**NEWSFLASH BOOKLET**

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# Your Own Home

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| NEW SOUTH WALES | QUEENSLAND | VICTORIA |
|---|---|---|
| Sydney 1300 367 688<br>sydney@bantacs.com.au<br><br>Burwood 1300 367 688<br>burwood@bantacs.com.au<br><br>Central Coast 02 4390 8512<br>centralcoast@bantacs.com.au<br><br>Hornsby 1300 241 248<br>hornsby@bantacs.com.au | Brisbane 1300 911 227<br>brisbane@bantacs.com.au<br><br>Caboolture 07 5497 6777<br>admin@bantacsningi.com.au<br><br>Gold Coast 0435 437 586<br>goldcoast@bantacs.com.au<br><br>Mackay & Whitsundays<br>07 4951 1848<br>mackay@bantacs.com.au<br><br>Ningi 07 5497 6777<br>admin@bantacsningi.com.au<br><br>Toowoomba 07 4638 2022<br>toowoomba@bantacs.com.au | Melbourne 03 9111 5150<br>melbourne@bantacs.com.au<br><br>North Melbourne 1300 123 842<br>northmelbourne@bantacs.com.au<br><br>**SOUTH AUSTRALIA**<br><br>Adelaide 08 8352 7588<br>adelaide@bantacs.com.au<br><br>**FIND OUT MORE**<br>http://bantacs.com.au/aboutus/ |


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# Important

**This booklet is simply a collection of Newsflash articles relevant to home owners. The articles are transferred from Newsflash into this booklet. It is not re written every time the law changes. Relevant articles from recent newsflashes are added to the end of this booklet at irregular intervals so make sure you read through to the end and read our monthly newsflash to keep our knowledge up to date.**

The following are just some of the matters that property owners should consider, please discuss your particular circumstances with your accountant as these statements are general in nature and not conclusive. Also the law changes constantly.

# 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 close to 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.

If you acquired your Principal Place of Residence (PPR) after 20th September, 1985 and used it as your PPR until some time after 20th August, 1996, when it became income producing, you can use the market value of the property at the time it becomes income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after it ceased to be your PPR. This is section 118-192 ITAA 1997 which is discussed in more detail below.

For more detail on Capital Gains Tax down load the free booklet from our web site http://www.bantacs.com.au/booklets/Capital_Gains_Tax_Booklet.pdf

# 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, if the owner is in the maximum tax bracket would incur $1,470 in tax (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 $1,470. Not only has he or she blown their $20,000 deposit (life savings) but they now have to find another $470 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.

# Demolishing a Rental Property To Build Your Home

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).

# Warning – Don't Rent Out Part of Your Home

The rent you receive will be taxable and it will mean that part of your home is not protected by your main residence exemption. The 6 year rule won't protect you here because you are still living there, it only applies if you are absent. IT 2167 discusses when you are considered to be renting out part of your home. If your tenants pay you more then just their share of expenses such as electricity, phone and food then you are in a profit making arrangement and should declare the rent you receive. If your tenants make a contribution to your mortgage this is not part of sharing the expenses this crosses the line to having to declare the income.

# Renting Out Your Old Home & Building Your Dream Home

The interest on the loan for your new home will not be deductible. Only the interest on the loan to originally purchase your old home will be deductible against the rent. Consider applying to the ATO for a ruling that Part IVA will not void an arrangement where one spouse buys the other spouse out of their share of the property. The dominant purpose may not be considered to be a tax advantage if the purchasing spouse wants to own a rental property but the selling spouse does not. Quote ID 2001/79 in your ruling request. Do not do this without first applying to the ATO.

# Owning Your Home in a Trust

The most significant reason you do not want to own your home in a trust is because it will not be covered by the main residence exemption. Capital Gains Tax is a tax on inflation. Without the main residence exemption it would be difficult to move homes. Assuming all properties have gone up by a similar amount, if you have no exemption you would have to pay tax on the increase in the value of your own home even though it would cost you the same for a similar house elsewhere. This could leave you with insufficient funds to purchase the new home. Section 118-110, which covers the basic circumstances that give rise to the main residence exemption states as its first requirement that the owner be an individual.

