WEALTHMATTERS

YOUR PERSONAL GUIDE TO WEALTH CREATION

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Negative gearing for property investors

Whether you are an established property investor or contemplating purchasing your first investment property, you may care to familiarise yourself with the way that negative gearing works.

A property is considered to be negatively geared if the owner has taken on debt in order to acquire it and the net rental income is less than the costs of maintaining the property (including the interest paid on the loan). Investors with negatively geared properties are able to claim the shortfall between their associated costs and rental income as a deduction against their total taxable income. In the event that your taxable income is insufficient to absorb the difference, then the remaining deduction can be carried forward to the next financial year.

Many Australians would not be able to enter the real estate market without taking on some form of debt. While taking on debt allows you to make investments that would otherwise be beyond your reach, it also ramps up your risk profile because you will have a greater amount invested. Furthermore, if your investment property is underperforming, you remain responsible for making the loan repayments.

Obviously, it is preferable to have an investment property that is positively geared, meaning that rental income covers the loan repayments, interest and routine maintenance. Paying tax on a profit is typically considered to be a better option than minimising your tax liability while making a loss.

Even if you think that your investment property will be positively geared, understanding the benefits of negative gearing can give you more peace of mind. If the property does lose money, you will be able to offset the loss against your taxable income. When a property is positively geared, the income earned is added to your total taxable income. As such, it is taxed at your marginal tax rate. The same applies to any capital gain that you make from selling a property.

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The importance of an appointor in a family trust

When it comes to family trusts, often overlooked in estate planning is the impact on the trust if the appointor should die or is unable to act.

Essentially a trust cannot operate correctly without an appointor, settlor, trustee and beneficiaries. In the event, the appointor dies or is unable to act will put the trust at risk of no longer being considered a trust (in legal terms).

The trustee is often believed to have full control over the functioning and affairs of the family trust when in fact the appointor has the ultimate control over the trust. Although they are not involved in the everyday running of the trust and the decision-making process, they have the power to replace current trustees and appoint new trustees. They also have the power to veto specific amendments put forward by the trustee, such as changing the end date of the trust.

The appointor is often viewed as the 'safe keeper' of the trust given the power they have to appoint and remove trustees. There can be some serious legal consequences by having a trust exist without an appointor.

Accordingly, the appointor should have an instrument, such as a deed, will or another form of legally binding document that will allow them to be effectively replaced in the event they are no longer able to act in that role due to death, illness or mental incapacity. By doing so, the implications of the current appointor passing away or being unable to act will not put the trust at risk because there will be clear terms in place to bring in a new, suitable appointor.

Handling investments that go awry

There a number of events that may indicate something is not right with your investments.

Remaining involved with and on top of the performance of your investments will allow you to recognise these indicators quicker. Consider the following:

Safeguard yourself in the beginning

One of the smartest moves you can make when it comes to investing is understanding what you are getting yourself into. Before making any financial commitments, ensure you have done your research. Do not let your heart control your thinking; many people invest in companies whose concepts they love without considering whether they will actually make any money. Make sure you understand the investment game, practice patience and diversify your portfolio.

Fall in value

It is advantageous to keep a progress report on the way your investments are performing. By doing so, you will be able to gauge in a timely fashion if your investment under-performs and whether this is just a seasonal trend or cause for concern.

Insolvency

In the case of a company you invest in becoming insolvent, it is best to hit the ground running in regards to getting your money back. Indicators of insolvency include a seize in interest payments, negative feedback in the media (mainstream news, social media channels, financial section of a newspaper) regarding the company or when you do not receive the distribution you expected.

If you have any doubts or concerns regarding your investments, it is always wise to speak to your financial advisor.

The ins and outs of property settlement

Understanding the settlement process when it comes to purchasing a house is important, particularly if you want to avoid extra stress and nasty financial and legal surprises.

Settlement involves the exchanging and signing of all the relevant documents pertaining to the sale of the property. Some of these documents include:

- Purchase contract
- Rates notice
- Documents concerning loan arrangement. Alternatively, you will need bank cheques if you have not arranged a loan.

