

# TOP **13** MISTAKES TO **AVOID with** GRANNY FLATS



## Before you get started

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## Letter from the Wealth Adviser Library

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Dear **Reader**

WELCOME TO THE WEALTH ADVISER LIBRARY.

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

KNOWLEDGE GIVES YOU A HUGE ADVANTAGE

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of eBooks that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

TAKE THE NEXT STEP

We invite you to meet with one of our advisers to discuss what it was you were hoping to achieve when you obtained this document, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find the details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

**Wealth Adviser Library**

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## Introduction

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Granny flats are increasingly being constructed in Australian backyards. There are a number of reasons for this trend:

- property owners wanting to convert their backyards into extra living space
- property owners wishing to increase their rental income potential
- property owners wishing to increase the resale value of their asset
- property owners taking advantage of tax deductions available for granny flats
- property owners catering for younger family members who are remaining in the family home longer before moving out
- the rise in the number of full-time working families, with grandparents assuming increasing child-minding responsibilities
- government desires to limit urban sprawl
- people are living longer, with the average life expectancy for Australians now over 80 years. Australia's ageing population means there is an increasing need to care for elderly family members.

The purpose of this eBook is to provide information on the potential pitfalls to avoid if you are considering constructing a granny flat on your property. In addition, as with any sizeable investment, we recommend you seek financial advice before constructing a granny flat on your property. This advice will help to determine if it is appropriate for your personal and financial circumstances.

## Mistake #1 Assuming a Granny Flat Will Increase the Value of your Home

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There is no guarantee that a granny flat will necessarily increase the value of a home when the time comes to sell, despite the considerable cost of constructing it. Considering that a house is the major asset for the majority of Australians, this is an important consideration. A granny flat may increase a house's value, but the fact is that sellers of homes with granny flats will only attract

potential buyers that are looking for (or would be willing to consider) a house with that feature. For many buyers, a granny flat in the backyard will not be a feature that they want or need. Some granny flats end up as nothing more than storage sheds.

Granny flats are not permitted to have a separate ownership title from the property they are constructed on, which means they also cannot be sold separately.

## Mistake #2 Assuming the Granny Flat can be Rented out to Generate Income

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Under current legislation, granny flats cannot be rented out in Victoria, Queensland and South Australia. They can only be rented out in New South Wales, Western Australia, Tasmania, the Northern Territory and the ACT. The planning and environment departments in these States and Territories can provide information about eligibility and any restrictions.

Even in States and Territories where granny flats can be rented out, there is no guarantee that they always will be. For example, during the mining boom in the first decade of the 21st century, the demand for any sort of accommodation in Western Australia was high, but this has since slumped dramatically with the subsequent downturn. Many rental properties are now vacant, and rental yields have dropped accordingly.

## Mistake #3 Potentially Reducing the Rental Income Potential and Occupancy Rate of an Investment Property

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Before you add a granny flat to an investment property, you need to consider that the rent you charge for the property will likely need to be reduced with the addition of the granny flat. This is because tenants will typically expect a rent reduction in exchange for having another person or other people renting out the granny flat in their backyard. Although

you will be able to charge rent for the granny flat, which combined with the reduced rent of the original property may result in a higher overall yield, there is no guarantee that both will easily be able to be rented out.

## Mistake #4 Not Understanding the Tax Implications

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For granny flat expenses to be tax deductible, the income generated needs to be regarded as a commercial transaction. The rent received from a relative who is only paying a nominal amount of rent (i.e. well below commercial rates) would not be regarded as a commercial transaction. While this means that this nominal rental income would also not be taxable for the granny flat owner, it means that any granny flat expenses cannot be used as tax deductions.

Tax deductions are only allowable against assessable income. This means the homeowner must charge commercial rates of interest to relatives or third parties to be eligible to claim tax deductions for expenses such as:

- interest on the loan for the construction of the granny flat
- a proportion of utility bills (e.g. electricity)
- a proportion of land rates for the property.

An additional potential taxation issue associated with granny flats is Capital Gains Tax (CGT), potentially making an otherwise exempt family home subject to CGT if it is used to produce assessable income. CGT on the eventual sale of the home will be based on the floor space of the granny flat and the time period this was rented out generating a commercial rent.

Assuming no commercial rent is received from the granny flat, there will be no loss of the CGT main residence exemption on the subsequent sale of the whole property.

## Mistake #5 Not Obtaining the Best Loan Finance

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As with any loan, you should obtain the most favourable interest rate available to construct the granny flat if required. There are several different financing options available, including:

- a home equity loan
- refinancing your existing property loan (including the addition of the granny flat) with either your current lender or an alternative lender if you can negotiate better terms
- taking out a separate loan for the granny flat on the most favourable terms available.

Although the loan for a granny flat is likely to be much smaller than the loan for your main property, it is still a significant investment. For example, to pay off a \$90,000 loan over 20 years at an interest rate of 6.6% will result in a total repayment of approximately \$344,000. It is therefore worth shopping around for the best possible deal. Even a small reduction in interest can make a sizeable difference to the total repayments over the life of a loan.

## Mistake #6 Not Considering the Impact of Potential Family Breakdowns

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As mentioned in the Introduction, people are living longer and Australia's population is ageing. Granny flats are increasingly being used as accommodation for elderly relatives, with their proximity making it easier for other family members to help with their care, as well as allowing these elderly family members to assist with child minding responsibilities in families where both parents work full-time. In these circumstances, consideration should be given to the potential for family break-ups.

