

Renting investing

A twist on the great Australian dream

For some, renting where they want to live and investing elsewhere is becoming a more attractive option than the traditional strategy of buying a home first. **FIONA MARSDEN**

For decades, young Australians heard one message loud and clear: buy a home to live in as soon as you can, because rent money is dead money.

For the Baby Boomer generation, this message probably made good sense. Many people left school and began working in their mid-to-late teens. They found a life partner and had children relatively early in the game.

Mothers often left the workforce to become the children's primary carer, so money was tight.

"People bought a home in affordable areas – usually on the suburban fringe – stayed there for the long term to raise their family, and gradually paid off their mortgage," says demographer Bernard Salt. "But they didn't do this with an eye to creating equity. It was primarily a lifestyle decision."

It was only after many years, when they'd made improvements to the property and paid down debt via a principal and interest loan, that they began to think about harnessing the equity and buying an investment property.

Fast-forward to 2011, and fewer people are following the traditional model of

partnering and having children in early adulthood.

Many Generation Ys study for longer, travel and change jobs more often than their Baby Boomer parents, so on a practical level they may not be ready to commit to settling down in one home for the long term.

There's also an attitudinal shift.

"Professional couples and singles in their late 20s and early 30s with no kids are very happy with their lifestyle," says Salt.

"They rent a home close to their place of work and they enjoy the lifestyle of the inner suburbs.

"They can't afford to buy where they live, but they're loath to go out to the 'burbs. They don't want to compromise."

What's more, declining affordability is making it harder for people to buy their first home. Figures from the Real Estate Institute of Australia show that the proportion of household income required to meet the average monthly loan repayment has risen sharply over the past 10 years: from 26 per cent in March 2001 to 31.9 per cent in March 2006, and 34.2 per cent in March 2011.

The combination of affordability issues

and lifestyle changes means that for many young Aussies, the traditional 'home first, investment second' model of property ownership simply doesn't fit.

However, the desire for ownership remains strong and anecdotal evidence indicates that people are finding more creative ways to achieve it.

"As affordability continues to fall, would-be homebuyers are being forced to compromise even more by going further into the suburban fringe," says Mark Armstrong of Armstrong Property Planning.

"They're starting to say, 'It's not worth it. We're going to rent close to the CBD and invest where we can afford to'."

According to Armstrong, Australia is gradually heading towards a more European model.

"Because of longstanding affordability issues," he says, "Europeans have a well-established tradition of renting in inner urban areas and investing their money elsewhere."

Salt puts it another way. "Gen Ys are increasingly making an investment decision based on their head and buying in suburbs where property is more affordable and rental

returns are higher. At the same time, they're making a lifestyle decision based on their heart by renting close to their workplace and the attractions of the inner suburbs. I think it's quite savvy of this generation to combine their lifestyle preferences with wealth accumulation."

TALKING TAX

If you're just starting out in the property market, buying an investment property and renting a home to live in can provide financial advantages.

"As an investor, the interest on your loan is deductible at your marginal tax rate," says Armstrong. By contrast, debt on a home you live in isn't tax deductible.

"If you buy a home for around the median price and you don't have a big deposit, you'll have to pay off an enormous slab of non-deductible debt. By buying an investment property instead, you're buying cheaper debt."

Buying an investment property instead of a home also means holding costs such as mortgage insurance, repairs and owners' corporation fees are tax deductible.

On the downside, there's land tax. The family home is exempt from land tax, but investment properties incur land tax when the value of the land exceeds a certain threshold.

Land tax is levied by the states, so the threshold varies. In Victoria, for example, it kicks in when the total unimproved land value of your investment properties exceeds \$250,000.

