Maximizing Your Tax Deductions for Profit

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If you are the owner of a holiday home in Australia, you must have some
knowledge of tax implications, deductions, and investment property. Here are some tips to help you
with that.

Not surprisingly, there is an appeal to owning a holiday home, no matter how small. In Australia,
around 2.7% of individuals report owning a holiday home of their own. But the majority of this
number belongs to a certain group mainly situated in Melbourne. Supposedly, 1 in every 20 residents living in Melbourne own a holiday home, which is double the rate of the rest of the country combined.

As residents of the capital city residents are seen to be more likely to own a holiday home, only 2% of people outside the capital have a holiday home. The non-capital city having a high percentage of such
people in Sydney and Brisbane. 2.8% of the residents in Sydney own a holiday home. With owning
such a luxury estate come obligations and responsibilities. The tax implications for holiday homes
work slightly differently than an ordinary house.

As Australia is a very popular tourist destination, a lot of tourists come here each year at different
seasons. So many investors have started businesses renting holiday homes to tourists. A holiday
home can be a good investment property. The rents have skyrocketed in 2023 as the same house
that could be rented at $1,165 for a week last year is now being rented at $2,882. But with the rents,
the cost of expenses rose as well.

Holiday Home: What is a Mortgage prison, and Who is a Mortgage Prisoner?

Mortgage prison is a situation where some borrowers cannot refinance. It is a catch-22 situation in which a homeowner is stuck paying an uncompetitive rate and can’t refinance to a cheaper home loan because of some specific reasons, including higher living costs

leading to a higher HEM calculation, the fact that they can't borrow because of higher interest rates and a "serviceability buffer", the living costs and rising interest rates make it harder to borrow money, and a lower home valuation from the new potential lender, which also cuts into equity.

Mortgage Prison is a situation where borrowers can not refinance

Most of the time, a mortgage prisoner has a mortgage but can't refinance their home loan. It has nothing to do with whether or not you are a good borrower. Instead, it concerns the fact that you may need more security to pay back the loan or have enough protection.

Investment property owners may find themselves in a mortgage prison if they purchase a property at a high price or if its value has declined significantly. In such cases, the property owner may need more time to refinance the mortgage or sell the property for enough to pay off the mortgage debt, leaving them in a difficult financial situation.

Why Are More and More People Getting Stuck With Their Mortgages?

Property prices going down and more people getting stuck in their home loans are caused by increased interest rates. Interest rates have been raised by the Reserve Bank of Australia six times in a row now. The central bank's cash rate is now at 2.60 percent to stop inflation from increasing. Since interest rates are expected to keep going up, and home prices are still going down, more loan-to-value ratios will be pushed out.

The loan-to-value ratio is the ratio between a home's worth and how much a home loan costs. For people with a small down payment, the loan-to-value ratio could change if the value of their house goes down and their equity falls below 20%. The borrower is at greater

risk if the loan-to-value ratio is high, so the lender is less likely to let them refinance their loan.

Interest rates are rising

Why Are Property Prices Going Down?

In a nutshell, when interest rates go up, mortgages cost more. People will have less of the bank's money to spend and will compete for cheaper properties. This means the market will have to drop property prices to keep up.

Every time the Reserve Bank of Australia raises interest rates, people's borrowing capacity from the bank goes down. With more rate hikes likely on the way, property prices will probably keep going down.

How Many Different Kinds of Mortgage Prisons Are There?

Mortgage prisons can occur for many different reasons. There are some specific situations where a borrower could get stuck in a mortgage prison. Ultimately, the exact nature of a mortgage prison will depend on the borrower and their loan. Some common types of mortgage prisons are discussed as follows.

Decreased Property Value

As the real estate market changes and home prices fall in some places, more homeowners could find themselves with less equity and a rising loan-to-value ratio (LVR), making it impossible for them to refinance. Your LVR can change if the value of your property goes down. It shows how much of the property's value the borrower still owes.

Loan to Value Ratio changes with the value of the property

LVR is a percentage found by dividing the amount still owed on the loan by the property's value and multiplying that by 100. For example, your Loan to Value Ratio would be 50% if your home is worth $800,000 and you still owe $400,000 on your mortgage. 400,000 / 800,000 x 100 = 50%.

Most lenders think an LVR of more than 80% is a high risk. So, if you buy a house with less than a 20% down payment which means your LVR is more than 80%, the lender may charge Lenders Mortgage Insurance (LMI) to protect themselves if you don't pay. LMI is usually associated with home loans used to buy a new home, but it can also be charged when a borrower refinances a home loan with an LVR of more than 80%.

Remember that your LVR is based on what your home is worth, not how much you paid for it. So, this extra cost could make it hard for people with high LVRs to refinance if they want to avoid taking on more debt. Also, some lenders will only consider refinancing a loan with a high LVR, especially if the borrower's finances are in good shape. Even lenders willing to refinance a home loan with an LVR of 85 or more are likely to charge higher interest rates.

Higher Standards of Serviceability

Some borrowers could end up in mortgage prison because the new rules make qualifying for a home loan harder. The Australian Prudential Regulation Authority (APRA) changed the rules for getting a mortgage in Australia in October 2021.

When you apply for a home loan, the lender uses a home loan buffer to determine how well you can repay the loan. So, a 3% buffer is added to the loan rate after figuring out if the borrower can repay the loan at the advertised interest rate. Before, the serviceability buffer was 2.5%, so now the standards are much higher. Because of the buffer, lenders are less likely to give new loans or refinances to people needing help if interest rates increase.