Some people put their home in a trust for asset protection purposes. The ATO has no objection to this if you are not trying to rent it back to yourself in an attempt to claim the interest, rates, insurance, repairs, maintenance etc as a tax deduction.

If your only reason for holding your home in a trust is for asset protection, consider one of the following alternatives:

1) Set up a mortgage trust and hold the property in your own name. Then in a round robin of cheques in your bank manager's office gift the trust the value of all the available equity in your home. The trust then takes a second mortgage (assuming your bank already has the first mortgage) on your home and lends you back the amount you gifted to it. You use this money to pay back your bank manager for covering the original amount you gifted to the trust. The mortgage trust does not need to lodge tax returns or charge you interest. This is not an arrangement with any tax advantage it is purely driven by asset protection so you do not have to worry about Part IVA. A bankruptcy trustee can claw back transactions intended to protect the asset from creditors but there is a time limit. Ideally, any creditor wanting to get their hands on your house will decide it is not worth it because by the time they sell you up and pay out the bank and mortgage trust there will be nothing left for them.
2) Hold your home in your spouse's name. Your main residence exemption can apply to a house held only in your spouse's name, so if you have a spouse who is unlikely to be sued, this is an even simpler method.

**Note** before acting on the above you should seek legal advice on your particular circumstances, timing and areas of risk to ensure that such an arrangement will protect you.

If you are thinking of holding your home in a trust so you can rent it to yourself and negatively gear it, you will be challenged by the ATO. In Tabone c FCT 2006 ATC 2211 the taxpayers held their home in a unit trust then rented it to themselves and claimed a tax deduction for all the expenses associated with owning the house. The AAT disallowed the deductions. In TR 2002/18 the ATO states it will not allow these arrangements to be negatively geared.

There were some interesting statements made by the AAT in Tabone's case:

1) The AAT found that the interest was incurred to provide a family residence and not expected to produce assessable income.
2) When the taxpayers tried to argue that they did not set up the trust for the tax advantage but for asset protection purposes the AAT would not accept this because they were employees so the need for asset protection was minimal. This point should be noted by anyone considering setting up an entity that provides both asset protection and tax benefits. Many accountants will argue that if the dominant purpose was asset protection, Part IVA cannot apply just because there was also a tax advantage. Now that the relevance of the need for asset protection is considered, it cannot be assumed that asset protection will shield a tax benefit if you are not exposed to any real risk.
3) The trust was a unit trust and as the taxpayers owned the units in the trust the AAT pointed out that no asset protection existed because creditors could access the assets of the trust because they were entitled to the units should the taxpayers become bankrupt. On this basis only a discretionary trust would provide effective asset protection but the losses from the property would be locked into a discretionary trust so unless other income can be channelled into it to offset the losses there is no tax benefit in holding the house in a discretionary trust.

4) Because the taxpayers borrowed the money used to purchase the units jointly and they both contributed to the repayments Mr Tabone, who used the money to buy the majority of units in the trust, would, if the interest was deductible, have only been entitled to claim a deduction for half. This finding is in conflict with other cases. Banks normally force couples to borrow in both names so just to be on the safe side, it is important that you can show a paper trail to the repayments with their source coming from the member of the couple who is claiming the deduction. Better still try and persuade the bank to accept the guarantee of the non borrowing member of the couple instead of showing their name on the loan.

The Tabones holding their home in a trust was just a win win for the ATO. The net loss on the property was not allowed and the Tabones would have to pay CGT to the ATO when they sold the property.

