STEP 8 – FINANCE ALTERNATIVES & GEARING

Finance & Property
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EQUITY/DEBT RATIO

Maximising returns by varying this ratio has several tax and other implications. These calculations done manually would take a very long time and are open to error.

Varying equity levels or ratios also demonstrates the best return on equity.

Varying interest rates on a feasibility model is advisable, to test the impact or a rise in interest. This may result in a decision to choose a capped facility, or a fixed interest facility.

Be very careful with negative gearing.

NEGATIVE GEARING

Negative gearing can only be justified where there will be a significant increase in rent in later years and/or there will be a substantial appropriate real capital gain. This is needed to offset the initial losses. Real net capital gains forecast are of course speculative.

Negative Gearing on residential property has been the basic platform of most real estate project marketing programmes for many decades. Thus highlighting the tax component of financial gain. This need not be restricted to residential.

Throughout this time, there has always been speculation about a change in legislation.

Existing tax legislation aimed at "artificial schemes" are addressed in part IVA, Sections 177A to 177G.

Compliance

To comply with allowable negative gearing requirements the loans must have the following characteristics.

- The lender and borrower must be "at arms length".
- The conditions and interest must be at market rates and terms.
- The rental rates must be at market rates.
- Whilst the lessor and lessee must be "at arms length", this can be achieved by the application of totally commercial and fully documented arrangements.
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Will the Law Change?

No one can foresee political strategies, however one should consider the implications of change and the likelihood of such changes occurring.

After all, it did change somewhat, for 2 years, in 1985, when Paul Keating was Treasurer. This was not retrospective. Negative gearing "losses" could be carried forward. It was repealed in the 1987 budget and effective from 1/7/87.

The image that negative gearing is carried out by the wealthy is not entirely correct. Many modest income borrowers are signed up at negative gearing seminars.

Property is an investment, so if profits are taxable, then therefore losses should also be deductible.

Retrospective taxation is extremely unpopular.

There are a lot of negatively geared voters.

Whilst some politicians and commentators regard negative gearing as a form of tax avoidance, there are positives.

National Benefits

- Negative gearing stimulates investment, building, employment etc.
- Every dollar claimed by a borrower as a deduction is assessable in the hands of the lender (albeit possibly at a lower taxable rate).

Personal Benefits

- Can increase the return (after tax benefits) in defined capital gain scenarios.
- Broadens the property portfolio thus reducing risk through diversification.
- Allows entry to a possible higher return by accessing niche markets.
- Creates a property portfolio more quickly.
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Conclusion
One could conclude that there would need to be some extenuating circumstances to upset the status quo regarding current legislation.

Negative Gearing Precautions

- Borrowing increases financial leverage risk, and risk management strategies should be considered.
- The employment or income source required to subsidise tax losses should be secure.
- A fall back position should be planned if unexpected vacancies need to be funded or financial difficulties force sale.

- The investment should be reasonably liquid should difficulties occur e.g. sale to existing syndicate members or others. The above-mentioned fall back position can be subject to a prior agreement or concessional option, benefiting a wealthy backer or lender, as a takeout provision.

- One needs to be sure that there will be real net capital gains (under the new tax legislation). This is often over estimated.

TYPE OF LOAN

Loans need not be restricted to the standard Bank mortgage.

There can be numerous sources of debt and equity to fund an investment. For taxation purposes, the classification of some instruments (between loans and equity) can change from time to time.

Some sources of property debt are:-

- Vendor Finance
- Private Lenders (Relatives/backers)
- A few Venture Capital Organisations (Property development)
- Finance Companies
- Trading Banks
- Investment Bankers/Private Banking
- Merchant Banks (Syndicates)
- Development Joint Venturers

The property can be funded by say 3 sources –

(1)	Secured debt – say Bank Mortgage	50%
(2)	Mezzanine debt ranking after secured debt but before equity e.g. Private Investors – say	35%
(3)	Owners contribution of equity in cash or land contribution etc.	15%
	TOTAL	**100%**

The comments below relate to the loan component of the above and what type of loans are available.

Principal and Interest Loans

These are less tax effective because of the component of principal which is not tax deductible.

However a long term amortised loan has only a small component of principal in the initial period, and may be appropriate in circumstances where a long holding period is required, maximising the impact of inflation on repayment.

In other words, putting as much of the repayment as possible down the track where the dollar is worth less.

These loans can always be refinanced with higher borrowings of interest only loans later on, if maximum negative gearing benefits are pursued.

Interest Only Loans

These maximise borrowings and tax benefits, thereby being common in negative gearing strategies.

They are often fixed term with or without break charges and can have an option to roll over to the same facility, or a different loan facility.

Fixed or Floating Interest

Generally speaking, if one looks at the floating interest rate graphs over the years, with the fixed rates and terms overlaid, the cheaper option has always been to stay with the floating rate.

Borrowers who know this and still elect to fix the rate, do so for risk management and budgeting reasons, where they wish to fix or know in advance what their exposure is.

Also, in periods of historically bottom level interest rates, cost advantages can occur if this happens to coincide with an acquisition.

Comparing Rates

Finance retailers have always included cunningly conceived "apparent concessions" in loan packages. This is especially so with longer term loans.

Now they are compelled by legislation to publish a "comparison" rate". This comparison rate allows a borrower to compare the actual rate of loan interest against another, taking into account all charges (nominal interest rate per annum compounding frequency, upfront and ongoing fees) – according to Consumer Credit Code.

FINANCE SOURCES

Prior to discussions with a reputable broker, prospective borrowers can familiarize themselves with rates, products and jargon. This will save time and a good reference site for this information is www.cannex.com.au.

However, once again this is a very specialized field, constantly changing and accordingly we rely on an experienced professional to assist us in this regard.