FACT SHEET

Direct Property Investment

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Introduction

Investment property can include residential property (i.e. houses, home units and holiday accommodation available for lease) and commercial property (i.e. shops, offices, factories and warehouses). Each option has different investment fundamentals.

Features

- Provides income from rent
- Provides potential for capital gain (higher capital gains are more likely in times of prolonged high inflation), but capital losses can also occur
- The investor controls the asset (provided mortgage payments are not in default)
- Property market is generally less volatile than equity market
- Cost of entry into the market is usually large so it is common to borrow (gear) to purchase
- Gearing can be used to reduce taxation liability (see separate leaflet 'Negative Gearing')
- Landlord insurance can help manage some of the risks i.e. malicious damage, loss of rent, rent default etc.

But Remember...

- High transaction costs are involved when buying and selling property
- Property can decrease in value as well as increase
- There have been real estate scams in Australia such as the sale of land visible only at low tide
- Tenanting the property may be difficult and extended vacancy may void insurance policies
- Extended vacancy may attract vandalism or squatters
- Damage or poor upkeep by some tenants can incur extra costs for repairs and maintenance
- Interest rates can rise, adding considerable cost to the investment if financed by borrowings at variable rates
- Property requires active management. It can be self-managed or an agent can be employed. Professional management assists in ensuring that
  - the property is tenanted;
  - the tenants pay the rent and maintain the property;
  - all bills are paid i.e. rates, body corporate fees;
- Landlords, as well as tenants, have legal obligations. Refer to the Residential Tenancies Act for each state or territory
- Investment in property is usually a long-term investment so ensure the timeframe is suitable
- Property is an illiquid asset. A portion of the property usually cannot be sold if some money is required and selling property can take time
- Rent received may not provide an adequate investment return
- Property needs to be appropriately insured

Government Income Support

Property investments are assessed under both the income and assets tests. The test that results in the lower rate of support (or nil rate) will apply.

Glossary

Assessable income: *Ordinary income and other amounts included under the Income Tax Assessment Acts.*
Cost base: *The asset cost adjusted for incidental costs in buying, selling, maintaining and preserving the asset.*
Depreciation: *A deduction allowed at specified rates for the decline in value of certain assets held by a taxpayer as determined by the ATO.*
Gearing: *Borrowing money to invest.*
Illiquid: *Not readily convertible to cash.*
Taxable Income: *Assessable income less allowable deductions on which tax is payable.*

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Under the income test the net income (income less specified expenses) is assessable. Net income is the same as taxable income excluding capital depreciation, special building write off, construction costs and certain borrowing costs i.e. loan establishment fees.

Allowable deductions can reduce assessable income from a property to nil. Losses from one property in a portfolio cannot reduce income from other properties or other sources.

Capital gains or losses are not included in the income test.

Under the assets test the property is assessed at its Net Market Value. This is the value that would be agreed to by a willing purchaser and a willing (but not anxious) vendor. The full market value of the investment less debt used to purchase the investment, whether secured or not, but not including that secured by the principal residence is assessable as an asset. This is automatically reviewed in March and September.

The GIS recipient estimates the value of the property. The department may have the property valued by a qualified professional however if considered excessive, a review can be requested. The assessed value is indexed annually for future valuation purposes.

Taxation

Rental income is assessable for income tax. Deductions are allowable against this income for various specified expenses, including depreciation, to calculate the taxable income. If the expenses are greater than the income the loss can be offset against other income to reduce the owner/s total tax liability. This is 'negative gearing'. (see separate leaflet).

Capital Gains Tax (CGT) may apply on the disposal of investment property purchased after 19 September 1985. Gains can only be reduced by capital losses. Losses can be carried forward indefinitely.

For assets subject to CGT disposed since 20 September 1999, where the asset was sold within 12 months, the capital proceeds less the cost base is assesable as income. For assets subject to CGT that were held for more than 12 months a 50% reduction applies to the assessible amount.

Taxation is complex and professional advice should be sought. The Australian Taxation Office (ATO) has publications including Rental Properties and Guide to Capital Gains Tax which are available on its website www.ato.gov.au or by telephoning 1300 720 092.

Costs

Buying and selling property involves costs estimated at about 5% of the purchase price. Costs include building and pest inspections, conveyancing, stamp duty, lender's fees if borrowing, insurance and agent's commission. On-going costs include interest and charges on borrowings, management fees, rates, taxes and body corporate fees if applicable, insurances, maintenance and repairs.

Care

When deciding to purchase an investment property it is necessary to know about the type of property, current rental and resale markets. It is prudent to get an independent valuation before purchasing. The purchaser has an insurable interest in the property once contracts have been exchanged.

Alternatives to direct property investment include property trusts (see FID leaflet Property Trusts), property securities funds, property syndicates and property related Exchange Traded Funds (ETFs).

Further sources of information include investment advisers, the Real Estate Institute of Australia and the Consumer Affairs Department in each State or Territory.