# Cover your Rental with Your Main Residence Exemption

Section 110-25 (4) allows you to include in the cost base of an asset all the costs of ownership that have not been claimed as a tax deduction. This can range from travel to the hardware store, cleaning materials, lawn mowing, light globes and of course interest, rates and insurance. Most of these items cannot be used to increase the cost base on a rental property because they have already been claimed as a tax deduction. You are more likely to spend money on the home you live in that will not necessarily increase its value.

Section 118-145 allows you to cover a home as your main residence for up to 6 years after you move out. You can then move back in again and cover it for another 6 years. This does not in any way prevent you from claiming a tax deduction for all the rental expenses.

Another incentive is that you are more likely to sell a rental than your own home so it is quite possible any capital gains left after you have attacked it with diligent record keeping may never be realised in your life time anyway. When you die as long as your real home was considered your home at your date of death (a choice your heirs can make after the event) and not earning income while you last lived there, your heirs inherit it at its market value at your date of death with all CGT exposure forgiven.

# Renovating or Building and Living There Before Selling

I hear over and over again from people in the property market how they are building or renovating homes then living there to apply their main residence exemption before selling and moving onto the next project. I am usually asked how long do I have to live there to cover it with my main residence exemption. They are usually shocked with the answer that it does not matter how long you stay there you are never going to get your main residence exemption on the property.

TD 92/135 states that if a property is built or renovated with a profit making intention the main residence exemption cannot apply. This is because the main residence exemption only applies to profits that are subject to CGT and CGT only applies if normal income tax does not. In the case of building or renovation with a profit motive (rather than as a rental property or private home) the profit would be caught as normal income. Note there are also GST ramifications which are discussed in our How not to be a Developer booklet.

The example given in the ruling is:

A builder constructs a spec home in which he and his family reside while construction proceeds on another spec home. Any profit on sale which gives rise to income is fully assessable to the builder even if a principal residence exemption is available for CGT purposes.

# Some Answers on Selling Solar Power Back to the Grid

A reader has very kindly alerted us to a PBR on this topic. Now PBRs are summaries of private binding ruling applications. Only the person who applied for the ruling can bind the ATO to their word. Nevertheless these rulings are a method of finding out just what the ATO is thinking when there are no other rulings on the subject.

There are thousands upon thousands of these PBRs so if any readers receive an interesting ruling response please don't assume we know about it. We would certainly appreciate hearing about yours.

In PBR 92788 it appears, reading between the lines, that the taxpayer was hoping to negatively gear their solar panel investment, because it talks of claiming interest and being unlikely to make a profit in the near future. The ATO found that tax did not apply to the activity because the panels were on the taxpayer's home rather than in a business environment and the operation was not of the size normal for electricity generation. Further their motive was not business like as it was to offset their electricity consumption and create a renewable energy resource. I wonder if the answer would have been different if they were likely to make a profit. This is a good outcome considering the record keeping involved would not be worth the small amount, if any, tax revenue that would be generated, so let's hope the ATO stick to this opinion.

The PBR specifically states that interest is not deductible. This can be used to address the CGT concerns, that if a home is used to produce income then only part of the main residence exemption is available. The formula for determining the percentage of the gain on the home that is subject to CGT is based on the rules that determine how much of the interest on the loan for the home would be deductible. So as you can see, even if, because the home is actually producing income, it is caught by the CGT provisions, as the PBR states none of the interest is deductible then the percentage of the gain that is taxable is still zero.

What still remains unanswered is the comment on TV by an MP that Centrelink would be taking the income received from selling electricity back to the grid into account when calculating the house owner's entitlement to the Pension and other benefits. We have had an election since then so hopefully that MP is no longer in Parliament.

Of course the situation is completely different if these panels are on the roof of your business. In this case, if you are registered for GST, you will have to remit 1/11th of what you receive to the ATO as GST. Regardless of whether your business is registered for GST or not the income from its solar panels will be taxable.

