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Old or New Property? That is the question

Interest in property investing has been building among Australian investors since they started to question the need for a heavy reliance on Australian equities in the growth part of their portfolios. Aside from that concern, Australians simply love holding bricks and mortar.

Now that SMSF trustees can also leverage property into their portfolios, they are turning to their advisers for help in implementing the SMSF side of the transaction.

Much has been written about the structures and techniques that need to be put in place so that advisers can now confidently advise on the implementation. But what about the property itself? This is fundamental to the success of the investment. Not addressing this aspect is like advising a client to invest in equities without recommending a specific stock or fund. Without obtaining such guidance, investors are often likely to act on their own inbuilt prejudices. Because everyone who has ever bought their own home thinks they are an expert in property, this will generally result in a focus on the investor's local area, because that is where they have knowledge and the ability to physically inspect the property, and emotion creeps into the decision-making process.

As a result, poor investment decisions may be made and lack of diversification arises. Capital city property markets move in different cycles and so the local area is unlikely to be the best place to buy at the time the client has the ability to invest.

The laws of physics don't change just because the vehicle for investment is an SMSF and advisers will therefore face all the usual questions relating to property. Does one invest in an apartment or house? Should it be new or old? Does one use negative or positive gearing?

Investors do not get excited about compliance and technical issues – they want to hear how they should approach a direct property purchase for maximum benefit.

When investing in property within an SMSF, clearly the overarching aim is to build as much wealth as possible, with the least risk, and in the smallest amount of time to deliver a better retirement outcome. In order to do this, investors need to understand what type of property works best in a portfolio.

There are different schools of thought when it comes to the argument of whether to invest in new or second-hand property. This article seeks to shed some light on the topic.

From an investor's perspective, new property provides a number of key advantages:

Simpler physical due diligence

The right property is unlikely to be in the client's home city. As a result, it is impractical to personally inspect dozens of potential older properties interstate. Buying a new property from a respected developer gives assurance as to the physical quality of the product, as well as a number of statutory protections.

Sufficient quantity of similar properties

Obtaining advice from someone with a large number of similar properties allows for research costs to be spread over a number of properties, providing a scalable solution for advisers and consistency across investors for reporting purposes. In effect, this is similar to a model portfolio for equities.

From an investor's perspective, there are a number of distinct advantages in new property. In no particular order these include:

Reduced maintenance costs: The simple fact that a building is new means the building and its fixtures and fittings are less likely to require maintenance.

Lower vacancy rates: Due to the desirability of living in a new dwelling, it is not often that a new building will have any vacancies.

Higher tax deductions: The Australian tax system includes a number of inbuilt biases that favour new properties. These include a building allowance for newly-constructed properties.

Newer buildings also have a higher component of depreciable plant and equipment, which attracts accelerated depreciation and delivers significant tax advantages over the early years of a property's life.

Older properties also have a number of advantages. Due to age, you will be able to purchase an older property for a comparatively lower price than a new property.

Also, generally speaking, gross yields are slightly higher for older properties than new properties.

Due to the discounted price you are also less likely to have shortfalls with bank valuations, so financing the property may be considerably easier.

Generally, the advantages of one may be disadvantages of the other and vice versa.

So what does this all mean for the SMSF property investor?

The key to successful property investment is holding for the long term. A key focus should be around the cash holding cost of a property. Every investor has a finite amount of money in superannuation and a certain level of contributions they can use to service their investments. This amount of money will drive the decision around the type of property to invest in. The lower the holding cost, the lower the likelihood that a client may be forced to sell the property at an inopportune time as a result of changing personal circumstances. This

is also a key advantage of an SMSF as a property investment vehicle, because it is sheltered from the ups and downs of life.

Case study: new property has a greater resale price with lower holding costs through SMSF ownership

To explain, consider an example of two SMSF property investors named John and Jane.

The two investors both earn $100,000 per annum, both contribute 9 per cent per annum, and have both borrowed 70 per cent to purchase the properties within their own SMSFs. The major difference is that John buys an older property and Jane buys a new property. Both are two bedroom units of comparable size and features.

