Hi and welcome to your September edition of Financial Independence.

This month actually marks the one-year anniversary since I published my first ever newsletter. I'm very pleased to have received a lot of feedback from many satisfied readers who have used my information to great success.

My goal with the Inner Circle was to help you increase your financial intelligence to help you identify and capitalise from wealth creation possibilities - and it seems like progress is being made!

For example, Bruce Innocent rang today to let me know that since December last year, he has implemented my advice to successfully complete 19 positive-geared property purchases. This is an amazing result... well done Bruce!

IMPORTANT!
SIGN UP FOR THE FREE GET TOGETHER TODAY!

The Get Together will be an excellent opportunity for you to network as well as to ask me any specific questions you may have. I'll also be speaking for about an hour on the topic of wealth creation. Be sure to secure your **free seats** by going to the Feedback Section.

Before we plunge into this months topics, I think now is a great time to take a reality check.

The newspapers are full of discussion about the 438 boat people stranded on board the *Tampa* ocean-freighter. While I'm sure there will be a diverse range of opinion about whether or not they should stay, I note in an editorial by Andrew Bolt in the Melbourne Hearld Sun (30/8) that some of these refugees are "...rich enough to pay $20,000 each to get here..."

My point is we are lucky to live in a country that other people would willingly sacrifice their life-savings and risk life and limb to enter a place we freely call home.

Yes, sometimes life is a grind and things don't go our way... but we should try to take a second every now and again to remind ourselves that wealth is not just measured by how much money you have in the bank.

This month we'll continue to build on the Three Pillars of Wealth philosophy.

- **Personal wealth**: Since it's tax-time, I think it's a good idea to review the issue of personal tax and how it is calculated. I'll also review the sort of audits the Tax Office completes so you know what you might be up against.

- **Business wealth**: It's time to move into Step Three of my business planning model. I'll outline ways that you can build a sustainable competitive advantage.

- **Real estate:** I'd like to build upon the August 'Hot Topic' with another PATTERN™ Template that provides a framework for how you can evaluate the numbers on a potential property acquisition. I strongly encourage you to work your way through the August Hot Topic before proceeding.

Personal Wealth:
Certainties in life... Birth, Death and _______?

I appreciate that some members may already be familiar with this topic, but I feel it is important to start at the basics so more complex topics can be discussed in the future.

Unless you use the services of a tax agent, your personal income tax return must be lodged with the Australian Taxation Office by the end of next month (October). Those who use a tax agent may have up until next March before needing to file your return.

Tax is a very simple concept that has been made unbelievably complex. My initial response to nearly every tax question is "it depends", because the tax rules are almost always to be applied on a case-by-case basis. Nevertheless, we can still analyse some of the ground rules.

All governments need money to carry out various services and the principal way funds are collected to provide these services is taxation.

Progressive Tax System

In Australia, we have what's known as a progressive personal tax system, which means the more you earn, the more tax you pay. In fact, the progressive tax rates are as follows:

Taxable Income	**Cents in the dollar in tax**
$0 to $6000	Nil
$6,001 to $20,000	$0 + 17% on excess
$20,001 to $50,000	$2,380 + 30% on excess
$50,001 to $60,000	$11,380 + 42% on excess
$60,001+	$15,580 + 47% on excess

The exact amount of tax you have to pay is calculated by taking your *taxable income* and multiplying it by the appropriate marginal tax rate. You then deduct any rebates or tax credits that you may be entitled to.

Your *taxable income* is calculated by deducting your *allowable deductions* from you *assessable income*.

If you earn a salary or a wage, then you will have tax automatically deducted from your pay under a system known as pay-as-you-go (PAYG).

You will be entitled to a tax refund if the sum of your PAYG withdrawals is more than the tax payable on your taxable income.

Similarly, you will owe the difference if your tax payable on your taxable income is more than the amount deducted through PAYG withdrawals.

The table below summaries how your refund or tax payable is calculated:

Assessable Income	$
Less Allowable Deductions	$
Equals Taxable Income	$
Multiplied By Your Marginal Tax Rate	%
Tax Payable	$
Less PAYG Withdrawals	$
Less Other Rebates / Credits	$
Tax Payable Or (Refund)	$

This brings in the first rule of personal tax that many people misunderstand:

You Can Only Generally Obtain A Refund
Of Tax You've Actually Paid

Sometimes tax may have been paid on your behalf (such as franking credits on dividends received), but the rule is the same... you will only receive a refund of tax which you have already paid. You cannot create a refund from thin air.

Tax Returns & Self Assessment

Your tax return must be on the appropriate form. This form is really just a massive data input sheet, which means that in the first instance your return will be scanned and input by a computer.

Your tax file number is simply a tracking device. As you'll see in a minute, it allows the tax office to create a file under which to store data about you at the same time as linking third party information back to the disclosures you make in your own return.

We operate under a system of self-assessment, which means you have to tell the Government how much tax should be levied in your circumstance. You can put down anything and it's likely to be accepted, but get it wrong and you may be hit with interest (currently 13.86% per annum) plus potential penalties (ranging up to 90% of the tax payable).

