NEWSFLASH BOOKLET

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DOMESTIC INVESTMENT PROPERTIES

(RENTAL PROPERTIES BOOKLET)

The following are just some of the matters you should consider when buying an investment property. Please discuss your particular circumstances with your accountant before you actually purchase a property, as these statements are generalised and not conclusive. Also the law changes constantly. This document is not advising you to invest in property, just discussing some of the taxation considerations.

Negative gearing

This is effectively running the property at a loss i.e the rental expenses (see below) are greater than the rent received. Note that the interest portion only of your loan repayment qualifies as a tax deduction, not the capital portion. This loss is then included in your tax return along with your other income, which reduces your total taxable income, probably resulting in a tax refund if you have paid tax at source on your other income. Your profit is then made when you sell the house. Capital gains tax may be payable but this is only payable on half the gain made and you would try to sell in a low income year, refer to discussion on capital gains tax. The costs associated with buying and selling property are high (i.e. stamp duty) so the investment would probably have to be long term to make a real profit. As time goes on you will pay more off the house or the rent will increase so the negative gearing may not be there any more. Ideally, you should be in a high tax bracket now and feel that properties are about to increase in value. Example of a negatively geared property:

Rental Income $200 p.w.	$10,400
Less Cash Flow Expenses Including Interest	10,500
Cash flow loss	100
Less Building Depreciation	1,200
	$1,300 Loss @ 48.5% tax Equals a Refund of $630.50.

Note the refund of $630 has only cost you $100 in real cash because the building depreciation is just a book entry. Building depreciation reduces your cost base for CGT purposes, if the property was purchased after 13th May, 1997. Not many properties stack up as well as the above example. Refer evaluating a rental property for more detail.

Note if you earn less than $21,600 your tax bracket is only 15% plus 1.5% Medicare levy. Accordingly, a loss of $1,300 would result in a tax refund of only $214.50. By 2007 the 48.5% tax bracket is expected to only apply to 10% of the population so make sure you crunch the numbers for your tax bracket.

Example of deductible expenses

Building depreciation for properties built after 17th July, 1985 refer to section headed Building Depreciation.

Motor Vehicle Expenses in relation to collecting rent, organising repairs, paying expenses, etc. There are various methods and requirements to calculate this claim, refer our How To Claim Your Motor Vehicle Booklet. The most popular method is to claim a rate set each year by the tax office of approximately 60 cents per kilometre based on a “detailed and reasonable estimate” of kilometres travelled. In order to use this method you must not claim more than 5,000 kilometres in the year for all claimable purposes, note if the vehicle is owned by two people they get 5,000 kilometres each. You must own the vehicle, make the appropriate election and personally incur the costs associated with the vehicle. Note if you do more than 5,000 kilometres you can reduce your kilometres to 5,000 in order to use this method or use another method.

- Travel Expenses as above i.e. airfares and accommodation if the property is in another state. A travel diary and receipts meeting the substantiation requirements would be required if away for more than 5 nights.
- Agent’s Commission to manage property.
- Telephone, Stamps, Stationery, Insurance, Advertising, Land Tax Secretarial, Bookkeeping, Tax Agent and Legal Fees regarding lease or rent recovery, not buying and selling.
- Borrowing Expenses, if more than $100 can be claimed over 5 years or term of loan whichever is the shorter period. If less than $100 can claim immediately.
- Depreciation on plant and equipment such as carpets, curtains, ceiling fans, some light fittings. Hot water systems, stoves etc.

Repairs or improvements?

Repairs and Maintenance, not improvements are deductible. For example if the house needed painting when you bought it then painting it would be an improvement or if the house did not have a garden hose then purchasing one would be an improvement, therefore not deductible. On the other hand if during the time of your ownership the hose wears out and you replace it or the paint starts to peel and you repaint, these expenses would be a deduction. No deduction is available for your own labour. Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle (IT180). IT 180 states that to claim the repair needs to be made during a financial year that rent is received. IT 180 is a very old ruling and a 2005 called Ormiston will change this refer Newsflash 118. If a property is used only as a rental property during the whole year then a repair would be fully deductible even though some of the damage may have been done in previous years when the property was used for private purposes (TR97/23). Note this does not apply if the damage was done in a period you did not own the property. If the state of disrepair the property was in at the time you purchased it is directly responsible for further damage when you own it, all the repairs relating to that damage are considered improvements (Law Shipping Co. UK). A repair can become an improvement if it does not restore things to their original state (case M60) i.e. replacing a metal roof with tiles. The whole cost of the tiled roof would be an improvement and no deduction would be available for what it would have cost you to put up another metal roof. But a change is not always an improvement. In ID 2002/330 the ATO states that the cost of removing carpets and polishing the existing floorboards is deductible. Yet in ID 2001/30 underpinning due to subsidence was considered by the ATO to be an improvement not a repair. It is not necessary to use the original materials to restore the thing or structure to its original state. Modern materials can be used even when these might be a slight improvement because they are more efficient. As long as the benefit is only minor or incidental it can still be considered a repair.

Work that replaces the whole thing or structure is an improvement not a repair. So don't pull down all of the old fence and replace it just replace the damaged area. TR 97/23 recognises that eventually the whole thing or structure may be replaced in a progression of repairs. These repairs are still deductible providing each repair is on a small scale, the progression is over a long period of time and that it is not just in reality a replacement done over time but individual repairs.

Tree removal is claimable if the tress have become diseased or infested during the time of ownership. Removal is also claimable if the tree is causing damage such as roots interfering with pipes and the damage was not present when you purchased the property. If a tree is removed because it may cause damage in the future or you are fed up with the leaf litter that has always happened since you bought the property, then you are making an improvement which is not deductible.

Note improvements that are still present when the property is sold can increase your cost base for CGT purposes.

Claimable loans

Traditionally, the interest is only claimable on a loan where the actual money borrowed is used directly to produce incomes i.e. buy the income producing property. The Roberts and Smith case of July 1992 has changed this. In this case a firm of solicitors borrowed money to pay the partners back some of the original capital they had invested in the firm. The Commissioner argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners; the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of property because technically they cannot owe money to themselves. The ruling goes on to say:

"The refinancing principle" in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships. The joint owners of an investment property who comprise a sec 6(1) tax law partnership in relation to the property cannot withdraw partnership capital and have no right to the repayment of capital invested in the sense in which those concepts are used in Roberts and Smith. Accordingly, it is inappropriate to describe a business, as a "refinancing of funds employed in a business."

IT2423 states that people who own less than three rental properties are not in business and therefore not in partnership under general law. This means that couples wealthy enough to be purchasing their third rental property can rent out their home then borrow the money to build themselves a new home and maybe claim the interest on the loan as a tax deduction against the rent earned on their old home. Note there have been a few cases were taxpayers have unsuccessfully tried to argue they are in business. In Cripps V Federal Commissioner of Taxation 1999 AATA 937 the taxpayers owned 14 town houses and other properties at various time. The ATO was successful in arguing they were not in business but the foundation of the ATO's argument was that they had an agent managing the properties. So it is crucial that you run the properties as a business i.e. fully mange them yourself.

Regarding linked and split loan facilities. These loans link a loan for the rental home and a loan for the private home together so the bank will permit repayments from both rental and wages income to be paid off the private home loan with the interest on the rental home loan compounding. Accordingly, in a short period of time the mortgage can be shifted from the private home to the rental home. As the rental loan was used to purchase the income producing property and pay interest on that property, technically all the interest on that loan will be deductible. The Commissioner says in TR98/22 this is a scheme with the dominant purpose of reducing tax and he will apply Part IVA to deny a deduction for the interest on the interest. The High Court found in Harts' Case 27-5-2004 that it was an arrangement with the dominant purpose of avoiding tax and caught by Part IVA but the court did not rule that interest on capitalized interest was not deductible. More details of the High Court's decision in Hart's Case and ways of capitalizing interest appear later in this booklet.

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A $100,000 loan used solely to purchase a rental property in financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of $2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be $98,000 owing on the rental property. In say 45 days when the borrower withdraws $1,000 to pay off his or her credit card the loan will be for $99,000. However, as the extra $1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

The next time the borrower puts his or her 2,000 pay packet into the account the Commissioner deems it to be paying only 1/99 off the non-deductible portion i.e. at this point there is $96,020 owing on the house and $980 owing for non-deductible purposes. When, 45 days later, the borrower takes another $1,000 out to pay the credit card, there will $96,000 owing on the house and $1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

In addition to the loss of deductibility, the accounting fees for calculating the percentage deductible could be high if there are frequent transaction to the account. The ATO has released TR2000/2 which confirms this and as it is just a confirmation of the law is retrospective.

To ensure deductibility and maximise the benefits provided by a line credit you will need an offset account that provides you with $ for $ credit. These are two separate accounts – one a loan and the other a cheque or savings account. Whenever the bank charges you interest on the amount outstanding on your loan they look at the whole amount you owe the bank i.e. your loan less any funds in the savings or cheque account.

Principal place of residence CGT exemption

Basically if you make a capital gain when selling your home it is exempt from capital gains tax but there are some catches and extra benefits. Ensuring that you qualify for the exemption is now more important than ever because indexing for inflation no longer applies. If you hold the property for 20 years it would not be unreasonable to expect it to double in value but with no exemption you could lose 25% of that increase in value in tax. This would mean you would not have the money to buy a similar house elsewhere or possibly not be able to afford to move.

However, if you acquired your Principal Place of Residence (PPR) after 20th September, 1985 and used it as your PPR until some time after 20th August, 1996, when it became income producing you can use the market value of the property at the time it becomes income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after it ceased to be your PPR.

Depreciation on a building

Residential buildings constructed after 17 July 1985 can be depreciated at 2.5% per year (4% if constructed between 18 July 1985 and 16 September 1987) when they are income producing (Div.10D: Sec. 124ZF-124ZLA now Section 43 & TD93/62). If the building was purchased after May 13 1997 this amount reduces your cost base for capital gains tax purposes, regardless of whether you actually claimed it or not, so in effect you are getting a tax deduction now in return for a higher tax bill when you sell. This may work against you if you are now in a low tax bracket relative to when you sell. With the new Capital Gains Tax laws only taxing half the gain it would be unusual to end up paying more tax on the gain than what you would have received in refunds over the years. If the building was purchased before 13 May 1997 the Section 43 deduction does not reduce your cost base for capital gains tax purposes unless you make a loss on the sale. If you claim this depreciation the building and the land are considered separate assets for capital gains tax purposes (TD/93/D266). This could be useful if you build an income producing property on the same land as your principal place of residence. Care should be taken when purchasing a property to enquire whether the previous owners claimed Div.10D depreciation. You can claim Div.10D even if you are not the owner who originally built the home. If you can't get the actual cost from the previous owner you can have it estimated by a quantity surveyor. Warning – The legislation regarding properties purchased after 13 May 1997 actually states that the cost base is to be reduced by all building depreciation <u>claimable</u>. If this law is interpreted literally by the ATO, foregoing the deduction in years of a low or zero tax bracket will not prevent you having to "pay back", when you sell, what you could have claimed and probably at a higher tax rate. The ATO has stated in TD 2005/47 that you only have to reduce the cost base by the building depreciation that could be claimed if you amended your previous tax returns. In other words as you are only allowed to amend back 4 years (sometimes only 2) any depreciation missed in the years before that will not reduce the cost base.

GST

Properties rented to households will be input taxed. This means that the rent does not need to be increased to include GST. But an input credit cannot be claimed for the GST paid on expenses relating to the property. Note rental properties leased to motel/resort/apartment management bodies are commercial rentals even though the end user may be a household. Accordingly, the above exemption of only being input taxed does not apply and it may be necessary for owners of such properties to register for GST or at least an Australian Business Number.

In media release Nat 2000/50 the Commissioner of Taxation announced that the owners of domestic rental properties will not need to have an ABN even if their tenants use part of the premises for business purposes. Landlords don't even have to have and ABN if they are renting a property to a business that is providing the accommodation to their employees i.e. The Defence Force.

The letting of domestic rental properties does fall within the definition of an enterprise. This means owners are entitled to an ABN but there should never be a need for them to have one. This also means landlords have the same responsibilities under the ABN withholding provisions as other businesses. A landlord must withhold 48.5% of a payment for rental property expenses if the invoice does not contain an ABN. For example before paying a cleaner or repairer of a property get their ABN!