## Queensland Land Tax And Working Overseas

If your home is in Queensland and you are living overseas, you may be subject to land tax once you have been away for more than 6 months. You will be treated as an absentee unless you can prove you ordinary live in Australia. This would mean working for the Australian government overseas or an Australian employer who you worked for, for at least a year before leaving Australia. If you are considered an absentee you will not qualify for a land tax exemption on your own home; so if the total unimproved value of your Queensland land holdings is $350,000 or more you will be liable for land tax.

## Changing Main Residences

A reader was recently very surprised to find out just what a huge tax mess he had got himself into because when he moved from his old home into something bigger and better, it took him more than 6 months to sell his old home.

This is a terrible trap in the CGT legislation. You are only allowed to cover both properties with your main residence exemption for 6 months, back dated to the last 6 months before you sell your old house. But there are other conditions such as the old house must not be used to produce income while you are not living there and it must have been used as your home for at least 3 months in the last 12 months before its sale. This means that if the period in which you hold both properties is for longer than 9 months after you move into the new home you will not be entitled to the 6 months overlap concession at all.

Further, there is no resetting of the cost base to the market value when you first moved out because that section requires it to become income producing. So you are stuck with a choice to expose to CGT your new house or your old house for any period exceeding the 6 months. The one you choose to expose will have to have its capital gain calculated for the whole period you owned it and then apportioned between days covered with your main residence exemption and days not. If you purchased the home after 20th August 1991 you will be entitled to increase the cost base by anything associated with holding it, even maintenance such as cleaning and lawn mowing.

## Solicitors Corner – Life Tenancy

This new section has come into newsflash after discussions with a solicitor. It will include various articles on areas where our professions overlap. We will welcome any contributions from solicitors, please do not hesitate.

TR 2006/14 www.law.ato.gov.au/atolaw/view.htm?DocID=txr/tr200614/nat/ato/00001 is the ATO ruling on life tenancy. It is so difficult to follow and appears to contradict itself that we suggest taxpayers get a ruling from the ATO before relying on it.

Life tenancies are usually created in a will, giving the beneficiary (Life Tenant) the right to live in a property or to receive income from an investment. Once the tenant dies ownership of the asset transfers to the remainderman, another beneficiary of the will. This arrangement is common when a parent remarries, they leave their new spouse a life tenancy in the family home with the deceased's children being the remaindermen.

A problem arises if the life tenant decides they would like to move or give up their rights. This can be seen as a disposal of an asset at market value to the remaindermen, for CGT purposes. The value of the asset would be the rent or in the case of shares the expected dividend multiplied by the life tenants life expectancy. The life tenant could be trapped by in a home that is no longer suited to their needs because they cannot afford the CGT.

# Cross Collateralising

There is a school of thought it is better to spread your investment loans over a few banks, giving each bank rights to only one or two properties so that if anything goes pear shaped there is a buffer. All this really does is slow the banks down. Unless your loan is limited recourse then if you default on your loan and the sale of the secured property does not cover the debt then the banks will pursue you and your other properties for the balance. Sure these properties may be mortgaged to another bank but they can still force you to sell them and give them the balance of the proceeds after paying out the mortgage to the other bank.

Just recently I came across the down side of this demarcation between banks. Clients were looking to sell a property that secured the deposits for a few rental properties with one bank but wanted to use the proceeds to pay off the loan with another bank. They were going to live in this other property so the interest on its loan would no longer be tax deductible. The trouble was they had plenty of equity but in properties with the second bank not the first so they were going to have to go through the cost of refinancing; a problem that would not have arisen if the loans were all with the same bank.

# The CGT Main Residence Exemption Should Never Be Taken For Granted

Section 118-150 allows you to back date your main residence exemption over vacant land and your home during construction providing you move into it as soon as practical after completion and continue to cover it with your main residence exemption for another 3 months. ID 2006/185 also states that if you live there for more or less than 3 months you can use section 118-145 (the absence rule sometimes referred to as the 6 year rule) to continue to cover the property with your main residence exemption, even if you move out in less than 3 months, as long as you still own it.

