BAN TACS
National Accountants Group

NEWSFLASH BOOKLET
Visit us at www.bantacs.com.au

Buying A Rental Property

Phone 13000 22682

For website technical support, email technicalservices@bantacs.com.au
For all accounting & tax support contact one of our offices or just go to www.taxquestions.com.au

NEW SOUTH WALES

Sydney 1300 367 688
sydney@bantacs.com.au

Burwood 1300 367 688
burwood@bantacs.com.au

Central Coast 02 4390 8512
centralcoast@bantacs.com.au

Hornsby 1300 241 248
hornsby@bantacs.com.au

QUEENSLAND

Brisbane 1300 911 227
brisbane@bantacs.com.au

Caboolture 07 5497 6777
admin@bantacsningi.com.au

Gold Coast 0435 437 586
goldcoast@bantacs.com.au

Mackay & Whitsundays
07 4951 1848
mackay@bantacs.com.au

Ningi 07 5497 6777
admin@bantacsningi.com.au

Toowoomba 07 4638 2022
toowoomba@bantacs.com.au

VICTORIA

Melbourne 03 9111 5150
melbourne@bantacs.com.au

North Melbourne 1300 123 842
northmelbourne@bantacs.com.au

SOUTH AUSTRALIA

Adelaide 08 8352 7588
adelaide@bantacs.com.au

FIND OUT MORE

http://bantacs.com.au/aboutus/

Visit Bantacs.com.au About Us section to view office details & information about BAN TACS practitioners

Liability limited by a scheme approved under Professional Standards Legislation

How to pay off a 20 year home loan in 3 years using less of your own money than at present

"Ninety percent of all millionaires became so through real estate"
Andrew Carnegie

Online Animation reveals how you can pay off your home faster and how to start today

Canterbury Property Services Since 1980

Visit https://info.canterburyservices.com.au/3-year-home-loan-video/

Important

This booklet is simply a collection of Newsflash articles relevant to rental properties. 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 investors should consider, please discuss your particular circumstances with your accountant before you actually purchase a property as these statements are general in nature 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.

This booklet is part of a series that divide the BAN TACS Newsflash articles into the different stages of the property investing experience. Please make sure you also read the others:

Before You Buy A Rental Property
http://www.bantacs.com.au/booklets/Before_You_Buy_A_Rental_Property.pdf
Owning a Rental Property http://www.bantacs.com.au/booklets/Owning_A_Rental_Property.pdf
Selling A Rental Property http://www.bantacs.com.au/booklets/Selling_A_Rental_Property.pdf
Your Own home http://www.bantacs.com.au/booklets/Your_Own_Home.pdf

If you would like material that has a more structured approach it is recommended that you purchase Winning Property Tax Strategies http://www.bantacs.com.au/book_winning-property-tax-strategies.php
.

Before You Buy A Rental Property

Please make sure you read the first booklet in this series
http://www.bantacs.com.au/booklets/Before_You_Buy_A_Rental_Property.pdf
For the sake of completeness of each book some articles have been repeated.

Clauses In Real Estate Contracts

Not all Real Estate contracts are the same, not only should you read them before signing but you should take it to your Solicitor first. Don't let a pushy Real Estate agent talk you into signing up without professional advice. Think about the huge amount of money involved, here are just a couple of examples of what can go wrong. A client went to an auction not expecting to buy so had not had the contract checked out. She assumed it would be just like any other contract. She was buying the property to use as her home in about a year's time so was pleased to agree that the seller could continue to use it in his business for 12 month after the sale. The contract said the vendor would be providing vacant possession and that GST did not apply to the sale. But here is the kicker, have a look at this clause:

> *No GST Payable By Vendor*
> *The Purchaser warrants that the property is intended to be occupied, and is capable of being occupied, as a residence. If this warranty is false and the vendor is obliged to pay GST,* ***the purchaser hereby indemnifies the vendor in respect of his obligation to pay such GST and any accrued interest or penalty thereon****.*

This is a typical reaction by the vendor's solicitor to uncertainty about the operation of the GST Act. They just push all the responsibility onto the purchaser rather than find an answer. Of course the poor purchaser can't even find out whether GST is likely to apply to the transaction because they don't know enough about the vendor's personal circumstances. If the ATO look into the transaction the vendor has no reason to fight the ATO and the purchaser has no right to fight the ATO.

So the moral of this story is read the contract, get advice and never ever agree to be responsible for someone else's GST even if you think it won't apply. Right or wrong, confidentiality means you will have no right to argue your case, you must just pay up another 1/11th of the purchase price, over $50,000 in my client's case. Mind you I have my doubts that such a clause could be successfully enforced through the courts.

Ok now that the nagging is over let's have a look at the issues the solicitor should have examined to give his client the correct advice rather than just trying to dump responsibility onto the purchaser.

The first sale of a residential property is subject to GST but any sales after that are exempt from GST. This property had been sold as a residential property before so if it was still considered a residential property no GST would apply. But the house was actually being used as a medical practice. If the property is considered commercial rather than residential GST will apply to the sale. So when is a house a commercial premises?

It is all about the condition the property is in at the time of sale yet the solicitor, again in a slap dash approach of who cares about the law we will just contract our way out of any liability rather than look it up, also wanted the purchaser to sign another clause in the contract stating that she would use the premises as residential property after the sale. Effectively, now because my client didn't read the contract, by simply signing a contract agreeing to purchase the property she was committing fraud because she had already agreed to rent the premises back to the seller for commercial use for a year. Oops on the soap box again, anyway here is what GSTR 2000/20 states about residential premises:

Residential premises is defined as land or a building that:

(a) is occupied as a residence or for residential accommodation; or

(b) is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation;

(regardless of the term of the occupation or intended occupation)

.... It is their physical characteristics that mark them out as a residence. In turn, these characteristics determine when the use or proposed use is for residential accommodation.

..... To be residential premises as defined, a place need only provide sleeping accommodation and the basic facilities for daily living, even if for a short term.

24. The definition of 'residential premises' in section 195-1 refers to land or a building that is occupied as a residence or for residential accommodation or is intended and capable of being occupied as a residence or for residential accommodation.

26. The physical characteristics common to residential premises that provide accommodation are:

(i) The premises provide the occupants with sleeping accommodation and at least some basic facilities for day to day living.

(ii) The premises may be in any form, including detached buildings, semidetached buildings, strata-title apartments, single rooms or suites of rooms within larger premises.

28. The definition states that residential premises must be capable of occupation as a residence. To be a residence in this sense, a place normally should have the facilities required for day to day living. These characteristics are inherent in the fabrication of the structure itself. The premises should have such things as areas for sleeping, eating and bathing, but it is not necessary that these things be arranged in a similar manner to a conventional house or apartment.

29. Premises that lack these basic features, may not be either residential premises or commercial residential premises. Supplies of buildings or other structures without these characteristics are subject to GST under the basic rules, regardless of whether or not they are or have been at one time, occupied as some form of residence.

There is much more in GSTR 2000/20 if you need further clarification but the paragraph that caught my client in particular was:

31. In some cases, the purpose for which the premises are to be used will be evident from their form or fit-out. This is most clearly the case where premises have been fabricated, or altered, to accommodate commercial or professional activities.

The property was used to provide professional medical service before and at the time of the sale and my client had agreed to continue to use them as such. So this was not the sale of residential premises it might have all the things necessary to be a house but it was commercial premises and the supply of commercial premises is subject to GST, that is, if the seller is registered for GST.

