NEWSLETTER

April 2017

Introduction

Welcome to our third newsletter for 2017! This newsletter contains our blog articles from March, all of which focussed on debt, plus the all-important market update for the two main investment asset classes: residential property and the Australian share market. As ever, please feel free to send this newsletter to anyone you think would find it useful – and get in touch with us yourself if there is something you would like to discuss.

Did You Know… the month of April

April has been an important month in Australian history.

In 1831 the Sydney Herald (now the Sydney Morning Herald) was first published. April 1890 saw Andrew Barton 'Banjo' Paterson pen the words to the Man from Snowy River, later made into a feature film. In 1915, of course, April 25 was the day the ANZACS landed at Gallipoli. One thing you might not know is that in April 1933, Western Australia voted to secede from the Commonwealth of Australia. In the shape of things to come, that decision was simply ignored by the Commonwealth and the UK governments. And in 1984, future Olympians rejoiced when the song Advance Australia Fair was made the Australian National anthem – raising the word 'girt' to previously unseen levels of popularity.

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MARKET UPDATE

Property Update

The month just passed saw something unusual happen. The big four banks, along with most other lenders, raised interest rates. That is not what was unusual. What *was* unusual was that the rise did not follow any move from the Reserve Bank of Australia. When the RBA meets each month, it sets a target cash rate for interest rates throughout the economy. It then enters the lending markets and buys or sells such that its market rate is achieved. So, if the RBA decides that interest rates need to rise or fall, it involves itself in the market accordingly.

This is the main way that changes to home loan mortgage rates arise. The RBA changes its target rate, and the big banks end up changing their lending rates in the same direction (and usually to the same extent). But this change was different. The RBA did not change the official target cash rate. But the banks raised their home loan lending rates. The banks explained that they had to do this because of a rise in US interest rates. The US is such a large global player that the increase in rates there means that Australian banks now have to pay more for money they borrow on international markets. Remember, banks don't use their own money for much of their lending. They borrow it themselves, and make their profits on the difference between the interest they pay and the interest they charge. If the interest being paid by any given bank increases, then it has to increase the interest it charges if it wants to maintain its profits.

At least, that is the bank's story. It is always a bit suss when all of the banks make the same 'commercial decision' to raise rates like they have – you would expect a competitive market to encourage one or more of them to try to compete on price (interest rates are the price of bank lending). But there is not much we can do about that.

What we can do is pay attention to the likely impact of interest rate rises. The obvious one is that, if the price of borrowing rises, people can usually afford to borrow less. This means that they have less money available to buy housing, which should mean prices are lower than they otherwise would have been. It remains to be seen whether this translates to prices actually falling – property all over the east coast has been growing at a very rapid rate over the last 24 months – or whether it merely slows the rate of growth. On the east coast, most good judges are hoping for a sharp reduction in the rate of growth of prices. On the west coast, not so much.

Remember too that lower house prices are not really bad news. The only people who really suffer when house prices fall are people who are about to sell a property and either:

(i) not buy another one; or

(ii) buy another one that is worth less than the one they sell.

For everyone else (people trading properties or people buying a property without selling one, which includes first home buyers), lower prices are actually good news.

And most people agree that in Australia's hottest markets of Melbourne and Sydney prices have started to get ridiculous. A reduction is probably a good thing.

Share Update

March was a reasonably good month for share investors. Having started the month at 5,704 points, the ASX 200 finished the month at a tick under 5,900. This is a rise of 3.3%. Most of the gain happened in the last week of the month, where world share prices rose, encouraged by things such as rising interest rates in the US (yes, the very ones that saw interest rates rise for Australian property borrowers.

Month by month analyses are not especially helpful in the share market. If we take the analysis out a little longer, then we can see that the 12 months to the end of March 2017 were collectively very strong. The ASX 200 rose from 5,082 on 31 March to that level just below 5,900 – reflecting annual growth of 16% for the year. Here is how the year looked graphically (thanks to Google and Yahoo Finance):

Open	5,896.20	Mkt cap	-
High	5,901.50	P/E ratio	-
Low	5,864.90	Div yield	-

And remember, this is the change in share prices: you need to add dividends to the overall rate of return as well. Dividends vary company to company, but they are typically around 4% per annum. This adds up to a 20% or so return on shares between April 2016 and March 2017.