Evaluating a rental property

By: Julia Hartman B.Bus CPA – Tax Accountant, Last Updated: 2005, 14th September

Firstly, I would like to point out this article is not intended to encourage you in any way to buy a rental property. It is simply a tool you can use to consider the potential of the property away from all the selling hype. Before you actually sign a contract please get an accountant to check your workings as the following is a generalisation and there may be specific issues with your particular property.

Data You Will Need:

(a) Amount borrowed

(b) Interest rate of loan. Note: unless you have no personal debt the loan should be interest only and the worksheet is based on this.

(c) The tax bracket applicable to the taxable loss or taxable profit on the property. The tax brackets for 2007 are $6,001 to $25,000 16.5%, $25,001 to $75,000 31.5%, $75,001 to $150,000 41.5%, over $150,000 46.5%. So if before buying the property you were earning $75,000pa the tax rate applicable would be

31.5% if negatively geared or 41.5% if positively geared. You need to consider whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.

(d) Building depreciation claimable per year if property built after 17th July 1985.
(e) Depreciation on any plant and equipment.
(f) Original purchase price of the property.
(g) How much you think the property will go up in value per year. If this is too difficult, don't worry as the worksheet will give you a bare minimum required and you can just decide whether it is likely to be more than that amount.
(h) The tax bracket that will be applicable to the capital gain you make when selling the property i.e. you may have retired by then and be in a lower tax bracket. You need to consider here whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
(i) Annual actual out of pocket costs of holding the property such as insurance, body corporate fees, repairs, borrowing expenses (amortised over the first 5 years of the loan), rates, property management fees and sundry expenses such as travel, stationery, phone calls etc.
(j) Rental Income per annum
(k) Estimated future selling costs such as real estate commission, auction fees, solicitor, advertising etc.
(l) Cost of purchasing the property i.e. stamp duty, solicitors fees etc.

Worksheet

Tax Calculation:

Income from Rent as per (j) above		$
Less Expenses:		
Out of pocket running expenses (i)	$	
Interest on the Loan (a) x (b)	$	
Building Depreciation if applicable (d)	$	
Plant and Equipment Depreciation (e)	$	$
	-----------	----------
Taxable Income (Loss)		$

If the above results in a taxable income do not continue with the following. You only need to consider the return verses investment in other products.

If the above results in a taxable loss calculate your tax refund as discussed in (c). Carry this amount to the cashflow analysis below.

Cashflow Analysis:

Tax Refund as calculated above		$
Rental Income (j)		$

		(m)$
Less Expenses:		
Interest Expense on Loan (a) x (b)	$	
Out of pocket running expenses (i)	$	
	------------	(n) $

Net Cash Inflow or Cash Outflow (o)		$

If (n) exceeds (m) i.e. a net cash out flow, you will need to contribute the amount above from your after tax dollars to support the property. To work out how much you have to earn to contribute take (c) away from 100 then divide (o) above by this amount and multiply by 100. Negatively geared properties are all right if you make a capital gain on sale that exceeds the accumulated losses. Note capital gains tax only applies to half the gain if you have held the property for more than a year and you could delay selling until you are in a lower tax bracket then when you claimed the deductions.

If (m) exceeds (n) the property is cashflow positively geared but as the building depreciation is reducing your cost base you still need to consider how much you will make out of the capital gain and consider how the return compares with other forms of investment.

Capital Gain:

To calculate the gain after tax on the sale of the property take your cost base, which is either the amount you purchased the property for plus holding costs not already claimed plus stamp duty, solicitor's fees and improvements. If you lived in the house before you rented it and it was first rented after 20th August, 1996 you must use the market value of the property at the time it became income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after you ceased to live in it. Calculate your capital gain as follows:

The cost of the property i.e. (f) + (l) + improvements you have not claimed **or** market value if first rented after 20th August, 1996 and improvements made since then	$	
Reduce by building depreciation claimed (d) x years held	$	

Sub Total	$	
Add costs of selling such as agents commission, auction fees, solicitors etc. (k)	$	

Cost Base	$	
Less Selling Price	$	

Capital Gain	$	(p)

Tax Payable is the rate discussed in (h) multiplied by half the capital gain (p), if you have held the property for over a year. Note the year is from your agreement to purchase to your agreement to sell not settlement dates.

Breakeven Point

Assuming you had to subsidise the property i.e. (o) was a net out flow. Does the capital gain (p) exceed the cash outflows over the years you held the property i.e. (o) x years held? If not you have lost on the deal.

If you find it difficult to estimate how much the property might sell for in the future it may be easier to calculate how much it must go up in value each year to breakeven. This is not very accurate because the years you are going to hold the property for are unknown so it is difficult to amortise the buying and selling costs. The idea is to calculate the net cost of holding the property as a percentage of the original purchase price of the property as follows note it assumes no improvements to the property.

Cash Out Flow:

Take the amount in after tax dollars that the property is costing per year to hold by the original purchase price and multiply by 100, using the letters from above:

(o) / (f) x 100 = %(q)

Reduction in Cost Base:

The depreciation claimable each year multiplied by half the tax bracket you will be in when you sell, divided by the original purchase price multiplied by 100.

(d) x (h) x 50% = / (f) x 100 = %(r) (Careful probably less than 1%)

After Tax Dollars Translation:

Only 75.75% of any gain made on the property will be available to cover the above after the capital gains tax has been paid. Accordingly, the cash flow and cost base needs to be adjusted as follows:

(q) + (r) = / 75.75 x 100 = % (s)

Conclusion:

(s) is the percentage that the property must go up in value each year just to breakeven. This is before allowing for inflation. If it does not go up by at least this amount you have lost on the deal.

It has been assumed in the above that you have not yet purchased the property so none of the concessions that effect properties bought before now have been considered. The return calculated above should be compared with other investments available. This calculator is also an excellent method of comparing houses with different rent return ratios in areas where capital growth would be different. For example Mount Isa compared to Brisbane.

Warning if you decide to rent out your home

Section 118-192 of ITAA97 deems you to have sold and repurchased your home at market value if you first rent it out after 20th August 1996. Most people thought section 118-192 was a concession to help out if they hadn't been keeping records because they never intended to rent it out. Very few people realised that this was not an optional election but binding on everyone. The depressed state of the property market when this provision was introduced has meant that some people are up for capital gains tax even when they sell the their home for less than they paid for it.

Imagine the situation where a person buys at $100,000 with a respectable 20% deposit but $5,000 is used up in stamp duty, legal fees. bank fees and searches so the bank loan is for $85,000. Very little is paid off the principle as at the start of the loan it just doesn't happen. He or she is then transferred so decides to rent out the house because the market has dropped and the house cannot be sold for as much as was originally paid for it. As it is now a rental property the logical move is to change the loan to interest only. The market recovers a little and he or she finally sells for $90,000 but the price had dropped by 20% (it happened around 1996) when the property was first rented out. He or she has made a notional capital gain of $10,000 less selling costs of say 4,000 equals $6,000 less the discount taxable income will be $3,000. This gain could push many people into the maximum tax bracket so tax could be as much as $1,455 (let alone child support and loss of Centrelink benefits and possible surcharges) on a loss! So out of the $90,000 the bank gets $85,000 the Real Estate and solicitor $4,000 and the tax man $1,455. Not only has he or she blown their $20,000 deposit (life savings) but they now have to find another $455 over the top of the selling price to pay the tax man. This is also a double tax because the original stamp duty paid on the purchase is ignored when setting the cost base on only the market value without acquisition costs.

Non residence with Australian investments

It is a lot easier to become a non resident for taxation purposes than it is for immigration purposes. If a non resident has a rental property in Australia they are still subject to Australian tax at non resident rates on it. If the property makes a loss these losses can be carried forward and offset against future Australian income. In order to carry these losses forward an Australian income tax return must be lodged for each year.

The carried forward losses described above are reduced by any exempt income received (section 36-10) but section 36-20 states that this does not include income made exempt by Section 128B - refer next paragraph.

If a non resident has interest, dividend or royalty income with an Australian source it will only be subject to Australian withholding tax and as a result will be excluded from an Australian income tax return. Note dividend withholding tax rates are 30% for residents of countries with no double tax agreement and 15% for countries with a double tax agreement but if the dividend is franked the withholding tax rate is effectively zero. Section 128B.

Note if you are a non resident there is no point in negatively gearing any interest, dividends or royalties (other than considerations unique to your country of residence) as the withholding tax is calculated on your income before deductions and these deductions would not be claimable in your Australian tax returns as the corresponding income is excluded under 128B so there would be no link of cost of earning income under section 8(1) of the 1997 Act.

A non-resident may also be liable for tax on a capital gain arising from a CGT event that occurs in relation to an asset that is connected with Australia, even if the gain does not have an Australian source

Developers who decide to rent out house built for resale

Newsflash number 33 outlined the extreme GST consequences if a developer decided to rent out a property before it is sold. The problem arose because no GST input credits are allowed for a property used for domestic rental. The entitlement to input credits was pro rataed on a time basis. As in these sorts of cases about 95% of the time the property was held and it was rented out, only 5% of the GST input credits on the land and building costs are claimable yet full GST (subject to use of the margin scheme) is payable on the sale because it is the first sale of a new home.

In the Property and Construction Industry Partnership Issues Register item number 4 the ATO has now agreed to pro rata the input credits on the basis of income received . The formula for apportioning input credits between the taxable supply of the home and the input taxed supply of rental accommodation is as follows:

Consideration for the taxable supply of the premises

Consideration for the taxable supply of the premises plus rental income

Note the above explains the calculation but spares you the details of how this is dealt with in each adjustment period as these changes do not change the article in Newsflash 37 on adjustment periods.

You should also consider reading our How Not To Be A Developer Booklet available on our web site, www.bantacs.com.au under free publications.

Interest, dividends and rent when overseas

This all revolves around whether you are a resident of Australia for tax purposes. Note you can be working overseas and being taxed on the wages you earn in that country by that country. But if you are still a resident of Australia for tax purposes Australia gets to tax your Interest, Royalties, Dividends and Rent from anywhere in the world. It is only your wages earned overseas and that meet the requirements of 23AG i.e. 91 days work, that are exempt in Australia. The interest on the overseas bank account, that your overseas wage is paid into, is taxable in Australia even if the wage isn't. Whether you are a resident of Australia for tax purpose is a question of fact but a big deciding factor is whether you have gone overseas for a period of less than 2 years.

If you are not considered a resident of Australia for tax purposes then you are not taxed by Australia (other than withholding tax) on your interest, royalty or dividend income that has a source in Australia but you are still taxed in Australia on your rental income if the property is in Australia.

Note if you make a capital gain on an asset "connected with Australia" you are subject to tax on that gain in Australia whether you are a resident or not.

Residents of Australia with Overseas Investments

This also covers Australian Residents for tax purposes that are overseas at the time, even if they are working temporarily overseas and even if their wages income is exempt under section 23AG.

Dividend Royalty and Interest Income from Investments Overseas – Under our double tax agreements this should be subject to withholding tax in the country it is earned. Nevertheless, the full amount you have earned before the withholding tax was deducted should be included in your Australian tax return as foreign income with the withholding tax shown as foreign tax credits.

Rental Properties – If your net rent income is taxed in the country the property is located in you are entitled to a foreign tax credit for any tax paid. Your net rent income is determined according to Australian tax law and included as foreign income in your Australian tax return. Section 43 depreciation is available for buildings, alterations etc which began after 21st August, 1990 section 43-20(1) or 26th February, 1992 section 43-20(2).

The foreign tax credit can only be used to offset tax payable in Australia on foreign income of that particular class but unused tax credits can be carried forward and used to cover future foreign income of the same class. Interest income is in a different class to other passive incomes.

Residents of Australia will be subject to capital gains tax on any assets acquired after 19th September, 1985 unless the applicable double tax agreement specifically excludes this. The 50% discount is available if the asset is held for more than 12 months. For the purposes of the tax return this amount is recorded as capital gains not foreign income. A capital loss is not quarantined as foreign income is, (note non capital foreign losses will not be quarantined at all after 1-7—06) a foreign capital loss can only be offset against capital gains but they can be Australian or foreign. Capital losses have special offset rules refer IT2562. In short this allows foreign capital losses to be offset against Australian capital gains first thus maximizing any other foreign capital gain and so maximising the opportunity to utilise the foreign tax credits from the foreign capital gain. If you are entitled to a credit for foreign tax on your capital gain your tax return will need to be lodged manually with a note detailing this as there is no facility within a normal tax return to record the credit.

