PROFESSIONAL SERIES

TAX SECRETS

Make your Lifestyle Tax Deductible

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I LOVE REAL ESTATE

Turn your lifestyle into a business
Make your lifestyle tax-deductible

The true secret of saving money on your tax bill, is being able to deduct expenditure that you have incurred anyway, before you pay your tax. It's a simple little formula, but it can mean big dollars in tax savings if you structure yourself for tax savings.

Step One: Earn your income

Step Two: Pay your expenses

Step Three: Pay tax on the balance

Unfortunately, there are too many taxpayers – namely those who work for someone else (a boss), who pay tax this way.

- **Earn income**
- **Pay tax**
- **Pay expenses out of balance**

When you start to turn your lifestyle into a business, you are converting what would have previously been non-deductible expenditure paid out of after-tax dollars, into tax-deductible expenditure paid out of pre-tax dollars.

Let me give you some examples to show you how this works:-

Example:

A friend of mine worked in a government job and longed to own a boat; not just a boat but a catamaran. He could never justify such a big expense to either himself or his wife, until he started to do some calculations on what would happen if he turned the purchase into a business.

By making the boat a business asset and putting it to work to earn income by hiring the boat out to charter with a recognised boat charter company, it meant all his expenses relating to the boat including interest on the loan, insurance, repairs and travel to conduct maintenance checks and repairs, were now tax-deductible against the income earned from chartering the boat.

Of course, he needed to keep track of the amount of time he spent using the boat himself for private purposes and that percentage of the total expenses would not be tax-deductible. So if he used the boat two months of the year himself for holidaying etc. then two twelfths or one sixth of the total expenses he would not be able to claim. He was going to buy a boat anyway – this way the income it earns helps him pay for it and he can claim the expenses as a tax-deduction.

The laws on having boats and aeroplanes as businesses has changed over the years so make sure you check the current tax rules before rushing out and buying either.

While my mate was fixated on a boat – it could just as easily have been a holiday apartment, luxury car, aeroplane or rural property. What you are actually doing, is converting a lifestyle choice into a business decision.

Example:

Having grown up on a cattle property, my love for the land has always been very strong, so I put my money where my mouth was, when an opportunity came up to buy my 54 acre piece of paradise. I call it my toy farm because it is a lot smaller than the properties I grew up on.

Whilst I wanted to have the lifestyle, I knew how much work even a toy farm would be. For this reason, initially I set it up to be commercially viable, so that I could have the lifestyle I wanted without the work. I set up a commercially viable hydroponics operation growing predominantly lettuces. The income from the farm was sufficient to pay for a fulltime farm manager to maintain the property and keep it looking beautiful.

My motives were not purely financially driven, but also lifestyle driven. Having said that, not only did the commercially viable hydroponics operation mean I got my farm maintained for free from a tax perspective, it also had a flow on effect in terms of cars and machinery which then also become a business expense, and therefore tax-deductible.

Another example:

If somebody liked doing craft and that was their passion, a perfect example of making their lifestyle tax-deductible is to make their craft profitable. I have lots of clients doing exactly that, whether it be craft, painting, scrapbooking, or any other hobby that is their love. So why not make the expenditure that you would have had anyway, tax-deductible or even better than that, make it profitable.

Some obvious ways to do exactly that are to set up an avenue to sell your finished product. The more traditional ways of doing that would be the local craft market, CWA drives, or even offer them to retailers to onsell. However, with the advance of modern technology, the profitability of a home-based business can be taken to a whole other level.

Another example:

One of my clients had a passion for craft; scrapbooking, patchwork and generally making pretty things.

She set up her own website through one of the free web providers, took some pictures of her work, and loaded them onto her website. She set up a blog page and showed views of how the finished items were actually made. The idea took off and now she has a thriving home-based business, that is not only profitable, but all the things that she used to spend money on anyway, are now tax-deductible.

If we take all of this to another level, once you have a profitable endeavour running from a premises, it also means that home office expenses become deductible. This could mean that a percentage of your mortgage interest, electricity and rates could all be tax-deductible.

The downside of claiming these expenses is that when you sell your home, a percentage of your capital gain, will as a consequence, be taxable (See Chapter 11 on Capital Gains Tax).

Example:

My sister is in a similar situation. She is a teacher, but her real passion through all these years is painting. After an illness and some major life changes, she made the conscious decision to follow her passion.

Initially she went through the rollercoaster ride, as many artisans do, of wondering if anyone will actually like what she creates. So she put some of her paintings up for sale on the internet on 'eBay' and bingo, people want them and are prepared to pay for them.