This was her out. She asked for more information about the seller and the entity that operated the business. They were different. The medical practitioner operated his business in his own right but owned the premises in partnership with his wife. Yes, the medical practice was registered for GST. My client could find this out by doing a search on http://abr.business.gov.au/LookupTool.aspx She also found out that the Practitioner and his wife were not registered for GST and that their partnership that owned the premises (not the medical practice) did not have a turnover of more than $75,000 per annum. Accordingly, they are also not required to be registered for GST. The trick here is that as the sale of the property is the sale of a capital asset, it is not part of turnover so it will not push them to register, if they are not registered they do

not have to charge GST even though the sale is of an asset that would be subject to GST. Here is the important references:

Section 23-5 states that if the annual turnover of supplies you make in the normal course of your enterprise, exceed $75,000 you must register for GST. Section 185-25 excludes from the calculation of annual turnover the supply of a capital asset.

Next Edition of Newsflash we will look at the problems a going concern clause can cause in a contract and why you must have vacant possession.

More on Real Estate Contract Clauses

Following on from Newsflash 261 where we examined the nightmare a GST clause can cause we now look at vacant possession and a going concern clause which can be equally as catastrophic, so never ever sign a contract without getting advice.

Going Concern:

If the sale of a commercial property qualifies as the sale of a going concern the seller will not have to pay the ATO any GST when they sell the property. The trouble with property is its market value seems to ignore the GST component. This means that the seller may well get the same price for the property whether they charge GST or not, the difference being whether they have to send 1/11th of the selling price off to the ATO, So sellers are always on the lookout for a way to avoid this. A going concern clause, is a dream come true for a seller of a commercial property. It pushes the GST obligation onto the unsuspecting buyer who has already paid full market value for the property.

A going concern clause only ever has a good outcome for the buyer if they just can't afford the funds up front to pay the GST and then wait for the ATO to refund it. Before a going concern clause can apply both the buyer and seller must be registered for GST. If the contract was subject to GST then the buyer would be entitled to claim it all back from the ATO anyway.

Say the market value of a property is $550,000 if the contract is subject to GST then the seller would have to send off $50,000 to the ATO and only end up with $500,000 in the hand. The buyer may hand over $550,000 but in the next BAS he or she will get $50,000 back as an GST input credit so is really only out of pocket $500,000. This means that if the sale is going to be subject to the going concern provisions the property should really change hands for $500,000. I don't like your chances of talking the seller into that when they know the valuation is $550,000. So just don't agree to the going concern clause, register for GST and pay the full $550,000.

The main reason you don't want to agree to a going concern clause is because if you ever de-register for GST or stop using the property in a business, for example as per last edition, the purchaser was eventually going to turn the professional offices back into a house, then you have to pay back the "notional" GST input credit you received. In the example above, that means effectively paying another $50,000 for the property. Notional, because you didn't actually receive it, it was just that the seller didn't have to pay it to the ATO, but the law is like this because the going concern exemption from GST is intended to make the property cheaper by the value of the GST. This is something that does not always happen unless the purchaser is well informed and a very good negotiator.

All this may lead you to decide to sell the property and cut your losses. That won't get you out of it either. Let's assume you decide this rather quickly so the property is still only worth $550,000 but what if your purchaser is not as gullible as you were? If the purchaser does not agree to use the going concern exemption (and they only should if you sell it below market value) you are going to give the ATO $50,000 of your sale proceeds even though you may still owe the bank the $550,000 you paid for it.

Vacant Possession:

This is a much more straight forward problem. It is only an issue if you intend to use the property as your home. If you don't move into the home as soon as practical after settlement then you will not be able to begin to cover the property with your main residence exemption until you actually move in. Sure it may be only a short time before the tenant moves out. It is not the portion of the gain that you will pay tax on that is the problem. It is the fact that you will need to keep records for the whole time you own the property in order to be able to calculate the whole gain to apply that small percentage to.

Going Concern Clauses In Real Estate Contracts

Interesting, fresh after our discussion on the horrors of a going concern clause in a real estate contract in the 1st February edition of Newsflash, the decision in MBI Properties Pty Ltd v FC of T 2013 ATC 20-372 was handed down on the 12th February. MBI had to pay back $215,000 in GST even though they had paid full market price for the property. So please don't read the article on clauses and think it couldn't possibly be that bad.

In the MBI case they should not have agreed to the contract being one for a going concern because they intended to lease the apartments back to a hotel group. As it was the hotel group operating the business not MBI all MBI were doing was renting residential property to the hotel group. Residential property rents are not subject to GST. To qualify for the going concern concession you need to be making supplies that are subject to GST.

Please note that despite market price being paid for the property the purchaser had to then pay the ATO another 1/10th of the purchase price because they didn't use the property for the correct purposes. The ATO still considers them to have benefitted from a discount by not paying the GST. The unfortunately reality in most of these cases is that it is really the seller who has benefited by not having to send of 1/11th of the selling price to the ATO yet still managing to sell for full market value.

If you must enter into a contract to buy a property as a going concern make sure you pay at least 1/11th below the market value because if you ever stop using that property to make GST supplies you are going to have to pay the ATO back the GST discount that you supposedly received.

Don't be misled into thinking that a going concern sale avoids GST. All it does is remove the obligation from the seller to send 1/11th to the ATO and the ATO to send that 1/11th back to the buyer. This helps with cash flow at settlement that is all. The buyer is still considered to have received the GST input credit so must charge GST when they sell (or sell 1/11th below market value) and they must pay the GST back if they de register or stop using the property for GST purposes, for example change of use to a residential rental property.

In MBIs case they acquired apartments that would be leased to an entity that provided serviced apartments. Sure this is a commercial use of the apartments by the other entity but MBI was doing nothing more than renting residential property to that entity.

Fortunately, MBI is a related party to the seller so it will all come out in the wash but there are Mum and Dad investors also caught up in this. Their cases are yet to be heard by the courts.

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.

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

The letting of domestic rental properties does fall within the definition of an enterprise. This means owners are entitled to an ABN but there should never be a need for them to have one. This also means landlords have the same responsibilities under the ABN withholding provisions as other businesses. A landlord must withhold 46.5% of a payment for rental property expenses if the invoice is for more than $50 before GST and does not contain an ABN. For example before paying a cleaner or repairer of a property get their ABN!

ATO Warning About Registering for GST when Buying a Property

The ATO is concerned about developers selling domestic properties cheap to purchasers as long as they register for GST. This can result in the ATO collecting another 10% of the selling price off the purchaser.

Don't be fooled the developer can sell the property to you cheaply because they will not be liable for GST which may be as much as 10% of the purchase price.

The developer sets the property up as a going concern so it can be sold exempt from GST the trouble is once you use the property as a domestic rental you (not the developer) must pay the ATO 10% (not margin scheme) of the purchase price in GST.

According to ATO's Interpretive Decision 2002/710 because the property is being used for a purpose that is only input taxed the owner must, under section 135-5 repay any GST that has been claimed back in the past on the asset. Even though the sale was exempt from GST you are considered to have received the benefit of that GST so you will have to pay it back.

Utilising the Margin Scheme

If you buy a property off someone who is not registered for GST or agree to have the margin scheme apply to the sale you will probably have paid the market price but you won't qualify for any GST input credits. This is fine if you are not registered for GST and are only going to use the property as a residential rental or your home because you would not have qualified for the GST input credit anyway. And what is even better for you is you don't need to read any further through this article.