Reader's question

Due to the recent increase in property prices a reader has a nice problem in that the value of their rental property has nearly doubled in the year they have owned it. They are now in a position to sell their own home and the rental property to build their dream home debt free. That was until they realised the huge CGT liability on the rental property.

If they move into the rental property for 12 months until their new home is completed and then sell the rental property, they have halved the portion of capital gains that will be taxable on the sale. But there are even further benefits available from section 118-140 as discussed in Newsflash 50:

> **Section 118-140** Your main residence exemption applies to two homes for a period of up to 6 months. This is intended to allow you time to sell your old home after purchasing a new one. To qualify:
>
> 1) The first home must have been your residence for a continuous period of at least 3 months in the 12 months immediately preceding the date of sale.
>
> 2) If you were not living in the first home at any time during the 12 months preceding the date of sale it can not have been used for producing income (i.e. rented out or used as a place of business).
>
> Note section 118-140 is not optional it must apply so if you have made a capital loss during the period of overlap you cannot claim it

The above does not put any restrictions on the new home so it is not relevant that it was owned for more than 12 months before the sale of the original home or that it was rented out for the first 12 months. The reader is still entitled (in fact it is compulsory) to the 6 month overlap that exempts from CGT the new home for the 6 months before they move in. Accordingly, if they sell after owning the property for 2 years and living in it for 1 year, they will now only be taxed on one quarter of the capital gain and that will then be halved to allow for the CGT discount on properties held for more than 12 months.

Tens of thousands of dollars saved by getting the right information first. This just emphasises the need to talk to an accountant before you do anything.

The 50% CGT discount

Newsflash 60

As you are probably aware you need to hold onto a property for over 12 months from the date of signing the agreement to purchase to the date of signing the agreement to sell in order to qualify for the 50% CGT discount. Some clients have been making a very quick gain on properties and are impatient to sell in case prices fall. The choice is sell now and lose a lot of the profit in tax or hold on and take a risk on future prices. From the buyers point of view they are probably more concerned that prices will continue to escalate but are not in a rush to start paying interest on the loan. In fact the chance to fix a contract at today's prices but not have to pay anything for several months could be very attractive to some buyers.

ATO ruling TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option.

Of course an option gives a purchaser the chance of avoiding entering into the contract to buy the property so you must charge a large enough amount for the option to ensure that the purchaser will exercise it after the date you specify.

Overseas rental properties

Newsflash 61

In ID2002/764 the ATO clearly states that, from 1st July, 2001 Section 160AFD allows the interest, borrowing costs etc. on an overseas rental property to be offset against Australian income to the extent that it exceeds the overseas rent received.

Note this is rental income after the deduction of other expenses such as rates, insurance and repairs. Providing they do not exceed the total amount of rent received. If the rates, insurance and repairs exceed the rent received the balance is carried forward to be offset against future foreign income and the interest is fully deductible against Australian Income.

Depreciation – Rental properties

Newsflash 68, October 03

There has been considerable publicity lately about claiming building depreciation on rental properties by having a quantity surveyor calculate the original building costs and value of plant and equipment. A good reference regarding the building costs is ATO ruling TR 97/25 available from the ATO web site. There are a couple of little catches to relying on a quantity surveyor's report. The first one being that you can only rely on a quantity surveyors report if you have exhausted all other means of finding out the original building costs. The legislation even compels the seller of a property to provide you with this information - Subsection 262A(4AJA) of the 1936 Act. The second catch is if the original owner was a spec or owner building the calculation cannot include their labour or profit.

Before you spend money on a quantity surveyor make sure you have exhausted all other means of ascertaining the original building price because the ATO will not permit you to use the quantity surveyor's report if you can ascertain the original cost. You should also find out if the original owner was a spec or owner builder. Further make sure the quantity surveyor you use is aware of the changes in depreciation rates for plant and equipment since 1st July, 2004.

Demolishing a rental property

Newsflash 71, December 03

The owner of a rental property wishes to demolish it and build a home she can live in on the site. She asks what valuations etc will be required to keep property records of the cost base for CGT purposes.

Answer:

No need to get valuation. Both the original cost of the property, the demolition costs and construction costs of the new house will be included in the cost base for CGT purposes. This property will always be subject to CGT even though the portion will decrease over the time it is used as a main residence. Accordingly, you need to keep very good records of all expenditure including rates, interest, R&M and insurance while it was your main residence.

References:

ID 2002/514 if the demolition expenses were incurred to enhance the value of the land, and are reflected in the state of the land when it is sold, they are included in the cost base, even when incurred to facilitate the construction of another dwelling.

TD 1999/79 the demolition of the house is a CGT event. But it does not create a capital loss unless money is received for it (ie insurance). ID 2002/633 says that this is because the building has a zero cost base.

Subsection 112-30(5) the original cost base is attributed to the remaining part (ie the land).

Ultimate secret plan and clever trick with rental properties

Newsflash 73, 1st February 04

In Newsflash 55 (available from our Web site) we covered National Australia Bank v FCT 1993 ATC 4914. The case resolved that a loan provided jointly to an employee and associate was 100% exempt from fringe benefits under the otherwise deductible rule even though the employee would have only been entitled to 50% because the other 50% was in regard to an associate of the employee i.e. a spouse.

Not only does this allow a high income earner to maximise the negative gearing benefits but when the property is sold at a profit the capital gains will still be apportioned on the basis of ownership. Therefore the low income spouse receives an equal share of the gain despite the fact he or she did not claim an equal share of the expenses. Further this provides brilliant flexibility in that if the low income earner becomes the higher income earner simply change the person who participates in the salary sacrifice arrangement.

There were many doubters that such a golden opportunity has existed since 1993 without being brought to public attention. To prove our point we applied to the ATO for a ruling. They took many months as they were reluctant to concede the case has set a precedent. Eventually, under threat of taking the matter to the problems resolution unit they issued their ruling and it accepted that this case was valid.

Now this ruling is a private ruling so can only be enforced on the ATO by the individual applicant. Accordingly, each employee wishing to utilise this case needs to pursue his or her employer to accept the case or apply for their own ruling to be safe. There will be a major problem with employers as they get no real benefit from the arrangement yet would be made to pay FBT if the ATO takes a narrow view or have to pay their accountants to apply for a ruling. This is probably why the concept has not yet taken off which is a shame as it can save employees thousands of dollars per year.

To solve this we have prepared a kit to present to your employer. The kit explains the whole concept in detail. There is a page for the employer, the employee and the employer's accountant. There is also a checklist of dos and don'ts to make sure you stick within the bounds of the precedent case, a worked example, suggested issues for the employment agreement, an employee declaration and booklets of advice on CGT and Rental Property Taxation Issues. The kit includes a copy of the ruling we have received and all the paperwork necessary for the employer to apply for their own private ruling by simply putting in their personal details, signing and posting. At $150 (tax deductible) the kit is considerably cheaper than your employer going through the ruling process from scratch. But more importantly it will help you explain it to your employer and your employer's accountant how simple it is for you to save tax every year. More details are available on our web site www.bantacs.com.au or phone 07 5497 6777 for a copy.

Wraps – Vendor finance arrangements

Newsflash 74, 15th February 04

If the Vendor Finance arrangement has the following features the income stream received, once the wrap arrangement has begun, is considered to be principle and interest by the ATO. The income stream received before the wrap arrangement is entered into is considered rent. Reference ID2003/968.

Typical Features of a Wrap (Vendor Finance Arrangement)

1) The purchaser pays a deposit at the time of entering into the arrangement.
2) The settlement (change of the title deed to the purchaser) does not take place for several years after the arrangement is entered into.
3) The purchaser has the right to occupy the property prior to settlement
4) The purchaser pays a weekly amount (regardless of the name it is given in the arrangement) for the right to occupy the property
5) As part of the arrangement the purchaser pays the rates, taxes and insurances on the property.
6) The balance of the purchase price to be paid on settlement of the arrangement is reduced by the weekly installments.
7) If the purchaser fails to complete the arrangement the deposit and weekly installments are forfeited.

Now what about the profit on the sale of the property? Is that normal income or capital gain and when is it taxable? Assuming an agreement similar to that described above the answer to this question revolves around whether the vendor is in the business of selling houses or an investor just realising an investment. The key issues in differentiating here, according to ID2004/25, 26 & 27 are:

1) The Vendor did not use the property for any other purpose than to enter into the wrap. A straight rental of a property before entering into a wrap arrangement would avoid this point.
2) The property was sold at a profit
3) The wrap arrangement was entered into within 6 months of the vendor purchasing the property.
4) The Vendor is in the business of purchasing properties to resell. It would be difficult for the ATO to argue this case if the Vendor only bought and sold one property.

If you are caught by all of the above then CGT cannot apply to the sale of the property as the profit on the sale is revenue in nature. If a transaction is caught as income, CGT does not apply or in other words CGT is the last option if income tax doesn't catch it. But even if you weren't caught by the above and CGT applied there would be no discount if the property was held for under 12 months. If you did hold the property for less than 12 months before entering into the wrap it is better to argue that you are in business and caught by the above because the profit on sale would be revenue in nature and as a result not assessable until settlement which could be 25 years away (ID2004/27). If you hold the property for less than 12 months but it is subject to CGT you don't qualify for the discount but would be assessable on the profit when entering into the wrap.

Section 104-15(1) of ITAA 1997 states that a CGT event happens when the owner of a property enters into an arrangement with another party to allow them to live in the property and title may transfer at the end of the arrangement. Section 104-10(3) states that the time the CGT event happens is the time of entering into a contract for the disposal of the asset, not when settlement (title passes) takes place.

For example this means that the vendor who enters into a wrap on a property that has been previously used as a rental and held for more than 6 months will be subject to CGT on the property in the financial year the wrap agreement is entered into. Accordingly, if at this stage the property has not been held for 12 months no CGT discount will be available even if they eventually end up holding the property for 25 years under the arrangement.

If you are not subject to CGT on the property because it is considered trading stock ie caught by all 4 points above, you are not entitled to claim building depreciation. Reference ID 2003/377.

Confusion over rollover relief because U.S. different

Newsflash 75 Article, 1st March 2004

No rollover relief is available on investment properties in Australia. The only rollover relief is available to active assets of a business and it specifically excludes assets that have been used to produce rental income section 152-40(4)(e).

Who says you can't buy positive cashflow properties?

Newsflash 77, 1st April 2004

I'm not talking about buying way out in a mining town. My example is based on typical properties in one of our fastest growing shires, Caboolture. The only catch is you need to be a high income earner whose employer will allow you to salary sacrifice (refer Newsflash 73). The following is based on a couple where the high income earner earns $80,000pa and the low income earners only income is the rent. They own the property jointly. **House $230,000 Rent $210pw:**

Income	$210 x 52 =		$10,920	Assume: Bldg Deprn $130,000 x 2.5%	$3,250
Less Cash Flow Expenses:				Plant & Equipment Deprn	700
Rates		$1,600			
Interest $230,000 x 6.5%		14,950			
R&M		500		Tax & Medicare on $80,000	$24,407
Insurance		400	17,450	Tax & Medicare after introducing the	
Out of Pocket			6,530	rental property & salary sacrificing the	
				cashflow expenses.	17,843
Less Tax Reduction			6,564		6,564
Positive Cash Flow			34		

Go to www.bantacs.com.au for a calculator that will allow you to work out your particular circumstances.

Landlords' depreciation

Newsflash Issue: 77

The ATO has issued a draft ruling on rental property depreciation as a preliminary to a ruling expected in May, 2004.

From a tax agents point of view I welcome the clarification. There has long been confusion over what items in a house are plant and equipment and what qualify for special building write off. This combined with uncertainty as to the effective life acceptable to the ATO has blown the budget for many purchasers who relied on information provided by ill informed Developers and Quantity Surveyors. Mind you it is not an easy task to break down these costs. Light fittings are a typical example. If a light fitting simply hangs off a light globe it can be depreciated as plant and equipment (Wimpy International v Warland 1989) but if it is fixed to the ceiling it can only be depreciated as part of the building costs and then only if part of a residential building built after July, 1985 (ID 2002/1015).