Her passion is 'yard art', painting pictures for the outdoors and multi-media paintings for the indoors. She now has her own website and blog page and as a result, gets to buy her paint, canvas, brushes and any other ancillary items out of pre-tax dollars.

As you can see, by setting up profit centres around your lifestyle decisions, you can not only have the lifestyle you want, but make your lifestyle tax-deductible at the same time. Turning your lifestyle decision into a business, a commercially viable business, gives your endeavours longevity and sustainability.

I remember advising a would-be charity organisation about this concept, and their retort was that they had very large pockets and didn't need to make a profit. My response was clear: "No matter how big your pockets are, if you are not topping them up, they will eventually run dry."

"Profitability guarantees sustainability"

This concept can be taken further when you consider turning your passion into an income source and ultimately into your primary source of income. After all, isn't that the ultimate? Earning an income doing what you love? That way it's not work, and you are earning money doing it.

There are rules around how much money your need to make and how much you have invested into the business which affect whether the Tax Office sees it as a business or meanly a hobby, so make sure you talk to your accountant about this for your particular area of interest or passion.

When you add the benefits of earning your income as a business and being able to earn that income through tax efficient structures such as discretionary and hybrid trusts, the prospect of following your passion and actually making a living from it, becomes very attractive.

I deal with this concept in more detail in the next chapter, and for even more information about how tax and trusts work and the best ways to use them for asset protection visit my websites:

www.ILoveRealEstate.tv and www.DymphnaBoholt.com

Treat your property like a business

You need to treat your property investment purchase as you would a business. It is crucial that you understand this in order to develop a successful investment portfolio. I am going to propose two things here:

- **every property purchase should be selected on its merits;**
- **every purchase needs to be a business decision.**

In viewing your property as a business, one of the very first things you need to do is to analyse your goals. What do you want to achieve over the next few years? What position do you want to be in, in five years' time? Having made those very important goals very clear, you then need to determine the strategies you need to put in place in order to achieve them.

When you buy your property as a business transaction your mindset changes. Your logic kicks into gear, and your emotion takes a back step, which it should. What I have found is that if someone is buying a business, they'll recognise, "This is new for me. I need to talk to my accountant about how to buy this business and what tax structure to put it in for both asset protection and taxation reasons." That approach is normal, appropriate and wise.

My suggestion is that you approach the purchase of your investment property and taxation in the same way. For instance, talk to a suitably qualified accountant that specialises in property purchases, and in particular, asset protection. Look at the property on a profit and loss basis.

Believe me, many people have trouble actually working that out. The structure in which your business is purchased is crucial. The way ownership of a particular property is held, will affect the amount of tax that you will pay on a property.

Increase your property income

A profit in a business is what's left over after expenses are deducted from income. Well, it's no different in an investment property purchase. You have the rental income coming in, minus expenses such as loan repayments and repairs. This is the area in your business plan where you consider such things as how you can increase your rental income and therefore your profit.

When you have a shop or other business, you are constantly thinking about what else you can do and how you can give better service, so you can increase your turnover. How much extra income would you generate by adding a slush-puppy machine, or a new line of soda? In a rental property, extra income means catering for your tenants in a better way.

There might be ways in which you can invest a relatively small amount of money for a relatively larger gain. It is all about value-adding. Just like at McDonald's: "Do you want fries and a drink with your order?" For your tenant it might be: "Would air-conditioning make you happier, stay longer and pay more rent?"

The extra things you do, and the extra services you provide can make all the difference to your rental property business, your bottomline profit and the overall growth of your investment portfolio. As an astute investor, you would always be considering ways to increase your property business profit. Here are a few questions that you might ask about an investment property you are considering buying, or about a property you already own to help maximise bottom line profits.

What can I do to make this property more profitable?

- Can I create a storage facility somewhere?
- Can I convert this into a dual income property?
- If I added a carport, would that increase my return?
- Would adding airconditioning make a difference to my yield? How much would airconditioning cost me?
- Should I offer furniture or internet connections?
- How can I make this property more desirable to my tenants overall and thus be justified in charging more rent?

Every time you put your hand in your pocket to spend money on a property, you need to ask yourself: "What is my return on that investment?" In the example following, it is well worth my while to spend the $700 and get the extra $1,300 per annum return. Unfortunately, when talking about an investment property, people tend to draw a blank, or their logical hat gets blown out the window and they don't think of their property purchase like a business purchase.

Example:

I was considering updating one of my rental units recently. It is in a block of four units and I wanted to bring it on a par with the other units. The tenant was moving out after 10 years, and the unit was run down.

