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Article from the Rental Properties Booklet. Visit us at www.bantacs.com.au

Evaluating a rental property

By: Julia Hartman B.Bus, CPA, CA, Registered Tax Agent
Last Updated: 2008, 22nd April

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.

Tax Promises for 2008/09

0	-	6,000	0%
6,001	-	34,000	15%
34,001	-	80,000	30%
80,001	-	180,000	40%
180,001	+		45%

Tax Promises for 2009/10

0	-	6,000	0%
6,001	-	35,000	15%
35,001	-	80,000	30%
80,001	-	180,000	38%
180,001	+		45%

So if before buying the property you were earning $80,000pa 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.

Disclaimer: Please note this information is constantly changing, please do not act on this information without further consultation with your accountant. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.