This is where the concern for investors lies as the draft ruling moves many items previously considered plant and equipment so depreciated at somewhere between 7.5 and 15% a year to now be part of the special building write off which only qualifies for 2.5% a year. These include Satellite dishes, cupboards, robes, signs and shelving. On the other hand in contradiction of ATO ruling IT242 the draft moves wall ovens back into plant and equipment.

The effective life of an item, that qualifies as plant and equipment, determines the rate of depreciation. For example the paper considers carpet to have a life of 10 years this means it can be depreciated at 10% prime rate or 15% diminishing. I strongly doubt that the ruling will be an exact replica of the draft as some of the classifications between building, articles and plant contradict case law. It is not all one sided either the changes, proposed to take effect from 1st July, 2004, in some cases will shorten the life expectancy. Stoves and Hot Water System's effective lives have been reduced from 20 years as per TR 2000/18C5 to 12 years in the draft ruling.

Note extending the life expectancies increases the time it takes to write off a piece of equipment but does not decrease the amount claimable over the life. Investors who feel they may be in a higher tax bracket in the future may even benefit by this. Regardless all the life expectancies issued by the ATO are only guidelines only. If you can justify a different rate you have the option of using it.

The ruling will only effect items purchased after 1st July, 2004 so if you are thinking about replacing the stove in a rental property it may be worth waiting until next financial. Though in view of the draft it wouldn't be hard justify an effective 12 years right now by opting to set your own life expectancy.

Rental Properties that were built after July, 1985 qualify for depreciation on the original cost of the building.

Before you spend money on a quantity surveyor make sure you have exhausted all other means. The ATO will not permit you to use the quantity surveyor's report for building depreciation if you can ascertain the original cost by other means. Subsection 262A(4AJA) requires the seller of a property to provide you with the original information. TR97/25, which is available from the ATO web site, is a good reference. You should also find out if the original owner was a spec or owner builder as the building depreciation calculation cannot include his or her labour or profit.

Residential properties, on which construction first commenced after 18th July 1985 and before 16th September 1987, are entitled to be depreciated at 4% per annum. If constructed after 16th September 1987 they are only entitled to 2.5% depreciation. Note the 4% may be attractive now but it means the property only has around 5 more years until the depreciation is finished. At the rate of 4% it is depreciated over 25 years where as 2.5% lasts 40 years.

Note the above applies even if the current owner did not own it during that period.

CGT – 50% discount – Timing

Last Updated: 2004, June 6th

In order to qualify for the 50% CGT discount you must hold an asset for more than 12 months. That is 12 months and at least one day from the date of the agreement to buy to the date of the agreement to sell. TD 94/D92 and Case 9451 (1194) 28 ATR state that a simple condition in the contract such as subject to finance will not delay the date of the contract. Only a condition precedent to the formation of the contract delays the date that the contract is deemed to be entered into. Most conditions on contracts are conditions subsequent so will not delay the contract date. To be a condition precedent it really has to be a condition that must happen before the contract comes into being. Accordingly, it would be difficult to use a condition precedent to delay a contract yet have a binding sale.

Year end tax planning for rental property owners

Last Updated: 2004, May 1st

The following suggestions really only shift tax deductions from next year into this year. Accordingly, they should not be entered into unless you are in the same or higher tax bracket this year than you will be in the following year.

1) If your loan interest is calculated daily yet not entered on the bank statement until July ask the bank to advise in writing how much accrued at the 30th June.

2) Consider buying equipment under $300 (GST inclusive) i.e. light fittings or curtains for immediate write off. Note all identical items must total under $300 so it may be worth buying one curtain in this year and another next year. If the item is part of a set it is the value of the whole set that must be under $300. The item must not be predominantly used for business purposes. Items under $1,000 can go into a low value pool for accelerated depreciation. Note that is under $1,000 per owner i.e. $1,500 for a hot water system on a property held jointly by husband and wife can go into their individual under $1,000 pool as it is only $750 each.

3) Prepay the interest on the loan for the rental property up to 12 months in advance as discussed in detail last week.

Investors who pay the bank next year's interest before 30th June, 2004 can claim the amount as a tax deduction this financial year.

The deductibility of prepaid interest, paid by an individual taxpayer in respect of a rental property for a period not exceeding 12 months is not subject to special timing rules under section 82 KZM of the ITAA 1936 according to ID2002/939.

Taxpayers who have a loan for a rental property or shares can make up to 12 months interest payments in advance and qualify for a tax deduction at the time the repayments are made. Be careful that the ATO cannot argue that it was really a repayment of capital. Make sure the arrangement with the bank is that the payment is interest. Simply putting the money into the loan account will not work as the bank will treat that as a repayment of capital. You must not make an advance payment for a period in excess of 12 months or the whole amount will only be able to be claimed in the period the interest is applicable to not when paid. Businesses do not qualify for this concession unless they elect to enter the simplified tax system. If your business is in the simplified tax system you may want to consider making 12 months lease payments in advance also.

As this arrangement is only moving tax deductions from next year into this year it could work against you if you are in a higher tax bracket next year than this year.

Hart's case decided for the ATO – Linked split loans

Last Updated: 2004, June 15th

On Friday 27th May, 2004 the High Court handed down its decision on Linked Split Loans in favour of the ATO.

I do not find it too surprising that they found that these types of loans were a scheme with the dominant purpose of a tax benefit therefore caught by Part IVA. This case was a clay pigeon for the ATO and yet it still needed to go all the way to the High Court. It was a clay pigeon because the banks marketed these arrangements on the basis of the tax savings. Therefore it was difficult for the taxpayer to argue a different motive.

It is important to remember this case does not change the deductible nature of interest or for that matter interest on interest. Gleeson & McHugh specifically stated that the question of the deductibility of interest upon interest does not need to be addressed because the issue was already decided on the basis that there was a scheme to gain a tax benefit.

The moral of the story is not to get involved with mass marketed tax schemes unless they have an ATO ruling. This is because the ATO has no trouble proving your primary motive was a tax benefit as there is always an abundance of marketing propaganda to prove this.

On the other hand don't lose sight of the fact that you are not obliged to pay more tax than necessary. In IT 2330 the ATO states:

> "Notwithstanding that an arrangement may not be capable of explanation by reference to ordinary business or family dealing and even though it may be entered into to avoid tax, it will not attract the operation of section 260 (now Part IVA) if its purpose is to take advantage of a specific or particular provision in the Income Tax Assessment Act and complies in every respect with the requirements of the specific or particular provision, i.e., the choice principle."

This approach is supported in Harts case where the judges stated;

> "If such a taxpayer took out two separate loans, and the terms of the loan for the investment property were different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then ordinarily that would give rise to no adverse conclusion under [Part IVA]. It may mean no more than that, in considering the terms of the borrowing for investment purposes, the taxpayer took into account the deductibility of the interest in negotiating the terms of the loan. How could a borrower, acting rationally, fail to take it into account?"

Unfortunately the judges concluded that such a loan was not normally available so it was not reasonable to argue it was a normal arrangement apart from the tax benefit. Ultimately it was the linking of the loans that sunk them. This should not discourage investors seeking similar loans that stand on their own merits rather than being linked to a non deductible loan.

Fine tuning this theory in relation Part IVA we need to recognise that this test has two elements. Firstly there has to be a scheme and secondly it needs to have a dominant purpose of a tax benefit. In Hart's case it was recognised that a scheme as per 177A(1)(b) can basically include any …. course of conduct. So there is no point in poking around here for a gap other than to say the legislators could not have intended this section to be so wide or it would catch everything.

So now let's look at the dominant purpose of a tax benefit test. Which must also be present for Part IVA to apply. No this does not mean that if you walk into a newsagency to buy an invoice book your dominant purpose was to gain a tax deduction for the book and as it was a "course of conduct' that is it no tax deduction because this is a tax scheme. We have to be more realistic than that. Nevertheless the High Court found that Hely J was correct in stating:

> "A particular course of action may be both tax driven, and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine in favour of the

> taxpayer whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit".

So finding another reason to justify the arrangement is not enough. It is all about the dominant purpose.
The simpler the arrangement the better, the more artificial it becomes the more it meets the definition of a scheme.

The court having disallowed the capitalised interest because it was part of a tax scheme did not have to rule on whether capitalised interest itself was tax deductible. I feel that the capitalised interest would normally be deductible providing it has not been created as part of a scheme with a dominant purpose to save tax.

Say for example you have a line of credit on your rental property and a separate loan on your home. Your tenant may pay you a couple of months rent in advance which you pay off your home loan as everything is up to date and cash flow looks good at the time. Over the next two months you have quiet a few personal expenses that take up all of your wages. Then the rates and some repairs are due on the rental property. You need to draw the funds to cover the rates and repairs from the line of credit on the rental property and due to lack of funds the interest that month has to be capitalised. Luckily you just manage to make the P&I payment required on your home loan. This scenario is not a scheme. Events just happened that way and it is not for the ATO to tell you how to manage your affairs. Linking the two loans or a systematic approach to the increase in the loan on the rental property may point towards a scheme. Just watch out for spare funds to make extra repayments on your home and don't prop up the rental property with your spare cash if you can use the equity in your rental property instead.

This principle can also work with a business instead of a rental property.

The struggle of getting your tax right

Last Updated: 2004, 15th July

I had a bit of fun with our Rental Property experts at the ATO this week.

Many rental property owners have just received a letter requesting more information to be provided when they lodge their 2004 Income Tax Return. It also includes a page with helpful advice on areas where the ATO believes mistakes are being made. In particular it states:

> *"Tenants in common may hold unequal interest in the property – one may have a 20% interest and a second may have a 80% interest; the rental income and expenses would be divided accordingly."*

I got on the phone to the ATO to ask, does this mean if I own a property as 50:50 tenants in common with my brother and he borrowed to buy his share yet I didn't borrow for my share then I could claim half of my brother's loan interest as a deduction against my half share of the rent. I added that I was quite happy to accept this as I was in a higher tax bracket than him. The first person I spoke to at the ATO didn't like that idea so said only the person who incurred the expense could claim it. I said oh good so if I pay all the rates then I can claim 100% of the rates against only my share of the rent. I got put abruptly on hold for that one.

The next person I spoke to at the ATO tried to tell me it was a case of who actually paid the bill so I painted a picture of my brother and I being disorganised and not fussed about money between us. This I must admit was a lie as you couldn't get two more anal people in regard to money but then we don't own a rental property together anyway.

I was then transferred to another extension where the voice mail told me they were on leave and to ring another extension. This involved hanging up and going back through all the mechanical options and guess what, the next extension was on leave too. I hung up again. When I rang back and explained the problem again. The person I talked to put me through to Guy Witcomb who gave me what I believe to be the correct answer. That is, the interest is deductible to my brother, as it is in regard to his share where as all other expenses were directly related to the property, so split on the basis of ownership. Guy also said that he disagreed with the statement made in the ATO letter.

I then asked him how I should prepare the tax return to be sure that I was correct and asked was there an ATO ruling or something I could rely on. He said that the only way I could be sure was to apply for a private ruling. I told him I've lodged an application for a private ruling, on another issue, in February and still did not have a reply. So at that rate I would not have an answer to this ruling before I was due to lodge my tax return. Guy suggested that I send the application for the ruling with the income tax return. I then asked him should I prepare the tax return according to the letter they sent out. He said it would be alright if I did as there would be no penalty if it was wrong but I would be up for over 11% interest on the amount of tax under paid during the time the ruling was being processed.

What was most alarming was the number of people I spoke to at the ATO that tried to come up with a plausible explanation rather than referring to the law. It appeared any story at all would do just to get me off the phone. Yet the public are asked to rely on this advice and even if they can prove that the ATO gave them the wrong advice they will still have to pay over 11% interest on the tax short fall. If they can't prove that the ATO gave them the wrong advice they could also be up for a penalty of 75% of the tax shortfall.

Rental property CGT audits

Last Updated: 2004, 1st August

Each year around this time there is much talk about an ATO hit list. In my 12 years in practice not many of the threats filter through unless they can be simply generated by a computer.

Most taxpayers know to be very careful with their interest income because the ATO's computer cross matches with the banks. The same reverence should be paid to capital gains made on rental properties. The ATO is well aware that the property boom will be a huge boost to revenue.