Because the block of units is located in a warm climate, I asked the agent about providing airconditioning and by how much I would be able to increase the rent if I did install a $700 air-conditioner. The agent informed me that air-conditioning would increase the rent by about $25 per week. Multiplying $25 per week by 52 weeks, I arrived at $1,300. A $1,300 return on a $700 investment. That's approximately a 185% return per annum! Needless to say, I installed an air-conditioning unit!

Reduce your property expenses

When you have a shop, you are also always trying to find ways to reduce your expenses. I was having a chat recently to a cabinetmaker who was looking at purchasing a particular machine, which was fairly expensive. I asked him what he thought was the added advantage in having this machine. In other words, how was having this machine going to add value and extra profit to the business?

For one thing, the cabinetmaker told me, it would save him two men's wages per year, because the machine had the capacity to do what the men were currently doing. In addition, he could then use those two men to go out and do more installing and other related tasks, in order to increase the business's bottom line. In my opinion, that cabinetmaker made a wise business decision.

It's exactly the same with your property. Ask yourself, "How can I reduce my expenses to increase my bottomline?" "Do I need to spend money in order to save money in the long term?" "Am I being inefficient with the expenses on my property, and could costs be cut without compromising quality?"

Here are some ideas you might like to consider for your new purchase or existing investment property:

- Negotiate management terms with your managing agent. Management rates and terms are flexible and the more competitive the market, the lower the negotiations can go. Also, the more properties you have in an area, the better the deal you are likely to be able to negotiate.
- Always pay your rates on time as councils impose a penalty if you don't pay your rates by a set date.
- Have your rates reassessed! In some areas, rates are just automatically increased, and I have known of a number of cases where asking for a rates assessment review resulted in the rates bill coming down, even if only marginally.
- Shop around when getting maintenance carried out on your property. Your agent could be getting complacent about getting you the best deal on cost of repairs and in some cases, they may be taking a cut or a referral fee for giving the work to a particular handyman or contractor.

- Shop around for the right insurance policy. Whilst premiums vary greatly, the cheapest one may not always be the best option. Make sure you are adequately covered in the areas you need cover.
- Consider including some or all of the outgoings on your rental property in the lease, so the tenant is responsible for the costs. Whilst this is usually not popular in the residential market, it is common in the commercial market.
- One of the areas where you can really cut costs is having the right loan. Over the years I have seen many clients wasting sometimes hundreds of dollars every month by having badly structured loans. Cash flow is the life blood of any business, and your investment property is a business.

Since a correctly structured loan makes such a difference to the profitability of your real estate investment, I thought we should focus on some of the more important issues about financing and structuring your loan.

Getting the right loan

When purchasing a business, you would normally do a substantial amount of research on what you are able to borrow at any point in time on that business. You would research the serviceability on that business. You would research the financing limitations on that business. Conversely, when people buy investment properties, they normally just go to their regular banker or broker and say, “Can I get a loan to buy this property?” However, what is really sad, is that in most cases, provided the client meets the bank’s or financier’s criteria, the answer is “Sure, sign here, press hard - three copies.”

This happens all the time without any consideration for cross securitisation, cash flow, taxation implication, structure or the client’s future purchasing intentions or capabilities. A badly structured loan can really limit your long-term goals.

It is this type of incompetence that encouraged me to set up my own mortgage brokering franchise, and I encourage you to contact them for a free financial fitness health check at www.wizdom.com.au

Example:

A couple decide they want to buy a positively cash flowed property, and in their searching, they find a nice little over-50s retirement duplex and/or unit. Unbeknown to our investing couple, borrowing on this type of property would probably be restricted to a maximum of 60% LVR (Loan to Value Ratio). Furthermore, in some cases, when the units are small – less than 50 square metres, such as hotel rooms and small bedsits, the borrowing levels could even be lower or non-existent.

Our couple is equity-rich, but they have been persuaded to buy this particular property because their friend bought one and everyone says it is a great idea. Their friendly bank loans officer says there won’t be a problem with borrowing. What the bank officer is not telling them is that they will be taking a big chunk of their available equity in their home in order to buy the property and the two loans would be cross securitised.

They might be better to not buy that type of property, because it requires so much of their available equity, thereby limiting their available equity for future purchases. Also, the bank would have complete control, with security over both properties! What they should have done, is take control of their borrowing destiny, and not have their investment portfolio tied up in the same bank as the home loan on their existing property. The type of property they should have selected, because they had limited equity/funds available for investment from their existing assets, should have been a property on which they could have borrowed more than 60%.

To find out more **call (03) 9490 8888** now or go to **www.iloverealestate.tv** to register for our next **FREE Webcast** where you'll discover the strategies, techniques, structures and support you need to successfully invest and prosper from Australian real estate.

Yours in success,

Dymphna.

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