TAX with Shukri Barbara

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RISKS WITH EXCESSIVE BORROWING

In a stagnant market, negatively geared debt may consume any equity you had in the main residence as additional security for loans, writes **Shukri Barbara**

To highlight the impact of the slowdown in growth, we look at two real-life cases, where some of the facts have been altered to maintain privacy. The first is 'mum and dad' investors and the second is a small business owner. Both started out with some equity in their home.

'Mum and dad' purchased a property in Queensland in 2001 and then in New South Wales in 2002, at a time when the market was rising and it appeared nothing could go wrong. Taking the advice of their mentors, they set up a line of credit (LOC) secured by their home to cover payments in excess of the rental income.

Over the years, the LOC continued to rise to a point when in late 2012 a review showed that while the NSW property had grown by $129,000, the Queensland property had actually fallen in value by $74,000 from the original cost of $274,000. However, over the ownership period the net rental cash losses amounted to $130,000 for the NSW property and $116,000 for the Queensland property, a total of $246,000. An average rate of 35 per cent was received annually as a tax refund, which was quickly spent.

A growing family meant increased living expenses with loss of partner income as mum attended to children at home. Together with limited salary growth, the situation created concern with serviceability of the rising LOC loan and the overall risk to the home.

To get relief, the NSW property was sold first, realising a gain. Noting that capital losses can only be offset against capital gain, consideration was given to the prospects of the Queensland property. With no practical possibility of gain in the reasonable future and given the personal situation and weak cash flow, it was decided to sell and realise a loss, which could be offset against the NSW property gain to minimise tax.

INVESTORS SHOULD REVIEW THEIR CASH FLOW REGULARLY

The net gain of $55,000 from the sale of both properties was far exceeded by the compounded annual rental losses over the years, as reflected by the outstanding LOC loan, which now had to be repaid from personal savings.

The small business owner had a similar situation using an LOC as a buffer to cover excess cash payments of interest and other rental expenses. They had a Queensland property fall from $394,000 at purchase to $300,000. They also had a Northern Territory property which had grown nicely. Due to a slowdown in their industry, together with a sudden death in the family, business income had almost dried up, leaving the LOC buffer, secured by the home, to cover rental deficits.

The real problem was that the buffer was reaching its limit. To obtain additional finance, the bank would need to get new valuations. Low valuation would impact on all loans, especially the home, which was of most concern.

The issue came down to timing, as the buffer only had three-month value in it. Furthermore, it was found that cash flow could be improved as the personal mindset and the business environment improved.

Following advice, the Northern Territory property was sold, realising a gain. After repaying the loan, the remaining equity and gain was enough to provide a three- to four-year buffer, which was determined to be long enough to recover the overall financial position.

The market can't be forecast accurately. Excessive borrowing can be dangerous. You must ensure you review your cash flow and your overall position regularly. ■

"DUE TO A SLOWDOWN IN THEIR INDUSTRY, TOGETHER WITH A DEATH IN THE FAMILY, BUSINESS INCOME HAD ALMOST DRIED UP"

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