The ATO computers have two ways of catching you out. Firstly, the ATO computer will automatically send you a questionnaire if you stop declaring rent income without completing the CGT section of the tax return. If that doesn't catch you out then the ATOs data matching with the titles office is sure to get you.

Unlike audits involving human intervention these computer generated questionnaires will happen 100% of the time so it is not just a case of are you feeling lucky.

Evaluating a rental property - Another angle

NewsFlash Issue: 90, By: Julia Hartman B.Bus CPA – Tax Accountant, Last Updated: 2004, 15th October

The following may be hard to work through but it is important you understand the issues involved before you purchase a rental property. The rent return compared to purchase price has been eroded over the last couple of years. So much so that you can expect to be out of pocket each week to help support the property. Your tax bracket has considerable bearing on just how much you are out of pocket. Note the maximum tax bracket is $70,000 in 2005 and $80,000 in 2006. You need to be in this bracket by at least the amount of the tax loss on the property to use the calculation for the maximum tax bracket. The following example, I feel is very generously in favour of the rental property as it is based on an expected return of $300 per week rent on a property purchased for $350,000, that is a 4.5% gross return. It also assumes that the property is rented all year. The return had to be this good just to get the necessary capital growth reasonable. So please do the numbers if your gross return is less than this.

Assumptions:

Property Cost $350,000 Original Building Costs $200,000 Interest Rate 7% on the full $350,000

Rental Income $300pw	$15,600
Rates R&M Insurance etc	4,000
Interest $350,000 x 7%	24,500
Building Deprn 200,000 x 2.5%	5,000
Tax Loss	17,900

Note Building Depreciation Reduces the Cost Base

Now if you are in the 48.5% tax bracket by the amount of the loss (ie Over 87,900 this year and $97,900 next year) your refund will be $17,900 x 48.5% = $8,681. So the cash flow on this rental property, for someone on nearly $100,000 per year would be.

Rent	$15,600
Tax Refund	8,681
	24,281
Less: Rates etc	4,000
Interest	24,500
Out of Pocket	4,219

The best case scenario is a drain on the family budget of $4,219 per year or $81 per week. In order to justify this cost the property must go up in value 2% a year before making any real profit or allowing for inflation. This is calculated as follows:
The annual out of pockets are $4,219 in after tax dollars per year or in other words 1.2% of the original cost
The building depreciation reduces the cost base by $5,000 per year. So every year there is an accumulating tax bill of $5,000 x 24.25% = $1,213 or 0.3% of the purchase price
Gain will be effectively taxed at 24.25% in other words only 75.75% of the gain will be available after tax.
Gain Required each year ;
(1.2 + 0.3) / 75.75 x 100 = 2% Per Year Before making any real profit or allowing for inflation

This situation is even worse if you are in the 31.5% tax bracket in fact it increases the gain required by half again because the tax refund is much less. Further when the property is sold it will probably push you into the 48.5% bracket therefore you will be taxed on any capital gain the same as the example above. This means the taxpayer in the 31.5% tax bracket will require a 3% capital gain each year to breakeven before considering inflation.

The loss on the rental property will only result in a $17,900 x 31.5% = $5,638 tax refund so the cashflow for a taxpayer in the 31.5% bracket is as follows:

Rent	$15,600	
Tax Refund	5,638	
	21,238	
Less: Rates etc	4,000	
Interest	24,500	
Out of Pocket	7,262	$140 pw

In the 31.5% bracket the property is costing $7,262 in after tax dollars per year or in other words 2% of the original cost. The cost base still reduces by $5,000 per year. So every year accumulating a tax bill of $5,000 x 24.25% = $1,213 or 0.3% of the purchase price. The gain will be effectively taxed at 24.25% in other words only 75.75% of the gain will be available after tax. Accordingly, the gain required each year is:
(2.0 + 0.3) / 75.75 x 100 = 3% Per Year Before making any real profit or allowing for inflation.

Losing interest deductibility

Imagine how you would feel if you borrowed $100,000 to invest in shares. Then when it came time to do your tax return your Accountant told you the interest is not tax deductible because the money went from your loan to your cheque account in order to write a cheque to your broker. A recent AAT case decided that if loan funds are intermingled with other funds before being used for income producing purposes they are no longer considered to have their source in the loan.

Interest is not deductible on a loan unless the proceeds of the loan have been used to purchase or relate to an income producing investment. The link can be simply lost by paying some spare cash off the loan and drawing it back later, or not being able to trace the flow of the funds to the investment. The ATO's own ruling states "a rigid tracing of funds will not always be necessary as appropriate." Yet in Domjan and Commissioner of Taxation [2004] AATA 815 the ATO successfully argued that the placing of borrowed money into a savings/cheque account with other personal funds broke the link necessary to prove the funds were borrowed for tax deductible purposes.

The AAT is not the highest court in the land but relevant nevertheless. The sitting AAT member stated:
"I accept the Commissioner's submissions. Where the funds have been intermingled it is impossible to determine the use to which they have been put. In other words the purpose of the borrowing cannot be ascertained. It cannot be said that the expenditure – that is the payment of interest – has been incurred in the course of gaining or producing assessable income"

Mrs Domjan also tried to argue that when she deposited private funds into her loan account they were quarantined from the loan so when she drew money from the loan for private purposes it was simply a redraw of those funds, not a separate loan for private purposes. She also contended that any private funds put back into the loan after the redraw should go only towards reducing the loan for private redraws. Further she should not be penalised for using her private funds to temporarily reduce the interest on the loan and as a result reduce her tax deduction. The AAT found that the funds could not be divided so all repayments were to be spread equally over the loan and she could not choose the character of the funds she was redrawing from.

Mrs Domjan was in for a penny in for a pound. She even claimed that as the bank required her to insure her home because it was security on the loan, the insurance should be tax deductible. No luck here either.

The AAT also found that when Mr Domjan used a lump sum he personally received to pay off his half of the loan, the amount had to still be split equally between them as they were co debtors on the loan. Therefore even though he had paid his share back he was still entitled to claim half the interest that related to Mrs Domjan's share. As a result of this it would now be prudent, when only one member of a couple is borrowing to buy their share of an income producing jointly owned investment, the loan should only be in his or her name, not both. Trying to get a bank to agree to this may be a problem. If the bank will accept the non borrowing partner only giving a guarantee and his or her name does not actually appear on the loan, the problem may be avoided.

What was alarming was the fact that Mrs Domjan, who prepared her own tax return received, a 25% penalty on the basis she had been careless in claiming the interest in relation to the redraws. The ATO's argument being she had been careless in relying on a draft ruling after the final ruling had been issued. In the ATO's world taxpayers preparing their own tax returns should have a knowledge of the thousands of ATO rulings available and check regularly for updates. The AAT agreed with the ATO. I have quiet a problem with this conclusion because unlike the draft ruling the final ruling did not cover redraws. So the ATO's argument is really that Mrs Domjan should have followed up the daft to read the final ruling and then realise that by ommitting parts of the draft but not issuing a counter view the ATO was really saying they no longer held the view expressed in the draft. The issue of redraws was eventually addressed in another ruling 2 years after Mrs Domjan had lodged the returns in questions.

Probably Mrs Domjan greatest mistake was representing herself before the AAT. Though I have no answer as to how the average taxpayer can afford to be equally represented against the ATO and its unlimited, taxpayer funded, resources.

Depreciation on improvements

The following is an extract from Leary & Partners (Phone 1800 808 991 P/L Accountants News. I find their honest approach very refreshing because I am fed up with Quantity Surveyors advertising just pay me the money and I will get you lots of tax deductions, when they are not responsible for the tax return. Leary and Partners make a great effort to be correct by employing Kaylene Arkcoll. The contents of this article has our full support though we would like to point out if a roof is replaced in its entirety it would not be considered a repair but an improvement.

Despite what most taxpayers believe, purchasing a house that has had a post 1985 refurbishment or alteration does not automatically guarantee them a Division 43 deduction. They must first prove the three W's: What? When? And Why? An often impossible task. Much of the frustration and disappointment we have observed could have been avoided if the taxpayer had simply consulted their accountant prior to purchase. Empowered with the following basic advice they could have made a fully informed investment decision.

Before they claim a Division 43 deduction a taxpayer must be able to establish:

a) the scope of the work done
b) the date at which the work was done
c) the cost of the work and
d) whether the work was of a type that qualifies for a Division 43 deduction.

If they are unable, or unwilling, to obtain reasonable proof of these facts (as decided by the ATO), they are not entitled to a Division 43 deduction. Claiming a deduction without the required proof could result in both rejected claims and penalties. As quantity surveyors, we can assist the taxpayer meet requirement c, but only if they have the documentation necessary to satisfy the other three requirements.

Ideally the claim should be based on formal documentation. This may take the form of architectural drawings, specifications of works, contract documents, receipts or photographic records of the works. If formal documentation of this style is not available, it may still be possible to substantiate a claim if the basic details of the work can be obtained from the property owner at the time or the contractor. How much documentation is required and in what form will depend on the nature of the work. Brief notes from a phone conversation with the previous owner may be appropriate for a claim on a minor item such as a security grille but may not be sufficient as sole documentation for a large, complex refurbishment claim.

Some of our clients believe that simply by inspecting a building a quantity surveyor should be able to determine exactly what was done and when. We wish this was true! Without the ability to compare the building pre and post the work being undertaken, many minor structural or aesthetic changes are impossible to detect – let alone prove to an auditor. Similarly, unless work is obviously quite new, a physical inspection is unlikely to conclusively establish a construction timeframe. Sometimes our knowledge of the industry allows us to check potential information sources that the property owner may not have considered. However, we cannot retrieve data that had been destroyed or that was never recorded in the public domain. One of the proofs of professionalism is being aware of when to say, and being prepared to say “We can’t substantiate this claim.”

TR 97/25 authorises quantity surveyors to prepare an estimate of costs where the original costs are not available. This mandate does not extend to us estimating the scope of works or time of works if documents supporting these are not available. Putting such estimates into a quantity surveyor prepared depreciation schedule does not magically make them proven fact. No matter what the schedule says, ultimately the onus of proof remains with the taxpayer.

Undocumented building additions – Properties we inspect often have a balcony, pergola, carport or shed that are not shown on the Council approved drawings. We can prove the existence and scope of these works, but not when they were done. If we take a conservative approach base the cost estimate on the earliest (and hence cheapest) possible construction date, we are advised the claim is unlikely to be challenged.

Undocumented refurbishments – We constantly find ourselves dealing with undocumented refurbishments such as kitchen and bathroom makeovers undertaken by previous owners. Even when our inspection supports the fit out of these areas being newer than the original building, it is extremely difficult for us to translate this into a substantial claim.

Unless the refurbishment included major structural alterations, there will be no council record of the work. Consequently, even if the taxpayer is certain in their own mind of the approximate age and scope of the work, they can rarely obtain hard evidence to substantiate their opinion. For example, they can’t prove whether the room was completely refurbished as a one-off project, whether it was partially refurbished or whether individual items were progressively repaired and replaced.

Further, the expenditure must have qualified as s 43-70 `construction expenditure` when it was incurred by the property owner. This will not be the case if the property owner was entitled to claim the cost as a repair deduction. This makes claims for painting, tiling, roofing, etc., virtually impossible to substantiate unless we can prove the work’s background history.

Lack of appropriate documentation regularly prevents a claim on most, if not all, of the work.

A typical example – The taxpayer bought a pre-1985 house. The vendor’s real estate agent told them that the vendor had recently rewired the house and completely replaced the metal roof sheeting. The taxpayer subsequently asked us to prepare a taxation depreciation schedule that included the costs of the re-wiring and re-roofing.

No council building approval had been granted for the work. No documentation had been, or could now be, obtained from the vendor. The real estate agent had changed company and could not be located. The electrical wiring was not by nature something that could be reliably dated by visual inspection and the roof sheeting did not appear obviously new. Further, these items could potentially have been a tax deductible repair for the previous owner.

Despite the client’s strong representation that they were entitled to a deduction, we could not include the re-wiring or re-roofing in our schedule.

Tips – These tips may assist you to maximise your claim if you purchase an older rental property.