20% is a *really* good year - please do not think that this is the sort of return that you will get in any 12 month period! But share markets do this from time to time. That is why you hear people say 'time in the market' is the important thing: the longer your hold your investment, the more of these very good years you experience.

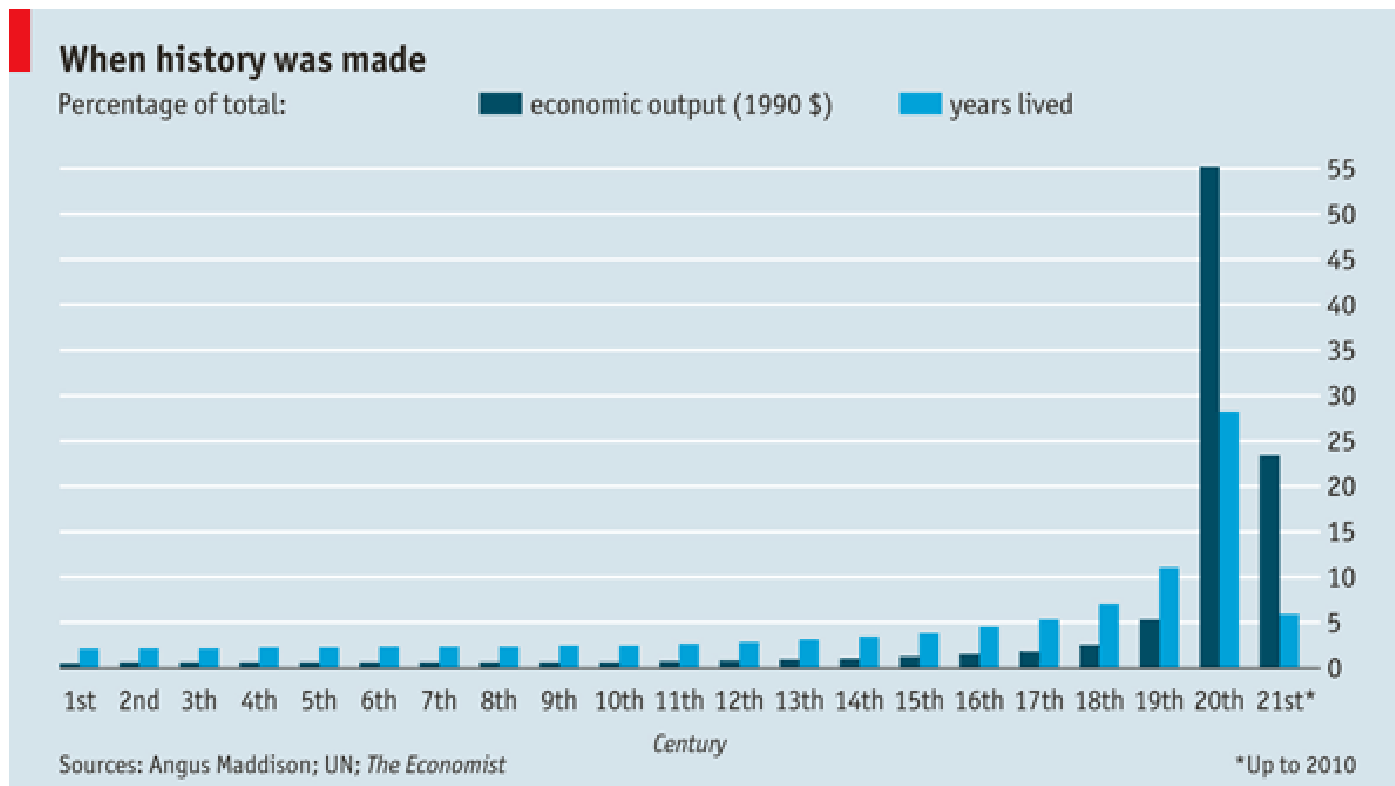
What's more, it is worth remembering that, last April, no one was predicting that share market returns would be 20% for the coming 12 months (although there was one US commentator who predicted a 50% fall during 2016. We won't mention his name as we are sure his mates have told him all about it. The interesting thing is that he remains a share market commentator. Some people have no sense of shame.

