BAN TACS
National Accountants Group

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

Owning 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 location details and information about BAN TACS practitioners

Liability limited by a scheme approved under Professional Standards Legislation

Advertisement

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

"Ninety percent of all millionaires became so through real esta

Andrew Carneg

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 read the others Before You Buy A Rental Property, Buying A Rental Property, Selling A Rental Property and Your Own Home. 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

Deductible Rental Property Expenses

The following list is just a summary the these expenses are discussed in more detail later in the book, having them here in one spot maybe a useful checklist.

- Agent's Commission to manage property.
- Interest on money borrowed in relation to the rental property

- Telephone, Stamps, Stationery, Insurance, Advertising, Land Tax, Secretarial, Bookkeeping, Tax Agent and Legal Fees regarding lease or rent recovery, not buying and selling.
- Borrowing Expenses, if more than $100 must be claimed over 5 years or term of loan whichever is the shorter period. If less than $100 can claim immediately.
- Depreciation on plant and equipment such as carpets, curtains, ceiling fans, some light fittings. Hot water systems, stoves etc.
- Motor Vehicle Expenses in relation to collecting rent, organising repairs, paying expenses, etc. There are various methods and requirements to calculate this claim, refer our Booklet http://www.bantacs.com.au/booklets/Claiming_A_Motor_Vehicle_Booklet.pdf . The most popular method is to claim a rate set each year by the tax office of approximately 76 cents per kilometre based on a "detailed and reasonable estimate" of kilometres travelled. In order to use this method you must not claim more than 5,000 kilometres in the year for all claimable purposes, note if the vehicle is owned by two people they get 5,000 kilometres each. You must own the vehicle, make the appropriate election and personally incur the costs associated with the vehicle. If you do more than 5,000 kilometres you can reduce your kilometres to 5,000 in order to use this method or use another method.
- Travel Expenses as above i.e. airfares. Meals and accommodation are also deductible if you are required to stay away from . A travel diary and receipts meeting the substantiation requirements would be required if away for more than 5 nights. Best to keep a travel diary anyway. An electronic version is available at the bottom of this page https://www.bantacs.com.au/shop-2/
- Repairs and Maintenance, not improvements are deductible. For example if the house needed painting when you bought it then painting it would be an improvement, therefore not deductible. On the other hand if during the time of your ownership the paint starts to peel and you repaint, the expense would be a deduction. No deduction is available for your own labour. Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle (IT180). IT 180 states that to claim, the repair needs to be made during a financial year that rent is received. **Note** improvements can increase your cost base for CGT purposes.
- Depreciation on the building if it was built or renovated after 16th September 1987.

Repairs or Improvements?

Repairs and Maintenance, not improvements are deductible. For example if the house needed painting when you bought it then painting it would be an improvement, therefore not deductible. On the other hand if during the time of your ownership the paint starts to peel and you repaint, the expense would be a deduction. No deduction is available for your own labour. Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle (IT180). IT 180 states that to claim, the repair needs to be made during a financial year that rent is received.

In Ormiston case 2005 he was permitted to claim for the costs of holding a "rental property" for 4 years even though it was never actually rented out because it was being renovated but this did not include repairs.

If a property is used only as a rental property during the whole year then a repair would be fully deductible even though some of the damage may have been done in previous years when the property was used for private purposes (TR97/23). Note this does not apply if the damage was done in a period you did not own the property. If the state of disrepair the property was in at the time you purchased it is directly responsible for further damage when you own it, all the repairs relating to that damage are considered improvements (Law Shipping Co. UK). A repair can become an improvement if it does not restore things to their original state (case M60) i.e. replacing a metal roof with tiles. The whole cost of the tiled roof would be an improvement and no deduction would be available for what it would have cost you to put up another metal roof. But a change is not always an improvement. In ID 2002/330 the ATO states that the cost of removing carpets and polishing the existing floorboards is deductible. Yet in ID 2001/30 underpinning due to subsidence was considered by the ATO to be an improvement not a repair. It is not necessary to use the original materials to restore the thing or structure to its original state. Modern materials can be used even when these might be a slight improvement because they are more efficient. As long as the benefit is only minor or incidental it can still be considered a repair.

Work that replaces the whole thing or structure is an improvement not a repair. So don't pull down all of the old fence and replace it just replace the damaged area. TR 97/23 recognises that eventually the whole thing or structure may be replaced in a progression of repairs. These repairs are still deductible providing each repair is on a small scale, the progression is over a long period of time and that it is not just in reality a replacement done over time but individual repairs.

Tree removal is claimable if the trees have become diseased or infested during the time of ownership. Removal is also claimable if the tree is causing damage such as roots interfering with pipes and the damage was not present when you purchased the property. If a tree is removed because it may cause damage in the future or you are fed up with the leaf litter that has always happened since you bought the property, then you are making an improvement which is not deductible.

Note improvements can increase your cost base for CGT purposes.

Depreciation – The Quantity Surveyors Report

There has been considerable publicity lately about claiming building depreciation on rental properties by having a quantity surveyor calculate the original building costs and value of plant and equipment. A good reference regarding the building costs is ATO ruling TR 97/25 available from the ATO web site.

There are a couple of little catches to relying on a quantity surveyor's report. The first one being that you can only rely on a quantity surveyors report if you have exhausted all other means of finding out the original building costs. The legislation even compels the seller of a property to provide you with this information - Subsection 262A(4AJA) of the 1936 Act. The second catch is if the original owner was a spec or owner building the calculation cannot include their labour or profit.

Before you spend money on a quantity surveyor make sure you have exhausted all other means of ascertaining the original building price because the ATO will not permit you to use the quantity surveyor's report if you can ascertain the original cost. You should also find out if the original owner was a spec or owner builder.

If the building is too old to qualify for depreciation it may not be worth paying for a depreciation report just for the plant and equipment. You are entitled to calculate the second hand value of plant and equipment yourself and your accountant will have a program that will calculate the depreciation each year.

Depreciation on a Building

Residential buildings constructed after 16th September 1987 can be depreciated at 2.5% per year when they are income producing (TD93/62). If the building was purchased after May 13 1997 this amount reduces your cost base for capital gains tax purposes, regardless of whether you actually claimed it or not, so in effect you are getting a tax deduction now in return for a higher tax bill when you sell. This may work against you if you are now in a low tax bracket relative to when you sell. But usually it works out in your favour because of the 50% Capital Gains Tax discount you effectively only increase your taxable gain by half what you have claimed over the years. If the building was purchased before 13 May 1997 the Section 43 deduction does not reduce your cost base for capital gains tax purposes unless you make a loss on the sale.

Warning – The legislation regarding properties purchased after 13 May 1997 actually states that the cost base is to be reduced by all building depreciation claimable. The ATO has stated in TD 2005/47 that you only have to reduce the cost base by the building depreciation that could be claimed if you amended your previous tax returns. In other words as you are only allowed to amend back 4 years (sometimes only 2) any depreciation missed in the years before that will not reduce the cost base.

If you claim this depreciation the building and the land are considered separate assets for capital gains tax purposes (TD98/24). This could be useful if you build an income producing property on the same land as your principal place of residence. Care should be taken when purchasing a property to enquire whether the previous owners claimed Div 43 depreciation. You can claim Div 43 depreciation even if you are not the owner who originally built the home. If you can’t get the actual cost from the previous owner you can have it estimated by a quantity surveyor.

Depreciation on Improvements

The following is an extract from Leary & Partners (Phone 1800 808 991) P/L Accountants News. I find their honest approach very refreshing because I am fed up with Quantity Surveyors advertising just pay me the money and I will get you lots of tax deductions, when they are not responsible for the tax return. Leary and Partners make a great effort to be correct by employing Kaylene Arkcoll.