1. Arrange with the local council to carry out a building approval and approved drawings search. Most councils will allow you to search their archives once you have a signed contract of sale. It’s worth doing this search before settlement, as unauthorised building addition may also give rise to safety and liability issues.
2. Treat with scepticism any sales advise about the scope of cost of works done by the vendor. It may contain a large degree of “marketing spin”.
3. Ask the vendor to advise in writing if they have made any alterations or improvements to the property.
4. If they have, ask them for copies of the architectural drawings and building approval documents (for large projects).
5. Even if they no longer have any physical documentation, the vendor should be able to provide you with a signed written statement containing. (i) a detail description of the work done, (ii) a simple explanation about why they did the work (e.g. to fix damaged items, to update or improve existing items or to add new items to the property), (iii) the approximate date the work was done, and (iv) possibly, the approximate cost of the works.
6. Ask the vendor if they have photographs of the property taken before any works were carried out. These will be invaluable as supporting evidence and in some cases may be sufficient by themselves.

7. Ask the vendor to advise in writing whether they used the house as their residence or for rental purposes. This may affect the tax treatment of their expenditure.
8. A print out from an accounting package showing the deduction being claimed by the previous owner is useful, but is unlikely to contain sufficient detail by itself to substantiate a major claim. (Just as it would not have been proof in its own right for the previous owner).
9. Make sure you ask for and receive all documentation before the contract is settled. If this is not possible, make supplying the documentation a condition on the contract. Vendors are often far less obliging once they have your money in their hands.

Negative gearing

The increase in the maximum tax bracket and the relatively low rental returns due to increased house prices means that a negative geared positive cash flow property is not only hard to find but no longer suitable for most investors.

Negative gearing is effectively running the property at a loss, that is rental deductions exceed the rent income. A positive geared property is one where the rent exceed the deductions. A positive cash flow property can be either negative or positively geared but the cash out flows from the property are less than the cash in flows. It is easy enough to understand how this can happen with a positively geared property. For a negatively geared property to be cash flow positive the taxpayer is entitled to claim tax deductions for expenses that do not affect cash flow. The most common example of this is depreciation on the building, carpets, hot water system etc. If your intention is to negative gear to the max you would borrow 100% of the purchase price on an interest only loan. This means the money to buy the building, carpets, hot water system etc. was not a cash outflow to you. It was a cash out flow to the bank. Your only cash outflows are interest, rates, insurance, repairs, agents fees etc. Your tax return will include a deduction for all these amounts plus depreciation. If the property is running at a loss for tax purposes, the loss can be offset against your wages income, on which you have already paid tax. This should result in a tax refund which is another cash in flow from the rental property. For example a $300,000 property, 100% lend, earning $350 per week rent. A little too good to be true these days even for places like Emerald so this gives you an idea of how difficult it is to get a positive cash flow property now:

Based on $350 per week	Tax Return		Cash
Rent	$18,200		$18,200
Tax Refund $8,656 x 48.5			4,198
Less:			
Rates	1,500		1,500
Insurance	400		400
Agents Fees	1,456		1,456
Interest	18,000		18,000
Repairs	500		500
Depreciation	5,000		______
Taxable Loss	8,656	Net Cash Inflow	542

Note the above assumes the taxpayer is in the 48.5% tax bracket even after deducting the taxable loss. The maximum tax bracket for the 2005 financial year starts at $70,000 and in 2006 it will start at $80,000. So to achieve the outcome above you need to be earning $88,656 or more. If you are only in the 31.5% tax bracket, or the rental loss puts you there, your tax refund will only be $8,656 x 31.5% = $2,727. This means the above property would be cash flow negative by $929 per year, despite the extremely good buy it appears to be.

If your property is cash flow negative you are looking to make your profit out of the sale of the property. If you keep the property for more than 12 months you will also qualify for the 50% CGT discount. So even if the sale pushes you into the maximum tax bracket you are still only really paying 24.25% (48.5% / 2) tax on any profit you make.

Now for the Sunday morning brain wakeup. If a property cost you $300,000 its probably only going to return you $250 per week at best. So even if you are earning the $93,440 per year needed to keep the negative gearing benefit in the maximum tax bracket it would be cash flow negative $1,922 per year in after tax dollars. To make $1,922 in after tax dollars on the sale, the property needs to increase in value by $1922 / (100-24.25) x 100 = 2,537. Further any building depreciation you are entitled to claim during ownership increases your taxable capital gain on sale. Assuming the building depreciation is $4,000 per year this is accumulating a tax bill for you of $4,000 x 24.25% = $970 each year. Paying tax is not tax deductible so in order to get the money to pay this extra $970 in tax the property will need to go up $970 / (100 – 24.25) x 100 = $1,281. So the property needs to go up in value by $2,537 + $1,281 = $3,818 per year. Which is only 1.3% of the purchase price. But if you were in the 31.5% bracket when you owned the property and the capital gain on the sale pushed you into the maximum tax bracket then you would need the property to go up by $4,206 / (100-24.25) x 100 = $5,552 plus $1,281 = $6,833. Which is 2.3 % of the purchase price. So the tax bracket does matter and very few investors will be in the maximum tax bracket after deducting the rental loss.

Based on $250 per week	Tax Return		Cash
Rent	$13,000		$13,000
Tax Refund $13,440 x 31.5			4,234
Less:			
Rates	1,500		1,500
Insurance	400		400
Agents Fees	1,040		1,040
Interest	18,000		18,000
Repairs	500		500
Depreciation	5,000		
Taxable Loss	13,440	Net Cash Out Flow	1,922

Note building depreciation only applies to work done after 17th July 1985. Between 1985 and 1987 the depreciation rate was 4% which means these properties only have 5 to 7 years depreciation left. Work done after 16th September, 1987 is depreciated at 2.5% over 40 years.

Travel costs and initial repairs for a rental property

If a repair was necessary when you purchased a rental property it cannot be claimed as a tax deduction because it improves the property beyond that state it was in when you purchased it. These repairs are referred to as initial repairs. The cost of initial repairs can be included in the cost base of the property so you do receive some benefit when the property is sold. Note the cost of your travel and accommodation cannot be claimed as a tax deduction at the time the initial repair is carried out nor can it be included in the cost base when the property is sold. In ID 2004/732 the ATO states that travel and accommodation do not meet the definition of capital improvements.

Caution with rental property interest

You are only allowed to claim interest if the money borrowed was used to buy something that was income producing. Accordingly, if you use a line of credit to pay off your credit card that you have been living off then that amount was borrowed for non tax deductible purposes. This makes an awful mess of a normally tax deductible loan and can reduce it to 100% non tax deductible within 5 years because any repayments have to be pro rataed between the loan for the Rental Property and the loan for the Credit Card this of course means a larger portion of the repayments pay off the Rental Property and the portion of Credit Card debt increases each month.

We also now have Domjan's case to contend with. Unless there was a clear connection between the monies borrowed and the expense the interest is not deductible. In Domjan's case the placing of borrowed funds into a personal cheque account to pay Rental Property expenses broke the nexus and the interest on the borrowed funds was not deductible. The ATO is not enforcing Domjan yet but it does give them the precedent if they ever want to.

A substantial part of the ATO argument in Hart's case was the fact the bank marketed the arrangement as a tax minimisation scheme. If you can't afford the interest payment that month because of financial hardship and the bank lets you add it to your loan balance you will not be caught by the precedent in Hart's case.

So generally, what should you do? Note there may be better ways, looking at an individual circumstances:

1) Only use a Line Of Credit with a Credit Card used for private purposes, on a non deductible Loan
2) If other loans for Rental Properties are Lines of Credit, only draw on them for rental property expenses and make sure these expenses are paid direct not mixed with in a private cheque account or a credit card used for private purposes as well.
3) Compound interest only when financially necessary.

4) If you do not have a Main Residence or are considering buying a new one and renting out the one you are in, do not use funds in the offset account to pay rental property expenses. Draw them from the Line Of Credit keeping the offset amount as high as possible. The net result has no effect on interest but this will increase the amount of deposit you will have in the offset account for your Main Residence. When you draw this out, the original loan for the Rental Property or your old home once it is rented, is still fully tax deductible.
5) An offset arrangement is far better than a Line of Credit as it leaves the funds available for private purposes if needed.

When are rental property travel expenses claimable?

Travel re Purchase and Signing of Contract to Buy - Never claimable
Travel to Improve the Property – Never claimable ID 2004/732
Travel to Repair & Maintain the Property While Rented – Claimable against current year income
Travel to Repair & Maintain the Property While Not Rented – Claimable for CGT purposes as a holding cost, if the property was purchased after August 1991. This is the case even if you are living in the property at the time of the travel.

Travel costs and initial repairs for a rental property

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Rental property secret plan & clever trick

Salary sacrifice the cost of plant and equipment under $300 per owner and still claim the equipment under the depreciation provisions in the owners personal tax return.

An employer is entitled to claim a tax deduction for any expenses it reimburses an employee for. If the expenses are not relevant to the employer's business then a FBT liability normally arises. But if the expense is otherwise deductible to the employee or an associate the otherwise deductible rule exempts the payment from FBT. Yet it is still tax deductible to the employer just as wages to the employee would have been.

If an employee is entitled to claim depreciation on equipment for a rental property and the equipment is under $300 per owner the depreciation rate is 100%. The employee is entitled to depreciate equipment on a rental property regardless of whether he or she has been reimbursed for that expense. So in the same year both the employer and the employee get to claim a tax deduction for the same piece of equipment. From the employees point of view they get the purchase price of the equipment tax free from their employer and then get a refund of the price of the equipment multiplied by their marginal tax rate. Nice little double dip.

When you first purchase a rental property there are usually quite a few items that are under $300 per owner. But be careful if they are part of a set it is the cost of the set that must be under $300. If they are identical items such as curtains all curtains purchased that year must be under $300 per owner ie $600 if owned in name of husband and wife.

Don't despair if you purchased the property several years ago you can still take the original paper work to your employer and ask for reimbursement in the current year. The only difference is you will not be able to claim the depreciation at 100% in your personal return for the current year because you have already done so when the property was purchased.

If you can get your hands on a tax invoice for the equipment your employer would also be entitled to a input credit even though it is for a domestic rental property. As your employer has 1/11th of the price reimbursed to him or her by the ATO they should only reduce your pay by 10/11ths of the price. And yes you still get to claim the full 11/11ths in your personal tax return.

Building a spec or a rental?

Building a Spec Home:

GSTR2003/3 states at paragraph 10 "The sale of new residential premises by a registered entity in the course or furtherance of an enterprise it carries on, is a taxable supply for GST purposes." Unlike the rental property situation discussed above if you build a spec home it's sale is part of your normal business turnover so it will cause you to be registered for GST. Section 9-20(1) (b) includes as an enterprise an adventure or concern in the nature of trade. MT 2004/D3 states at paragraph 170 that an adventure or concern may be a one-off transaction that does not amount to a business. At paragraph 187 MT 2004/D3 states that the realisation of an investment does not amount to trade. So if you did not build the property to sell but only to rent then when you sell it, it is not part of a normal sale in your enterprise of rental properties and as such does not force your taxable supplies over $50,000 if all you are involved in is domestic rentals thus you are not required to be registered for GST. Even though the sale of the house would be the first sale of a new residence and therefore subject to GST you are not registered for GST so you are not caught.

If you buy land with the intention of building a home on it to sell then the proceeds of the sale are normal business income, the 50% CGT discount is not available to you and GST will apply. You are entitled to claim GST credits for the cost of building the home and purchasing the land if it was not purchased under the margin scheme. As your buyer is unlikely to be in the business of buying and selling houses they will not be able to claim the GST back.

To Rent Out Domestic Accommodation on the Land:

If you buy land with the intention of building a home on it to rent, when you eventually sell the profits on the sale are a capital gain and subject to the 50% CGT discount if it is more than 12 months between the time you agreed to purchase the land and the time you agreed to sell the house and land.

Steele's case created the precedent that interest can be claimed as a tax deduction while you hold land with the intention of building a rental property on it.