If on the other hand you are entitled to a GST input credit on the property you are purchasing it is important you do not agree to the contract being under the margin scheme. Here is how the numbers work:

Using the margin scheme means, that GST is only paid on the difference (margin) between the selling price and the original purchase price. So let's say the seller originally purchased the land for $200,000 but was not entitled to a GST input credit because the original seller was not registered for GST. Having purchased for $200,000 she then builds a commercial shed on the land and sells it to you for $530,000. If you agree to the sale being subject to the margin scheme she only has to pay $30,000 ($530,000 - $200,000 = $330,000/11) to the ATO netting $500,000 from the sale. You are not entitled to claim any GST input credit but can use the margin scheme when you sell, if the buyer agrees.

On the other hand if the margin scheme was not used the property could change hands for $550,000 the seller would have to send $50,000 to the ATO, still netting $500,000 but the ATO would pay you $50,000 in GST input credits if you are using the property to make GSTable supplies. The difference here is whether you get the $30,000 up front or when you sell by using the margin scheme. Not only is it better to have the money now while it is worth more but you cannot be sure that your purchaser will agree to the margin scheme. So if you are registered for GST and entitled to claim the GST input credits back on the purchase, do not agree to purchase a property under the margin scheme.

The trap is because you are registered for GST you are going to have to charge GST when you sell. If the property is still not a residential property at that stage and your purchaser has good advice, they will not agree to the sale being under the margin scheme. So while you didn't get any input credit on the property when you purchased it, when you sell you will still have to pay the ATO the whole 1/11th of the selling price. Assuming both your purchase and sale are at the market value, which for some strange reason seems to ignore GST, you have paid more than your fair share of tax.

If after reading this you are kicking yourself that you didn't use the margin scheme in a particular contract, it is not too late, providing you can get the purchaser to agree you can apply to the ATO for an extension of time to apply the margin scheme at http://www.ato.gov.au/content/00315699.htm.

Mining Town Story of Woe

I used to advise investors to visit Broken Hill before they buy in a mining town. Here is another great example

http://www.abc.net.au/news/2015-02-07/house-passed-in-at-auction-after-million-dollar-price-dive/6077724

SMSF, GST and Commercial Property

Quite often commercial property is purchased as a going concern. The objective of the GST going concern concessions is to allow the sale to take place without any GST charges.

Firstly, we should point out that, as a general rule we advise sellers that it is better to pay the GST up front and let the purchaser claim the GST back. The bottom line is the same, it is just a matter of funding

the GST until the ATO refunds it. The advantage is, that you don't have to worry about an ATO narrow view of the going concern rules coming back to bite.

Now, back to the point which is such a typical example of how the ATO can nitpick and throw the whole going concern concession out the window. In most cases when a SMSF buys a commercial property they borrow to do so. This means that the property must be purchased in the name of a bare trust, which is required to hold the property until the loan is paid off. To purchase a property as a going concern both the seller and purchaser must be registered for GST. In this situation the ATO will require both the SMSF and the bare trust to be registered for GST.

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.

Data You Will Need

(a) Amount borrowed
(b) Interest rate of loan. Note: unless you have no personal debt the loan should be interest only and the worksheet is based on this.
(c) The tax bracket applicable to the taxable loss or taxable profit on the property. The tax brackets for 2007 are $6,001 to $25,000 16.5%, $25,001 to $75,000 31.5%, $75,001 to $150,000 41.5%, over $150,000 46.5%. So if before buying the property you were earning $75,000pa the tax rate applicable would be 31.5% if negatively geared or 41.5% if positively geared. You need to consider whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
(d) Building depreciation claimable per year if property built after 17th July 1985.
(e) Depreciation on any plant and equipment.
(f) Original purchase price of the property.
(g) How much you think the property will go up in value per year. If this is too difficult, don't worry as the worksheet will give you a bare minimum required and you can just decide whether it is likely to be more than that amount.
(h) The tax bracket that will be applicable to the capital gain you make when selling the property i.e. you may have retired by then and be in a lower tax bracket. You need to consider here whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
(i) Annual actual out of pocket costs of holding the property such as insurance, body corporate fees, repairs, borrowing expenses (amortised over the first 5 years of the loan), rates, property management fees and sundry expenses such as travel, stationery, phone calls etc.
(j) Rental Income per annum
(k) Estimated future selling costs such as real estate commission, auction fees, solicitor, advertising etc.
(l) Cost of purchasing the property i.e. stamp duty, solicitors fees etc.

Worksheet

Tax Calculation:

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

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

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

Cashflow Analysis:

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

(m)$

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

Net Cash Inflow or Cash Outflow (o) $

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

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

Capital Gain:

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

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

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

Cost Base $
Less Selling Price $

Capital Gain $ (p)

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

Breakeven Point

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

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

Cash Out Flow:

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

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

Reduction in Cost Base:

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

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

After Tax Dollars Translation:

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

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

Conclusion:

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

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

To encourage you to do this calculation on as many properties as possible we have created a spreadsheet to speed up the process https://www.bantacs.com.au/shop-2/property-breakeven-point-calculator/

Who's Name to Buy an Investment Property In

The question usually revolves around whether you prefer asset protection or tax benefits. Combining both gets more complicated.

If you are not concerned about asset protection you would probably prefer to hold a property in your personal name so that any tax losses from the property can be offset against your personal income. Make sure you crunch the numbers if you have a choice between holding the property in the name of a low income earner or a high income earning spouse. If it is only going to be running at a tax loss for a short period of time you should focus more on the tax situation once it becomes positively geared or the capital gains tax on its sale. A close to positive property should be held in a low income spouse's name or a discretionary trust.

The trouble with a discretionary trust is that it cannot distribute losses so they sit in the trust until there is income to offset against them. This means you cannot offset the rental property losses against your own income. That is unless you have a source of income in the trust or another trust that can distribute income into the trust that holds the rental property, this income stream cannot be from your personal services. The advantages of a discretionary trust are that each year you can decide who in your family receives the profits or capital gain and a discretionary trust, being a separate entity from yourself gives you a reasonably good level of asset protection, providing it has a corporate trustee.

Companies are not suitable for investment properties because they do not qualify for the 50% CGT discount. Unit or fixed trusts can give you the negative gearing benefits but as they do not offer any real asset protection or discretion to distribute profits they are no better than owning the property personally but they are more costly to run. Hybrid trusts are a combination of a fixed unit trust and a discretionary trust that depending on the promoter claim to provide all sorts of benefits, see below as to why this is not true.

So in short none of the structures mentioned so far give you all the answers, basically you have to choose either the negative gearing benefits of offset the rental property losses against your own income or asset

protection and flexibility to distribute profits. The only exceptions to this are when you can distribute profits from another trust into the discretionary trust that holds the investment property or when you hold the property in a Self Managed Superannuation Fund (SMSF).

Self managed superannuation funds allow you to still, through salary sacrificing, offset the investment property loss against you wages income even though the property is owned by the super fund. Up until age 60 any profits made from rent income are only taxed at 15% and capital gains at 10%. After 60 if you retire and put the fund into pension phase all rental income and capital gains are tax free to the fund and tax free when the proceeds pass from the super fund into your hands. And the asset protection is the best you can get providing you don't deliberately divert income to the fund to defeat your creditors. The down side is your money is locked away and you can only borrow against the property once so leverage is limited. For these reasons it is usually better to consider a SMSF in your forties or later.

Asset Protection

To effectively protect assets held in other entities from people who may sue you personally you must make sure you do not own, in your own name, anything that would give creditors access to these other entities. For example, if you hold your assets in a unit trust and you own the units your creditors would be entitled to those units in the case of bankruptcy and it is quiet probable that the units will give them the right to demand redemption which could lead to the assets being sold and the proceeds distributed to your creditors because they now own the units. Similarly if your assets are in a company and you own the shares your creditors would be entitled to the shares which would give them control of the company allowing them to liquidate the assets and distribute the proceeds to shareholders.

