

A photograph of a multi-story building with a balcony and a tree with autumn leaves in the foreground. The building has a dark facade and a balcony with a railing. A tree with yellow and orange leaves is in the foreground. The text "rental properties" is overlaid on the image.

rental
properties

Rental Properties

(Kindly produced in conjunction with BANTACS Julia Hartman B.Bus CPA)

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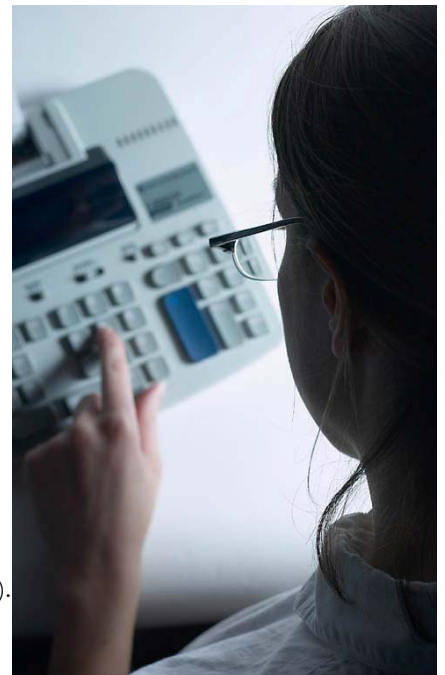
The following are just some of the matters you should consider when buying an investment property. Please discuss your particular circumstances with your accountant before you actually purchase a property, as these statements are generalised and not conclusive. Also the law changes constantly. This document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

negative gearing

This effectively running the property at a loss i.e the rental expenses (see list 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 the 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 so the negative gearing may not be there any more because your interest expense has decreased. 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 \$100 p.w.	\$5,200
Less Expenses Including Interest	<u>6,500</u>
	\$1,300 Loss @ 48.5% tax Equals a Refund of \$630.50.

Note the refund of \$630 has cost you \$1,300 so there must be some profit on the sale to make the investment worthwhile. If you earn less than \$20,000 your tax bracket is only 17% plus 1.5% Medicare levy. Accordingly, a loss of \$1,300 would result in a tax refund of only \$240.50. Refer the section on Building Depreciation. You can further increase your refund by claiming building depreciation if the property was built after 17th July, 1985. This will increase your cash refund with no corresponding expense coming out of your pocket. Note if you purchased the property after 13th May, 1997, this will reduce your cost base for capital gains (refer to capital gains tax section).



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, all of which I cannot list here. The most popular method is to claim a rate set each year by the tax office of approximately 50 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 Curtains over 6 2/3 years, Blinds & Venetians over 20 years, Carpets and Vinyl over 10 years, Lawn Mowers, Furniture over 13 1/3 years, Hot Water Systems over 20 years, Air Conditioners room units over 10 years central over 13 1/3 years, Security over 20 years or Fire Systems but not doors, The Motor on Steel Roller Shutter Doors, Prefabricated Built-in Robes and Cupboards but not kitchen Cupboards; Ceiling Fans, Dishwasher, Electrical Meters & Switchboards, Insinkerator, Intercoms, Freestanding Electrical Appliances such as Fridges over 13 1/3 years, Microwaves over 6 2/3 years, Vacuum cleaners over 10 years, Washing Machines over 6 2/3 years TVs, etc, Satellite Dish, Sprinklers, Lifts, Lights and Free Standing Stoves over 20 years. Swimming Pools cannot be depreciated as plant in Australia Case T102 1986.

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). Do not make repairs in a financial year during which you may not receive any rental income (IT180). 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 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.

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 income 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 where 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 times. 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 manage 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 is 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, via the credit card, now 1/99 or 1% of the interest is not tax deductible.

claimable loans

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. This type of account is offered by ANZ and Suncorp.



capital gains tax

Major changes have been made to the way capital gains tax will be calculated. The changes will apply to any sale after 21st September, 1999. In particular, the averaging provisions have been abolished for any asset sold after 21st September, 1999. This makes a dramatic difference to taxpayers who have carefully planned their income around the sale of an asset. Note it is retrospective so you might have shifted your income all over the place to accommodate but if you hadn't sold the asset by 29th September 1999 it is a total waste.

The CGT changes include:

- 1) Assets held before the end of September 1999 can be indexed only up to that date and if you choose to utilise the indexing provisions you cannot take advantage of the 50% reduction of your capital gain, refer 2.
- 2) All assets (other than pre 21st September 1999 assets that elect to use indexing) will now have their capital gain calculated without regard to increases in the CPI. If the asset is held for more than a year only half of the gain calculated will be taxable capital gain.
- 3) Active business assets for business under \$5million that are not owned by a company will receive a further 50% reduction in CGT on assets held for more than a year. Rental properties are not active assets. .
- 4) Averaging is gone for any asset sold after 21st September, 1999 i.e all of your taxable capital gain will be added to your other taxable income and can if high enough push you into higher tax brackets just like any other income. Items 2) and 3) above are the compensation for this.
- 5) The cost includes commission, stamp duty, legal fees, purchase price, and cost of improvements. When the property was purchased after 21 August 1991, interest, rates, insurance and repairs can also be included in the cost base (Sec. 160ZH (6)) providing they have not previously been claimed as a tax deduction.

If you purchased the property before 19 September 1985 capital gains tax does not apply. This is another reason to try and rent your old home and claim the new loan as a tax deduction (refer Claimable Loans). If you lived in the property before you rented it out and do not wish to protect your current home with the principle place of residence exemption, you may elect to apply this to the rental property for up to six years (118-14 1997 Act). The election does not have to be made until the property is sold. Further, if you rent the house out for six years and you move back in again you can then move out and rent the house out again for another six years exempt from capital gains tax. In other words, as long as you live in the house every six years it can continuously have your principle place or residence exemption.