Be careful here if you sell the home within 5 years of it being built GST will apply to the sale if you are already registered for GST in the enterprise that owns the home. To be more specific, income from domestic rental properties is not normally subject to GST so the owner is not normally registered unless they have another reason such as the enterprise also has commercial rental properties. MT 2004/D3 states at paragraph 170 that an adventure or concern may be a one-off transaction that does not amount to a business. At paragraph 187 MT 2004/D3 states that the realisation of an investment does not amount to trade. When I refer to the enterprise I am quarantining transactions in relation to the enterprise. So if you are a sole trader accountant registered for GST but you also own a rental property in your own name, the sale of that rental property is not in the furtherance of you business as an accountant. Even though they are both owned by the same person they are not part of the same enterprise. If an enterprise's turnover of supplies subject to GST exceed $50,000 the enterprise must register for GST. As domestic rental income is not subject to GST an enterprise that only receives domestic rents is not required to be registered for GST. While the sale of the rental property will exceed $50,000 this is not part of the normal turnover of the enterprise so it will not create the need for it to be registered. So to get back to my original point. If your enterprise is registered for GST and you sell a new rental property within 5 years of it being built you will be required to charge GST, if you are not registered for GST the sale of a new rental property in less than 5 years will not force you to be registered providing of course you can prove that you built the property to rent not to profit from its resale.

GST and sale of properties held for rental

Even holding domestic rental properties is considered an enterprise and qualifies for an ABN but normally landlords don't bother as they are not required to charge GST on rent on residential properties. So even if their turnover is more than $50,000 it is not for supplies to which GST applies to so they are not required to be registered. The eventual sale of the rental property will turnover more than $50,000 but this is not included in the $50,000 test unless they are in the business of selling rental properties. So if you are just a normal investor in domestic rental properties your turnover of GST supplies in the course of your business is never likely to exceed $50,000. At paragraph 186 of MT 2004/D3 states that the realisation of an investment does not amount to an enterprise in its own right. Even though the sale of the property is for more than $50,000 it is not part of your turnover so will not force you to be registered for GST. If you are not registered for GST, you will not have to remit GST on the sale of a rental property. If you are registered for GST the sale of a domestic rental property will still not be subject to GST providing it is not considered the sale of a new home. Refer above.

Landlords are required to charge GST on rent for commercial premises if they are registered for GST. They are required to be registered for GST if their rents for the year exceed $50,000. Now the $50,000 is in turnover so it doesn't include the sale of capital assets but if you are registered for GST when you sell it you may be required to remit 1/11th of the selling price in GST. If you have built or substantially renovated the rental property within 5 years before you sell, you need to read the above article about new houses.

MT2004/D3 at paragraph 214 points out that an asset purchased as an investment and therefore not subject to GST when it is sold can become subject to GST by being applied to an enterprise in the way it is sold ie subdividing or building on it. If this is the case you need to read the section above of Does GST Apply to the Sale?

ATO is Processing Rulings on Rental Property Kit

Over a year ago we created a kit that provided a simple method for employers to obtain a binding ruling from the ATO that they could pay their employee's rental property interest as an exempt fringe benefit. The ATO was refusing to answer these ruling applications but has finally started to respond, conceding that the arrangement is legal.

Any readers who have lodged an application and not yet received a response should chase it up with the ATO office that sent them the letter saying the matter was under review. If you still don't receive a response please e-mail julia@bantacs.com.au

Those not familiar with the concept should read the following, if they jointly own a rental property with their spouse and they are in different tax brackets. In short the kit effectively moves income from the high income earner to the low income earner.

The National Australia Bank (1993 ATC 4914) case resolved that the interest on a loan provided jointly to an employee and associate was 100% exempt from fringe benefits under the otherwise deductible rule even though the employee would have only been entitled to a deduction for 50% because the other 50% was in regard to an associate of the employee i.e. a spouse.

Not only does this allow a high income earner to maximise the negative gearing benefits but when the property is sold at a profit the capital gains will still be apportioned on the basis of ownership. Therefore the low income spouse receives an equal share of the gain despite the fact he or she did not claim an equal share of the expenses. Further this provides brilliant flexibility in that if the low income earner becomes the higher income earner, simply change the person who participates in the salary sacrifice arrangement.

There are many doubters that such a golden opportunity has existed since 1993 without being brought to public attention. To prove our point we applied to the ATO for a ruling. They took many months as they were reluctant to concede the case had set a precedent. Eventually, under threat of taking the matter to the problems resolution unit they issued their ruling and it accepted that this case was valid.

Now this ruling is a private ruling so can only be enforced on the ATO by the individual applicant. Accordingly, each employee wishing to utilise this case needs to pursue his or her employer to accept the case or apply for their own ruling to be safe. There will be a major problem with employers as they get no real benefit from the arrangement yet would be made to pay FBT if the ATO takes a narrow view or have to pay their accountants to apply for a ruling. This is probably why the concept has not yet taken off which is a shame as it can save employees thousands of dollars per year.

To solve this we have prepared a kit to present to your employer. The kit explains the whole concept in detail. There is a page for the employer, the employee and the employer's accountant. There is also a checklist of dos and don'ts to make sure you stick within the bounds of the precedent case, a worked example, suggested issues for the employment agreement, an employee declaration and booklets of advice on CGT and Rental Property Taxation Issues. The kit includes a copy of the ruling we have received and all the paperwork necessary for the employer to apply for their own private ruling by simply putting in their personal details, signing and posting. At $150 (tax deductible) the kit is considerably cheaper than your employer going through the ruling process from scratch. But more importantly it will help you explain it to your employer and accountant how simple it is for you to save tax every year.

More details of the kit are on our web site. The calculator has been up dated for the 2006 tax rates. If you wish to purchase a kit please ring the Ningi office on 07 5497 6777. You may also like to visit the ATO web site and read ID 2005/219 which is a summary of a response to an application along the lines of the kit.

Lease options

A lease option is a rental agreement where the tenant has the option to buy the premises at a time set in the future at an already agreed price. You may recall a Newsflash article on wraps in February 2004. This article pointed out that unless a wrapped property had been used for rental purposes, before the current tenant then the sale of the property would not be subject to CGT and the 50% discount. Instead the profits would be taxed as ordinary income but the tax would not be payable until settlement. On the other hand if the property had previously been rented then CGT and possibly the 50% discount applied but the catch was that the tax would have to be paid in the year of the wrap not on settlement.

Lease options remove this problem. The exercise of an option not the granting of it, is the trigger of a CGT event. Further the house being subject to a rental arrangement before the exercise of the option may satisfy the ATO that the primary purpose of owning the property was to derive rent not for resale at a profit. A property purchased to rent out will be subject to CGT on the sale and possibly the 50% discount. On the otherhand where a property is purchased with the intention of resale at a profit it would be subject to normal tax rates with no 50% discount.

Section 104-15 states that tax the CGT event happens when the prospective purchaser has the right to the use and enjoyment of an asset and there is an agreement that the title will eventually pass to that person. The section is stated as intending to apply to hire purchase agreements but does not exclude other arrangements. The ATO in TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option. These two statements can only be reconciled by the assumption that an option is not an agreement where the title will eventually pass because the event is uncertain.

Lease Options certainly seem to be an improvement on wraps from a taxation point of view. If you are new to the whole concept of wraps and lease options have a look at our article on Wraps in our Capital Gains Tax booklet under free publications on the web site. For more information on Lease Options visit
www.naked-investor.com

Please do not take the above as a recommendation of Lease Option arrangements or support of the information on the naked investor web site. We are simply advising on the tax consequences.

Reader's question

A reader was recently told by his accountant that he could not claim the interest on his investment property while it was being built because it was not technically available for rent. This issue was resolved many years ago in Steele's case where the intended use was what counted.

The ATO accept this in their Rental Properties 2003-2004 publication NAT 1729. The booklet, on page 9 says that interest is deductible while the building is in progress if the intention is to rent it out. It even goes so far to say if the owner changes his or her mind and decides to use the building for private purpose the interest then becomes non deductible. This leaves the door wide open to claim interest right up until the time you change your mind, the only problem being proving that you originally intended to use it for rental yet never did.

It is not recommended that you do this with a home that becomes your main residence as the effect it has on your main resident exemption is probably not worth the initial tax deduction.

Considering repairing your rental property before June 30th

You will not be entitled to a tax deduction for the expenses you incur if you replace something in its entirety. For example replace a worn fence a bit at a time over a few years rather than all at once. Replacing all the cupboards in a kitchen so they match rather than just the damaged one will mean that none of the expenditure is deductible on the other hand replacing a vanity can be deductible as a repair if the pipes from the old vanity are used.

Durable items for a rental property normally need to be depreciated over time but if they are under $300 they can be written off immediately. Like items must be added together when applying the $300 test so it may be better to buy one set of curtains this year and wait until July before you buy the next set.

Make sure any work you do qualifies as repairs not improvements. For example if the house needed painting when you bought it then painting it would be an improvement or if the house did not have a garden hose then purchasing one would be an improvement and therefore not deductible. On the other hand if during the time of your ownership the hose wears out and you replace it or the paint starts to peel and you repaint, these expenses would be a deduction. A repair can become an improvement if it does not restore things to their original state i.e. replacing a metal roof with tiles. But a change is not always an improvement. The ATO says the cost of removing carpets and polishing the existing floorboards is a deductible repair yet underpinning due to subsidence is considered to be an improvement.

Tree removal is claimable if the trees have become diseased or infested during the time of ownership. Removal is also claimable if the tree is causing damage such as roots interfering with pipes and the damage was not present when you purchased the property. If a tree is removed because it may cause damage in the future or you are fed up with the leaf litter that has always happened since you bought the property, then you are making an improvement which is not deductible.

Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle It is better not to make repairs in a financial year during which you may not receive any rental income. If a property is used only as a rental property during the whole year then a repair would be fully deductible even though some of the damage may have been done in previous years when the property was used for private purposes

Div 43 building depreciation

If your rental property was constructed after 17th July, 1985 then you are entitled to claim building depreciation but it is not all good, you also have considerable responsibilities under the legislation.

Back on 13th May 1997 government announced that any rental properties purchased after that date would have their cost base for CGT purposes reduced by any building depreciation that was claimable. The key word here being claimable. This meant that even investors who did not bother to claim the building depreciation were still required to calculate what they could have claimed in order to reduce their cost base when calculating the gain on the sale. In many cases this meant that they had to incur the cost of a quantity surveyors report to calculate the original building costs.

It is nearly 9 years later but the ATO has finally acted to make this situation a bit fairer. As announced in Newsflash 118 taxpayers who have not claimed building depreciation while owning the property only have to reduce their cost base by the depreciation they could have claimed over the last 4 years as they are only entitled to amend back that far. This seemed a little fairer as it allows the taxpayer to recoup some of the costs of the QS report by amending previous years and only having to reduce the cost base by the depreciation you can claim. Nevertheless, taxpayers were still trapped into incurring the expense of a QS report.

PSLA 2006/1 has made this situation even fairer. It is the ATO's opinion that if you have not been prepared to incur the expense of a QS report in order to qualify for the deduction during the period of ownership you should not be forced into incurring the cost just to calculate your capital gain. Accordingly, if there is no other method of ascertaining the original building costs other than a QS report you are not required to reduce the cost base by any claimable building depreciation as long as you have not claimed any during the period of ownership. But note PSLA 2006/1 goes to great lengths to set out when and only when it would consider your only method of obtaining the original building costs is a QS report. For example when the seller has moved somewhere overseas and you have no way of finding him or her. It also points out that the person you purchased the property from is required by law to provide you with this information if any previous owners have been claiming building depreciation. But it does recognise that even if you were the one who incurred the building costs there are circumstances where this information would be considered not available. It does not give an example but I presume this would be where the house was a private residence and rented out many years later when the original invoices etc had been disposed of.

There are two vital points to PLSA 2006/1 the information must not be available and the taxpayer has not been claiming division 43 depreciation during any of the time of ownership. It does not say so but the examples give the impression that if you do know where the person you purchased the property from is you must insist upon them providing you with the information as they are required to do under section 262A (4AJA) of the 1936 Act.

Property owners who are relying on a QS report to calculate the original building costs should also look at the examples provided in PSLA 2006/1 as they show when the ATO considers that you have no other option than to rely on a QS report. Note you are only permitted to use a QS report to ascertain the original building costs if there is no other means available.