Both properties are located in a southern Sydney suburb, are within close proximity to each other and both cost $400,000.

The table summarises the differences in the holding costs of these two properties.

In order to keep the analysis consistent, we have used the following assumptions for both properties: the interest rate on the housing loan is 7 per cent, the vacancy rate on the properties is 0 per cent, the real estate management fees are 6.6 per cent and the loan-to-value ratio (LVR) is 70 per cent plus costs.

	New Jane ($)	Old John ($)
Purchase price	400,000	400,000
Income		
Rent	20,800	20,800
Depreciation claim	11,771	1550
Expenses		
Interest	20,870	20,879
Rental costs	6602	7202
Shortfall pre tax	(6680)	(7280)
Shortfall post tax	(3829)	(5872)
Holding cost per week	(74)	(113)

In Jane's case, and assuming there is no vacancy, she will collect $20,870 in gross rent and will claim $11,771 in depreciation on the building and its fixtures and fittings. Although there is no actual income stream from the depreciation claim, it has been included on the income side of the balance sheet as it will actually be a positive to Jane's after-tax cash-flow position within her fund.

Jane's total interest bill at a rate of 7 per cent will be $20,870 and miscellaneous rental costs will be $6602. Therefore, the total shortfall will be $6680 in the first year, or $128 per week.

This dramatically changes once the tax benefits of investing in property are accounted for, with the post-tax cash flow being equal to negative $74 per week.

John's position is similar in terms of cash flow on a pre-tax basis, with the older property expected to cost his fund $140 per week. However, due to the property being older and the fact that a large part of the depreciation claim would have been reduced in the first five years after construction, John's depreciation claim is lower at $1550 in the first year. Hence, the post-tax cash flow will be negative $113 per week in the first year.

As it stands, the two properties are of equal value and the only assumed difference is age. As shown, the holding costs are lower for the newer property mainly due to the difference in the depreciation claim. In dollar terms the older property will cost $39 per week more to service. In other words, the older property costs 53 per cent more to service.

This lower cash servicing cost provides greater comfort for long-term holding of the property. It is likely to rely less on ongoing contributions to service the loan. Most lenders who specialise in SMSF property loan products apply a rigorous servicing model. As a result, serviceability is usually the constraint on the level of borrowing available, rather than deposit size.

Case study: new property is more expensive but has the same holding costs for the SMSF

An alternative approach to looking at this is that the lower after-tax holding cost means an SMSF can support a higher value property for the same level of after-tax cost. This provides access to greater amounts of gearing and, importantly, provides a greater asset base over which to amortise the additional fixed costs of borrowing in an SMSF.

This case study looks at other advantages of buying a newer as opposed to an older investment property. This will allow us to see what an investor can get for an extra $39 per week. In this instance, a $570,000 new property is used. All prior assumptions will hold in this new comparison.

	New Jane ($)	Old John ($)
Purchase price	570,000	400,000
Income		
Rent	28,760	20,800
Depreciation claim	14,729	1550
Expenses		
Interest	28,760	20,879
Rental costs	8875	7202
Shortfall pre tax	(9537)	(7280)
Shortfall post tax	(5741)	(5872)
Holding cost per week	(110)	(113)

So while the new property is worth a lot more and would cost a lot more to acquire the cash flows for the two properties are almost identical. The new property costs $3 per week less to hold, even though the property is worth $170,000 more.

Assuming that over the next 10 years both properties grow at 6 per cent, in that time the older property will be worth roughly $716,339 and John's profit before tax will be $316,339.

The new property at the same growth rate will be worth roughly $1,020,783. Therefore, Jane's pre-tax profit will be $445,783. Jane's pre-tax profit is an extra $129,444, even though both properties are almost identical in cash flows. Jane has, of course, invested an additional $51,000 in deposit to maintain the same LVR.

The case for new investment property is compelling unless there is some overriding issue the SMSF trustees are considering.

If the aim of the investment property acquisition for the SMSF is to meet the sole purpose test and build retirement wealth, then the debate about new versus old regularly falls in favour of the new property on all objective criteria.

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