Your return will be scanned into a computer and then processed against pre-set validity checks. If you are within the Australian Taxation Office parameters of normal, then your return will be processed and you are unlikely to ever be audited.

But if you are somehow seen as abnormal or high risk, then you can expect closer scrutiny of the accuracy of the information you've submitted.

Keeping Records

You are generally required to keep tax records for at least five years from the date of lodgement of the tax return, although if fraud is suspected, then the Tax Office can look beyond this five- year limitation.

What Happens If You Are Selected For An Audit?

The Taxation Office has the right to complete a tax audit, which is usually a thorough investigation by trained tax investigators to ensure you have complied with the tax laws.

In the majority of cases, the audit is designed to ensure you have included all your income and that your deductions are legitimate.

As an individual taxpayer, you may be subject to one of the following types of audit:

<u>Income Matching</u>: The Government receives information from various sources about income that is paid to you. For example, interest, dividends, social security benefits etc. They then use your tax file number to match the third party information against the disclosures you've made in your personal income tax return, and differences are flagged with a 'please explain'.

<u>Desk Audits</u>: These sorts of audits have become less popular. What used to happen was the Tax Office would interview a taxpayer to establish if anything has been left off the return or if all the deductions were valid. It was usually conducted in an interview format, so the direct questioning had some benefits.

<u>Substantiation Audits</u>: These are far more common than desk audits. The taxpayer receives a request via mail to provide documentary evidence about a deduction that has been claimed in the tax return direct to the investigation department.

<u>Work-related Expenses Compliance Program</u>: This is a newer style of audit that began about four years ago and focuses specifically on work-related expenses.

You are allowed to claim up to $300 of work-related expenses without documentation, but what the Tax Office found was that there was widespread misuse of this allowance, together with broader substantiation requirements.

This sort of audit is a forward-looking approach, where the Tax Office requests that the taxpayer submit substantiation information supporting the work-related expenses *at the same time* as lodging a return.

If you are selected for any sort of tax audit then I suggest you contact your accountant as soon as possible. Try to avoid dealing direct with the Tax Office, because it is important to know what your rights and or responsibilities are. Be especially careful of the information you supply, especially if it is the original documentation - always keep copies!

In summary, as an individual taxpayer, our taxation system operates on the basis of the more you earn, the more income tax you pay. You can generally only receive a refund if you have first (pre) paid tax or someone has paid tax on your behalf.

Finally, our taxation system is based on self-assessment, which means the onus on lodging a full and complete tax return rests with you. There are penalties for non-compliance and you must keep tax records substantiating the assessable income and allowable deductions for at least five years from the date you lodged the return.

If you are selected for any type of audit then I strongly recommend you immediately seek the help of an accountant as soon as possible.

Business Wealth:
Forging A Competitive Advantage

Unless you operate in an industry where there is very little competition, the success of your business will be determined by how well you differentiate your product or service.

The essential question to ask is "How or why are you different from everyone else?"

You can begin to answer this question by completing the following two sentences:

Question One: I am in the business of:	Question Two: My business will grow by:

Many businesses fail to adequately answer these two questions, or alternatively answer them in a general way, like saying I'm in the business of making money and my business will grow by attracting more clients. That's great, but you never address the issue of *how* you are going to make it happen!

Once you've answered these questions, you are ready to be let in on perhaps the biggest business secret I know...

If Your Product Or Service Is Tailored To Fulfil A S*pecific* Need Or Want,
Then You're Sure To Succeed Where Others Fail.

This is why in I asked you to link your product or service back to a specific need in the 'My Business Quadrant Template'.

The key to building a competitive advantage is to deliver a solution to your customer's need or want in a way that is better than anyone else in the market place.

Don't Be Fooled Into Trying To Capture As Many Clients As Possible!

It's likely that you already have a competitive advantage that can be used as a platform to capture new business. Review the strengths you noted in your 'SWOT' analysis and attempt to relate them back to the link between the product or service you supply and the need you fulfil.

Having considered these items, you're ready to complete the Third Business Template which can be downloaded by clicking the attached Business Template pdf.

You'll note the template is broken down into equal parts.

The left half of the template is again broken into halves. Looking at the template, you'll note the top left half requires that you answer the question of why your are in business. The bottom left half simply replicates information from your 'My Business Quadrant' Template.

Let's analyse the results. Can you link the reason(s) why you are in business back to a specific need that you are fulfilling? Are the customers you are attracting aligned with the reason you are in business?

The right side of the template attempts to link the growth of your business with your SWOT analysis strengths. My experience is

It Is Easier To Grow Your Business From An Existing Strength Than It Is By Trying To Develop A Perceived Opportunity.

Review your answers. Do you see a trend in the way you deliver solutions to your customer's needs and how you have created business strengths? Capitalising on this trend will propel you on to bigger and better results.