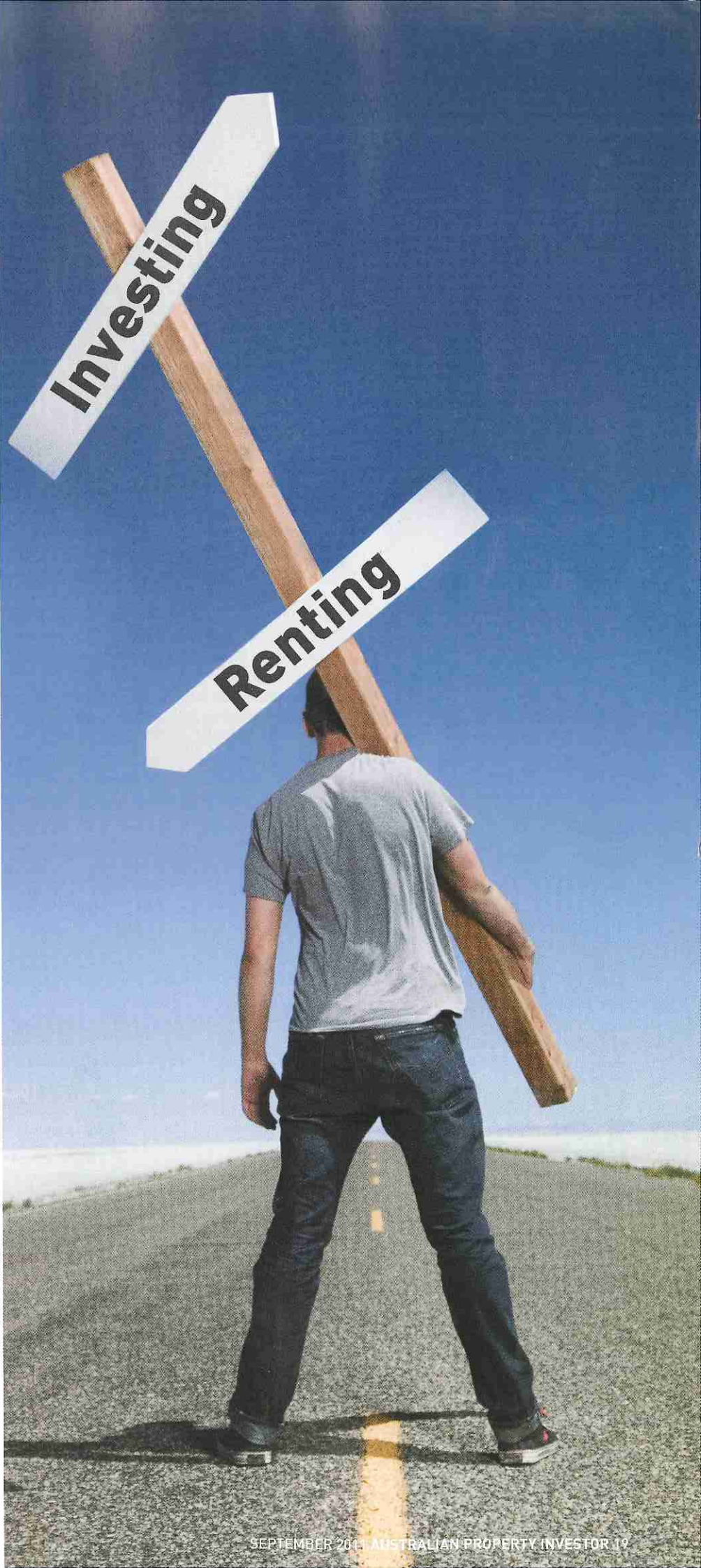
"Land tax rates are based on municipal council valuations, which, in Victoria, have significantly increased in recent years," says Danny Lustig, CPA and partner at Lowe Lippmann. "This has bought many more people into the land tax loop."

In saying this, land tax is tax deductible at your marginal rate, which somewhat reduces the impost.

Buying an investment property instead of a home to live in also means you'll be liable for capital gains tax (CGT) if and when you sell it. CGT is payable at your marginal tax rate and is based on the difference between what you paid for the property and what you sell it for.