Despite what most taxpayers believe, purchasing a house that has had a post 1985 refurbishment or alteration does not automatically guarantee them a Division 43 deduction. They must first prove the three W's: What? When? And Why? An often impossible task. Much of the frustration and disappointment we have observed could have been avoided if the taxpayer had simply consulted their accountant prior to purchase. Empowered with the following basic advice they could have made a fully informed investment decision.

Before they claim a Division 43 deduction a taxpayer must be able to establish:

a) the scope of the work done
b) the date at which the work was done
c) the cost of the work and
d) whether the work was of a type that qualifies for a Division 43 deduction.

If they are unable, or unwilling, to obtain reasonable proof of these facts (as decided by the ATO), they are not entitled to a Division 43 deduction. Claiming a deduction without the required proof could result in both rejected claims and penalties. As quantity surveyors, we can assist the taxpayer meet requirement c, but only if they have the documentation necessary to satisfy the other three requirements.

Ideally the claim should be based on formal documentation. This may take the form of architectural drawings, specifications of works, contract documents, receipts or photographic records of the works. If formal documentation of this style is not available, it may still be possible to substantiate a claim if the basic details of the work can be obtained from the property owner at the time or the contractor. How much documentation is required and in what form will depend on the nature of the work. Brief notes from a phone conversation with the previous owner may be appropriate for a claim on a minor item such as a security grille but may not be sufficient as sole documentation for a large, complex refurbishment claim.

Some of our clients believe that simply by inspecting a building a quantity surveyor should be able to determine exactly what was done and when. We wish this was true! Without the ability to compare the building pre and post the work being undertaken, many minor structural or aesthetic changes are impossible to detect – let alone prove to an auditor. Similarly, unless work is obviously quite new, a physical inspection is unlikely to conclusively establish a construction timeframe. Sometimes our knowledge of the industry allows us to check potential information sources that the property owner may not have considered. However, we cannot retrieve data that had been destroyed or that was never recorded in the public domain. One of the proofs of professionalism is being aware of when to say, and being prepared to say "We can't substantiate this claim."

TR 97/25 authorises quantity surveyors to prepare an estimate of costs where the original costs are not available. This mandate does not extend to us estimating the scope of works or time of works if documents supporting these are not available. Putting such estimates into a quantity surveyor prepared depreciation schedule does not magically make them proven fact. No matter what the schedule says, ultimately the onus of proof remains with the taxpayer.

Undocumented building additions – Properties we inspect often have a balcony, pergola, carport or shed that are not shown on the Council approved drawings. We can prove the existence and scope of these works, but not when they were done. If we take a conservative approach base the cost estimate on the earliest (and hence cheapest) possible construction date, we are advised the claim is unlikely to be challenged.

Undocumented refurbishments – We constantly find ourselves dealing with undocumented refurbishments such as kitchen and bathroom makeovers undertaken by previous owners. Even when our inspection supports the fit out of these areas being newer than the original building, it is extremely difficult for us to translate this into a substantial claim.

Unless the refurbishment included major structural alterations, there will be no council record of the work. Consequently, even if the taxpayer is certain in their own mind of the approximate age and scope of the work, they can rarely obtain hard evidence to substantiate their opinion. For example, they can't prove

whether the room was completely refurbished as a one-off project, whether it was partially refurbished or whether individual items were progressively repaired and replaced.

Further, the expenditure must have qualified as s 43-70 `construction expenditure` when it was incurred by the property owner. This will not be the case if the property owner was entitled to claim the cost as a repair deduction. This makes claims for painting, tiling, roofing, etc., virtually impossible to substantiate unless we can prove the work's background history.

Lack of appropriate documentation regularly prevents a claim on most, if not all, of the work.

A typical example

The taxpayer bought a pre-1985 house. The vendor's real estate agent told them that the vendor had recently rewired the house and completely replaced the metal roof sheeting. The taxpayer subsequently asked us to prepare a taxation depreciation schedule that included the costs of the re-wiring and re-roofing.

No council building approval had been granted for the work. No documentation had been, or could now be, obtained from the vendor. The real estate agent had changed company and could not be located. The electrical wiring was not by nature something that could be reliably dated by visual inspection and the roof sheeting did not appear obviously new. Further, these items could potentially have been a tax deductible repair for the previous owner.

Despite the client's strong representation that they were entitled to a deduction, we could not include the re-wiring or re-roofing in our schedule.

Tips

These tips may assist you to maximise your claim if you purchase an older rental property.

1. Arrange with the local council to carry out a building approval and approved drawings search. Most councils will allow you to search their archives once you have a signed contract of sale. It's worth doing this search before settlement, as unauthorised building addition may also give rise to safety and liability issues.
2. Treat with scepticism any sales advise about the scope of cost of works done by the vendor. It may contain a large degree of "marketing spin".
3. Ask the vendor to advise in writing if they have made any alterations or improvements to the property.
4. If they have, ask them for copies of the architectural drawings and building approval documents (for large projects).
5. Even if they no longer have any physical documentation, the vendor should be able to provide you with a signed written statement containing.
   (i) a detail description of the work done,
   (ii) a simple explanation about why they did the work (e.g. to fix damaged items, to update or improve existing items or to add new items to the property),
   (iii)the approximate date the work was done, and
   (iv)possibly, the approximate cost of the works.
6. Ask the vendor if they have photographs of the property taken before any works were carried out. These will be invaluable as supporting evidence and in some cases may be sufficient by themselves.
7. Ask the vendor to advise in writing whether they used the house as their residence or for rental purposes. This may affect the tax treatment of their expenditure.
8. A print out from an accounting package showing the deduction being claimed by the previous owner is useful, but is unlikely to contain sufficient detail by itself to substantiate a major claim. (Just as it would not have been proof in its own right for the previous owner).
9. Make sure you ask for and receive all documentation before the contract is settled. If this is not possible, make supplying the documentation a condition on the contract. Vendors are often far less obliging once they have your money in their hands.

Interest

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A $100,000 loan used solely to purchase a rental property in

financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of $2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be $98,000 owing on the rental property. In say 45 days when the borrower withdraws $1,000 to pay off his or her credit card the loan will be for $99,000. However, as the extra $1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

The next time the borrower puts his or her 2,000 pay packet into the account the Commissioner deems it to be paying only 1/99 off the non-deductible portion i.e. at this point there is $96,020 owing on the house and $980 owing for non-deductible purposes. When, 45 days later, the borrower takes another $1,000 out to pay the credit card, there will $96,000 owing on the house and $1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

In addition to the loss of deductibility, the accounting fees for calculating the percentage deductible could be high if there are frequent transaction to the account. The ATO has released TR2000/2 which confirms this and as it is just a confirmation of the law is retrospective.

To ensure deductibility and maximise the benefits provided by a line credit you will need an offset account that provides you with $ for $ credit. These are two separate accounts – one a loan and the other a cheque or savings account. Whenever the bank charges you interest on the amount outstanding on your loan they look at the whole amount you owe the bank i.e. your loan less any funds in the savings or cheque account.