In Keep v FCT AAT 2013 709 the period of time that the taxpayer lived in his newly constructed home was not clear but the shortest period was just one week short of the 3 months required. The CGT was over $20,000 so I bet he wished he had stayed that extra week. Nevertheless, the use of the absence rule, section 118-145 was not argued. Maybe because there were doubts that he even established the property as his main residence at all. The judgement didn't even allow him a partial exemption for the period of time that it was agreed he actually lived there.

Here are the factors from the case that I feel may have influenced the decision that he did not actually establish his main residence exemption at all even though he was living there.

1) There was no evidence of any gas or electricity accounts kept in his name. Apparently they were connected in his ex-spouse's name so he could not produce evidence.
2) He had not changed his address for some items from his sister's place where he had lived before the house was finished and after he moved back out of the house.
3) He had a drivers licence in a different state.
4) As a fly in fly out miner he didn't always return home to the newly constructed house, instead staying at his sister's place on some breaks.
5) His income tax return for the relevant year showed his sister's address.
6) No one vouched for him in court that the place was used as his home, they only sent letters.
7) The biggest mistake of all, he represented himself in court. This probably explains why he didn't argue section 118-145 or at least a partial main residence exemption.

The judgement is disappointing because it lacks analysis of the law involved. Possibly the sitting AAT member may have been influenced by the credibility of the witness, something that is not clear in the judgement. I certainly hope Mr Keep appeals and argues, with the help of representation, far more strongly that he did at least establish his main residence exemption for some period of time and then section 118-145 takes over. It would be nice to have more test cases on this issue; people representing themselves give the ATO precedents to use against taxpayers that are not thoroughly tested. I feel that the ATO is pushing this area rather aggressively, for example in their capital gains calculation they only allowed him $70,000 for the cost of constructing the house when in actual fact the costs were nearly 4 times that amount.

The point I want to stress here is your main residence exemption is not an automatic right. It is your obligation to prove that you qualify.

# Resetting the Cost Base When First Rented

Section 118-192 resets the cost base and acquisition date of a property to the market value at the date it first becomes income producing providing for every day of ownership up to that date it was fully covered by your main residence exemption. There are a few catches that readers need to know about this section:

1) If you later demolish the dwelling on the property you will lose that reset and have to calculate the capital gain right back to the date you purchased the property.
2) If you die your heirs will not be entitled to use the reset cost base, they will have to go back to the original purchase cost. Section 118-192 requires you to have been entitled to a partial exemption from CGT as a result of the property becoming income producing. When you die a CGT event takes place but no CGT is payable because the liability rolls over to your heirs or your estate. Accordingly, you personally receive a full exemption not a partial one.
3) There is no market value measurement if the reverse applies i.e. you make a rental property your home. Instead the capital gain for the whole period of ownership is calculated and then apportioned between days covered by your main residence exemption and days not.

The bottom line is you can never be confident of relying on section 118-192 so you should keep records.

# Share Investing with a Mix of Borrowings and Cash

As Noel Whittaker will tell you Australians are very good at paying their debts but not so good at saving. This is why borrowing to invest, works so well, it is a form of compulsory saving. It also allows you to get more money working for you in the share market sooner. Which accelerates wealth creation if your shares do better than the interest rate you are paying, on the other hand if the shares go down in value you could end up owing the bank more than your shares are worth and still have to pay interest on the loan.

Now if you have a home loan but some available equity you should borrow the full amount that you are investing in shares as that loan will be tax deductible, if you have spare cash you were going to invest, pay it off your home loan instead, minimising your non deductible interest.

Young people in the mining industry or working overseas might not be ready to buy their own home, This is not a bad idea considering the cost of buying and selling a home if you are only going to live in an area for a short while. They may want to invest in the share market instead because it is so cheap to get their money back, or they may want to use the share market to help them save a deposit for their home. Note Noel Whittaker would suggest that before you invest in the share market you should be comfortable with the idea of sticking with that investment for 5 years.