Low Credit Score

Getting stuck in mortgage prison is also possible if you have bad credit. Lenders check the credit of everyone wanting a home loan to see if they can trust them to repay it. You must make some payments to get the best home loan to refinance deals and interest rates. You should work on your credit score before you can refinance.

A good credit score plays a vital role in achieving a good loan

Decreased Borrowing Capacity

Some people are stuck in their mortgages because of rising living costs and higher interest rates. Even if their income has stayed the same, they cannot borrow because they can't afford or get a loan with a higher rate. Those who took out a home loan when interest rates were at all-time lows are especially at risk for this type of mortgage prison and are probably already feeling the stress of their mortgage.

Too Old for Refinancing

When you're over 50, refinancing your home can take much work. Even though it's possible, lenders may only give you a loan if you want a longer repayment period. Lenders want to know that you'll be able to repay your loan in full before you retire if you're an older borrower. Lenders often ask people over 50 to include an exit strategy with their loan application.

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Fixed Interest Rate Expiration

Borrowers close to the end of a fixed interest rate may feel like they are mortgage prisoners when they look at the interest rates available after their fixed term is over. Borrowers with meager fixed rates are in for a big surprise when it comes time to repay their loans. Both fixed and variable interest rates are much higher than they used to be a few years ago.

If your fixed-interest period is ending and you're worried about being unable to pay a loan with a higher interest rate, you should talk to your broker or property accountant. Depending on your situation, they may refer you to their assistance team or work with you to find a solution.

How to Escape Mortgage Prison and Save More Money

Borrowers need to look into different lenders and brokers and compare them to avoid getting stuck in a mortgage prison. You can also avoid and get out of mortgage prisons by getting professional financial advice. Here is a list of things that will help you to escape mortgage prison and reduce costs.

Balanced Debt-To-Income Ratio

If you want to refinance, you should know how car loans, credit cards, store cards, and even loans for investment properties can affect your ability to borrow. Many major lenders have a debt-to-income ratio policy that says applicants can't have more debt than six times their annual income.

Debt greater than six times annual income can be a problem

Owner-occupied loans rarely cause trouble. Most of the time, the problem is caused by debts and loans that the homeowner took out after getting their home loan. Mortgage holders should consider closing unused credit cards, paying off car loans when the fixed-rate loan roll-off period ends, and putting investments on hold to lower their risk. In this time of rising interest rates, many lenders have cut back on lending to people with more than six debt-to-income ratios and won't lend to people with more than seven debt-to-income proportions.

Early Refinancing will Give You an Edge

As part of their responsible lending policies, banks test loans at a rate that is 3% higher than the interest rate they offer. When rates were lower, you could have applied for a mortgage with a rate of 2.00% p.a. and a buffer of 3%, which added up to a total of 5%. Now that interest rates are at 5% per year, you might not be able to use the standard assessed buffer of 3%.

Refinancing immediately can be a good solution

The best way to avoid this situation is to refinance immediately. Those worried about rising interest rates should do what they can to increase their income before applying. For example, they could work more hours or wait until their pay goes up before using.

Check Banks' Age Policies

It's essential to pay attention to the age policies that banks and lenders use since each lender has a different policy about when someone is expected to retire. This is especially important for people who live in their own homes and whose loan term will last longer than the bank's assumed retirement age.

A good exit plan, like downsizing, can help you deal with potential problems

People with a mortgage should consider this when planning for the future. A good exit plan, like downsizing, can help you deal with potential problems. Many banks want to know how you plan to pay off your loan if you're over 50 or if your loan term will last until you retire and you won't have a steady income. Borrowers can get out of debt by paying off their home loan with their super balance or by making investments and making money without doing anything.

Find Out About Changes to How Banks Calculate Living Expenses

Because inflation has increased living costs, banks have raised the number they used to figure out living costs. Before applying for refinancing, people with mortgages might want to cut back on their spending for 3 to 6 months. Applicants should also consult with their broker about anything that might lower their living costs.

Watch Loan-To-Value Ratios

As property values across the country drop into negative growth, people who bought recently at a loan-to-value ratio (LVR) of 95% will have negative equity and won't be able to refinance if the property market drops 10%, as many economists predict. Some markets have already lost more than 10% of their value.

Homeowners with newer loans tend to have bigger mortgages and higher mortgage costs than their incomes. As home prices in many suburbs fall from their recent record highs, more and more mortgage holders will see their mortgage-to-value ratios increase.

What to Do if You Find Yourself in Mortgage Prison?

If you are trapped by your mortgage, you could try one of the following:

- Don't spend money on things you don't need.
- Cut down the amount you can charge on your credit cards.
- Call your service providers and ask for better deals on your utilities.
- Contact the hardship team at your broker.
- Move to a smaller or less expensive house.
- Ask for a raise to make more money.
- Consider getting help from a property accountant and broker with your finances.

Additionally, if you are planning to invest in the property market, you should talk to financial experts, like mortgage brokers, buyers agent, financial planners, and a specialist property accountant. They will help you make smart decisions about your investments and spot any risks that might come up. By investing in property in a thoughtful and careful way, investors can avoid getting stuck in mortgage prison and increase their chances of making money in the property market.

We offer a 15-minute free consultation to discuss your tax, property investment and business needs. Book your complimentary consultation now.

Book Now

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