positively geared, if I set up a redraw facility, I'll be losing money in tax on renting it out," Rose explains.

"Renting it out would basically be a significant cost in tax. So I've rented the Rushcutters Bay property out. The rent is $580 per week."

That's why she's come to API's property experts for help. In API's new 'Fork in the Road' series, investors face two choices with two potentially different outcomes. Rose wants to know exactly what she should do with her finances and whether she should sell her Cammeray property.

If she did part ways with her current principal place of residence, she obviously wouldn't have to pay capital gains tax. But Rose also hopes to somehow keep the Cammeray property if possible, as she's investing for the long-term and wants to accumulate assets, rather than sell them off.

And of course, the fact she owns her Cammeray property outright means she has a whole heap of equity she can use. Her lender recently told her she could put down a massive $350,000 as a deposit on a third property, if she chooses, and borrow up to $1.2 million. Of course, she could also buy another two or three properties for the same amount.

Her salary is quite good and so Rose has strong borrowing power. But while it's obviously an exciting position to be in, it's also perhaps slightly daunting.

After all, Rose wants to make sure she's making smart moves now, so she can retire comfortably after years of hard work.

"My goal would be to try and build a portfolio and keep buying properties, making sure I can build equity and keep borrowing, so I need to make the right decisions," she says. "West Sydney would be my next destination or even outside Sydney."

It's such a common predicament in the investing game, isn't it? Knowing you can borrow, but not knowing exactly where to buy. And next time, Rose wants to make sure she structures the purchase correctly, so she's not left with a big loan on a potential principal place of residence, and a small loan on an investment.

"Somebody advised me to open a line of credit and use it as a deposit with another bank, to avoid further securitisation of my properties," Rose says. "But I'm a bit confused as to how this actually works."

At the moment, the lease on the Rushcutters Bay property has another seven months or so to go, (expiring in June). It's an interest-only loan, on a variable rate of 4.8 per cent. Rose doesn't have much super to rely on, so will need to be able to keep leveraging and using equity to build a portfolio.

But how many properties should she buy, if any? More importantly perhaps, should she sell her current principal place of residence? Let's find out!

> "My goal would be to try and build a portfolio and keep buying properties, making sure I can build equity and keep borrowing, so I need to make the right decisions."
>
> ROSE DENNING

CATE BAKOS
Cate Bakos Property

THE NUMBERS | ROSE DENNING

Location	Description	Purchase date	Purchase price	Purchase costs	Loan on the property	Current value	Rent per week
Cammeray	1-bed unit	2008	$395,000	$15,000	$0	-	PPOR*
Rushcutters Bay	2-bed unit	2013	$656,000	$30,000	$683,000	$656,000	$580
Total			$1,051,000	$45,000	$683,000	$656,000	$580

*Principal place of residence (PPOR).

It's interesting, Rose, that you feel you've made a mistake. Technically you have, but when I look at the calibre of the properties you've bought and the growth you've experienced since purchasing your Cammeray property in 2008, it hasn't all been bad.

The issue you've been focusing on is the lack of deductibility in your Cammeray property. However what you haven't considered with that positive cash flow 'issue' is the fact that you'll need your property portfolio to balance in terms of cash flow, and this property will be able to aid that. If every property is negatively geared, your borrowing capacity will hit a brick wall and your journey will come to a sudden stop.

So rather than advise you to sell your Cammeray property, I'm actually advising you to enjoy the positive cash flow and the counterbalance it enables alongside the negative cash flow properties, which you'll later add to your portfolio, including the already purchased Rushcutters Bay property.

In your 'fork in the road', I believe you have the option to own five investment properties. I've formulated this strategy based on four main goals:

- To keep building your portfolio as you said you would like to.
- To avoid further cross-securitisation, in order keep your options open in terms of where you live and if/when you choose to sell.
- To keep your overall cash flow as close to neutrally geared as possible.
- To diversify your purchases so that you have exposure to all eastern states.