Companies and trust are useful entities in which to place businesses that could be sued as they will normally protect the owners of the entity but they do not work so well the other way around.

In a discretionary trust the beneficiaries have no fixed entitlement so a creditor cannot force the trust to distribute money to them. But be careful, if you have loaned money to the trust a creditor can demand that money be repaid. This is also the case for loans to companies or unit trusts.

The next problem you have with holding an asset in a company or trust is the difficulty, if it is a negatively geared investment, in offsetting the losses against other income. If the investment is held in an individual's name they can offset any losses from the property against their other income for that year and if there is not enough to offset all the losses the balance is carried forward to be offset against income in future years.

Companies and trust cannot distribute losses so any loss from the investment is locked into the entity to only ever be offset against income to that entity. This is fine if the entity has another source of income that can be applied to the loss rather than that income being distributed to you. Note this will not work if the income received by the entity is really your personal services income because the entity is required to distribute that income directly to you with only the deduction of certain direct costs of earning that income.

It is not wise to hold an investment in the same entity as a business. Businesses are generally considered risky and if the business could not meet its financial commitments creditors would be entitled to the investment because it is owned by the same entity.

You can hold the negatively geared investment in a different entity to your business. If the business is in a trust or company and the entity that owns the investment owns shares in the company, units in the unit trust or is a beneficiary of the discretionary trust that holds the business then income can be streamed (with very careful planning) from the business into the entity that owns the investment in order to use up the loss.

You could also hold positive and negatively geared investments together in the one entity so that they offset each other. It would be unusual for an investment to be positively geared when you initially purchase it and depending on the type of investment it may be costly in stamp duty and capital gains tax to transfer it into the entity with the new investment. If you have a positively geared investment already in an entity it maybe worth considering buying your new investment in that entity if it is the type of entity that would be the best choice for the new property.

Note companies are not entitled to the 50% CGT discount so the choice for investments with capital growth would normally be trusts, SMSFs or individual ownership. There is a way you can achieve asset protection while holding an investment in the name of an individual.

Setting up a mortgage trust that has priority over possible creditors on any properties you or your entities own is a form of asset protection that works whether you are protecting your assets from a tenant or another outside party but it takes maintenance. The idea is that you set up a simple trust then in a round robin of cheques in your bank managers office you gift that trust the value of the equity available in the properties you

wish to protect. The mortgage trust then lends you the same amount which you use to pay back your bank manager. No doubt he or she will be so full of warm fuzzies from the whole experience of helping you that he or she will neglect to charge you any fees for the transactions. The mortgage trust takes a second mortgage on the rental property as security for the loan. Now this arrangement is not going to help you if you are already or will soon be in trouble because the bankruptcy trustee can claw it back. As the property goes up in value the mortgage will have to be increased by the same round robin of cheques in the bank manager's office. There is no need for the mortgage trust to charge you interest and as a result there is no need for the trust to lodge a tax return. As there are no tax consequences of this arrangement there is no need to consider whether it would be caught by Part IVA.

A mortgage trust can also be utilised to protect your own home and allow you to hold it in your own name so that you qualify for the main residence exemption from Capital Gains Tax.

Hybrid Trusts

Warning this and the following article are quite complex and are only important for you to read if you are considering utilising a hybrid trust, which we strongly recommend you do not do. This article explains why. If you will take our word for it and just avoid hybrid trusts you can also avoid reading these articles.

A Hybrid Discretionary Trust is a combination of a Unit Trust and a Discretionary Trust. Initially, the trust is run as a unit trust. This allows the high income earner to borrow money to purchase the units in the trust effectively allowing the units to be negatively geared because the income stream from the trust is, less than the interest on the loan. The unit holder has a fixed interest in the trust so they are entitled to claim a tax deduction for interest on money borrowed to invest in the trust. On the other hand in a discretionary trust there is no fixed entitlement to income, as a beneficiary, so interest on a loan to invest in the trust is only deductible if it is on lent to the discretionary trust at the same or higher interest rate. These conditions on the loan mean it can never be negatively geared.

Getting back to the unit trust situation. The trust buys a rental property with the money subscribed for the units. This rental property is normally the security for the loan. Be careful here as the rental property will need to be held in the name of the trust and the loan will need to be in the name of the unit holder who will be the high income earner in the family.

Eventually the negative gearing advantage will be lost either because rents have increased or the property is sold for a capital gain. After all, that is why you got into the investment in the first place so to plan for this not to happen is to plan to fail. At this point in time the Hybrid trust redeems the units by paying back either the original amount invested or the unit's share of the current market price of the assets in the trust. Which, depends on the terms of the trust deed. Though there is a chance that CGT would deem the pay back price to be the market value of the units. Some argue that if the units only entitle the holder to an income stream, not the capital growth component, the value of the units is less than the unit's portion of the value of the assets held in the trust. Whether the units are redeemed at their original cost, the market value of the future cash flows or at an amount equal to the units share of the trust's assets, each outcome has its own self defeating problems.

If the units in the unit trust have to be redeemed for the market value of their share of the assets in the trust, either as required by the deed or by CGT law. The high income earner will receive taxable income from the trust. If the property investment has gone according to plan this income will exceed the benefit of the negative gearing in previous years. There is the advantage of the capital gain receiving the CGT discount but this would have been available had the property been held in the high income earners name anyway, so at this point in time no advantage has been gained by having the unit trust. After the unit is redeemed there maybe some benefit in the future if the property is not sold ie the reason for redeeming the units was because the property had become positively geared due to rent increases. Now the discretionary members of the trust (low income earners) will receive this income but it has come at the cost of the high income earner having to realise a capital gain that would have not been necessary if he or she had simply held the property in his or her own name. Or even if they did this until it was positively geared then paid the same capital gains tax to transfer it to a low income spouse. The only advantage the trust gives them in these circumstances is that they don't have to pay the stamp duty on this transfer. There are stamp duty concessions for transfers between spouses. It is also possible that the stamp duty on the transfer, necessary if the property is not held in a HDT, may be less than the cost of establishing and running the trust all those years anyway.

If on the other hand the units can be redeemed for the amount that was originally invested, the investor never made a profit on the investment and with the advantage of hind sight the ATO can say the investor never

intended to do so. In TR 95/33 particularly paragraphs 30 to 35 and 47 to 51 the ATO discusses how arrangements that have no chance of making a profit cannot be negatively geared. Paragraph 34 discusses how in Fletchers case the AAT found that the taxpayers never intended to stay in the arrangement for until it became profitable. Further with all the PR about HDTs giving a tax advantage the ATO could use Part IVA to claim the whole arrangement void as a scheme to avoid tax.

On the final hand as the units are only an entitlement to an income stream, even if the market value substitution rule comes into play their value would be considerably less than the value of the underlying assets in the trust. This strategy puts the investment on very shaky grounds in the early years when it was negatively geared. Again TR 95/33 states that if an investment is made with no real intention of making a profit at some time in the future it cannot be negatively geared. Caught this way is the worst case scenario because the negative gearing advantage to the high income earner is lost and you still have incurred all the costs of setting up and running a HDT.

If you are looking at a positively geared property there is no advantage in a HDT. Instead go for a normal every day discretionary trust if you need flexibility of distributions in the future. If you don't need the flexibility in the future just buy the property in the low income earner's name.

