

22/09/2009

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Upgrading the family home

By far one of the most common questions we receive from existing and potential clients is around the issues of upgrading the family home.

Many people buy a house then work hard to pay it off as quickly as they can and this makes a lot of sense. Understandably they quite often grow a personal attachment to the property as this is where they have lived for some time and possibly raised their family there. When the need or opportunity arises to upgrade the home they would prefer not to sell the original property.

Quite often they then think - **I will turn this property into an investment property.**

The major problem with this strategy is it is very inefficient from a tax point of view. Usually the debt on the original property is quite low and quite often there is a need to borrow substantially for the new property.

There is no delicate way to explain this except to say that it rarely makes any financial sense to retain the original family home.

When it comes to borrowing money the tax treatment of that money is entirely dependent on what the purpose of the borrowings is for. If the purpose of the borrowed funds is to buy a house to live then this is not a deductible expense under the ATO's rules.

If however, you are borrowing to buy an investment which will produce assessable income then the borrowings would be deductible.

This means effectively the majority of debt ends up on the wrong house.

The main way to fix this is to consider selling the original home and pay those funds into the new property, thereby reducing the non deductible debt on the new principal residence.

Of course this is not what many people want to do, so if that is not an option you need to consider other planning strategies that may help.

Things like:

- Looking at borrowing further to invest in other asset (perhaps lower income producing assets such as small cap shares or International shares) to create deductions which could help offset the extra income you would be receiving by way of rent on the now rental property.
- Perhaps making a concessional or salary sacrifice contribution to superannuation.
- Other general tax planning strategies.

The six year rule

Many people are unaware that they can decide to move out of a house that they previously occupied as their principal residence (PPR) and rent it out whilst living elsewhere without losing the PPR exemption in terms of retaining the Capital Gains Tax exemption on that property.

This only works if you do not buy another house to live in as you can only claim one principal residence exemption.

If you do move out of a house you previously occupied as a PPR and rent it out the interest on debt that is attributable to that property and other legitimate deductions can be claimed as a deduction and offset against the rent or income that is received. This is because the purpose of those borrowings is now to generate assessable income.

I had a property I lived in once which I then rented out and then within six years I moved back in to the property. After another year I moved back out and rented again. This meant that I was able to claim the PPR exemption for the entire period I owned the property. Whilst I was not living in the property and renting it out I was able to claim costs such as interest and property maintenance etc. as deductions.

I owned this property for 15 years and it retained its PPR exemption for that whole time.

Converting an investment property to a PPR

I received this actual question below from a prospective client and thought it raised some interesting points worth discussing.

I have currently purchased an investment property in my name, but am considering moving into this property to be able to utilise the PPR ruling. My partner also has a PPR property in his name that he purchased with a sibling. If we were to get married, and he/or I sold one or both of these properties, will we both still qualify for the PPR ruling as these properties are in separate names? Or will we need to select one property for PPR as a couple?

Many Thanks for your advice.

Our Answer

When you buy a property as an investment and then subsequently move into it, you are only eligible for a partial CGT exemption. The exemption is calculated based on the length of time the property was held as an investment compared to the length of time as a PPOR.

If you are in a relationship (you don't have to be married) you usually have to choose one property only to claim the PPOR exemption on. If you are changing main residence you can claim an exemption for up to 6 months on both properties to enable you to sell one. I think if the relationship is serious you would need to select one property as your PPOR.

The importance of good advice

These questions really highlight that even if you are considering purchasing an investment property or upgrading your family home you should seek good advice from a qualified adviser.

We regularly help people by reviewing current and proposed arrangements to identify areas where they can obtain greater tax efficiencies and dramatically improve their overall financial position.

Why not give us a go?

We are happy to provide a complimentary initial discussion.

Disclaimer:

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