Section 262A (4AJA) requires the seller of a property that includes building works begun after 26th February, 1992 on which the seller or a previous owner has claimed building depreciation to provide the buyer within 6 months of the end of the financial year in which the sale occurred, the information necessary to ascertain the original building costs. So a major concern for property owners where works were performed after 26th February, 1992 is how on earth do they get this information to provide to their purchaser when they sell. It is interesting that there does not appear to have been any litigation on this matter over the last 14 years as I doubt that sellers ever meet their obligations under this section. The trouble is if you don't enforce it when you buy then it could be enforced on you! Lucky the Governments policy is to minimise the red tape created by legislation.

Just why houses are so expensive

The following has been reprinted with the kind permission of Australian Property Investor Magazine. They publish a monthly magazine with statistics on every State and lots of interesting articles. They also publish a free online newsletter at the beginning of each month and this article is from that online newsletter. You can subscribe to this free newsletter by going to www.apimagazine.com.au/newsletter.

Australian PropertyInvestor

Government fees cost more than land

Taxes and compliance costs make up one-quarter of the price paid for new housing in Australia, fresh research has found. The Residential Development Council of Australia says that makes government costs the largest expense that new homebuyers face apart from construction, topping even the price of land.

The Residential Development Council commissioned planning and economic consulting firm Urbis JHD to review cost structures for the development of new housing and to identify how much government-related costs have grown over the past decade.

The researchers found such charges accounted for as much as 35 per cent of the cost of a new detached house and up to 28 per cent of the cost of a new unit. They also found government-related costs had climbed rapidly in recent years, with increases in state-based infrastructure charges, compliance costs associated with increased government regulations such as the Building Code of Australia, and the introduction of the GST.

For instance, in northwestern Sydney total government costs on a house-and-land package rose 197 per cent in the past five years from $67,000 to $199,000. In Redland shire outside Brisbane, they rose 583 per cent from $19,872 to $135,799. In Melbourne, government costs were up 146 per cent from $37,052 to $91,135.

Residential Development Council executive director Ross Elliott says governments must realise that taxes and compliance costs are making houses less affordable.

"Government-related charges, levies, taxes and compliances have all played a crucial role in fuelling the substantial increase in the new housing market," he says. "Housing affordability is a national issue and governments that express concern should look at this research and understand how their actions are contributing to that problem."

Elliott says the escalating government costs are forcing some developers to shy away from housing projects. "A significant concern is that developer margins are now getting squeezed to the point where developing new estates in some areas is no longer feasible," he says. "This is contrary to the often-expressed view by governments that developers will simply absorb additional costs.

"This will not only add to concerns about housing affordability because of diminished supply, but it may also create a new problem – that of housing availability.

Property investors

In addition to the Newsflash issues discussed in the lead up to the end of the financial year, property investors should note the following:

Repairs - If you are considering doing repairs to your rental property before the end of the financial year, take care to make sure they will qualify for a full tax deduction. This will not be the case if you replace something in its entirety. For example replace a worn fence a bit at a time over a few years rather than all at once. Replacing all the cupboards in a kitchen so they match rather than just the damaged one will mean that none of the expenditure is deductible on the other hand replacing a vanity can be deductible as a repair if the pipes from the old vanity are used.

Durable items for a rental property normally need to be depreciated over time but if they are under $300 they can be written off immediately. Like items must be added together when applying the $300 test so it may be better to buy one set of curtains this year and wait until July before you buy the next set.

If you are looking to do some repairs to your rental property to reduce your taxable income before the end of the year make sure they qualify as repairs not improvements. For example if the house needed painting when you bought it then painting it would be an improvement or if the house did not have a garden hose then purchasing one would be an improvement and therefore not deductible. On the other hand if during the time of your ownership the hose wears out and you replace it or the paint starts to peel and you repaint, these expenses would be a deduction. A repair can become an improvement if it does not restore things to their original state i.e. replacing a metal roof with tiles. But a change is not always an improvement. The ATO says the cost of removing carpets and polishing the existing floorboards is a deductible repair yet underpinning due to subsidence is considered to be an improvement.

Tree removal is claimable if the trees have become diseased or infested during the time of ownership. Removal is also claimable if the tree is causing damage such as roots interfering with pipes and the damage was not present when you purchased the property. If a tree is removed because it may cause damage in the future or you are fed up with the leaf litter that has always happened since you bought the property, then you are making an improvement which is not deductible.

Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle. It is better not to make repairs in a financial year during which you may not receive any rental income. If a property is used only as a rental property during the whole year then a repair would be fully deductible even though some of the damage may have been done in previous years when the property was used for private purposes

Travel Costs - You are entitled to claim for your travel costs to inspect the property, repair it or collect the rent. Don't worry, if you do not have a log book or receipts you can use the kilometre method which, depending on the size of the motor in your car, will allow you to claim around 60 cents a kilometre. All you need is a record of the times you travelled to the property and multiply them by the distance between your home and the property or the shops and the property if you are getting materials. There is a 5,000km limit on this method but the limit is per car per owner of the car so if you also use your spouse's car your limit is extended to 10,000 kilometres. If your spouse also owns the property and you take turns in driving you can claim up to 5,000 kilometres each for the same car but this does not mean you can claim the same trip twice.

Interest etc - Consider prepaying the interest on the rental property loan up to 12 months in advance and get a tax deduction in the year that it is paid. Make sure your bank understands what you are trying to achieve. Simply depositing the amount into the loan account will not work as it will be considered a repayment of the principal.

If you have sold a rental property for less than the debt relating to it you can still claim the interest on the debt as a deduction against your other income. Take care to stay within the guidelines of the two successful cases in this regard. All the net proceeds of the sale should be used to repay as much off the loan as possible. Appear to be unable to repay the loan from the sale of other assets other than the family home. Don't refinance the loan to extend its term or increase the interest rate. You must appear to be doing all that is possible to eliminate the loan so refinancing to reduce the interest rate is ok. On the other hand if you have to change the loan from principle and interest to interest only because that is the only way you can afford the repayments as you are no longer receiving rent, you may be able to justify changing the loan.

Don't let the fact that the property has not been rented all year stop you from claiming the expenses relating to it. So you may still want to prepay interest etc on a vacant property if you need the tax deduction. Just as long as it has not been used for private purposes and your intention all year was to use it as a rental property. It may have been empty due to renovations or a suitable tenant could not be found.

Last year this issue was put to rest in Ormiston's case where a property was vacant for 4 years and he was still entitled to deductions totaling $70,000 over that period. Ormiston purchased a house he intended to use as a rental property after performing some renovations himself. 4 years down the track he had still not completed the renovations but was entitled to claim expenses such as rates, insurance, interest etc as a tax deduction, for all of the 4 years despite the fact the house never earned a cent of income. He never completed the renovations and sold the property before it was ever rented.

Depreciation - If your domestic rental property was built after 17th July, 1985 you are entitled to claim building depreciation. The rate is 4% for properties constructed before 16th September, 1987 and 2.5% for properties built after that date. This rate is applied to the building costs of the original owner of the building. This information is required by the act to be passed on by each seller of the property. If, and only if you can't find out the original cost of the building you can have it estimated by a quantity surveyor. Many investors think that they will have a quantity surveyor estimate the cost in the hope of getting a higher base for the depreciation.

Don't waste your money if you have the original costs as you cannot use the quantity surveyors report. Unlike building depreciation, you can estimate the value of the plant and equipment in a house when you first purchase it. You do not need to use a quantity surveyors report, the ATO will accept a reasonable estimate of the second hand value of items such as carpets, stoves, hot water systems, air conditioners, light fittings, fans, curtains etc

Capital Gains - If you have a purchaser interested in buying your rental property but you don't want the gain to be included in this year's taxable income yet are concerned they may buy elsewhere if you wait till July, give them an option to buy the property after June 30th. Make sure the option price is high enough that they will not back out. They will probably be glad to secure the property at today's prices with settlement date in the future. This strategy also works if you are delaying selling until you have held the property for 12 months to qualify for the 50% discount.

Back Issues & Booklets

To obtain free back issues of the fortnightly BAN TACS Newsflash or any of the following booklets visit our web site at www.bantacs.com.au/publications.php. You can also subscribe to our Newsflash reminder.

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learn how to
drastically advance **your financial future**
through property and personal investment

Australian Property Investors Network (APIN)

www.apin.com.au

What does **APIN** offer ?

Seminars & Workshops

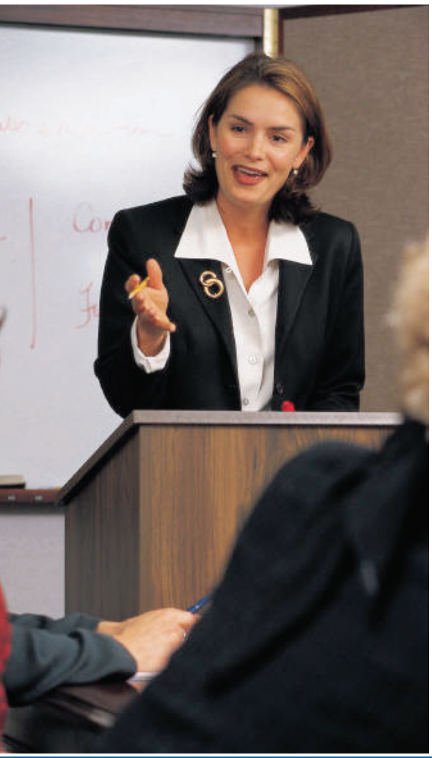
Why is that most people aren't taught how to be rich or happy? We are trained to do most things in our lives, in order to do them well enough to get by. We are taught how to read and write, how to cook, how to drive. We are taught how to do incredibly complex and challenging tasks like designing and building bridges over wide spaces, how to cure diseases, to fly airplanes, yet when it comes to creating personal wealth and happiness, we're left to find out for ourselves.

There's another, more subtle reason why most people don't achieve wealth and happiness. Deep down they don't believe that there is a choice to be made between being rich and being happy. They believe that somehow you can't have both, which is why in the end they don't get either.

The money that slips through your fingers could make you wealthy if spent more wisely.

Our free seminars and information evenings will provide you with leading edge valuable and up to date information. As a bonus you will be able to meet other like minded people who are either starting out on the road to success or are avid investors sharpening their investment knowledge. As a further advantage we encourage you to meet and freely talk with our alliance partners. These hand picked people both male and female are leaders in their own right, they are also licensed, qualified and independent.

These evenings are fun and informative plus you will have access to lots of support material in the form of e-books, books and cd's on a wide range of topics. Come and learn the many strategies used by successful investors NO SECRETS just sensible plain English techniques that really work in any market at any time.



Education

It's true what they say "*the difference between the rich and poor is what they know and what they do*". Property is more than houses and unit investing. Do you know how to buy a property using an option, how about knowing all the ins and outs of being your own "DIY Developer"?

There are many ways to make money in real estate and with the correct tools and strategies you too can play with the best.

TIME x INTENSITY = SUCCESS.

You can't expect to get results in life if you have all the information but fail to apply the principles needed to succeed.

Our programs, e-book, books and home study kits will give you the ability to learn and gather what you need at your own pace in your own time. We encourage you to learn from our expert alliance partners all that you can, so when you are ready to act you will have the education to get into your first investment or do your own JV building renovation makeover.

On going Support

Through APIN's Alliance Partners and Discussion Forums you can fortify your ideas and gain strength by exchanging information. Creating alliances generates business opportunities increasing your network and of course - your cashflow.

We have a mentoring service for those that are not quite ready to take those steps without guidance, extra information and some affirmation. Helping you to create a "*safe*" environment for your first steps.

Who is on your team?

When looking at people who are successful, you will notice they have a hand selected group of people to support and advise throughtout the journey to success.

- YOU
  - Mentor
  - Financial Planner
    - Insurance
  - Solicitor
    - Conveyancer
  - Developer
    - Architect
  - Accountant
    - Bankers
  - Coach

Property Opportunities

Through our Australia wide network we select opportunities that "stack up". We use an independent Research company (Guardian) who are licensed financial planners and real estate agents to use our pre selection due diligence program. From investment properties, development sites, future land subdivisions, building makeovers to even golf course resort projects.

APIN also align ourselves with a select group of builders and developers where we negotiate wholesale purchasing, saving you 10% off the retail price. These opportunities are not available to the public but only members of the APIN site. We can introduce you to the key people who are experts in their fields, saving you thousands of hours of frustration and heartache. Very shortly APIN will also be offering FREE property advertising on our site through resisearch.com who are one of our alliance companies. APIN is fast becoming the most exciting site in Australia.