To give you good options now while you're a busy professional, and later in relation to where you decide to live once you get closer to retirement.

The (proposed and hypothetical) breakdown of properties in your portfolio will be:

Cammeray, NSW $600,000
Rushcutters Bay, NSW $656,000
Kensington, Vic $750,000
Ascot, Qld................................. $350,000
Geelong West, Vic $350,000

Your overall debt would be $2,155,000 and at five per cent interest rates, would cost $107,750 per annum. Your rental return, based on the typical yields in each nominated area, would be $121,160 per annum. Your own rental costs per year would likely be in the vicinity of $30,000 to $35,000 while you're renting. I've also apportioned 1.2 per cent of the total portfolio value to cover the other holding costs.

The Cammeray lounge

Despite the raw interest and rents showing that you're positively geared, your calculated holding costs based on the above 1.2 per cent equate to $32,472 per annum. This then makes the total portfolio negative cash flow before tax. Obviously while you're working you can enjoy the benefit of the negative gearing and any associated depreciation. When you do eventually face retirement you can then make some decisions about letting go of your principal place of residence in Rushcutters Bay and pursuing the western Sydney property, or whatever your wish is then.

You would be seriously advised to consider the benefits of fixing some of your loans – certainly the 'buy and hold' properties such as the interstate ones. Your exposure to debt in this low interest rate environment is attractive now but could change for the worse if interest rates increased. You'd also be advised to use the $350,000 in equity but to have each loan secured only against each property and not cross-secured. Your mention of using other lenders is interesting but not necessarily crucial. Any lender could offer standalone loans. A line of credit for the $350,000 would be a good idea. That way you only pay interest on the amounts that are drawn down. You'll need to carefully note which portions are used for each property, so that your tax position is clear for every asset. In addition, you would be advised to utilise an offset account, so that your earnings and savings offset your daily interest, and your quest to reduce the debt is aided optimally. While these properties are investment properties, you shouldn't be making any early repayments. Instead, channel all of your savings into your offset account.

I'd recommend you keep Cammeray and Rushcutters Bay – and hold both as investment properties for now. While your Cammeray property would be positively geared, this gearing will enable you to balance your cash flow across the portfolio and it will enable you to comfortably hold your more aggressively negatively geared future purchase, including Rushcutters Bay. To manage your cash flow sensibly, at least while you're working, you'll need to rent. Given you love Rushcutters Bay, a nice one-bedroom property there will cost you about $550 to $650 per week. Your cash flow and tax related benefits will outstrip that of living in your Rushcutters Bay apartment.

I would apportion the $350,000 equity into three deposits for property purchases as follows:

First of all a growth property in Melbourne's inner northwest/west, where the yields are stronger compared to other parts of Melbourne. Your next move to diversify and invest in a slightly stronger yielding city asset could be an apartment in Brisbane's inner north. For example, the blue-chip suburb of Ascot on a five per cent rental yield; $350,000 with $330 per week rental income. My reason for selecting Ascot is that this suburb is close to the CBD and has strong tenant demand. Finally, to diversify into a smaller secondary city in another state again, I'd consider a sensible townhouse purchase in an area where your returns are likely to be closer to neutrally geared.

ROSEMARY JOHNSTON
Property Investment Association of Australia

You have created a great foundation for your future, Rose. Let's look at your property investment options.

- Move to Rushcutters Bay and pay a lot of tax on the rental income from Cammeray.
- Stay in the Cammeray property and reconsider what to do next.

This is a great temporary solution while you gather your experts around you to investigate your choices. It's vital you make your decisions from the big picture goals, the ones that support your future income.

- Borrow against Cammeray and 'fix the problem' by buying a negatively geared property that has great capital growth prospects.

The concept is that the rental income from Cammeray would be able to 'offset' the negative rental income from a new property and reduce your taxation exposure.

In my experience trying to fix a problem takes your eyes off the main agenda, which is to create wealth for your future. It's usually much better to refocus on what you want to achieve and make decisions to support this outcome rather than trying to patch up a situation.