Once you have completed the template and some analysis, I recommend you work through the following 10 questions:

1. What is unique about the product or service I offer?
2. What do I offer that attracts new clients?
3. How do new clients find out about me?
4. How do I keep my customers pleasantly surprised?
5. How often do I communicate with my database?
6. What prompts customers to buy?
7. What are the risks associated with buying my product / service from a client's perspective?
8. What other product or service (if any) is needed before a client can buy from me?
9. What other product or service (if any) is purchased after a client has bought from me?
10. Is my product / service immediately recognised in my industry? Why or how?

In summary, the third step in my Better Basic Business Plan is to establish a competitive advantage. In most cases, you will already have a competitive advantage, it just may not be formalised or you may have never thought about how or why your market reputation has evolved.

Once you understand why people buy from you, you can develop strategies to entice new customers, at the same time as locking in existing customers by continuing to deliver solutions to their needs.

Real Estate: Making Sense Of The Dollars!

It can be very difficult to make sense of the numbers when it comes to evaluating a potential property investment purchase. The good news is I've developed a PATTERN™ Template to help you work through the process, which is available for download by clicking the appropriate Property Template pdf.

Like all PATTERN™ Templates, you should complete this *before* you submit any offer. Once you have filled in all the necessary data, I suggest you file it in your purchase file.

The great news is that I soon hope to release an 'Online Property Evaluator' that will build upon this PATTERN™ Template... perhaps as early as October, but in the meantime we'll have to make do with a manual financial calculator.

Section ❶ - Property Summary

As always, Section 1 requires that you complete some basic information about the property and the agent you are buying from to help you manage your purchase file.

Section ❷ - 11 Second Solution

By now you should be familiar with the '11 Second Solution'. It is designed to help you quickly determine whether a property is likely to be positive cashflow or not.

Section 2 walks you through the three-step process and then asks you to compare the outcome with the asking price. Tick the box titled 'Meets Criteria?' if the '11 Second Solution' outcome is more than the 'Asking Price'.

Here's an example to illustrate the point. You find a property that rents for $120 per week. In calculating the '11 Second Solution' outcome you would take this weekly rent ($120), divide it by 2 ($60) and multiply the result by 1,000 ($60,000). If the asking price was less than $60,000 then you would proceed to Section 3. You may note that the '11 Second Solution' ignores the impact of closing costs.

Section ❸ - Purchase Costs

When I began investing in property I had no idea that there were many additional costs beyond the purchase price that I paid.

These additional expenses are commonly known as 'closing costs'.

Generally it is fair to allow for about 5% of the asking price as closing costs, but until you are familiar with what makes up this allowance, I suggest you work through the items in Section 3 line by line.

It may also be a good idea to distinguish what costs can be capitalised into your loan, and what items you will need to pay for out of your own pocket (called funded costs).

Section ❹ - Rental Income

Be wary of the 'best case scenario' syndrome, which occurs when you are sold a property on the basis it is rented for 52 weeks a year, that is, never vacant.

In reality, vacancies are a silent killer of positive cashflow and it is prudent to budget for when your property will not be generating cashflow. As a general rule, I allow for 4 weeks a year, which reduces my expected annual occupancy rate to 92.31%.

Once you have calculated the 'Total Budgeted Annual Rent', it is wise to redo the '11 Second Solution' to ensure your property is still likely to be positive cashflow.

Section ❺ - Mortgage Repayments

You'll note that the PATTERN™ template has been structured to capture all the relevant parameters you will need to calculate your mortgage repayment.

Until I publish the online deal analyser, I suggest you use either a financial calculator, or the simple Excel spreadsheet I've included with this edition.

Section ❻ - Annual Cash Expenses

In this Section you need to determine what the annual cash costs of owning your investment property will be, since these costs will be funded out of your positive cashflow.

No doubt you'll need to complete some investigative work *before* you sign a contract, as it is important to be as accurate as possible. Some of the required information (such as council rates) can be derived from the sale contract, but other details can only be found by ringing around.

Section ❼ - Summary

The final section ties all the previous information together. Begin by subtracting your mortgage repayment and annual expenses from your annual budgeted rent to derive your total annual cashflow.

Then divide your total annual cashflow by your total funded costs (from Section 3) to calculate your annual cash on cash return.

Finally, compare your total annual cashflow with your risk free return, which is calculated by taking your total funded costs and multiplying it by an appropriate cash management or term deposit rate.

Analysis

When you have finished the template, ask one final question... "How many of these properties can I afford to own?"

Assumptions

This spreadsheet ignores the impact of taxation on your investment, since your mortgage repayments may include interest and principal components.

Also, some of the purchase costs will not be deductible for tax purposes. Instead, they will be deemed to form part of the cost of the property.

David has agreed to devise a PATTERN™ Template to handle the taxation implications of purchasing, owning and disposing of an investment property. This will be ready in the near future.

That's the end of the September edition.

As always, I encourage you to continue to post questions and comments on the forum and hope that you will be able to use the additional business and property resources I've introduced in this newsletter.

Watch out for more information about upcoming meetings and other special member's only offers.

Until next time remember, success comes from doing things differently.

Regards

Steve McKnight