Regarding linked and split loan facilities. These loans link a loan for the rental home and a loan for the private home together so the bank will permit repayments from both rental and wages income to be paid off the private home loan with the interest on the rental home loan compounding. Accordingly, in a short period of time the mortgage can be shifted from the private home to the rental home. As the rental loan was used to purchase the income producing property and pay interest on that property, technically all the interest on that loan will be deductible. The Commissioner says in TR98/22 this is a scheme with the dominant purpose of reducing tax and he will apply Part IVA to deny a deduction for the interest on the interest. The High Court found in Harts' Case 27-5-2004 that it was an arrangement with the dominant purpose of avoiding tax and caught by Part IVA but the court did not rule that interest on capitalised interest was not deductible. Nevertheless the ATO will block any attempts from rental property owners to claim capitalised interest even though business and share investors are entitled to claim a deduction for capitalised. For all the detail on capitalised interest go to https://www.bantacs.com.au/topics/property-investors/capitalising-interest/

What Makes Loan Interest Deductible

Traditionally, the interest is only claimable on a loan where the actual money borrowed is used directly to produce incomes i.e. buy the income producing property. The Roberts and Smith case of July 1992 has changed this. In this case a firm of solicitors borrowed money to pay the partners back some of the original capital they had invested in the firm. The Commissioner argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners; the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of property because technically they cannot owe money to themselves. The ruling goes on to say:

"The refinancing principle" in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships. The joint owners of an investment property who comprise a sec 6(1) tax law partnership in relation to the property cannot withdraw partnership capital and have no right to the repayment of capital invested in the sense in which those concepts are used in Roberts and Smith. Accordingly, it is inappropriate to describe a business, as a "refinancing of funds employed in a business."

IT2423 states that people who own less than three rental properties are not in business and therefore not in partnership under general law. This means that couples wealthy enough to be purchasing their third rental property can rent out their home then borrow the money to build themselves a new home and maybe claim the interest on the loan as a tax deduction against the rent earned on their old home. Note there have

been a few cases were taxpayers have unsuccessfully tried to argue they are in business. In Cripps V Federal Commissioner of Taxation 1999 AATA 937 the taxpayers owned 14 town houses and other properties at various time. The ATO was successful in arguing they were not in business but the foundation of the ATO's argument was that they had an agent managing the properties. So it is crucial that you run the properties as a business i.e. fully mange them yourself.

Non Residence With Australian Property

It is a lot easier to become a non resident for taxation purposes than it is for immigration purposes. If a non resident has a rental property in Australia they are still subject to Australian tax at non resident rates on it. If the property makes a loss these losses can be carried forward and offset against future Australian income. In order to carry these losses forward an Australian income tax return must be lodged for each year.

The carried forward losses described above are reduced by any exempt income received (section 36-10) but section 36-20 states that this does not include income made exempt by Section 128B, that is income that is exempt because it is not taxable in Australia because you are a non resident.

If a non resident has interest, dividend or royalty income with an Australian source it will only be subject to Australian withholding tax and as a result will be excluded from an Australian income tax return. Note dividend withholding tax rates are 30% for residents of countries with no double tax agreement and 15% for countries with a double tax agreement but if the dividend is franked the withholding tax rate is effectively zero. Section 128B.

Note if you are a non resident there is no point in negatively gearing any interest, dividends or royalties (other than considerations unique to your country of residence) as the withholding tax is calculated on your income before deductions and these deductions would not be claimable in your Australian tax returns as the corresponding income is excluded under 128B so there would be no link of cost of earning income under section 8(1) of the 1997 Act.

A non-resident may also be liable for tax on a capital gain arising from a CGT event that occurs in relation to an asset that is connected with Australia, even if the gain does not have an Australian source.

Non residents are not entitled to the 50% CGT discount but they are entitled to cover a property with their main residence exemption under section 118-145 (absence rule) if they lived in it as their home when they were a resident of Australia for tax purposes.

For much more information about residency issues refer our Overseas Booklet http://www.bantacs.com.au/booklets/Overseas_Booklet.pdf

Make sure you get an ABN

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 49% of a payment for rental property expenses if the invoice is for more than $75 before GST and does not contain an ABN. For example before paying a cleaner or repairer of a property get their ABN!

Developers Who Decide to Rent Out House Built for Resale

In the Property and Construction Industry Partnership Issues Register item number 4 the ATO states that when a builder has claimed the GST input credits back on a house built to sell but then decides to rent the house out until the market improves, only a portion of the input credits need to be paid back. This is calculated on the basis of income received . The formula for apportioning input credits between the taxable supply of the home and the input taxed supply of rental accommodation is as follows:

Consideration for the taxable supply of the premises

Consideration for the taxable supply of the premises plus rental income

Note the above explains the calculation but spares you the details of how this is dealt with in the BAS for each adjustment period .

You should also consider reading our How Not To Be A Developer Booklet http://www.bantacs.com.au/booklets/How_Not_To_Be_A_Developer_Booklet.pdf

Interest, Dividends and Rent When Overseas

This all revolves around whether you are a resident of Australia for tax purposes. Note you can be working overseas and being taxed on the wages you earn in that country by that country. But if you are still a resident of Australia for tax purposes Australia gets to tax your Interest, Royalties, Dividends and Rent from anywhere in the world. Further, unless you are an overseas aid worker then Australia will also get to tax your overseas wages but you can use the tax you paid overseas to offset Australian tax.

Whether you are a resident of Australia for tax purpose is a question of fact but a big deciding factor is whether you have gone overseas for a period of less than 2 years, whether you have your family with you and whether you abandon your home here and set up a new home overseas.

If you are not considered a resident of Australia for tax purposes then you are not taxed by Australia (other than withholding tax) on your interest, royalty or dividend income that has a source in Australia but you are still taxed in Australia on your rental income if the property is in Australia.

Note if you make a capital gain on an asset "connected with Australia" you are subject to tax on that gain in Australia whether you are a resident or not. If you are not a resident you are not entitled to the 50% CGT discount. This is calculated pro rata based of the days during ownership that you were a resident and the days you were not.

The Struggle of Getting Your Tax Right

I had a bit of fun with our Rental Property experts at the ATO. Many rental property owners had received a letter requesting more information to be provided when they lodge their 2004 Income Tax Return. It also includes a page with helpful advice on areas where the ATO believes mistakes are being made. In particular it states:

> "*Tenants in common may hold unequal interest in the property – one may have a 20% interest and a second may have a 80% interest; the rental income and expenses would be divided accordingly.*"

I got on the phone to the ATO to ask, does this mean if I own a property as 50:50 tenants in common with my brother and he borrowed to buy his share yet I didn't borrow for my share then I could claim half of my brother's loan interest as a deduction against my half share of the rent. I added that I was quite happy to accept this as I was in a higher tax bracket than him. The first person I spoke to at the ATO didn't like that idea so said only the person who incurred the expense could claim it. I said oh good so if I pay all the rates then I can claim 100% of the rates against only my share of the rent. I got put abruptly on hold for that one.

The next person I spoke to at the ATO tried to tell me it was a case of who actually paid the bill so I painted a picture of my brother and I being disorganised and not fussed about money between us. This I must admit was a lie as you couldn't get two more anal people in regard to money but then we don't own a rental property together anyway.

I was then transferred to another extension where the voice mail told me they were on leave and to ring another extension. This involved hanging up and going back through all the mechanical options and guess what, the next extension was on leave too. I hung up again. When I rang back and explained the problem again. The person I talked to put me through to Guy Witcomb who gave me what I believe to be the correct

answer. That is, the interest is deductible to my brother, as it is in regard to his share where as all other expenses were directly related to the property, so split on the basis of ownership. Guy also said that he disagreed with the statement made in the ATO letter.