If the property won't become positively geared or be sold until the high income earner retires simply hold it in the high income earners name and save a fortune in set up costs of a HDT.

In Case 2/2008 2008 ATC the AAT held that interest payments on loans taken to purchase units in a hybrid trust were not deductible. "Under the trust deed, the beneficial interest in the fund was divided into the unit component (held on trust for unit holders) and the discretionary component (held on trust for discretionary beneficiaries). The trustee could, in its absolute and uncontrolled discretion, determine the proportion of either component. The discretionary powers of the trustee applied to a wide range of amounts, including income, profits and capital gains or losses. The trustee could make decisions as to whether any such amounts were capital or income, and whether expenses were to be paid out of capital or income."

TD 2009/17 is the ATO's final ruling on hybrid trust deeds. The ATO have basically said that the unit holders must receive all the benefits from the investment of the borrowed money to be able to claim all the interest as a tax deduction. Further, it is not just a matter of what is received it is a matter of what the trust deed says. So if for example the deed says that the units can be redeemed by the trustee for the original price paid then the trust is caught ie interest not deductible, even if the units are never actually redeemed.

Other clauses that will create problems:

- The units carry no entitlement to capital gains
- The units only carry an entitlement to part of the income produced by the money invested
- The units can be redeemed by the trustee for less than the market value of the underlying assets
- The units only carry an entitlement to the capital gain

The last two points will result in no interest being deductible. The first two will result in the interest being apportioned between the benefit the borrowings provide to the unit holder and the other private expense of providing benefits to the family of the unit holder. A rule of thumb given in the determination is that the interest deduction should not exceed the amount of the income received from the trust.

Even some fixed trust deeds have some flexibility in them that could result in them being considered hybrids. This is the case even if they are never used as hybrids because the ATO looks at the possibilities provided within the wording of the deed, not what has been done to date.

Do not ignore this ruling and hope you will fly under the radar. Every trust tax return has to answer a question on whether it is a hybrid or not so it won't be long before the ATO look into your affairs.

In Forrest vs FCT 5th February, 2010 three judges in the Federal court destroyed some of the ATO's arguments against hybrid trusts. The ATO's argument was that Minderoo was purely a discretionary trust so no deduction was allowed for the interest on the borrowings. Unfortunately, the ATO pursued this argument with such confidence that it neglected to put forward other possible arguments against the interest being deductible or even that only a percentage should be deductible because some of the money was being used to generate a capital gain for the discretionary beneficiaries.

Case Findings - In response to the ATO's argument that the clauses giving the trustee wide discretionary powers to decide what is and isn't capital showed that the trust was discretionary because this meant that the trustee could effectively decide who received the income from the trust. Forrest argued that this power was only there to allow the trustee to categorise income streams as it chooses, a mere power to classify income, not that the trustee can use it to decide whether the income goes to the unit holders or the discretionary beneficiaries. Forrest further argued that the unit holders right to all income other than capital gain was

already stated in another clause in the deed and that clause overrode the discretion in this regard. Once the dissection between capital gains and normal income is made Forrest argued that then and only then the discretionary clause allowed the trustee to classify income within those wide powers, which had only been given to avoid arguments if the nature of the income was not clear. The judges accepted that the argument that the trustee could use the clause to distribute any income as it suited was flawed because to do so would be a breach of the trustees fiduciary duty to the unit holders. The court accepting this meant the unit holder had a fixed entitlement to income so was entitled to deduct the interest on the loan to buy the units. This case also shows that a trust with discretionary beneficiaries can be still classified as a fixed trust.

The ATO have issued their impact statement on Forrest's case
http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/WAD101of2008/00001
Basically they accept that minor discretionary powers will not turn a fixed trust into a discretionary trust but they are holding firm on the argument of apportionment. They are saying the statements made in TD 2009/17 stand, if someone else receives some benefits from the borrowings then the interest has to be apportioned. Generally as a rule of thumb this means no negative gearing.

They now accept that minor discretionary powers will not tarnish the trust as discretionary though of course there still needs to be a clear entitlement to income for the unit holders.

Damage Control by the Promoters of Hybrid Trusts

Just in case someone tries to tell you their hybrid trust deed gets around all the problems remember that this means you will definitely not be able to negatively gear the property in the trust against your own income. So just what advantages are they offering you? Even if you find a hybrid trust that the ATO approve of, ask yourself first why do you want to use a hybrid trust? To meet the ATO requirements there are no tax advantages. Maybe the spruiker is promoting the deed for other perceived advantages such as:

Asset Protection – If you own the units in the trust your creditors will be entitled to those units and as a result the underlying asset. If you try to limit the rights of the unit holders to less than the underlying asset then you are going to be caught as not having a fixed entitlement so you won't be entitled to a tax deduction for the interest on the money borrowed to buy the units. If this is the case you may as well use a discretionary trust.

Succession Planning – If you intend never selling the asset then you do not have to worry about how you will be taxed on the capital gain anyway so the main tax benefit of hybrids is not relevant to you. We have a law in Australia that limits the life of a trust to 80 years. Some deeds claim to be able to avoid this limit. I have asked a few solicitors about this and they claim it is not possible. So if the trust is forced to wind up in 80 years time there will be a forced CGT event. If instead you leave the asset to your heirs in your will and they do the same no CGT will arise until someone sells it. The rollover relief on death can allow a property to pass down through generations indefinitely. If you would prefer your heirs to hold the property in a trust set up a testamentary trust created in your will. This will achieve the same result with the added benefit of allowing your heirs to distribute income to their minor children without incurring to pay the higher rates of minor's tax.

Simply holding the property till you retire maybe all the planning you need. Businesses should consider operating through a trust with a wide definition of beneficiary in the deed so you can distribute before tax profits from the business into a discretionary trust that owns the negatively geared property. This will offset the losses so making the distribution from the business trust effectively tax free and still protect the rental property from the creditors of the business trust.

The ATO has issued a product ruling to Chan & Naylor Australia Pty Ltd, it is PR 2011/15. Before I launch into the details of this ruling the most important factor is that it only applies to trusts where units are issued between the 27th July, 2011 and 30th June 2014, not the deeds they were promoting at the peak of this scam. They have had to modify their deed to the extent there is no real tax benefit anyway.

Other promoters of hybrid trusts have received private rulings along similar lines. At least Chan and Naylor obtained a product ruling so their future clients can rely on it. Anything less than a product ruling and you will need to get your own personal ruling from the ATO.

All these rulings are along similar lines to the, they provide no real tax benefits over and above other trust deeds.

When Do You Need A SMSF?

There seems to be a lot of publicity lately about spruikers and Self-Managed Superannuation Funds (SMSFs). Scare tactics have also been employed by government organisations. Yes, there are a lot of responsibilities in running your own SMSF but they are no more complicated than dealing with GST and other bureaucratic red tape the government seem to think it is reasonable to impose on the average taxpayer. And yes SMSFs are not for everyone but don't be led to think that an adviser who recommends a SMSF is a spruiker. There are many, many good reasons to have a SMSF, especially if you are investing in property.

Once you reach 60 years of age and transfer your superannuation to pension phase its earnings and capital gains will be tax free to the fund and you. Further superannuation is the best form of asset protection that you can get. Even before pension phase the maximum tax on your superannuation earnings is 15% and10% on capital gains yet you will get an effective tax deduction at your marginal rate for contributions to the superannuation fund. The main downside is limited access to the funds until retirement conditions are reached. There has been much discussion about the details of SMSFs in the last couple of newsflashes and our free SMSF booklet should cover all your questions www.bantacs.com.au/booklets/SMSFs_Booklet.pdf this article is not about the details of investing through a SMSF but whether it is suitable for you.