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.

For more detail on Capital Gains Tax download the free booklet from our web site www.bantacs.com.au

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

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 claimable. 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. If you really don't want to claim the Div.10D/Section 43 depreciation I suggest you ask for a private ruling on whether the section is to be interpreted literally, or consider buying a pre-1985 property.

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 an 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

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. You should also read your Rental Property Booklet before going ahead, it will also help you work out the values you will need for the following.

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 are \$6,001 to \$21,600 18.5%, \$21,601 to \$58,000 31.5%, \$58,001 to \$70,000 43.5%, over \$70,000 48.5%. So if before buying the property you were earning \$58,000pa the tax rate applicable would be 31.5% if negatively geared or 43.5% 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. Note this is only likely to help you in the first 5 years.
- (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), 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 can (note it is your option) 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 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. The following assumes you have not made any improvements to the property and have held it for more than 12 months. The figures are in before tax dollars to equate to (p) above.

Annual cash outflow (o) grossed up for tax i.e. $100 - (c)$ then divide (o) by this amount and multiply the answer by 100.	\$
Plus the effect of depreciation reducing your cost base i.e. (d) divided by 2	\$
Buying and selling costs amortised over time held i.e. add (k) & (l) together & divide by the number of years the property is held	\$

Annual before tax cost of holding the property	\$ (q)

The property needs to increase in value by this amount each year or presented another way divide (q) by (f) to work out what percentage increase you require to breakeven. I stress the breakeven point you have yet to get a real return on your investment if you achieve this.

Note the above is without definitions because they are provided within our Newsflash Investment Property Handout. 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.

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.

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.

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

Note 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.

There is no point in negatively gearing any overseas investments (other than considerations unique to the country you have invested in) unless you have other foreign income of the same class to offset the loss against.

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, 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.

Australian residents and foreign losses

Foreign losses that cannot be offset against foreign income in the year incurred can be carried forward and deducted against foreign income of the same class in future years. The four classes are interest income, passive income that is not interest, offshore banking income and all other assessable foreign income.

A capital loss is not quarantined as foreign income is, 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.

Unlike other partnership losses that are automatically transferred to the individual partner, foreign losses made by a partnership are quarantined to be offset against only foreign income of the same class only earned by the partnership (TD 92/113).

If you are offsetting a foreign loss against foreign income you are only permitted a tax credit for the amount of foreign tax that would have been payable on the net amount. But this is not the case with Capital losses which have special offset rules refer IT2562.

Note: All of the above is written for the small investor not companies or trusts and there are more complex rules if you have a significant investment in a foreign entity.

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

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

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

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

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).*

the ultimate secret plan and clever trick with rental properties

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.

wraps – vendor finance arrangements

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 instalments.
- 7) If the purchaser fails to complete the arrangement the deposit and weekly instalments 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.

who says you can't buy positive cashflow properties?

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. 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	Tax & Medicare after introducing the	
Out of Pocket	<u>17,450</u>	rental property & salary sacrificing the	
	6,530	cashflow expenses.	<u>17,843</u>
Less Tax Reduction	<u>6,564</u>		6,564
Positive Cash Flow	34		

CGT – 50% discount – timing

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.



landlords' depreciation

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.

year end tax planning for rental property owners

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.

linked split loans

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.

linked split loans

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

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 shortfall. 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

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 ATO's 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

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%		<u>5,000</u>
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	<u>8,681</u>
	24,281
Less: Rates etc	4,000
Interest	<u>24,500</u>
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 ;

$(1.2 + 0.3) / 75.75 \times 100 = 2\%$ Per Year Before making any real profit or allowing for inflation

evaluating a rental property - another angle

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 $\$17,900 \times 31.5\% = \$5,638$ tax refund so the cashflow for a taxpayer in the 31.5% bracket is as follows:

Rent	\$15,600
Tax Refund	<u>5,638</u>
	21,238
Less: Rates etc	4,000
Interest	<u>24,500</u>
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 $\$5,000 \times 24.25\% = \$1,213$ 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:
 $(2.0 + 0.3) / 75.75 \times 100 = 3\%$ Per Year Before making any real profit or allowing for inflation.

INVESTMENT NETWORKING

FOR YOUR
BUSINESS AND YOU



some **work** others **network**

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.





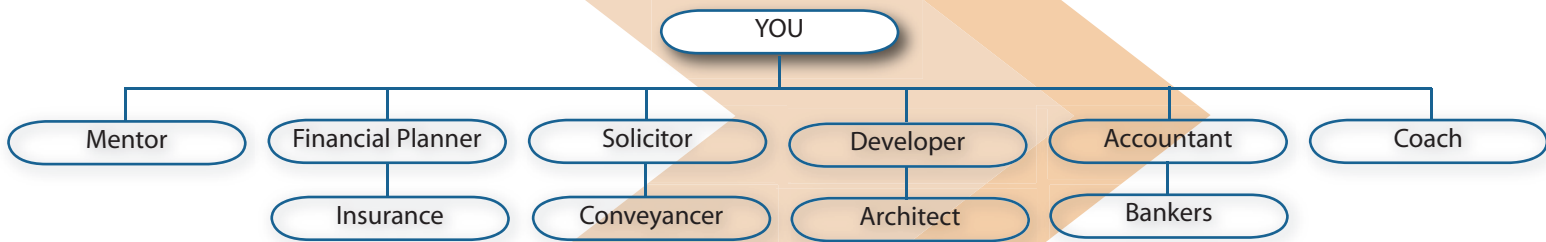
On going Support

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 throughout the journey to success.



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.