I then asked him how I should prepare the tax return to be sure that I was correct and asked was there an ATO ruling or something I could rely on. He said that the only way I could be sure was to apply for a private ruling. I told him I've lodged an application for a private ruling, on another issue, many months before and still did not have a reply. So at that rate I would not have an answer to this ruling before I was due to lodge my tax return. Guy suggested that I send the application for the ruling with the income tax return. I then asked him should I prepare the tax return according to the letter they sent out. He said it would be alright if I did as there would be no penalty if it was wrong but I would be up for over 11% interest on the amount of tax under paid during the time the ruling was being processed.

What was most alarming was the number of people I spoke to at the ATO that tried to come up with a plausible explanation rather than referring to the law. It appeared any story at all would do just to get me off the phone. Yet the public are asked to rely on this advice and even if they can prove that the ATO gave them the wrong advice they will still have to pay over 11% interest on the tax short fall. If they can't prove that the ATO gave them the wrong advice they could also be up for a penalty of 75% of the tax shortfall.

Demolishing a Rental Property

The owner of a rental property wishes to demolish it and build a home she can live in on the site. She asks what valuations etc will be required to keep property records of the cost base for CGT purposes.

Answer - No need to get valuation. Both the original cost of the property, the demolition costs and construction costs of the new house will be included in the cost base for CGT purposes. This property will always be subject to CGT even though the portion will decrease over the time it is used as a main residence. Accordingly, you need to keep very good records of all expenditure including rates, interest, R&M and insurance while it was your main residence.

References ID 2002/514 if the demolition expenses were incurred to enhance the value of the land, and are reflected in the state of the land when it is sold, they are included in the cost base, even when incurred to facilitate the construction of another dwelling.

TD 1999/79 the demolition of the house is a CGT event. But it does not create a capital loss unless money is received for it (ie insurance). ID 2002/633 says that this is because the building has a zero cost base.

Subsection 112-30(5) the original cost base is attributed to the remaining part (ie the land).

Residents of Australia with Overseas Investments

This also covers Australian Residents for tax purposes that are overseas at the time, even if they are working temporarily overseas.

Under our double tax agreements dividend, royalty and interest income from overseas investments should be subject to withholding tax in the country it is earned. Nevertheless, the full amount you have earned before the withholding tax was deducted should be included in your Australian tax return as foreign income with the withholding tax shown as foreign tax credits.

If your net rent income is taxed in the country where the property is located, you are entitled to a foreign tax credit for any tax paid. Your net rent income is determined according to Australian tax law and included as foreign income in your Australian tax return. Division 43 depreciation is available for buildings, alterations etc which began after 21st August, 1990 section 43-20(1) or 26th February, 1992 section 43-20(2).

The foreign tax credit can only be used to offset tax payable in Australia on foreign income, if it is not used in the year it is withheld then it is lost forever.

Residents of Australia will be subject to capital gains tax on any assets acquired after 19th September, 1985 unless the applicable double tax agreement specifically excludes this. The 50% discount is available if the asset is held for more than 12 months. For the purposes of the tax return this amount is recorded as capital gains not foreign income. A foreign capital loss can only be offset against capital gains but they can be Australian or foreign. Capital losses have special offset rules refer IT 2562. In short this allows foreign capital losses to be offset against Australian capital gains first thus maximizing any other foreign capital gain and so maximising the opportunity to utilise the foreign tax credits from the foreign capital gain. If you are entitled to a credit for foreign tax on your capital gain your tax return will need to be lodged manually with a note detailing this as there is no facility within a normal tax return to record the credit.

Year End Tax Planning for Rental Property Owners

The following suggestions really only shift tax deductions from next year into this year. Accordingly, they should not be entered into unless you are in the same or higher tax bracket this year than you will be in the following year.

1) If your loan interest is calculated daily yet not entered on the bank statement until July ask the bank to advise in writing how much accrued at the 30th June.

2) Consider buying equipment under $300 (GST inclusive) i.e. light fittings or curtains for immediate write off. Note all identical items must total under $300 so it may be worth buying one curtain in this year and another next year. If the item is part of a set it is the value of the whole set that must be under $300. The item must not be predominantly used for business purposes. Items under $1,000 can go into a low value pool for accelerated depreciation. Note that is under $1,000 per owner i.e. $1,500 for a hot water system on a property held jointly by husband and wife can go into their individual under $1,000 pool as it is only $750 each.

3) Prepay the interest on the loan for the rental property up to 12 months in advance. Investors who pay the bank next year's interest before 30th June, can claim the amount as a tax deduction this financial year.

The deductibility of prepaid interest, paid by an individual taxpayer in respect of a rental property for a period not exceeding 12 months is not subject to special timing rules under section 82 KZM of the ITAA 1936 according to ID2002/939.

Taxpayers who have a loan for a rental property or shares can make up to 12 months interest payments in advance and qualify for a tax deduction at the time the repayments are made. Be careful that the ATO cannot argue that it was really a repayment of capital. Make sure the arrangement with the bank is that the payment is interest. Simply putting the money into the loan account will not work as the bank will treat that as a repayment of capital. You must not make an advance payment for a period in excess of 12 months or the whole amount will only be able to be claimed in the period the interest is applicable to not when paid.

Reader's Question – Claiming Interest

A reader was recently told by his accountant that he could not claim the interest on his investment property while it was being built because it was not technically available for rent. This issue was resolved many years ago in Steele's case where the intended use was what counted.

The ATO accept this in their Rental Properties Guide. The booklet, says that interest is deductible while the building is in progress if the intention is to rent it out. It even goes so far to say if the owner changes his or her mind and decides to use the building for private purpose the interest then becomes non deductible. This leaves the door wide open to claim interest right up until the time you change your mind, the only problem being proving that you originally intended to use it for rental yet never did.

It is not recommended that you do this with a home that becomes your main residence as the effect it has on your main resident exemption is probably not worth the initial tax deduction.

Div 43 Building Depreciation

If your rental property was constructed after 16th September, 1987 then you are entitled to claim building depreciation on the original construction costs, not the price you paid for it.

Back on 13th May 1997 the government announced that any rental properties purchased after that date would have their cost base for CGT purposes reduced by any building depreciation that was claimable. The key word here being claimable. This meant that even investors who did not bother to claim the building depreciation were still required to calculate what they could have claimed in order to reduce their cost base when calculating the gain on the sale.

There is an ATO concession for taxpayers who have not claimed building depreciation while owning the property. They only have to reduce their cost base by the depreciation they could have claimed over the last 4 years as they are only entitled to amend back that far (possibly only 2 years if their affairs are simple and the property is not jointly owned).

Further, in PSLA 2006/1 the ATO has made this situation even fairer. It is the ATO's opinion that if you have not been prepared to incur the expense of a QS report in order to qualify for the deduction during the period of ownership you should not be forced into incurring the cost just to calculate your capital gain. If there is no other method of ascertaining the original building costs other than a QS report you are not required to reduce the cost base by any claimable building depreciation as long as you have not claimed any during the period of ownership. But note PSLA 2006/1 goes to great lengths to set out when and only when it would consider your only method of obtaining the original building costs is a QS report. For example when the seller has moved somewhere overseas and you have no way of finding him or her. It also points out that the person you purchased the property from is required by law to provide you with this information if any previous owners have been claiming building depreciation. But it does recognise that even if you were the one who incurred the building costs there are circumstances where this information would be considered not available. It does not give an example but I presume this would be where the house was a private residence and rented out many years later when the original invoices etc had been disposed of.

There are two vital points to PLSA 2006/1 the information must not be available and the taxpayer has not been claiming division 43 depreciation during any of the time of ownership. It does not say so but the examples give the impression that if you do know where the person you purchased the property from is you must insist upon them providing you with the information as they are required to do under section 262A (4AJA) of the 1936 Act.

