Cornerstone Wealth

Financial Advice Based on Solid Foundations

Fact Sheet – Home to Investment

What do you mean Home to Investment?

Often when people move to a new home they wish to retain their current home and use it as an investment property. This avoids having to pay stamp duty and real estate agent fees on an alternative investment property. The difficulty that arises is getting the debt associated with the investment property rather than the new family home in order to make the interest payments tax deductible. The tax deduction for interest relates to what the funds are used for, not the security for the loan. Therefore the funds you borrow to buy the new family home are not tax deductible.

Can the debt be transferred to the Investment Property?

It depends. Most couples own their home jointly. In this scenario, the higher income earning spouse could borrow the funds to buy the lower income earning spouse's portion of the current family home. A written real estate valuation of the property will need to be obtained and 50% of the valuation is the amount which the higher income earning spouse will pay the lower income earning spouse for the half share. This full amount can be borrowed and the interest claimed as a tax deduction.

The amount the higher income earning spouse pays the lower income earning spouse to purchase the share of the investment property, can then be invested in the lower income earning spouse's share of the new property. The lower income earners borrowing on the flat will need to reduce to nil.

Can you give an example?

Sure. Frank and Mary own their family home valued at $400,000 jointly and have a mortgage of $100,000. They bought the property for $300,000. They have 3 kids and need to move into a larger home nearer to the children's school and Frank's work place. They decide to maintain the current property and rent it out. The new home will cost $500,000.

Mary can sell her 50% portion of the current home to Frank for $200,000 and Frank can borrow this amount from the bank in order to pay Mary. The investment property (current home) then has $250,000 debt associated with it (i.e. $200,000 plus Frank's share of the $100,000 remaining mortgage). The interest on the $250,000 borrowing will be deductible to Frank while the property is rented or available to rent.

Frank and Mary can then purchase their new home with the $200,000 Frank paid Mary for her share of the investment property less the $50,000 of Mary's share of the debt on the investment property, in addition to $300,000 additional borrowing. Note the interest on the $350,000 is not tax deductible.

	Scenario One	Scenario Two
Investment property debt	$100,000	$250,000
New family home debt	$500,000	$350,000
Total debt	$600,000	$600,000

Issues to consider

1. Don't let the tail wag the dog - it is important not to let your current situation (ownership of a property) drive your future decisions. Step back and ask:
   - What are we trying to achieve?
   - What is the best way of achieving it?
   - What is the best structure to achieve it? For example a family trust may provide greater benefit.
2. Debt - after completing the transaction Frank and Mary will have $600,000 in debt and $300,000 in equity (their own assets). They really need to consider if this is that something they want hanging over their head and do they have the cash flow to maintain it? Selling their current home may bring about greater flexibility, reduce stress and enable them to be more generous.
3. Risk - all of Frank and Mary's assets are held in a single asset class (residential property) and only in two properties which represents a high level of risk. Further diversification would be prudent.
4. Capital Gains Tax - when the investment property is sold by Frank, all the capital gains will be attributed to him except for the principal residence exemption of the time you have lived there. The cost base for Frank when the property is sold will be 50% of the original purchase price $150,000 + $200,000 = $350,000. If the property is sold immediately ($400,000) by Frank after transfer to his sole name, there would not be any capital gains tax to pay as the principal residence exemption would still apply, however, if it is sold in the future, the principal residence exemption would be apportioned. Capital gains are added to taxable income and taxed at marginal rate, including the capital gain.
5. Ownership - it may be prudent to purchase the new property as tenants in common, with Frank owning 75% - 90% (even 99/1 is acceptable). In using the tenants in common scenario, keep in mind the possibility of sale whereby capital gains will apply. If your long term goals are to purchase and retain property until retirement, when taxable income is at a lower marginal rate, tenants in common works very well.

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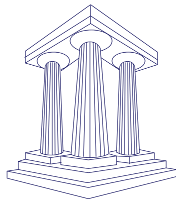

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