"Even though you'll only pay CGT on half the capital gain, if you've held the investment property for more than a year, it can still be quite a burden if the asset has achieved strong capital growth," says Armstrong.

If you buy an investment property today for \$500,000 and sell it for \$1 million in 10 years' time, you'll incur a capital gain of \$500,000. Even with the 50 per cent dis-



CASE STUDY

The right balance

For 29-year-old Andrew Martin, renting and investing balances his lifestyle and financial goals.

"My mates always opt for buying their own place to live," he says, "but I would rather rent to live and buy to invest."

The Sydney-based business development manager owns two investment properties in the Perth suburbs of Maddington and Spearwood.

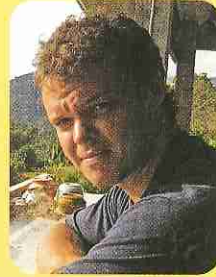
He purchased the Maddington house in 2005 for \$175,000. It's now valued at around \$340,000 and rents for \$300 per week. He bought the house in Spearwood for \$475,000 in 2010; spending another \$25,000 on renovations. The property delivers rent of \$420 per week.

Andrew cites practicality and development potential as among his reasons for choosing to invest in these Perth properties. "Neither property needs much maintenance," he says, "and both areas are rezoned for dual occupancy for future development."

Meanwhile, Andrew splits a weekly rental bill of \$950 with two others to live in a three-bedroom home in the Sydney seaside suburb of Clovelly. "There's no way I could afford to buy it," he says, "so renting is an attractive alternative, and it doesn't lock me in for the long term."

Andrew plans to invest in a property in Sydney and when the equity in all three properties increases he'll leverage against it to develop the Perth properties and sell off 50 per cent.

"My worst case scenario is that one day I'd sell the three properties and buy a place in Sydney that suits my lifestyle and budget," he says. "However, I'd rather keep investing. I'd like to accumulate 10 properties in 10 to 15 years' time."



count, you'll still be liable to pay CGT on \$250,000.

However, as Chris Gray of property advisory firm Empire points out, CGT remains a theoretical liability if you don't sell the property. "If you keep it, you won't pay CGT," he says, "and you'll still get all the tax benefits to help offset your holding costs along the way."

MONEY IN, MONEY OUT

Gray is a strong proponent of renting and investing. "People have been brought up to think they have to buy a home to live in," he says, "but financially, it makes every sense in the world to rent and invest elsewhere instead."

Gray began buying property 20 years ago and has been renting and investing for a decade. He now owns a \$10 million portfolio of median-priced properties ("I think there are 13, but sometimes I lose track!") in prime inner Sydney suburbs including Maroubra, Coogee and Bondi Beach. His portfolio delivers roughly \$400,000 per year in rental income.

"Median-priced investment properties typically provide a four to five per cent rental yield," he says. "That's \$400 to \$500 per week for a property worth \$500,000. There's huge demand for rental properties in this price bracket, so asking rents go up."

THE NUMBERS

Buyer profile (single borrower)	Renter-investor	Owner-occupier
Salary	\$85,000	\$85,000
Value of proposed property	\$500,000	\$500,000
Interest rate*	9.3% p.a.	9.3% p.a.
Incoming rent	\$35,000 p.a.	Nil
Outgoing rent	\$14,440 p.a.	Nil
Bank will comfortably lend	\$678,000	\$512,000

*This is an assessment rate 1.5 per cent higher than the current standard variable rate of 7.8 per cent p.a.

However, at the upper end of the rental market (\$2000 to \$4000 per week for properties worth \$1 million-plus in Sydney) most people who can afford to rent these properties can also afford to buy them. The demand is small, so the rental price comes down, and the rental yield might only be one to three per cent.

"Effectively, you'll get three times your money by renting a \$1 million-plus property to live in and buying lots of cheaper properties as investments," says Gray.