Property owners who are relying on a QS report to calculate the original building costs should also look at the examples provided in PSLA 2006/1 to see if they are entitled to use a QS report. The ruling shows when the ATO considers that you have no other option than to rely on a QS report. Note you are only permitted to use a QS report to ascertain the original building costs if there is no other means available.

Section 262A (4AJA) requires the seller of a property that includes building works begun after 26th February, 1992 on which the seller or a previous owner has claimed building depreciation to provide the buyer within 6 months of the end of the financial year in which the sale occurred, the information necessary to ascertain the original building costs. So a major concern for property owners where works were performed after 26th February, 1992 is how on earth do they get this information to provide to their purchaser when they sell. It is interesting that there does not appear to have been any litigation on this matter, as I doubt that sellers ever meet their obligations under this section. The trouble is if you don't enforce it when you buy then it could be enforced on you!

Considering Repairing Your Rental Property Before June 30th

You will not be entitled to a tax deduction for the expenses you incur if you replace something in its entirety. Accordingly, it is better to replace a worn fence a bit at a time over a few years rather than all at once. Replacing all the cupboards in a kitchen so they match rather than just the damaged one will mean that none of the expenditure is deductible on the other hand replacing a vanity can be deductible as a repair if the pipes from the old vanity are used.

Durable items for a rental property normally need to be depreciated over time but if they are under $300 they can be written off immediately. Like items must be added together when applying the $300 test so it may be better to buy one set of curtains this year and wait until July before you buy the next set.

Make sure any work you do qualifies as repairs not improvements. For example if the house needed painting when you bought it then painting it would be an improvement and therefore not deductible. On the other hand if during the time of your ownership the paint starts to peel and you repaint, the expense would be a deduction. A repair can become an improvement if it does not restore things to their original state i.e. replacing a metal roof with tiles. But a change is not always an improvement. The ATO says the cost of removing carpets and polishing the existing floorboards is a deductible repair yet underpinning due to subsidence is considered to be an improvement.

Tree removal is claimable if the trees have become diseased or infested during the time of ownership. Removal is also claimable if the tree is causing damage such as roots interfering with pipes and the damage was not present when you purchased the property. If a tree is removed because it may cause damage in the future or you are fed up with the leaf litter that has always happened since you bought the property, then you are making an improvement which is not deductible.

Take care to perform repairs only when the premises are tenanted or in a period where the property will be tenanted before and after with no private use in the middle. It is better not to make repairs in a financial year during which you may not receive any rental income. If a property is used only as a rental property

during the whole year then a repair would be fully deductible even though some of the damage may have been done in previous years when the property was used for private purposes

Claiming Interest

Consider prepaying the interest on the rental property loan up to 12 months in advance and get a tax deduction in the year that it is paid. Make sure your bank understands what you are trying to achieve. Simply depositing the amount into the loan account will not work as it will be considered a repayment of the principal. Note this is only shifting tax deductions between years so consider your tax bracket in the following year.

If you have sold a rental property for less than the debt relating to it you can still claim the interest on the debt as a deduction against your other income. Take care to stay within the guidelines of the two successful cases in this regard. All the net proceeds of the sale should be used to repay as much off the loan as possible. Appear to be unable to repay the loan from the sale of other assets other than the family home. Don’t refinance the loan to extend its term or increase the interest rate. You must appear to be doing all that is possible to eliminate the loan so refinancing to reduce the interest rate is ok. On the other hand if you have to change the loan from principle and interest to interest only because that is the only way you can afford the repayments as you are no longer receiving rent, you may be able to justify changing the loan.

Don’t let the fact that the property has not been rented all year stop you from claiming the expenses relating to it. So you may still want to prepay interest etc on a vacant property if you need the tax deduction. Just as long as it has not been used for private purposes and your intention all year was to use it as a rental property. It may have been empty due to renovations or a suitable tenant could not be found.

This issue was put to rest in Ormiston’s case where a property was vacant for 4 years and he was still entitled to deductions totaling $70,000 over that period. Ormiston purchased a house he intended to use as a rental property after performing some renovations himself. 4 years down the track he had still not completed the renovations but was entitled to claim expenses such as rates, insurance, interest etc as a tax deduction, for all of the 4 years despite the fact the house never earned a cent of income. He never completed the renovations and sold the property before it was ever rented.

Repairs to Rental Properties

TR 97/23 is the ultimate ruling on this subject but it gets so long you wonder if it didn’t contradict itself somewhere way back. In this article we look at what sort of work qualifies as a repair and if so is it done at a time that qualifies it for a tax deduction.

Improvements to a property are not tax deductible and this includes repairing the property beyond the state it was in when you purchased it. TR 97/23 at paragraph 63 refers to these as initial repairs. Initial repairs are repairs that were necessary when you purchased the property or became necessary because of a fault existing when you purchased the property. Even if you were not aware that the repairs needed doing or that the price you paid did not reflect the defect they are still not deductible.

According to TR97/23 paragraphs 83 to 99 a repair can generally be described as remedying defects, damage or deterioration including the renewal of parts but not total reconstruction. Restoration of something lost or damaged, whether function or substance or some other quality or characteristic and restoration of efficiency of function. But be careful that you do not replace something completely or restore the property to a better condition than it was in when you purchased it. In ID 2002/330 the ATO states that the cost of removing carpets and polishing the existing floorboards is deductible. Yet in ID 2001/30 underpinning due to subsidence was considered by the ATO to be an improvement not a repair. So it is difficult to get a clear line of thought from the ATO rulings.

Replacing something completely or in its entirety as it is referred to in paragraph 15, 32(b), 43, and 114 to 119 of TR 97/23, is not considered a tax deductible repair. Replacing or restoring something in its entirety means that substantially the whole of something has been repaired. The something needs to be separately identifiable. If for example you replace almost all the fence on a property, you are replacing it in its entirety but if it is ultimately replaced by a series of repairs over several years that is ok TR 97/23 paragraph 119. Replacing a window or a wall in a factory is not a replacement in its entirety because the whole is the factory building. Replacing locks or an exhaust fan is a repair because it is not a replacement in

its entirety. In Domjan's case a vanity was not considered to be replaced in its entirety because the same water pipes were used. But according to TR 97/23 paragraphs 113 and 114 you can replace almost all the entirety and still be considered to have replaced all the entirety so no deduction.

A minor improvement as part of a repair will still be fully tax deductible but once you start to improve function beyond that originally or use materials significantly stronger than those previously, none of the costs may be deductible because it is considered an improvement, TR 97/23 paragraphs 16 and 22. If you can show separately the price of repairs done together with improvements and initial repairs you can still claim the repairs TR 97/23 paragraph 136. While not technically a repair, preventative maintenance is also deductible according to TR 97/23 paragraph 20.

TR97/23 at paragraph 5 recognises the fact that if a property is in good repair when purchased and suitable for rental then the first repairs are deductible as they have become necessary after the purchase.

Section 25-10 (1) of the 1997 ITAA states that repairs are fully claimable if the property is held solely for producing income. Section 25-10 (2) states, that if it is only partly held for producing income then you can only deduct a reasonable amount. So if the property is rented, available for rent or being repaired between tenants for all of the financial year there is not a problem claiming the repair. Even if it relates to damage done while you were living there TR 97/23 paragraphs 76 and 77. The wording "held for producing income" is very significant. This means you do not even get a look in unless it is held as a rental at the time of doing the repair and it must be producing income in the financial year the financial year the repair was done.

The problems arise when it is not a rental property all of the year. For example:

Lived there then moved out, did some repairs then listed it for rent, tenant moves in. This is the Mary-Ellen Walton example in TR 97/23 at paragraph 182. She did not get the deduction because the costs were to prepare the house for rent. The ATO claim it was not held for rental at the time the repairs were undertaken.