- Re-evaluate and work out what's best in the long-term.

In my experience the most prudent considerations now are:

- Where do you want to be in 10 to 15 years' time?
- What passive income would you like to create?
- What are you willing to do to achieve that opportunity?

Let's make some assumptions so I can demonstrate the principles of what's vital for you to consider.

- You'd like to create a passive income of about $2000 per week.
- The rental income from your property portfolio is five per cent. This means you would need to own an unencumbered property portfolio valued at $2 million to create your target income.
- Capital growth of seven per cent per annum, which is convenient for the purposes of this article, however in reality it can vary.

Now let's work backwards.

EXPERTS' SUGGESTIONS IN A NUTSHELL

Cate Bakos

- Keep the Cammeray property. Don't sell.
- Avoid cross-collateralisation.
- Buy another three properties in Victoria and Queensland to diversify.
- Use the $350,000 equity to your advantage by borrowing again.
- Consider locking in some interest rates and loans.
- Rent a property in Rushcutters Bay, and rent out the investment property in Rushcutters Bay, for maximum tax benefits, while still enjoying the lifestyle.
- Consider a smaller townhouse in an area where returns would be neutrally geared.

Rosemary Johnston

- Keep the Cammeray property.
- Aim to build a property portfolio worth $2 million debt free, which would provide a passive income of $2000 per week.
- Avoid towns with a population of less than 100,000 people.
- Use the $350,000 to buy three properties valued at $400,000 or four properties valued at $300,000.
- Aim to buy properties that have a rental yield of around five per cent plus.
- Before retirement, sell half of the properties to pay down debt.

EXIT STRATEGY

Your goal is to own a property portfolio valued at $2 million that's unencumbered and has a rental return of five per cent, giving $2000 per week passive income.

HOLDING STRATEGY

Holding properties with neutral to positive cash flow plus depreciation benefits supports lower risk investing. The key considerations to support a sustainable holding phase are likely to include the following items:

- Having contingency funding to support any unexpected expenses.
- Insurances to support any major unexpected expenses such as illness.
- Properties that support continuous rental income.
- Continued employment to create savings, and access equity to maintain the value of your properties and their rental appeal.
- Optimisation of the portfolio so it can withstand any interest rates rises. This shouldn't include any properties in towns under 100,000 people, as the economy is generally too reliant on one sector.
- Any tailored considerations.

ENTRY STRATEGY

If you have access now to about $350,000 in funds to create a property portfolio, (based on an assessment of your Cammeray property being worth closer to $540,000 and paying out the cross-collateralisation through a sale or refinancing), what could you do with this to create your future income?

This can be leveraged at an 80 per cent loan-to-value to give you $1.4 million to invest. You could buy three properties valued at $400,000 or four at $300,000 and leave some contingency funds for your peace of mind.

Let's apply our previous assumptions.

- This $1.2 million property portfolio doubles over the next 10 years to a value of $2.4 million and again over 10 years to $4.8 million.
- The rental yield remains at five per cent.
- You sell half of the properties to pay down the debt.
- You have created a passive income of just over $2000 per week on the $2.4 million unencumbered portfolio.

Now I hope you can see why I'm so upbeat for your considerations. This portfolio and your timing in the market can be optimised and adjusted for your circumstances, providing many choices.

However, before you move forward, you need to sort out Cammeray. Can you unravel the cross-collateralised mortgage or is it better to sell it because its taxation considerations aren't as workable as other options?

You have been a great saver and the above modelling only assumes you focus on paying down the mortgage at Rushcutters Bay. This is very conservative. This equity can be released in the future to support more investment if that's part of your considered property investment plan, created with your property investment adviser.

This fork in the road is a huge upset to your ideas and yet in the bigger picture it offers you the opportunity to create a more robust and sustainable property investment portfolio. It can give you even more confidence. Well done! API

**Rose's real name has been withheld for privacy reasons by request.*