For example, a wife's mother may move into a granny flat on the husband and wife's owner-occupied property. What will happen to her if the husband and wife subsequently divorce and there is a forced property sale? Ideally, the potential for this situation to occur should be discussed and a written, legally-binding

agreement should be prepared outlining what will happen in such situations, prior to the family member taking up residence in the granny flat.

In addition, such agreements should outline the financial obligations and expectations of all parties in relation to the granny flat. This is especially important if the family member who is residing in the granny flat has contributed to the cost of its construction.

## **Mistake #7**

### **Not Understanding Different Permits and Approvals Are Required**

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Different States and Territories in Australia have different planning permit and approval processes. Depending on the location, there are varying restrictions on living, patio and veranda space. Granny flats all require local council approval, with most applications generally requiring at least the following:

- surveyor's plans
- architectural drawings
- structural engineer's drawings.

In general, granny flats can only be built on residentially zoned property, with only one allowed per property. Granny flats cannot exist on subdivided, strata title, or community property.

## **Mistake #8**

### **Not Appreciating that “You Get What You Pay for”**

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The cheapest granny flats are DIY construction kits. The next step up is pre-built granny flats from kit home builders. The most expensive option is a custom designed granny flat. As with any purchase in life, you generally get what you pay for. The higher the quality of materials and builders used in construction, the higher quality the granny flat is likely to be, and the longer it will likely last before needing any costly repairs or maintenance.

With any construction project, you should feel comfortable in asking the builder to supply you with examples of similar previous work

they have done. In addition, they should be able to provide testimonials from previous customers regarding their ability to do the work on time and on budget. With the increasing demand for granny flats, many builders specialise in their construction these days. It is a competitive industry, so you should be able to shop around to find the best deal in terms of both quality and value.

## **Mistake #9**

### **Not Ensuring that your Granny Flat Builder has Adequate Insurance**

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Always remember that a granny flat builder will be constructing on and around your existing property. They should be able to produce a certificate of currency on request to demonstrate that they have adequate insurance coverage for the construction work.

## **Mistake #10**

### **Not Understanding the Access Required for Granny Flat Construction**

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Homeowners need to consider the ease of access to their property for delivering the necessary building materials to construct the granny flat.

In some circumstances, cranes may be necessary to lift building materials over the existing home. This will add to the cost of the granny flat construction.

## **Mistake #11**

### **Not Appreciating the Future Loss of Privacy**

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Whether your granny flat is used for family members such as grandparents or third parties, there will be an inevitable loss of privacy. For example, there are likely to be shared spaces between the granny flat and the owner-occupied property, such as patio areas. There is also likely to be some additional noise, with potentially additional vehicles and people accessing the property.

In addition, if you are an owner-occupier of the main property residence, you literally will have tenants in your backyard, unlike other rental property arrangements. This means they can potentially knock on your door at any time for maintenance or other issues. In addition, consideration needs to be given to the potentially uncomfortable situation where the tenant is in arrears with their rent, and how you as the owner will handle that situation with the tenants being so physically close to you.

## Mistake #12

### Not Understanding the Potential Impact on Government Benefits

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Before considering constructing a granny flat you may need to check with Centrelink about the potential impact on current or future government benefits on the property owner and/or the occupant(s) of the granny flat.

The standard Centrelink income and asset means tests for determining pension or allowance eligibility:

- Rental income less allowable deductions would ordinarily be counted as assessable income for means testing. Note that deductions allowed are not the same as those allowed for taxation purposes e.g. depreciation.
- For the principal home to be exempt from the assets test, the principal home and adjacent land, up to 2 hectares, must be on a single title block and the land must not be used primarily for commercial purposes

In relation to retirees there are specific concessions and detailed rules associated with

- aged care means testing
- the creation of life interests (the transfer of an asset to another person but retaining an interest in the asset).

## Mistake #13

### Not Considering Alternative Income-Generating Investments

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If your primary goal is to generate income rather than provide accommodation for a family member, there are numerous other income-generating investments to consider, such as managed share funds and trust funds. The major advantages of these forms of investment vehicles are that your funds are more liquid and you are able to diversify your asset portfolio (i.e. not rely too heavily on one property). And unlike a granny flat, these investments won't have any potential negative impact on your existing residence.

## Conclusion

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This eBook has outlined the most common mistakes to avoid with granny flats. In addition to the information contained in this eBook, consultation with an experienced financial adviser is recommended to determine if this form of investment is appropriate for your personal financial circumstances. If you subsequently decide that this is an investment you need to make, a skilled financial adviser will also be in a position to put strategies in place to help you avoid these potential granny flat mistakes.

It is our hope that the information presented in this eBook has set you thinking about planning your financial future. We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable. We also stand ready to serve you with holistic and professional advice, so please do not hesitate to contact us if we can be of further assistance.





## Take the next step

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We trust you enjoyed this publication and found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

We now invite you to take the next step and meet with an adviser to discuss what it was you were hoping to achieve when you downloaded this handbook and to establish if we can help you achieve your goals and objectives.

Next you will find details on how to book an appointment with one of our experts.

We look forward to meeting you soon.

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# Appointment Booking Request form

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Appointments are available Monday-to-Friday.

Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

Preferred appointment day and time

Day

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Date

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Time

am/pm

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If you would like us to contact you via email to confirm your appointment or to answer any questions you have, please provide a valid email address for our records.

Email

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Your Details

Title

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First name

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Last name

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Mobile

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## Our services

## Contact details

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