If you don't have a home you will no doubt start your investing by putting cash into the market. Then a financial advisor will probably suggest that you take the shares you have and use them as security to borrow more money to invest in more shares. This is a reasonable strategy. The problem arises when you are ready to sell the shares to buy a home.

The rule is interest is deductible on a loan when the money borrowed is used to buy an income producing asset. So the interest on the loan for the additional shares will be tax deductible. Let's say you used $20,000 of your own money and borrowed another $40,000. You now have a portfolio of $60,000 hopefully the first $20,000 was invested and then the borrowings arranged and the next $40,000 invested separately. 7 years later, the shares have doubled in value and you are ready to buy a house. Ideally you sell off all your shares and use the sale proceeds to pay off the loan and cover the deposit for your house. But any financial planner worth their salt will not let go of you that easily. They will suggest that you sell off enough to get back your original cash, the gains and reinvested dividends but keep the borrowings invested in the market, just secure them against your home instead.

This is where the big question of what the borrowed money was used to buy kicks in. The ATO could say well you invested $60,000 all in the same managed fund and you can't tell the difference between the units purchased with your cash and the ones purchased with the loaned funds so when you sell some off

2/3rds of the sale proceeds must pay off the $40,000 debt or part of the debt will no longer be tax deductible. Alternatively the ATO could say that originally you paid $1 per unit so for each unit you sell you have to pay $0.67 off the loan because 2/3rds of the purchase price came from borrowed funds. This works a lot better if the units have gone up in value, you get to keep the profit on the units you borrowed for and still keep the remaining portion of the loan tax deductible.

Of course many people will use the sale proceeds for their deposit and not know about this problem until they visit their accountant at the end of the year. By this time they no longer have the sale proceeds and the original loan is still outstanding. In this case the ATO would consider a portion of the interest on the loan not tax deductible.

So continuing with our example, let's assume the original 60,000 $1 units are now worth $2 each but also that you have been reinvesting the dividends so you now have 70,000 units or $140,000 with the $40,000 still owing on the loan because you have been paying interest only. Unfortunately, you cannot distinguish which units were bought with your original $20,000 and which with the borrowed funds. This is a shame because if you could sell off your 20,000 units and the units bought with the dividends that were reinvested and leave the other 40,000 units untouched with the loan still being 100% tax deductible, Reference IT 2661. Instead you will have to work on the basis that 2/3rds ($40,000/$60,000) of the units sold will be units purchased with the borrowed funds so the original dollar borrowed for those units will have to be repaid. This means that you can never get all your cash out unless all of the loan is repaid.

If caught in this situation it is probably better just to sell up all the investment, if the CGT is not too painful, pay out the loan, buy your home then borrow against it to invest again. It is a shame CGT could have been minimised if the units purchased with the borrowed funds could have been clearly identified from those purchased with cash and those reinvested.

## Buying and Immediately Subdividing To Sell

If you buy a property with the intention of immediately cutting it in half and selling off one of the lots, the ATO would argue that it is a profit making venture so you need to charge GST and the profit is taxed as normal business income. After all even with a short turn around it would be unusual for such an activity not to be profitable. In https://www.ato.gov.au/rba/content/?ffi=/misc/rba/content/1012730145598.htm PBR 1012730145598 a taxpayer successfully argued that they did not buy the property with the profit making motive. They wanted that particular property but not all the land to go with it. They bought it with the intention of making a home and subdivided to simply reduce their maintenance.

Don't just assume this could apply to your circumstances, make sure you get a ruling but it may be worth quoting this one.

## Ask BAN TACS

For $79.95 at Ask BAN TACS, www.bantacs.com.au/ask-bantacs.php, you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

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# How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?


......and the list goes on!
To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

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It includes Newsflash articles up to 298 June 2015