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The Smart Guide to...

your next investment property purchase

If you are considering the purchase of an investment property, and you have worked out what you want to spend, the type of property that you want and where it should be located, all you need to do is find the right loan to suit the occasion. As we will see that may not be as easy as you might think, there are a number of considerations to be made, a variety of products and options to consider, and most importantly structuring your total financing arrangements so as to maximise your financial situation.

Loan Structuring

To enable us to identify the most appropriate product for the situation it is important to understand your financial situation and therefore the structuring requirements for the finance. So our first step will be to look at the structures most commonly used in financing of the investment property.

In order to purchase an investment property you will require a deposit. This can be achieved by either saving the money or if you have an existing property, say a family home where you have some equity, you can borrow against this equity to go towards the investment property.

Of course if you are to purchase an investment property without using a second property you will only require a single loan.

Conceivably, an investor, who is a homeowner, could buy an investment property (and cover all the costs associated with the purchase) without having to find any cash at all. Most often, this is the recommended manner proposed by financial advisors to investors, because the tax benefits to investment are directly related to the borrowings and the associated costs i.e. when you maximise the borrowings you maximise the tax benefits.

To finance an investment property using the equity in the family home you will need to provide both the home and investment properties as security against the loan/s. This gives rise to three possible financing scenarios, those being:

1. One loan is sought for both the home and investment property. You can get a single loan facility, which can have several subaccounts. In this case we would set up two accounts, one for the family home and the other for the investment property. As they are separate accounts there is no confusion with the tax-deductible portion of the investment property and the non tax-deductible portion of the family home.

2. Two loans one for each property, where the existing home loan is increased to provide the funds required facilitating the investment purchase. The increase to the existing home loan should be done with a multi-account loan to ensure the investment portion is separate from the non-investment portion. This will ensure that the tax deductible and non tax-deductible portions are separate and easily recognised.

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3. Three separate loans one for each property and the third loan sits behind the loan on the family home and is used to draw the equity needed to facilitate the purchase of the investment property. Usually, in this case and in that of point 2, the loans are arranged so that the total borrowings against the properties negate the need for mortgage insurance (where borrowings are less than 80% of the value of the property). This option is not often used with the invention of the multi-account loans, which will be explained later in the article.

Which of the above structures is the best? Well that really is largely dependent on how you feel about separating the family home loan from the investment loan and secondly how much the lenders are going to charge you in fees for the set up. Our next step is to consider the types of loans that are available.

Types of Loans

There are several types of loans that are available to property investors and within these loans are a couple of fundamental options that you will need to decide upon. These options include:

1. Principal and Interest or Interest Only Loans

This is a choice between whether you wish to have the loan balance reducing by making principal and interest repayments or have the loan remain at the original level borrowed by only making interest repayments. Investors are usually advised to take an Interest Only loan, the theory being that principal reductions on an investment loan are not tax deductible, so therefore that money that forms the principal repayment could be used to either pay off the family home faster or further invest in another tax advantaged investment, thereby maximising your tax benefit.

2. Fixed or Variable Interest Rates

This choice is about whether you are comfortable with your loan repayments fluctuating with interest rate movements. Investors are quite often advised to select a fixed rate as this ensures a consistent monthly repayment amount allowing ease of budgeting, so should rates move up your repayment will not be affected. These days fixed rate loans are not as restricted as they once were, where many lenders allow some principal payments to be made without penalty, although in most cases penalties still exist should you pay out the entire loan whilst still in the fixed period.

There are four basic types of loans that lenders offer and that are available for investment property purchase. Each lender has their specific name for their product and each will operate a little differently from any other but what follows is a brief outline.

1. Regular Amortising 25 - 30 year loan

This is your regular loan that we all have become accustomed to over the years. You select the term that you wish it to run and decide whether you would like a fixed or variable rate. Usually the fixed terms run between 1 to 5 years although a couple of lenders do offer up to 10 years. Quite often you will also have the option of an initial interest only period of generally up to 5-10 years. Many investors would have a loan like this as these have been around for a long time.

2. Line of Credit Loan

As the name suggests this loan is a line of credit, which means the bank will approve a maximum loan amount against the property that secures the loan (generally 80% of the value), and you are free to draw this facility up and down at will. It operates like an overdraft account and most often comes with a cheque book and debit card for ease of access to funds. Generally these loans are interest only and have no term attached, which suits an investor as they are most often advised to get an Interest Only loan. This loan could be used on the investment property or the family home or perhaps one on each. These loans have a high level of flexibility in that you can park money in your loan when it is available and draw it as required without notifying the bank, as long as you stay within your approved limit. The downside is that the interest rate on a LOC is often higher than on a regular loan.