So superannuation has the best tax concessions and asset protection, it is just a question of whether this is the right time for you to lock your money away and whether you should do it in a SMSF or a public superannuation fund. It is a no brainer if you want to invest directly in a rental property. You cannot directly hold a rental property in the superannuation regime any other way than in your own SMSF. It is the same with investing in collectibles. On the other hand, if you want to invest in shares in public companies this can be achieved through the public funds. Some even allow you to make your own choice of the companies you invest in, from their range. So if you choose to direct your superannuation savings to shares then the circumstances when a SMSF is suitable are limited to when you want to diversify into property and/or your shareholding has reached the stage where the management fee that the fund charges you as a percentage of your investment exceeds the fixed costs of owning your own SMSF. This comes into play, as you approach the $200,000 mark in superannuation savings.

The simple solution to knowing whether you should buy your next rental property in a SMSF is to see your accountant before you buy a property; they will know exactly what is right for your circumstances. If you don't have an accountant, well now that you are going to own an investment property you will need one so find one and give them the chance to examine your circumstances before you go making one of the biggest decisions in your life.

Please don't let the entire scare mongering make you distrust advisers and think you have to nut it out on your own. Just make sure you consult an accountant that is independent and knows your circumstances well. They will cost a minute fraction of the amount you will be spending on the property.

Your accountant should be able to evaluate the property, telling you how much it is going to cost you to hold, how much it needs to go up in value on average to breakeven, how to manage your loans, how to keep the appropriate records for your tax return, what the ownership structure should be and why.

Now how to pick the spruikers? Glitz, glamor, lots of advertising and pressure are not the signs of a good advisor. There is probably no one fool proof tactic but word of mouth and independence is a good place to start. Our affiliates page was created to help our clients know who we trust, here is our word of mouth www.affiliates.bantacs.com.au/index.php.

Buying Australian Property From A Non Resident

Starting on the 1st July 2016 purchasers of properties from non-residents will be required to withhold 10% of the purchase price and remit it to the government. So it is important that before you purchase a property you make sure that the seller is a resident of Australia for tax purposes. Take care, if you get it wrong you will be up for another 10% of the purchase price. The seller could be right here in front of you with an Australian passport and still not be considered a resident of Australia for tax purposes. This will apply to all commercial property transactions but it will only apply to residential property transactions exceeding $2.5million. The seller can claim the 10% back from the ATO when they lodge their tax return.

Just Why Houses Are so Expensive

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

Government fees cost more than land

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

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

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

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

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

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

Elliott says the escalating government costs are forcing some developers to shy away from housing projects.

“A significant concern is that developer margins are now getting squeezed to the point where developing new estates in some areas is no longer feasible,” he says. “This is contrary to the often-expressed view by governments that developers will simply absorb additional costs. “This will not only add to concerns about housing affordability because of diminished supply, but it may also create a new problem – that of housing availability.

© Australian Property Investor Magazine – www.apimagazine.com.au Reproduced with permission

Buyers’ Agent fees

The ATO has issued ID 2009/9 which deals with a buyer’s agent fee that includes the cost of finding a suitable property manager. The argument being that that portion of the fee is deductible because it relates to the production of the rental income rather than acquiring the property. In the particular circumstances of the ruling the buyers’ agent charged the same fee to find a rental property as was charged for an owner occupier property so the ATO found that no cost had been incurred for this service.

Don’t let this completely deter you as it is an omission by the ATO that an additional charge by a Buyers’ Agent to find a property manager would be deductible.

Travel to Find a Rental Property

When section 110-25(4) was modified to include the capital costs of ownership it was considered that this category could include the cost to inspect a property before purchase. The question was whether the cost had been incurred at a point too soon to be considered a cost relating to the property. This particular angle has not directly been address but it is noted that the 2007/08 ATO Capital Gains Tax guide states that the travel costs incurred to find a property do not come within any of the five elements of the cost base. Section 110-25(4) is number 3 in these elements. So we can conclude that the ATO doesn’t think they can be included but the matter has not been decided by the courts.

Land Tax Thresholds for Each State

If you own land under the land tax threshold in each state then despite owning over the threshold over all, no tax is applicable. Main Residents and land used in primary production are exempt from land tax and excluded from the thresholds. The web addresses to check the Land Tax thresholds in your state are as follows:

www.osr.qld.gov.au www.osr.nsw.gov.au www.sro.vic.gov.au
www.dtf.wa.gov.au www.revenuesa.sa.gov.au www.sro.tas.gov.au
www.revenue.act.gov.au www.revenue.nt.gov.au

Borrowing Costs When Loan Not Approved

TD 93/48 states that the costs you may incur in trying to obtain finance for a rental property are not tax deductible as borrowing costs if the loan is not approved, because they are not a cost of incurring income. Though there is ample argument in the CGT section of the 1997 ITAA to include them in your cost base under section 110-25(4) ownership costs or 110-35(9) borrowing costs or 110-35(2) if they are for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser. Maybe even under 110-25(2) regarding money paid in respect or acquiring the property. Of course they can't be included in the cost base if you don't end up buying the property.

Off The Plan Apartments

Stacks the Law Firm have created a useful check list of 12 pitfalls of buying off the plan. The article is available at
http://www.stacklaw.com.au/web/page/top-12-pitfalls-in-buying-property-off-the-plan/news/3028

Buying Off the Plan

It's not as crazy as it sounds, there are some advantages such as benefiting from the capital growth on a property simply for the cost of the interest on the deposit. It is not unusual for these sorts of contracts to take 2 years to reach settlement. Sure you don't have the rental income during that time but you don't have the rental expenses either which is even better if the property is negatively geared. The catch is you don't know what you are getting so it is important to sign with a reputable developer. The risk is the developer could go broke or not produce the unit up to the standard you expected leaving you with a legal battle that isn't worth it for the sake of recovering your deposit.

When you finally settle so do all the other people in the complex. At this time there will be a certain percentage that need to get out because their circumstances have changed and for a while the market maybe flooded and the price could drop. There is also the risk that between signing the contract and settlement your personal circumstances could change and in the end the bank won't lend you the money to settle so you blow your deposit. Further, if the development was directed at investors the rental market may be flooded by many similar apartments coming up for rental at the same time. Many of these supply and demand problems can be minimised by investing in a smaller development but this may mean going with a less reputable developer.

The tax consequences are quite good in that your 12 months for the 50% CGT discount starts from the date you buy off the plan so you may well be able to sell before settlement and still get the discount (Reference ID 2003/456). Of course if you buy with the intention of reselling at a profit rather than holding it as a rental then CGT doesn't apply at all, the profit is taxed as normal income.

If you're an investor and use a deposit bond to pay your deposit you will not be entitled to a tax deduction for the cost obtaining the deposit (Reference PBR 80364) nor is it considered a borrowing expense but the interest will be tax deductible (Reference PBR 65790). The cost of setting up the deposit bond can be included in the first element of the property's cost base (PBR 33799). Some developers pay interest on the deposit, this is of course taxable income to you.

Investing in a Display Home

GST applies to commercial rents but not to premises that are used predominantly for residential accommodation. It is the ATO's opinion that it is the physical characteristics of the premises that determines whether or not premises are being used predominantly for residential accommodation.

In the property and construction industry partnership issues register at section 10 it state that the supply of a house by way of lease to be used by the builder as a display home is an input taxed supply under section 40-35 of the GST Act. So you can't claim the GST back when you purchase a property to be rented out as a display home but you do not have to charge GST on the rent you receive even though the property is not actually being used as a home.