Tenant moves out, you undertake some repair work then sell or move into the property when you have finished. The big problem here is while you are doing the repairs the property isn't really held as a rental because it is your intention to sell or move in. IT 180 (TR 97/23 paragraph 9 states this still applies) makes a concession that, providing the necessity for the repairs relate to a time that it was used to produce income and the repairs are incurred in the same financial year as the premises were used to produce income you can claim the deduction. But what if the tenant moves out at the end of June? You need to hurry up and "incur" these expenses. You do not have to have actually paid for them but you must have accepted liability i.e. be committed to the expenditure TR 97/23 paragraph 144. Even if the amount can not be calculated exactly, as long as the amount is capable of reasonable estimation. So having received a quote and instructing the person to go ahead would meet the definition of being incurred.

During the Financial Year You Move Out of Your Home and Tenants Move in and then you undertake some repairs. If a new financial has begun since you moved out and made it available for rent and it is available for rent all year then you will get a full deduction for the repairs even if they relate to damage while you were living there TR 97/23 paragraph 146. Repairs done while you lived there would not be deductible at all as it was not held for income purposes at the time the cost was incurred. Section 25-10(2) states that if the property was partly used for income purposes during the year a reasonable apportionment of the repair expense must be applied. TR 97/23 and IT 180 are the authorities on what the ATO considers reasonable. If the repairs are done in the same financial year as you have lived there but they are done while the tenant is living there the repairs have to be apportioned on a time basis according to TR 97/23 paragraphs 156, 160 and 161 though I feel you could use IT 180 to claim the lot if the repair was totally a result of tenant damage. TR 97/23 looks at the situation of a motor vehicle used 70% for business and 30% for private and states that if an accident happened or repair became necessary while being driven for private purposes 70% of the of the expense would still be deductible. This gives you an argument to apportion repairs to say a holiday home that is on and off used for private and rental purposes.

No Rent All Year In Ormiston's case AAT 2005 other holding expenses (not repairs because they were initial) were deductible for 4 years with the property not even being listed with an agent. It was purchased with the intention of renting it out but it never happened as it was never finished and was sold 4 years later still unfinished. You are not going to get the repairs if it has never been rented but if you are just between

tenants you can rely on Ormiston's case to be confident that the long period of time taken to perform the repairs or choose a more suitable tenant will not be a hindrance to your claim. So as long as the property is a rental property with no private use then expenses can be claimable between tenants even if the repairs took all of the financial year. But note the repairs themselves would not be tax deductible if no income was earned on the property in the year the repairs were incurred.

Travel Costs

You are entitled to claim for your travel costs to inspect the property, repair it or collect the rent. Don't worry, if you do not have a log book or receipts you can use the kilometre method which, depending on the size of the motor in your car, will allow you to claim up to 77 cents a kilometre. All you need is a record of the times you travelled to the property and multiply them by the distance between your home and the property or the shops and the property if you are getting materials. There is a 5,000km limit on this method but the limit is per car per owner of the car so if you also use your spouse's car your limit is extended to 10,000 kilometres. If your spouse also owns the property and you take turns in driving you can claim up to 5,000 kilometres each for the same car but this does not mean you can claim the same trip twice.

Body Corporate Fees

Body Corp Fees are not deductible if they are specifically for capital improvements ID 2004/933. Fees for general purpose sinking funds and administration funds are fully deductible even though some of the money may be spent on capital improvements ID 2004/934.

Asbestos

Removal of asbestos can be expensive and unless it is damaged in some way it will not qualify as a repair. Here is a neat trick if you are looking for a tax deduction and at the same time want to increase the value of your rental property. Best of all this applies even if you have just acquired the property so really properties containing asbestos have a hidden bonus of an instant tax deduction.

Section 40-755 to 40-765 are about being able to claim an outright deduction for environmental protection activities. In ID 2004/720 the ATO agreed that a landlord was entitled to a deduction for the cost of removing an asbestos shed from a rental property. So this environmental protection concession is not just for businesses. It can apply to rental properties and can apply to asbestos.

No Claim for Building Depreciation if no Tenant

Building Depreciation can only be claimed when the building is actually used in a deductible way in the income year in which the deduction is claimed. This means that if the property is vacant for the full year because of repairs or high vacancies you are not entitled to claim the special building write off. On the bright side selling, as it was not claimable during the period you do not have to reduce the cost base by this amount either. Nevertheless this can add insult to injury in a difficult year.

On the same basis if the rental property is being built during the year while interest, rates etc are deductible the building depreciation would not be.

What Qualifies for Special Building Write Off

Section 43-20 gives examples of what is included:

Buildings or an extension alteration or improvement

Structural Improvements or extensions, alterations or improvements to structural improvements

i.e. sealed roads, sealed driveways, sealed car parks, sealed airport runways, bridges, pipelines, lined road tunnels, retaining walls (but not the dirt behind the wall), fences, concrete or rock dams, artificial sports fields, earthworks that are integral to the construction Environment protection earthworks –or extensions, alterations or improvements to earthworks.

Excluded from the Special Building Write Off are:

- Earthworks that are not part of the construction ie landscaping and works that are not permanent and can be easily maintained ie dirt car parks, open dirt drains and tracks.

- Non Construction Costs such as demolishing existing structures, purchasing land, landscaping and plants.
- It also excludes the cost of preparing the site for building ie clearing, filling and draining.
- Plant and Equipment ie items that can be depreciated under section 40

Now the above list is not 100% if you have something unusual you had better get professional advice. The object of this article is to point out that it does not have to be bricks and mortar to be included in your Special Building Depreciation write off. For example if you paint a house that you have just purchased you cannot claim it as a repair because it restores the property to better than it was when you purchased it but you can depreciate the cost at 2.5% because it would fit the definition of improvement.

Rental Property Check List of Dos and Don'ts

1) Pay off non deductible debt as soon as possible but if it is on a home you may one day rent out use an offset account rather than pay directly off the loan.
2) Only use a Line Of Credit with a Credit Card used for private purposes, on a non deductible Loan
3) If other loans for Rental Properties are Lines of Credit, only draw on them for rental property expenses and make sure these expenses are paid direct not mixed with in a private cheque account or a credit card used for private purposes as well.
4) If you do not have a Main Residence or are considering buying a new one and renting out the one you are in, do not use funds in the offset account to pay the property's expenses. Draw them from the Line Of Credit keeping the offset amount as high as possible. The net result has no effect on interest but this will increase the amount of deposit you will have in the offset account for your Main Residence. When you draw this out, the original loan for the Rental Property or your old home once it is rented, is still fully tax deductible.
5) For a deductible loan an offset arrangement is far better than a Line of Credit as it leaves the funds available for private purposes if needed.
6) If only one member of a couple is borrowing for their investment in a rental property try to persuade the bank to only put the loan in that spouses name. Maybe the other spouse could go guarantor.
7) Don't transfer borrowed funds into your personal cheque account.
8) Don't pay interest more than 12 months in advance.

Plant and Equipment Costing Less Than $1,000

Plant and equipment costing less than $1,000 qualifies for accelerated depreciation in a low value pool at a rate of 18.75% in the first year regardless of what time of year it was purchased and 37.5% for each year after that, at a diminishing rate. If the rental property is owned 50:50 between two owners then a piece of equipment costing $1,999 would qualify to go into the pool. Once you decide to set up a low value pool all future acquisitions that qualify must be placed in the pool section 40-430. There are no grouping provision for low value pools (ID 2003/946) ie if you buy 2 curtains costing $900 each they both qualify for the low value pool.