3. Multi Account Loan

This loan has a bit of everything and provides the maximum flexibility of all loans. The loan is set up with sub-accounts so you can separate your different lending requirements and each account can be tailored with the features you need to suit the occasion. For example, lets say Account 1 is your home loan and you might like to have it as a principal and interest loan with a variable rate, Account 2 could be $30,000 Interest Only line of credit on variable interest and used for say your share trading and Account 3 could also be an Interest Only 5 year fixed rate for the investment property.

4. Offset Account Loan

The Offset Account loan is generally not a loan that an investor would use on the investment property but rather on their family home to use in conjunction with their investment. An Offset Account loan has a deposit account linked to the loan, the benefit is that any surplus funds that you might have, for example rental income, can be deposited into the deposit account and this is offset against the loan it is linked to. For example, if the loan amount outstanding is $100,000 and there is $5,000 in the offset account the interest that is charged on the loan will be calculated on $95,000. The effect this has is that the home loan gets paid out at a faster rate because your standard monthly repayment has been calculated on the full amount outstanding. Offset Account loans vary in the amount that is offset, meaning that some lenders may offset only 50% of the funds held in the account whilst others offset the full 100%, so you need to pay attention to ensure you get the best loan for your needs.

Case Study

Following is a case study, which has been prepared to demonstrate how all the above information comes together in reality. It is typical of what you would expect an experienced mortgage broker to arrange for you so as to maximise your situation from a lending, taxation and lifestyle perspective.
Take the case of Tom and Joan. Both are in their mid 40's, their children have left home and over the years they have reduced their home loan to $110,000 and its value has increased to $600,000.

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The current loan had been set up as a Line Of Credit, which receives both their salaries. They pay all their living and personal expenses with their credit card, which has a sweep facility to automatically clear the credit card every month from their home loan.

However, in embarking on an investment property strategy they need to re-define their goals. The original aim was to repay the home loan as fast as possible to achieve an unencumbered house and to live on the pension. Tom and Joan now want to purchase an investment property for $150,000. They still want to repay their home loan as quickly as possible and keep their cash flow situation as it is, but also want to be able to keep buying investment properties to create wealth.

From a lending point of view, this represents a number of conflicting requirements that requires a variety of loan products.

We settled for a discount variable rate home loan with principal and interest repayments, combined with an offset account. The investment loan, also at a discount variable rate but on interest only for five years was coupled with a line of credit.

This arrangement had the further advantage of clearly distinguishing between personal and investment loans, making it easier for Tom and Joan's accountant to identify and claim expenses.

How did this work?

Firstly their existing Line of Credit was converted to a Principal and Interest housing loan of $110,000 taking advantage of the bank's introductory discount rate. All income, including rental payments and salaries were directed to an offset account. Personal expenses continued to be met from the credit card and cleared monthly from the offset account.

This now meant that not only was the housing loan reducing, but the reductions were even greater. This was due to the combination of a cheap introductory rate along with the benefits of the offset account reducing the principal from which interest was calculated by the amount of both Tom and Joan's salaries together with the rental income, before funds were required to clear the credit card each month.

We then established an investment loan of $160,000 to purchase their investment property of $150,000 purchase price plus meet all the purchase costs. This had the advantage of not requiring Tom and Joan to contribute any cash funds to complete the purchase. It also meant that a larger portion of interest could be claimed as a tax deduction and returned to them as either an annual tax refund or less taxation being deducted from their salaries.

As there was still ample equity in the family home we set up a Line of Credit of $80,000 to enable them to fund the purchase of another investment property once they were ready. Now they could look around for a second investment property secure in the knowledge they could pay a deposit immediately. They could then put forward a loan application based on the full purchase price plus costs using the equity in the new investment property.

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This structure gave Tom and Joan peace of mind as it only marginally changed their personal cash flow arrangements whilst maximising their ability to repay the housing loan, purchase an investment property with no cash outlay and provide for future investment property purchases. In addition, due to the level of borrowing and income, we were able to have most of the normal fees and charges waived.

So what are the 5 most important points to look out for when preparing to finance your investment property?

1. Ensure you consult with one of our loan advisors who can help set up the most advantageous structure for you
2. Low interest rate means lower payments
3. Low fees…no one wants to pay fees
4. Interest only option for the investment property
5. Loan flexibility to ensure future purchases can be made easily

Please use this information as a guide only – it is not advice. You should seek professional advice when buying a property or taking out a loan and always refer to your loan contract for full terms and conditions.