You are entitled to claim depreciation and all other normal rental expenses. Note if the first owner of the display home was the builder who built it then the value you can depreciation at 2.5% for the purposes of Division 43 special building write off must not include the builder's profit margin.

Buying a Property in a Trust to Later Transfer to SMSF

The only property that a SMSF can buy off its members or their associates is business real property. This is a property that is used solely in a business (not necessarily the business of the member) though it could resemble residential property just as long as it is solely used for business.

The term associate is far reaching, in section 70 of the SIS Act, it includes entities that you control or would be expected to act in your interest. There is even an anti avoidance provision in section 66(3) to prevent you selling to an entity and then the SMSF buying from that entity. So don't let anyone talk you into buying a property in a trust so that later you can sell it to your SMSF.

SMSF Borrowing

The ATO is warning taxpayers that they are aware that some trustees are signing contracts to buy an investment property for a SMSF before the bare trust (security or holding trust) comes into existence. When a SMSF borrows it cannot use its current assets as security, only the asset being purchased and then only if it is held in a bare trust rather than directly in the name of the SMSF.

There is just too much involved in these arrangements to take the risk that the ATO could unwind the whole transaction. Accordingly, it is important to first obtain a lender before you seriously look to buy a property. Setting up a bare trust off the shelf could be costly. Your eventually lender may not be happy with the deed and will charge you to have their solicitor review it. It is usually cheaper to just go along with whatever bare trust deed your lender recommends, hence the need to choose your lender first.

Redirecting Employer Superannuation Contributions

Some big employers and government departments who traditionally paid their employees' superannuation into an employer based fund are loosening their rules a little to allow their employees to have their own SMSF. Unfortunately, in many cases the employer will still pay the employee's superannuation into the employer sponsored fund but that fund then allows the employee to transfer the funds into their own SMSF at monthly or annual intervals.

If your employer will not pay your superannuation directly into your SMSF and you have a negatively geared rental property in your fund then the loss from the property cannot be used to reduce the contributions tax on your employer's contributions.

For example say the rental property in your SMSF makes a $10,000 loss and you choose to salary sacrifice $10,000 into superannuation so that effectively that loss is offset against your taxable income ie you reduce your wage by $10,000. If paid direct to your SMSF no contributions tax is paid because the SMSF has a loss of $10,000 to offset against its income stream of your superannuation contribution.

Here is the problem, if your superannuation contribution detours via another superannuation fund first. That first fund is the one that must pay tax on it so the $10,000 is reduced to $8,500 after tax. All your SMSF is going to receive when the funds are rolled over is $8,500. This is not included as income to your SMSF it is just a rollover balance. So your SMSF has a carried forward loss of $10,000 which it may never use (no tax at pension stage) and you have lost $1,500 out of your superannuation balance. Sort of takes all the fun out of the arrangement, doesn't it.

Buying Non Residential Property In Your SMSF

Your SMSF can only purchase real estate from you if it is solely used in a business, not necessarily your business. The legislation uses the term "wholly and exclusively'. Regardless of whether the SMSF purchases the property from you or anyone else you cannot use the property for private purposes unless it is a farm or motel, something where the residential accommodation is minor and related to the business operations. Note that if your SMSF owns a holiday unit, even one leased back to a resort you cannot even stay one night in the unit. So if you go there for a holiday make sure the resort gives you one that you do not actually own and you pay for it.

SMSFR 2009/1 is the ATO ruling on these issues
http://law.ato.gov.au/atolaw/view.htm?DocID=SFR/SMSFR20091/NAT/ATO/00001

Providing the private residential area of the farm is less than 2 hectares members of the SMSF are allowed to live there and if already owned by the member the SMSF is permitted to buy it from the member. Note 2 hectares residential use of a small farm would not qualify for the concessions.

Here are some extracts from the ruling:

> The 'wholly and exclusively' threshold will be met if:
>
> the area containing the dwelling and used primarily for domestic or private purposes does not exceed 2 hectares; and
>
> the domestic or private use is not the predominant use of the property.

SMSFR 2009/1 also so allows the 'wholly and exclusively' test to be met when part of the land is not used for any purpose at all. It is a matter of examining only the part of the property that is actually in use. But of course the more of the land that is not used the less likely that business use is predominant over residential use.

Solicitors Corner – Buying Real Estate GST Free

When your client buys a property that is GST free because it is farm land or subject to the going concern provisions it is important that the seller provides you with their original contract to purchase the property and whether they were registered for GST at the time.

If your client ever wants to sell this property using the margin scheme they have to stand in the place of the person they purchased the property off because there was no GST on this current sale. The base price for the margin will not be the price your client pays but the price paid by the entity that sold the property to your client. Reference Section 75-11(5) GST Act.

Want more useful tax information for solicitors? We have a whole booklet on the topic:
http://www.bantacs.com.au/booklets/Solicitors%20Selection_Booklet.pdf

GST Clauses

In Tam V Mannall 2010 NSWSC 250 the contract read:

> "Normally, if a party must pay the price or any other amount to the other party under this contract, GST is not to be added to the price or amount."

The sale was for commercial premises by an entity registered for GST. The seller claimed that at the auction it was understood that the amount bid would be the net of GST amount, they apparently used the words "GST on top". The purchaser denied knowledge of this and won the case based on the wording of the contract. Although the outcome could have been different if there was some independent written evidence that the price was promoted as plus GST on top, as was the case in Ashton v Monte Leone 2010 NSWSC 258. The seller may then have been successful in arguing that the contract wording was a common mistake.

The contract used was a standard real estate contract. That is the trouble with auctions, you are forced to sign there and then and can't run off to your solicitor and accountant for advice. If you are considering bidding at an auction, don't just go along thinking nothing will come of it so why spend the money on professional advice.

From the seller's point of view, at an auction, the roles are very much reversed, you will not be presented with an offer where you can then go and seek advice. This seller got 1/11th less than they anticipated because they were locked into whatever happened on the day, probably expecting the real estate agent to look after their interests.

Auctions might get action but it is all too fast for anyone to do their due diligence before signing. The due diligence has to be done before the auction and as seriously as if you had already decided to buy or sell. Please if you are going to sell or buy at an auction ask for a copy of the contract before the day and get advice from a Solicitor and Accountant on just what that contract says. There are plenty of other dangerous clauses to be aware of. Even if you are buying a home to live in you still need to make sure there is a vacant possession clause and that there is not a going concern clause. Buying land that was once used as part of a farm can also have its dangers. I know, I am nagging now, I just want readers to understand that whether they are buying or selling there are no real estate deals that are simple enough to just rely on what the real estate agent tells you.

Queensland Land Tax For Trusts

In Queensland each trust you control will be assessed separately, for land tax purposes, if it has a different trustee. This would mean a different company for each trust. Companies cost around $800 to set up and $250 annual return fees. LTA020.1.1 states:

12. Where a trustee holds several parcels of land, each in the name of a different trust, but the beneficiaries of those trusts, at the time when the land tax liability arises, are the same, one assessment will issue to the trustee including all the taxable land that is subject of the trusts.

Example 6

Y is the registered owner of three parcels of land. Y holds parcel 1 as trustee for the Gold Trust, parcel 2 as trustee for the Silver Trust and parcel 3 as trustee for the Bronze Trust. At the time of determining land tax liability, each trust has the same beneficiaries. Y is liable for land tax as trustee under ss.20(2) and (3) of the Land Tax Act. One assessment is issued to Y under the Administration Act.