On top of having all the relevant documents, you will also need to consider:

- Registration fee for the Land Title Office
- Organise payment for your solicitor
- Organise insurance for the property
- Conduct a final inspection

When conducting your final inspection, ensure you:

- Check all light switches work.
- Inspect the floors, ceilings and walls for any holes, marks or other damages.
- Check all doors and windows to make sure they open and close properly.
- Turn on taps and ensure there are no leaks.
- Test all appliances such as the dishwasher, oven, stove top, air conditioner, bathroom fan, etc to ensure they work.

Money habits that limit wealth creation

Even high earners can make careless (and avoidable) money mistakes.

Use the below examples as a way to look objectively at your money behaviour and how it might be limiting your wealth creation.

No budget

Some people think nothing of spending $1500 on a weekend away, or $800 on a new outfit. But even if you earn $400,000 a year, spending a substantial amount of money each month on purchases and experiences adds up. Not preparing and sticking to a budget is a common mistake among high earners, as many believe that a budget is not necessary, given their high level of income. Regardless of how much you earn, individuals need budgets to know where their money goes and what needs to be set aside to achieve their financial goals.

Peer pressure

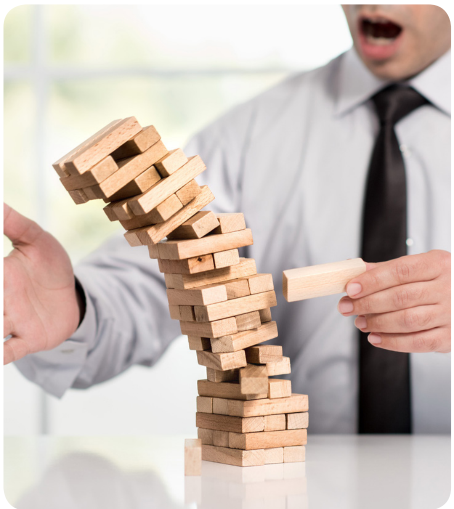
Peer pressure is not just experienced by teenagers. Do not be the partner who drowns in non-deductible debt, but takes an overseas holiday once a year or owns the latest model car just because that is what other partners have and do in your businesses.

Sunk cost fallacy

Avoid being the kind of investor who invests in projects regardless of potential returns. It is quite common for an individual to want to hang on to an investment that is doing badly because they feel both financially and emotionally invested, resulting in them being unwilling to sell.

Ignoring insurance

Going without insurance is dangerous. Being comfortable now does not ensure you will be



comfortable forever. Injury or illness to yourself or a dependent may create financial instability, particularly if you do not have the safety of insurance to fall back on.

Building your wealth

Understanding how to build your wealth, as well as how to manage your finances to remain wealthy is important.

According to ASIC, there are five particular practices you can put in place to ensure you are not only maintaining, but building your wealth. By following these five steps, you can set yourself and your family up for financial comfort well into the future.

Consider the following strategies for building your wealth:

Understand your financial starting point

There is no point in trying to build your wealth if you do not have a clear understanding of your current financial portfolio. It is necessary to know how you are currently acquiring your wealth as well as what your expenditures are. Only once you truly gauge your incomings and outgoings can you accurately assess how to effectively grow your wealth.

Eliminate debt from credit cards

One of the fundamentals of being wealthy is being comfortable and having money, so it makes sense to work away your credit card debt and refrain from using them. That will ensure you live within your needs; if you can not afford something do not buy it. If you can not cancel your credit card, insist on paying off the debt monthly to avoid paying any interest.

Organise superannuation

Most people will rely heavily on their superannuation as they enter into retirement. For this reason, it is paramount not to be passive when it comes to your super and how it is performing. Many people will set up a super account when they first start working and they will not think twice about it, which is actually quite irresponsible. You ought to be active in checking you are;

- Getting paid correctly or
- Contributing the right amount if you have a SMSF and
- Investments (your contributions are going towards) are performing well and will give you a good return.