If you use the diminishing cost method and the item is reduced to a closing written down value or adjusted value of less than $1,000 it can be moved into the low value pool. This will generally give you a higher rate of depreciation. It may be worth going through your depreciation schedule and look for items that have been reduced down to $1,000. Note if they originally cost less than a $1,000 you cannot move them into the low value pool. Items costing less than $1,000 can only be placed in a low value pool in the first year they become income producing. But items costing more than $1,000 that are now written down to below $1,000 can be moved into the pool at anytime. It is not necessary to move them the minute they drop below $1,000.

The above applies to both rental properties and equipment used in a business.

Claiming Rental Property Travel Expenses - Update

Travel re Purchase and Signing of Contract to Buy or travel to improve the property - Part of cost base for CGT purposes, if the property was purchased after 20th August, 1991, section 110-25(4).

Travel to Improve the Property – Part of cost base for CGT purposes section 110-25(4)

Travel to Repair & Maintain the Property While Rented – Claimable against current year income

Travel to Repair & Maintain the Property While Not Rented or Available for Rent – Part of the cost base for CGT purposes section 110-25(4) if the property was purchased after 20th August, 1991. This is the case even if you are living in the property at the time of the travel but for some reason during the time you own the property it is not covered by your principal place of residence exemption.

The ATO has a Heart

In a recent Private Binding Ruling by the ATO appears to have taken pity on a taxpayer who had a bad run.

In PBR 71690 the taxpayer had to repair the ceilings in a rental property twice before it was discovered that the builder had not put flashings in the walls. The first round of repairs the ATO disallowed as initial repairs but the second repair they let through.

TR 97/23 at paragraph 63 discusses how initial repairs are not tax deductible and describes these as repairs that were necessary when the property was purchased or became necessary because of a fault existing when the property was purchased.

Even if the purchaser was not aware that the repairs needed doing or that the price paid did not reflect the defect, the cost of the repairs are still not deductible. Further, it states that if the state of disrepair of the property at the time of purchase was directly responsible for further damage all the repairs relating to that damage are considered improvements (Law Shipping Co. UK).

If you are thinking that your hard luck story may arouse similar sympathy you had better make it good. In PR 71690 the water damage was so bad that not only did ceilings collapse but the stairway became a waterfall.

Insurance Costs Part of Special Building Write Off

Construction expenditure for the purposes of Division 43 special building write off includes the cost of the insurance policy, protecting against the death, disappearance or insolvency of the builder, while building the premises ID2006/213.

Renting Out a House You Built to Sell

There is a lot more information about this in our How Not To Be A Developer booklet http://www.bantacs.com.au/booklets/How_Not_To_Be_A_Developer_Booklet.pdf . Basically if you are registered for GST and build a house for resale but then change the purpose by renting the house out you have to pay back the input tax credits on the property. You see a property held for rental is input taxed so no GST credits are available on the cost of building it. If you have been claiming them because you intended to sell the property so will have to charge GST on the sale, then later change your mind or can't sell it. Then using it as a rental property will mean quite a large amount of GST has to be paid back.

Now I imagine you are starting to think that it is not as black and white as that. You may not have changed the purpose at all it is just logical to collect rent for the property while the market is slow. I imagine there were some developers caught between a rock and a hard place. They can't possibly afford to pay back the GST but could really benefit by receiving some rent to help meet the overdraft.

ID 2008/114 examines purpose beyond the current use and recognises a property can still be held for resale while it is rented. The following paragraph from the ID gives a clear guideline as to what would be considered holding a property for resale:

> Determining whether or not new residential premises have been actively marketed for sale will require consideration of all the relevant facts and circumstances. Although no single factor by itself is conclusive, the active marketing of new residential premises for sale may encompass activities such as listing the property for sale with a real estate agent or agents, advertising the premises for sale in relevant publications or via Internet advertising websites for real property, arranging 'open for inspection' times and/or showing prospective buyers through the premises. In the case of stratum units, actual arm's length sales of some of the listed units would be further evidence of active marketing. Listing premises for sale at a price that is significantly above market value may be an indicator that the premises are not being actively marketed for sale.

If you want to use this interpretation to your advantage you should apply to the ATO for you own ruling quoting ID 2008/114 as a precedent.

By the way you do not have to pay the GST back immediately, even if you are caught. You are only required to consider this issue once a year, when preparing your BAS for 30th June. You do not even have to consider an adjustment to the GST at the first 30th June after the original input credit has been claimed it is not until a full 12 months after the first 30th June that an adjustment must be made. Now if the property has at anytime been used for a rental then some adjustment needs to be made. But it may only be minor. Certainly if the property has now become a rental and it does not meet the available for sale status discussed above then you need to pay back all the GST. On the other hand with a property still available for sale, you only need to pay back a small portion of the GST. This portion is calculated by adding the estimated rent you expect to receive to the expected sale price then look at what percentage the rent is of this. This is the percentage of the GST credits you have to pay back. Yes, very vague but each 30th June you will have to re work this calculation until you sell it so eventually the right amount will filter through.

Properties that have been held as a rental for more than 5 years are not subject to GST when they are sold. Before this 5 year clock can start all the GST input credits have to be paid back.

Claiming Capitalised Interest

This is certainly an activity the ATO are trying to stop and they will deny you a tax deduction with as much huff, puff and bullying they can muster. On the other hand they will do anything to avoid taking the matter to the courts because they may well lose, considering they allow businesses and share investors to claim capitalised interest. Taxpayers willing to apply for a ruling and stand up to the ATO bluff have been successful but it is certainly not for the faint hearted. For all the information on claiming capitalised interest go to https://www.bantacs.com.au/topics/property-investors/capitalising-interest/

Rental Properties Under Construction

If your new rental property didn't earn rent during the financial year don't let that stop you claiming interest, rates and insurance etc. As long as you intend using the property as a rental when it is finished you can start to claim the expenses associated with it right away, except depreciation.

Holding On To A Rental Property As Interest Rates Rise

If increasing interest rates have you asking yourself whether you should sell your rental property. Before you do, crunch the numbers to get the situation in prospective.

First consider the costs associated with selling a property ie real estate agent's commission. You can expect these cost to be around $10,000. Now if your loan is for $400,000 and your interest rate has increased by 2% you will be paying an extra $8,000 a year in interest, so the higher interest rates have to continue for over a year before they have cost you as much as it would cost you to sell the property. There is also the CGT, even if you sell for the same price you bought for there will be CGT because of the building depreciation write back if you purchased the property after 13th May, 1997. Not to mention the stamp duty costs to buy another one later when you are ready to invest again.

The reserve bank increases interest rates to control inflation so increased interest rates are a good sign to an established property investor because the value of their properties have already increased and so have their rents. If the increased rent is not enough to cover it you should have more equity available to help through the adjustment.

If the Reserve Banks motive is to slow the market then this is a bad time to sell so hang on until interest rates decrease and market sediment improves. It's not as if interest rates are going to increase by 2% overnight. Generally it is just a quarter of a percent at a time so could take a year to increase by 2% and if that hurts everyone else before it hurts you then prices will drop and the Reserve Bank will back off.

Unpaid Maternity Leave & Rental Properties

If you own a negatively geared rental property and are intending to take some time off work to have children the rental property losses may well be wasted.

In the 2014/2015 financial year you can earn $20,542 and not pay any tax so if your rental property loss brings your income down below $20,542 but not below zero you get absolutely no benefit for the loss on your rental property. Now if the loss is large enough or your other income is low enough that you have an overall negative taxable income for the year you may be able to carry it forward to offset in future years but first you must offset exempt income. Exempt income includes family payments and child care payments

from Centrelink so you can see that it would have to be a very large loss before there will be anything left to carry forward into the following year.