13. Where parcels of land are held by separate trustees under trusts where the beneficiaries are the same, separate assessments are issued to each trustee.

Example 7

A is the registered owner of parcel 1 and B is the registered owner of parcel 2. A holds parcel 1 as trustee for the Beaver trust and B holds parcel 2 as trustee for the Bear Trust. Each trust has an identical set of beneficiaries. A and B are liable for land tax as trustees under s.20 of the Land Tax Act. Separate assessments are issued to A and B under the Administration Act.

If you would like to read more go to https://www.osr.qld.gov.au/legislation-rulings/public-rulings/land-tax/lta020-1.shtml

There is also the asset protection advantage of having properties in separate trusts. Here are the land tax rates for trusts; each trust gets a $349,999 threshold. So if the unimproved value of the land held by each trust is less than this, no land tax will apply. Note this is every year!

Unimproved Value	Land Tax
Up to $349,999	$0
$350,000 to $2,249,999	$1,450 plus 1.7 cents for each $ more than $350,000
$2,250,000 to $4,999,999	$33,750 plus 1.5 cents for each $ more than $2,250,000
$5,000,000 and over	$75,000 plus 2 cents for each $ more than $5,000,000

GST Purchasing Farm Land or Commercial Premises

In a recent media release the Government has announced it will be introducing legislation on reverse GST charges to Parliament in 2014.

Regular readers would be well aware of my concerns about GST clauses in real estate contracts. A reverse GST charge is intended to solve some of these problems where both parties to the contract are registered for GST and the contract is for the sale of a going concern or farmland. A reverse charge means that the seller does not have to pay any GST to the ATO, it is the purchaser's responsibility but at the same time they claim the GST back so it should have a net result of nil. There is also talk of widening the occasions when a going concern concession would apply.

It is intended that the new legislation will allow the margin scheme to be used in a reverse charge contract. This is a great change because at least if the ATO come along and decide, no the contract should have included GST the GST will only be 10% of the margin between the sellers purchase price and the selling price.

The new law will remove the old so developers entering into options or long term contracts on farm land should be concerned that the law could change between signing the contract and the eventual settlement. It may be worth considering not using the GST concessions at all. Pay GST and claim it back in your next BAS but you need to consider that the stamp duty on the contract will be higher as a result. At least make sure that your contact considers a possible change in the law before settlement.

Solicitors' Corner - Reviewing the Contract

I have seen contracts that state that if the ATO decides that the sale should be subject to GST then the purchaser must pay an extra 10% of the purchase price. This is not even good if your client is the seller because of the difficulties in actually recovering the money. Better to get it right from the start.

A margin scheme clause means that the buyer is not entitled to claim back the GST on the purchase. That is fine if the purchaser is simply purchasing the property as a residential rental or own home. Anything other than that then the purchaser is likely to be better off if the margin scheme did not apply. This should be taken into account when negotiating the price.

Going concern clauses are extremely dangerous. They mean that the purchaser does not qualify to claim back any GST on the purchase price but if they change the use or sell the property they may well have to pay the ATO another 10% of the purchase price even though they paid full market value. Generally a contract with a going concern clause should be for 10/11ths of the actual market value.

If the property is going to be used as a main residence it is important to have a vacant possession clause. If they do not move into the property as soon as practical after settlement they will only be entitled to a partial main residence exemption. If the seller has a tenant in the property under a lease, it is better to delay settlement until the tenant has moved out.

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.

Important To Read Before you Sign A Contract – 2017 Budget

Having failed to manage to collect the tax themselves the government is now shifting the heavy lifting to home buyers. This applies whether you are a property investor or just buying your own home. If you don't get this right you will end up paying the seller's tax for them.

From 1st July, 2017 the seller must provide you with a clearance certificate from the ATO if the property cost $750,000 or more. No exceptions. If you don't obtain a clearance certificate from the seller then you must withhold 12.5% of the purchase price and send it to the ATO. Even if you don't withhold 12.5% at settlement you still have to send that amount to the ATO out of your own pocket. That is a minimum of $93,750 if you don't have the clearance certificate and there is no chance of slipping under the radar because it is so easy for the ATO to data match with the titles office.

Apparently, it is also all too hard for the ATO to collect it's GST off property developers so again it is putting the onus onto house holders to collect it for them. If you buy a brand new property after 30th June 2018 then you must withhold 1/11th of the purchase price and send that to the ATO. No word yet on how this will work with the margin scheme and we strongly recommend at this stage that you withhold the whole 1/11th because you are not in a position to argue with the ATO if they come along later and say no, the margin scheme didn't apply or the margin is bigger. Confidentiality will prevent you from being provided with any information that you would need to fight the ATO. If you are now entering into an **off the plan purchase** that will settle after 30th June 2018 make sure the contract allows you to pay 1/11th less for the property in recognition that you will be sending the 1/11th to the ATO, non-negotiable. Note that this only

applies to residential premises or land, just the properties that mums and dads buy. They are not imposing this on business properties.

Purchasers Withholding 12.5%, 1/11th or 7% of the Price

Buying a property has now become a mine field of tax liabilities for the ill-informed purchaser. If you are required to hold back part of the purchase price to send to the ATO and you don't, you will have to pay the amount to the ATO anyway but out of your own pocket.

ATO Clearance Certificate – All sellers must be able to produce a clearance certificate from the ATO. If they don't and the property is worth more than $750,000, then the purchaser must withhold 12.5%. The clearance certificate is intended to prevent non-resident sellers from taking the money out of the country without paying any CGT. It does not matter even if you are certain the seller is an Australian resident. Regardless you need to see a clearance certificate.

Purchasers Paying the GST on New Houses or Land – To prevent phoenix companies not paying the GST on new house and land packages, new units or newly subdivided vacant residential land. In all contracts signed after 1st July 2018 the purchaser must withhold GST and send it to the ATO. It is then up to the seller to claim it back in their BAS. The amount to be withheld is 1/11th of the purchase price unless the margin scheme applies. Under the margin scheme the amount to be withheld is 7% or the seller can apply to have the ATO determine a lower percentage.

Regardless of whether the seller will ultimately have to pay that much to the ATO or whether GST even applies, the purchaser must withhold, this could cause quite a few problems with mortgagees.

The seller is required to give the purchaser their details but regardless the purchaser must withhold. We recommend that before you go withholding the lesser amount of 7% make sure the seller is actually registered for GST.

Owning A Rental Property

Please make sure you read this booklet next.
http://www.bantacs.com.au/booklets/Owning_A_Rental_Property.pdf

Winning Property Tax Strategies – The Book

By best selling authors Noel Whittaker and Julia Hartman, Winning Property Tax Strategies is a must-read for property owners and accountants alike. Residential property is Australia's favourite investment, yet many landlords fail to achieve their dreams of wealth because they get it wrong from the start. Winning Property Tax Strategies provides a unique insight into the many different facets of property investing. Primarily it addresses taxation issues, but the emphasis is that one size does not fit all. You can purchase it online by going to: https://www.bantacs.com.au/shop-2/ . The cost is $29.95 plus $6.55 postage – tax deductible of course!

Ask BAN TACS

For $79.95 at Ask BAN TACS, https://taxquestions.com.au/ , 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.

More Information

Please make sure you continue to keep your knowledge up to date by subscribe to our Newsflash reminder. There are many other booklets available on our web site https://www.bantacs.com.au/media-library/booklets/ in fact the whole web site is full of useful information so also have a look around under topics.

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

Disclaimer: The information is presented in summary form and could be out of date before you read it. It is only intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.