The thing that no one could have predicted was the effect that the Trump Presidency has had on the US market – an effect which has flowed on to all other international markets. Indeed, virtually every academic economist thinks Trump will be terrible for the US economy. This does bring to mind a famous line by Paul Keating: the thing about backing self-interest is that you know it is always trying. And the share market is the place where self-interest manifests.

You will hear us say it again and again. The short to medium term noise around the share market needs to be ignored in favour of the longer-term trends. Ten years plus is your best time frame for a share investment. Take your time getting money into the markets and then take your time getting money out again (so you do not get caught by the short-term fluctuations).

This is one of the reasons why superannuation is such an outstanding institution. Periodically, throughout our working lives, money is contributed into super and from there most of it is invested in the share market.

Why is this long term view important? Well, consider this graph sourced from the Economist magazine:



(This magazine is a great read, by the way: you can subscribe here)

This graph shows what has happened to economic output in developed economies like Australia throughout the last 20 centuries. As you can see, through most of recorded history economic output per person was flat – and lives were short. But, beginning in the 18th century, and then really ramping up in the 20th century, economic output per person has soared. In fact, inflation-adjusted wealth per person in countries like Australia has doubled every 35 years or so. This is now a long-term trend and, as such, it will not now be stopped. In the short term there will be negative years – recessions are inevitable. But long-term, the advances we humans have made in the last few hundred years will continue to hold us in good stead. And if you own representative assets such as a diversified portfolio of shares or residential land in a well-liked location, you will participate in this continued advance.

So there you go: this month we have given you an analysis of the last 2,000 years of economic development.

Tax Deductible Debt

As any business owner knows, there are ways to express the cost of anything: before tax and after tax. And as any successful business owner knows, it is the after-tax cost that needs to be minimised.

This is especially important when it comes to the interest you pay on your debt. Minimizing the real after tax cost of debt is necessary to maximize the real after tax return on your investments – including the investment you are making in your business or practice.

Interest is deductible where the purpose of the borrowing is to generate assessable income.

The critical word is "purpose". How do you prove purpose? Paper proves purposes. In the case of interest on debt, purpose is proved by looking at the detail of the borrowing and what it was actually used for. The courts have often looked at the question of purpose, in the context of whether interest on a loan is tax deductible against business or investment income. You can get an idea of the scope of their inquiries by reading ATO Taxation Ruling TR 95/25.

When you use borrowed money to generate income, it's always a good idea to create and retain a clear paper trail showing the deductible purpose. This paper trail should be long and detailed, including for example the original e-mail to your bank manager to get the ball rolling, the formal loan application, the loan documents and all other documents created in connection with and as a result of the loan. This includes things like bank statements reconciled to actual receipts, etc.

Tax deductible debt is cheap money

At present some people are borrowing money for as little as 4% a year.

If a business owner is in the 37% tax bracket, this means the *after tax interest* rate is just 2.5% a year

Inflation is running at about this level, which means the real interest rate is virtually nil.

In other words, once you consider tax and inflation, tax deductible debt is very cheap money.

Once you have debt, everything you buy is borrowed

I was chatting with Adam, a fellow financial adviser. We were discussing Eve, a new client Adam met while holidaying in Eden (NSW – and yes, the names have been changed). Adam said Eve was quite well off and had just paid $200,000 cash for a new parcel of shares. But when he looked at Eve's financial statement he noticed she also had a $200,000 home loan. It was not much. And her home was worth well over $600,000. But it was still a loan.

This means that Eve had in effect borrowed to buy the shares. This is because she could have used the cash she used to buy the shares to pay off debt instead. When Adam pointed this out, Eve tried to disagree. She told him she would never do that. She would never borrow money for investments.

The point is that, whenever someone has any debt, that person in effect borrows every time they spend any money at all. It does not matter whether they buy a litre of milk, a new shirt, a new car or a parcel of shares. They have in effect borrowed because the could have used the cash involved to pay off the loan. But they did not. This means they have more debt than they would have had if they had not bought the milk, the shirt, the car or the shares. So, they have 'borrowed' money to buy the milk.

What's more, because Eve's debt was a home loan, the interest was not tax deductible. If she was paying 4% to her lender, then this was the after-tax cost.

