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National Accountants Group

NEWSFLASH BOOKLET

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If Your Home or Investment Property Was Damaged in the Fires or Floods

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If your Home or Investment Property Was Damaged in the Fires or the Floods, The taxman is lurking behind those new green shoots of regrowth and what a bonanza to be had. The ATO can easily administer through already established data matching with land titles offices and insurance companies, while for the average taxpayer, the whole situation is so complex they are bound to be caught in the trap. So please spread this blog around.

Rebuild or Repair Paid for by Insurance:

If the insurance company repairs or rebuilds your main residence, ie no cash changes hands, you do not have to worry if you move straight back in when the rebuild is completed.

The complications begin if the property is not fully covered by your main residence exemption ie a rental property. That is the basis of the rest of this blog.

If it is a rental property, the old plant and equipment is neither scrapped nor replaced in your depreciation schedule. You just continue with your current written down values.

If the insurance company rebuilds your investment property, make sure you get all the information you can about the building costs, this will save you the cost of a quantity surveyors report. The good news here is you can start depreciating the cost of the new build under Div 43 for another 40 years. This amount cannot include landscaping or any of the demolition costs. If you have previously been claiming building depreciation you cannot scrap the old building ie write off any unclaimed building depreciation on the old building.

Despite all this your cost base remains the same for capital gains tax purposes.

If the original house remains it may not be considered a rebuild. The work may be considered a repair. TD 2000/38 is the ATO's opinion on this https://www.ato.gov.au/law/view/document?LocID=%22TXD%2FTD200038%2FNAT%2FATO%22&PiT=20070704000001 The examples suggest that the rollover is available when only part of the building is destroyed. But it is a repair when there is just damage to the building. The tax consequences of repairs are discussed further down.

Insurance Payout and you Rebuild:

Just a couple of extra things to consider in addition to the above. If the cash payout is less than the remaining unclaimed building depreciation, you can write off the difference.

Now to the capital gains. Note plant and equipment on which depreciation have been claimed are not part of the capital gains tax calculation other than to remove their values from any sale proceeds or purchase price. Regarding the CGT cost base there is a rollover relief under section 124-85 ITAA 1997 that allows you to ignore the fact that the insurance proceeds are more than the cost base of the house. See formula below to calculate the cost base of the house separate from the land.

If the insurance payout equals your rebuild costs, the rollover means, you effectively carry on with your current cost base ignoring the insurance payout and rebuild costs. This may mean you have a more valuable house when time comes to sell and that is when the capital gain is recognised on the benefit you received from the insurance company payout.

If it costs you more to rebuild than the insurance payout you add the extra costs to your cost base.

If the insurance payout is more than the rebuild costs, section 124-85 still allows a rollover (ie you stick with your original cost base) but only on the portion of the payout used up in the rebuild costs. Any excess of the insurance proceeds over the rebuild costs will be subject to CGT. That is assuming that the excess of the insurance proceeds is less than the difference between the cost base of the house and the insurance proceeds. In the unlikely case that it is more, seek professional advice. So now back to the cash that is left over after the rebuild and the CGT payable on this. The 50% discount will apply to this capital gain if the 50% CGT discount would have applied had you sold the house. For example if you have, at the time of receiving the insurance proceeds owned the property for more than 12 months and it is not owned by a company.

The rollover does not apply in the case of a capital loss. That is the cost base of the house (ignoring the land) is more than the insurance proceeds (apportionment of the cost base is discussed below). In this case the capital loss needs to be taken into account when you receive the insurance proceeds, which may be helpful to offset other capital gains or is simply saved up until you sell the property anyway, if you do not have any capital gains in the meantime.

Rebuild and Sell Trap

If you accept a cash payout, rebuild and then sell the ATO will treat you like any other spec builder. You will be subject to any profit on the build at normal income tax rates, no 50% CGT discount and you will have to pay GST on the sale proceeds!

Make sure you get advice before you go down this path, do the numbers it might not be worth it.

For more detail https://bantacs.com.au/Jblog/warning-do-not-sell-your-rental-after-a-rebuild/#more-954

Repairs Only

If all that your investment property needs are some repairs and the insurance company give you the option of taking cash or they do the repairs, from a tax point of view you are probably better off letting the insurance company do the repairs. That way there will be no tax consequences to you. Where as, if you organise the repairs yourself, you will need to consider all the rules regarding when repairs are tax deductible such as not replacing an item in its entirety or making an improvement. Due to the rules on assessable recoupments it will probably all contra itself out in the end but you will have to track it.

Section 20-20 to 20-30 ITAA 1997 is about assessable recoupments. It can only apply when the insurance proceeds are not caught by any other section of the Act. This means it does not apply to the loss of rent payment as that is definitely taxable income reference TD 93/58.

Generally, insurance proceeds relating to the loss of a capital asset are not income but then the corresponding repairs etc are not expenses either. The way the law requires you to deal with this is to include the repair expenses as a tax deduction and put a corresponding amount in as other rental income to offset any benefit of the deduction. This continues, possibly over many years, until all the insurance proceeds are used up. That is the unusual thing about assessable recoupments the money received from the insurance company is not assessable when you receive it but when you qualify to claim an expense associated with that income. If the insurance proceeds are never used up ie repairs cost less than the insurance proceeds then the remainder reduces your cost base for CGT purposes. If the property is a pre September, 1985 property this excess is ignored.