Consult with your financial advisor

If you find you a time poor and can not devote a lot towards managing and building your investment portfolio, why not consider bringing a professional financial advisor on board? They will have industry knowledge that is up-to-date and current. They will also have the legal knowledge to make sure the way you are managing your money is in regulation with the ATO. Take advantage of their knowledge so you do not have to do it all by yourself.

Investments

Being involved in the investment game could make you lots of money, but it could also mean losing some money. If you choose to invest, make sure you take the time to do your research. You need to understand the risks associated with whatever you invest in and make sure you are regularly assessing your goals in relation to the investment.

Understanding debt

Many people make the mistake of assuming that all debt is bad and that they should aim to reach a point where they are completely debt free.

Some debt can actually be an important part of the wealth creation process. There are different kinds of debt: good debt and bad debt. The main difference between good debt and bad debt is how much income it is capable of generating.

For example, a credit card debt will almost always be bad because it will not generate any income (unless you have made a particularly clever purchase). A mortgage for an investment property, on the other hand, may be a good debt because it can eventually pay for itself and then continue to generate additional income.

Generally speaking, most people will accrue bad debts in times of financial hardship. Credit cards and personal loans are the most common and problematic forms of bad debt.

In many cases, bad debts such as these can continue to chase you for some time, even if your financial situation improves significantly. Usually, as an individual's financial situation starts to improve, they begin investigating the possibility of taking on debt to use as leverage to secure wealth accumulating assets.

Unfortunately, if you have any remaining bad debts it may impact your borrowing capacity. While drawn out repayment periods can see your household cash flow being wasted on unnecessary interest payments.

You should also be careful about how much debt you are taking on, even if it is good debt. A slight rise in interest rates can push your repayments up significantly, and if you can not service a debt it might land you in a world of financial trouble. There are two steps that you can take to try to make sure that your debts are good debts that are working towards wealth creation.

First, you should aim to reduce your existing bad debts. If it is possible, you should avoid accumulating any additional credit card or personal loan charges. If you struggle to control your credit card spending, you may consider replacing it with a debit card. Working out a detailed household budget each week will make it easier for you to see where your money may be slipping away.

Second, you should start looking into what kind of good debt might be beneficial for you. When you are considering taking on debt for the purposes of long-term wealth creation there are three things you should look at:

- The potential that the debt and associated asset will have to generate income, both currently and in the medium-to-long term future. You should ascertain if this is sufficient to justify the interest payments that you will need to make.
- Whether or not the asset you are purchasing with the borrowed funds is likely to appreciate or depreciate in value. For example, borrowing to buy a new car would rarely qualify as a good debt because vehicles almost always depreciate in value.
- What the tax arrangements surrounding the debt will be. In the case of investment properties, negative gearing can reduce your tax bill significantly. This may make the debt even more beneficial in the long term.

Selling property using the margin system

Those who are registered for GST may be able to use the margin scheme to work out how much GST they must pay when they sell their property.

According to the Australian Taxation Office (ATO), the margin scheme is a method of calculating the GST you must pay when selling property as part of your business. The margin scheme can only be applied if the sale of the property is taxable. Since its introduction, the scheme has changed with multiple amendments and rulings which may affect eligibility.

The GST is calculated on:

- the increase in value since 1 July 2000, if the property was acquired before 1 July 2000, or
- the difference between the sale price and the price they paid, if the property was acquired after 1 July 2000.

Property sellers may be eligible to use the scheme if they are registered for GST (or required to be registered for GST) and if:

- they are selling their property in the course of their enterprise and GST applies to the sale
- they acquired the property before 1 July 2000, or
- they acquired the property after 1 July 2000 and the person who sold them the property met one of the following conditions:
  - Was not registered or required to be registered for GST
  - Sold them old residential premises
  - Sold the property using the margin scheme
  - Sold the property to them as part of a GST-free going concern
  - Sold the property to them as GST-free farmland.