A simple thing for Eve to have done would have been to use the $200,000 to repay her loan, then borrow $200,000 specifically to buy shares. Shares generate taxable income, in the form of dividends. Because tax is paid on dividends, interest on money borrowed to buy shares is deductible. If Eve is in the 37% tax bracket, then the after-tax cost of the debt falls to just 2.5%.

On a $200,000 loan, this equates to a saving of $3,000 per year. Every year.

THE GOLDEN RULE

This brings us to the golden rule of debt management, which is to:

1. use cash to pay for private costs, including loan repayments on private debt such as home loans; and
2. use debt to pay business and investment costs. Your business and your investments generate taxable income. So debt used to finance these activities is usually deductible.

Following this simple rule means you will pay off your expensive non-deductible debt as fast as possible. This minimises the after-tax cost of your debt. And when you minimise a cost – any cost – you increase your profits.

The golden rule does require you manage cash flow in the right way. If you don't, then you can fall foul of the tax laws. So, please contact us and we can show you how to manage your debts to legally and legitimately minimize your tax and therefore maximise your profits.

(First published on our website Friday March 10 2017)

Borrowing to pay super contributions

Gearing is the name we use whenever we borrow to make an investment. An investment financed with debt, at least in part, is sometimes described as a 'geared investment.'

As you may be aware, how you make an investment – the investment 'vehicle' – is often a more important decision than what you invest in. Buying the same asset in a different vehicle can mean an enormous difference in the eventual return on that investment.

There are various forms of investment vehicle, including things like family trusts and private companies. For many people, especially business owners, superannuation is an ideal investment vehicle.

The good news is that many business owners can borrow the money that they invest into super on behalf of the business owners.

When a business makes a super contribution on behalf of an employee, that contribution is a deductible expense of the business. And the person who runs the business can often qualify as an employee of that business. For this to be the case, the business needs to run through a separate legal entity, usually a company (on its own or as a trustee of a trust). The company is the official employer of everyone working in the business – including the people who ultimately own the company.

This means that super contributions made on behalf of the people who own the company (who are also usually directors of the company) are usually a legitimate expense of the business.

So, what has all this got to do with gearing? Well, a business can borrow to pay any of its legitimate expenses. This includes super contributions. And using debt often allows a business to make a super contribution that it could not otherwise afford. Like all business debt, provided the loans are properly organised, the interest is tax deductible. If a business is doing well, this might mean that the actual cost of the interest on the debt is reduced by 47%, which is the top marginal tax rate.

What's more, the super contribution will reduce the business' profit, which reduces the amount of tax paid by the business. Let's look at an example.

Virat and Samantha operate their cleaning business through a family trust, with a company as trustee. The company is on track to make $200,000 profit in the current financial year. This means that the trust will distribute $100,000 to each of Virat and Samantha. They will each pay about $27,000 in tax on this amount – nearly $54,000 in total.

If the company instead makes a super contribution of $20,000 for each of Virat and Samantha, the share of profits on which they pay tax will drop to $80,000 each. This will reduce the couple's tax bill by $15,600. So, they borrow $40,000 but pay $15,600 less tax. This means that the actual increase in indebtedness is only $24,400.

The $40,000 in contributions is taxed at 15% in the super fund. $6,000 in tax paid is paid there. Thus, the couple save $9,600 in net tax. They also now hold an asset worth $34,000 that they only had to borrow $24,400 to acquire.

Finally, the interest on the debt of $24,400 is deductible at the couple's effective tax rate of 30% (as it is outside of super), while the earnings on the money invested within the super fund are only taxed at 15%. This creates a nice ongoing arbitrage.

In summary, the couple borrowed $24,400 and used the tax they did not have to pay to contribute $40,000 into super. The super fund paid $6,000 in tax. This left the couple with new debt of $24,400 and a new asset worth $34,000.

Obviously, there are I's that need to be dotted and t's that need to be crossed in order to get the tax treatment right. What's more, there needs to be a strategy to eventually repay the debt. A simple way to do this is to make repaying the debt your first retirement priority. When it comes time to withdraw from your super, you can use some of the money withdrawn to repay the debt.

Remember, in the above example, the couple would only have to withdraw $24,400 to retire the debt. This leaves $9,600 in the fund.