You do not have to offset the insurance proceeds against other repairs that are not related to the claim.

You do not need a quantity surveyors report on the repairs because you have all the actual costs in front of you, you simply must use those, not an estimate.

Plant and Equipment Replaced by You with Insurance Proceeds:

If part of the insurance payout is to completely replace a piece of plant and equipment then you are considered to have disposed of the existing piece of equipment for the value of the insurance proceeds and acquired a new depreciable item for whatever amount you pay for the new piece. For example your hot water service has been completely destroyed so the insurance company pay you $2,000 to cover the cost of a new one. The way the ATO see it is the insurance company has paid you $2,000 for your old one. Now if that old one has been depreciated down to say just $300 then you have a profit on the sale of that old HWS of $1,700. The new HWS that you spend the $2,000 on will have to be depreciated over 12 years.

Fortunately, section 40-365 ITAA 1997 allows for a rollover relief when a piece of plant and equipment is involuntarily disposed of. It will effectively allow you to roll the $1,700 "profit" on the disposal of the old HWS into the opening balance of the new HWS. So, no income from the "disposal" in that year but you will only be left with $300 to write off over the next 12 years.

Insurance Payout and you Move On:

If the insurance company give you a cash payout and you do not rebuild then you are deemed to have sold the house. A CGT event is considered to have happened at the date you receive the cash from the insurance company. Your cost base is apportioned between the house and the land. The eventual sale of the land being a separate CGT event.

If this property was your main residence, normally vacant land cannot be covered by a main residence exemption, the only exception is section 118-160 when the main residence has accidentally been destroyed. Note section 118-160 is optional, you can choose not to cover the land with your main residence exemption if you calculate it is actually sold at a capital loss.

Your cost base is divided between the house and land by the following formula which is set by legislation:

$$\text{Cost Base of House} = \frac{\text{Cost Base x Insurance Proceeds}}{\text{Insurance Proceeds + Market Value of the Land}}$$

There is only an issue if your property is subject to capital gains tax, for example a rental property, that is, it is not covered by your main residence exemption. If this formula gives a lower relative cost base to the land compared with the house then you risk being taxed on a capital gain even though overall you made a loss or broke even. The CGT event for the house happens at the time you receive the insurance payout which is likely to be in an earlier financial year than you sell the vacant land. This means the capital loss on the land cannot be offset against the capital gain on the house.

Expenses During the Rebuild Process:

You can continue to claim interest on the loan and other holding costs during the rebuild even though the property is not available for rent. Recent changes to legislation have removed the tax deduction for expenses relating to vacant land even though the intention is to build a rental property. Fortunately, there is an exception in the case of natural disasters Section 26-102(6)(c) 1997 ITAA. So, if the property was earning income before it was damaged and you intend to earn income when it is repaired or replaced then you can continue to claim all the holding costs as a tax deduction, despite not receiving any income for even the whole financial year.

What if You Are Living Overseas?

It is imperative that you rebuild promptly, preferably getting the insurance company to do it. If you decide to sell up while you are living overseas and the property was once covered by your main residence exemption, you will lose all of your main residence exemption right back to when you first purchased the property. Where as if you wait until you return to live in Australia, before you sell, the original main residence exemption can apply.

If you take the cash from the insurance company and organise the rebuild yourself make sure you continue to use it as a rental property after the rebuild so that the rollover relief applies rather than the payout triggering a CGT event.

If you are not familiar with the new laws removing Expats' main residence exemptions retrospectively here is a link to a previous blog on the topic
https://bantacs.com.au/Jblog/expats-beware/#more-398

Of course, there are many twists and turns with the capital gains tax calculation which would bore you to death here. If you trigger any of the CGT events above, other than in the case of the simple destruction of your family home and sale of the vacant land, you need to seek professional advice.

For a table of items that are considered plant and equipment go to the back of this ATO guide https://www.ato.gov.au/uploadedFiles/Content/IND/downloads/Rental-properties-2019.pdf

Tips:

1) When it comes to your main residence make sure you move straight back in once the rebuild is completed.
2) If you are a non-resident of Australia for tax purposes and there was once a main residence exemption on the property there could be dire tax consequences unless you allow the insurance company to rebuild.
3) If the insurance company gives you the cash to repair your investment property make sure those repairs are undertaken in a financial year that the property earns income. Income can be the insurance payout for the repairs.
4) If you receive a payout for your investment property and then sell the land you may get caught with a capital loss on the land and a capital gain on the insurance payout. Unless they both happen in the same financial year or you sell the land before you get the insurance payout, the loss will not be able to be offset against the gain.
5) If the insurance company rebuilds your investment property make sure you get all the information you can about the building costs, this will save you the cost of a quantity surveyors report because the good news here is you can start depreciating the cost of the new build under div 43.
6) If all that your investment property needs is some repairs, from a tax point of view, you are probably better off letting the insurance company do the repairs. That way you don’t have to worry if the repairs technically qualify as a repair for tax purposes.
7) There may be CGT consequences if you receive an insurance payout and rebuild when the rebuild cost is not the same as the insurance payout.