For example, if you wanted to live in a \$1.5 million house, you could rent it for around \$700 to \$1000 per week, buy two \$750,000 or three \$500,000 properties and

rent them for a total of \$1200 to \$1400 per week.

"Straight away you're making \$500 a week, or \$26,000 a year," says Gray. "Add in the fact that all your debt is tax deductible and (depending on your marginal tax rate) that \$26,000 could increase to \$40,000 a year. That's half a salary for some people."

WHAT DO THE LENDERS SAY?

If you're a renter who's thinking of buying an investment property and you don't have any assets other than cash for a deposit, will you be at a disadvantage compared with a homeowner who already has a tangible asset to borrow against?

Not necessarily, says Sarah Wells of mortgage broking and buyers agent firm Red Concierge.

"With the introduction of the *National Consumer Credit Protection Act*, lenders are more focused on 'responsible' lending, not asset-based lending," she says. "Essentially, this means making decisions based on your net disposable income."

It comes down to your ongoing expenses in relation to your income as to whether you'll be able to service the mortgage comfortably.

"Take the example of someone in their 30s who has been studying for professional qualifications for many years," says Wells. "They may have only just started earning good money."

"This may not be a typical situation compared with their peer group, but as long as they can explain why they're in that situation and can demonstrate that they have the cash flow to service the loan, they can be in as strong a position as an owner-occupier when they apply for an investment property loan."

Wells also paints a hopeful picture for people in mid-life, such as divorcees with a settlement, who may be thinking of renting and investing.

"Some lenders look more favourably on investment loan applications from people at this stage of life," she says. "They're getting closer to the time when their working income will drop or stop, and they'll need an exit strategy."

When that time comes, they can sell the property to retire the debt. By contrast, lenders aren't keen to see borrowers in a situation where they have to sell their family home.

There's also anecdotal evidence that in cases where servicing is tight – that is, where the borrower's income will be heavily stretched to make the loan repayments – an investment loan application may get through where a home loan application doesn't,

because the property will produce ongoing income.

The figures in the table (on page 20) show that, despite having the same salary and wanting to buy a property of the same value, the owner-occupier can't borrow as much as the renter-investor because the interest on their loan won't be tax deductible and they won't receive any rental income. They would have to compromise by buying a more modest property and/or moving further out.

On the cautionary side, it's worth knowing that if your working income falls or your living expenses rise and you have trouble paying the mortgage, lenders may not be as flexible in renegotiating payment terms as they would if you were an owner-occupier.

A QUESTION OF SECURITY

Quite apart from the financial considerations, deciding whether renting and investing is a viable option comes down to your current circumstances and longer term goals.

"The strategy that's best for you depends

on what you want to achieve," says Wells. "For example, do you want to buy an investment property and hold it until you pay it off? If you're single now, what if you move into a long-term relationship later down the track? Would you want to use equity in the investment property to buy a family home?"

Regardless of your long-term goals, Wells recommends obtaining financial and tax planning advice to make an informed decision.

Last but by no means least, the suitability of renting and investing also depends on your character.

"My wife and I love change," says Chris Gray. "We like the flexibility of renting, because we can move as our family's needs evolve. We also feel that moving house and changing schools a lot will help our kids become more adaptable later in life."

However, he acknowledges that it's not a strategy for everyone. "Most people will continue to be owner-occupiers before they become investors, because they don't like change. They want the security of a long-term roof over their heads." **api**

What about the First Home Owner Grant?

Concerned that buying an investment property now means you'll miss out on the First Home Owner Grant (FHOG) when you eventually buy a family home? Fear not.

If you buy a property purely as an investment from July 1, 2000, and never live in it, you may still be eligible for the FHOG when you decide to buy a family home.

A cautionary note: to be eligible, you must also move into the home within the first year of settlement or completion of construction and live there for at least six months continuously. If you try to get the best of both worlds by moving in for six months, then moving out and making it a rental property, you may be liable for capital gains tax when you sell.

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