The strategy can be especially effective when (a) you have not made much use of super so far; and (b) you are close to retirement age – the repayment can happen sooner, which can bring peace of mind. We reckon Roger Federer will be all ears when he hears about this one.

WHAT YOU NEED TO GET IT RIGHT

In order for the above strategy to be applied, the business (that is, the company or the trust) has to actually employ the people on whose behalf the contributions are made. That means you must be able to prove that an employment relationship exists between you and your company.

Normal indicators of an employment relationship include:

- An employment agreement outlining the role to be performed;
- Use of a software payroll system that issues periodic pay slips i.e. fortnightly or monthly;
- Physical and regular payment of the salary from the business account to a personal bank account;
- Payment of super guarantee; and
- Insurance through Workcover for employees of the trust.

As with everything to do with tax, the key is to document the relationship. Remember, the ATO is not there to be difficult. If the employment relationship is genuine (and most people use companies or trusts specifically so that their personal liability is limited), then the tax concession is available.

We really hope this tip helps you in your practice. If you think it will, why not give us a call and we can show you exactly how to apply it in your particular set of circumstances.

(First published on our website March 24 2017)

Positive Gearing. What is it, how does it happen and do you want it anyway

You have probably heard the term 'positive gearing.' It is a similar concept to negative gearing, which is certainly in the news a lot these days.

We use the term 'gearing' whenever debt is used to fully or partly finance an investment. If you have $90,000 of your own and borrow $10,000 to buy an investment asset worth $100,000, you have 'geared' the investment. Similarly, if you borrow $100,000 to buy an investment worth $100,000, you have 'geared' the investment.

When you buy an asset, you usually receive some income from the asset. For a property, this income is the rent you collect. And when you borrow to buy an asset, you have to pay interest on the debt. This interest is an expense of holding the asset.

In strict terms, 'positive gearing' is where the income from an asset (the rent) exceeds the interest on the loan used to finance the investment. Less strictly, and more sensibly, the term is used when the income exceeds all the other expenses of holding the asset as well. For a property investment, this is things like land tax, rates, insurances, etc.

So, positive gearing means the rent more than covers the holding costs of an investment. You can use the rent to pay all of your bills, including interest. Any money left over is your profit while holding the investment.

As you would expect, then, 'negative' gearing is where the costs of holding a geared asset exceed the income that you receive from that asset. This means you make a loss while you hold the asset.

This is why negative gearing should only be considered where you think you will make a large gain later on – usually when you eventually sell the asset.

Positive gearing gets a lot of positive press, which makes sense. Making a profit while you hold an asset can reduce the risk of that investment. If you make a profit from day one, then you do not have to rely on making such a large capital gain in the future to make a decent return on the investment. Usually, this is a good thing.

Sadly, things are not actually that simple. Positive gearing is not necessarily something to aim for. Whether positive gearing is worth it depends on the circumstances that are creating it. These are as follows:

Borrow a relatively small proportion of the cost of the asset

The less you borrow, the lower the interest and therefore the greater chance you have of achieving a cash flow positive situation.

Let's say interest rates are 5% and the income return on an investment is 3%. If you borrow less than 60% of the purchase price, then the investment will be positively geared (assuming there are no other costs such as rates, etc.) If a property costs $500,000, and you borrow 60%, then this is $300,000. 5% interest is $15,000. If the rental yield is 3%, then this is also $15,000. The rent covers the costs: the property is positively geared.

Repay some of your debt

By the same logic, an investment that starts out negatively geared can become positively geared if you repay some of the debt. This is because paying off debt reduces the amount borrowed as a proportion of the total investment.

To reuse the same example from the previous paragraph, if you borrowed 70% of the purchase price of an asset that returns 3%, and you pay 5% interest, the investment would be negatively-geared. The interest will be $17,500 (5% of $350,000) and the rent will only be $15,000. But if you repay $50,000 of the debt the amount of interest you pay falls below the amount of rent you receive. The investment becomes positively geared.

Hold investments for a longer period of time

If an investment continues to pay income, that income will typically rise over time. This can be the result of nothing more than price inflation raising the price of things like rent (which is an expense for the tenant but is income for the landlord). Provided you keep your debt constant, and assuming that interest rates do not rise, then this 'natural' increase in income will often move an investment from negative to positive gearing.

Invest in assets paying high rates of income

Residential property typically pays a low rate of income when expressed as a proportion of the value of the asset. We usually use 3% as our rule of thumb for the rental 'yield' on a residential property. What's more, there are substantial holding costs for residential property, such as rates and insurances. This means that it can be difficult to achieve positive gearing if you use a lot of debt to buy residential property.

However, other assets often pay higher rates of income. Commercial property and certain shares typically give you more income than residential property, making it easier for the investment to be positively geared.

For example, suppose you bought a property ten years ago for $400,000 and it was paying 3% rent. That's $12,000. Interest rates were about 8% back then, meaning the interest expense would have been about $32,000 if you borrowed the whole purchase price. That's negative gearing. If you still had the property today, and you still owed $400,000, the situation would be different. The property could be worth up to $800,000, and 3% of that (the rent) is now $24,000. Interest rates have fallen to around 5%, or $20,000. The same property is now positively geared, because rents have risen and interest rates have fallen.

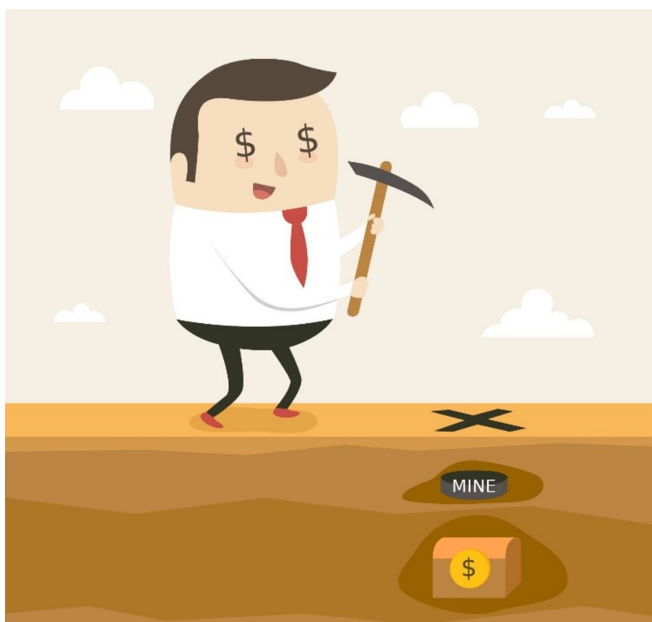
Interest rates do not always fall. But over the long-term most rents do rise, so many properties eventually become positively geared.

Positive Gearing is good – but be wary

(especially when it comes to property)

As we saw above, one way to achieve positive gearing is to invest in assets that pay a high rate of income. This means higher rents as a proportion of the value of the property. For example, if rent is $12,000 and the property is worth $300,000 then the rental return is 4%. If rent is $12,000 and the property is worth $400,000, the rental return is 3%.

So, income return has two parts: the purchase price and the rent. The lower the purchase price, the higher the income return. And this is why you need to be wary. For the same level of rent, the rental yield is higher if the value of the property is lower – that is, if the property is cheaper. But 'cheap' properties can be very risky investments. After all, when a property is cheap, few people want to buy it.



Think about a town that is going though a temporary boom, perhaps because the town is situated near a new infrastructure project, such as a water desalination plant. While the plant is being built, lots of workers need to live nearby. This drives the demand for rental accommodation up. But the plant will only take a few years to build, after which the workers will move on. This means that none of the workers want to *buy* a home in that area. So, rents rise but values do not. This makes for a higher income return. This high return might attract an unwary buyer looking for a positively-geared residential property.

After a few years the plant is built. The workers move on and demand for rental housing falls. This means that rents fall as well. This can mean that positively-geared investments become negatively-geared. What's worse, the investor's finds it hard to 'make back' the money they lose through negative gearing – by selling for a capital gain. Remember, few people want to buy a home here.

So, a positively-geared residential property can be a risky proposition. That's why you need to be careful. If you are thinking about a positively-geared investment, please contact us first. Done well, positive gearing can be tremendous. Done wrong, it can be calamitous.

(First published March 31 2017)

The Legal Stuff

General Advice and Tax Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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