All is not lost, with a bit of planning. In the financial year before the financial year you take leave it may be worth paying 12 months (no more or the whole deduction is delayed) interest in advance and any other expenses you can. Then when you are ready to return to work delay everything you can until the start of a financial year in which you will earn a decent income.

Repairing a Rental

The following relates to PBR 88199. The taxpayer undertook some repairs on his rental property when the tenants moved out in June. The repairs ran into the next financial year when he intended to sell it. Though he was still advertising it for rent hoping to sell it with a tenant. The ATO ruled that the repairs incurred after 30th June would not be deductible unless the property was available for rent while the repair expense was incurred and did earn some income in that financial year. Reference IT 180.

The taxpayer was relying on the tax pack 2008 Supplement which states: "You can claim expenses relating to your property but only for the period your property was rented or available for rent – for example, advertised for rent." Unfortunately claiming for repairs is a little more complicated than that, it is the legislation specifically relating to repairs that states income must be earned.

It's enough to make you want to try to recover some of the bond for the damage so that it is received in the next year. Another idea is to incur all the expense before the end of the financial year ie buy all the materials or accept a quote from a builder before the of 30th June. To incur an expense it does not have to bze paid you just have to have a liability to pay it.

On a better note the taxpayer was successful in claiming the replacement of the entire roof of the property as a tax deduction. This was done in a previous financial year. If you replace something in its entirety it is not considered a repair so only qualifies for depreciation which in the case of a roof would be over 40 years. The question is, is the roof an entirety itself or is it only part of the building and it is the building which is the entirety. The ATO ruled that the roof was not an entirety in itself because it relied on the walls to hold it up, so its complete replacement could be claimed as a tax deduction.

When Your Rental is Destroyed

Here are a few facts to help you make the sell or rebuild decision. First you need to split the cost base of the property between the house and land underneath. This is done by the following formula:

$$\frac{\text{Original Cost Base x Insurance Proceeds}}{\text{Insurance Proceeds plus Market Value of Land}}$$

Opting to sell the property – You will simply pay CGT on the difference between the cost base of the house and the insurance proceed and as a separate CGT event the difference between the cost base of the land including selling costs and the selling price. Careful if you think the land will result in a capital loss you will only be able to offset it against a capital gain from the house if you sell the land before you receive the insurance proceeds or at least in the same financial year as you receive the insurance proceeds. If the property was covered by your main residence exemption this is the only time you can sell vacant land and still qualify for the exemption.

Rebuilding – This is quiet a complex issue if you receive more from the insurance company than it costs you to rebuild because you may have to recognise a capital gain. But if the insurance company rebuilds for you or the cost of rebuilding is the same or more than the insurance proceeds then you can utilise rollover relief to avoid any CGT on the difference between your original cost base and the amount you received from the insurance company. Note if the insurance proceeds are less than your cost base you have to include a capital loss in the tax return of the year you receive the insurance proceeds. Don't move into the new building as your home because you will lose the rollover relief if it is not used as a rental for a reasonable period after the rebuild (TD 2000/44). The cost to rebuild (excluding plant and equipment) less any capital gain you would have made on the insurance proceeds if not for the rollover plus the cost base of the land as calculated above is your new first element cost base for the property. But if the insurance company simply replaces the house then your cost base stays as it always was.

Building Depreciation - Any unclaimed building depreciation must first be offset against the insurance proceeds. If there is any depreciation remaining it can be written off in full in the year the insurance money is received. If the insurance recovery exceeds the unclaimed building depreciation there is no effect on the tax return. Building depreciation at 2.5% of the cost of the new building can begin to be claimed in your tax return once the property becomes available for rent.

Plant and Equipment – Plant and equipment is not included in the CGT calculation. This will be discussed in detail in the next edition of Newsflash. The portion of the insurance proceeds to cover this is treated as the amount you received for the sale of the plant and equipment but if you decide to rebuild you can utilise rollover relief to ignore any profit made but you must continue to claim depreciation with your current written down values rather than the value of the new equipment. Even though you are using the old written down values the acquisition date is that of the new equipment so the depreciation rate may change, for example the new diminishing value rate of 200% of the prime rate.

Pre 85 Properties – Provided the replacement house costs no more than 120% of the market value of the original house or it is substantially the same as the original then it will continue to be considered Pre 85 yet you can now claim building depreciation.

ATO Audits

Please do yourself a favour and make sure you inform the auditor you will be taping the whole process and make sure you do. This will make them take much more care when making comments and prevent them from bluffing.

Depreciation and a Property's Cost Base

Division 43 depreciation is for building costs, where as, Division 40 covers depreciation on plant and equipment such as carpet, curtains, hot water systems and stoves.

If a property is purchased after 13th May, 1997 then any division 43 building depreciation claimable during the period of ownership must reduce the cost base. This is not too bad if you keep the property for longer than 12 months because the add back is only going to be taxed at half your marginal rate due to the 50% CGT discount where as the depreciation will be fully deductible at your highest marginal rate for each year.

Division 40 depreciation is a completely different issue. The assets depreciated under division 40 are not subject to CGT and considered separate from the property and are subject to normal income tax not CGT. So when you include the original purchase price of the property in the CGT calculation it must be first reduced by the value that you have attributed to plant and equipment in the depreciation schedule. For example if your quantity surveyors report or your estimated value) shows that the plant and equipment is valued at $50,000 and you paid $450,000 for the property then you can only include $400,000 of the original purchase price in the cost base of your CGT calculation. The $50,000 worth of plant and equipment is dealt with separately. By the same token when you sell the property the selling price is reduced by the value of the plant and equipment included in the sale.

If you do not know the market value of the portion of the selling price that is attributed to the division 40 assets then you can assume that their value is the same as their written down value in your depreciation schedule if you have used the ATO depreciation rates. This means that there is nothing taxable on the sale of the plant and equipment and the net effect of all this is that the cost base is reduced by the amount of division 40 depreciation claimed during the period of ownership. This is because the original purchase price was reduced by the value of the plant and equipment at the time of purchase and the selling price is reduced by the value of this plant and equipment not yet depreciated. The difference has to be the depreciation claimed.

Now if you buy additional plant and equipment or replace existing stuff this is all dealt with through the depreciation schedule.

Note if the property has at anytime not been used to produce rental income then some of the costs of division 40 plant and equipment will be included in the cost base.

Demolishing a Rental Could Expose it to GST

Before you go picking up that sledge hammer thinking you will get more for your rental property as vacant land have a read of ID 2009/20 and ID 2009/19.

In these examples the owners of both these rental properties were registered for GST because they did some development and held some properties simply as rentals.

Subsection 9-30(4) of the GST Act states:

> A supply is taken to be a supply that is input taxed if it is a supply of anything (other than new residential premises) that you have used solely in connection with your supplies that are input taxed but are not financial supplies.

Input taxed means you do not have to remit GST on the income you receive. One property had a demountable home on it which the owner sold off separately and the purchaser of the demountable home was required to remove the house at their own cost. In this case the ATO considered that the property had at all times been used solely as a domestic rental and was input taxed so the sale of the vacant land was not subject to GST.

In the other example the owners decided to demolish the property themselves. The ATO considered this to be using the property other than for input taxed supplies so GST applied to the sale of the vacant land.

Of course if they simply left the house on the land, GST would not apply either because it only applies to the first sale of residential property and then only if it has not been used as a rental for a continuous period of more than 5 years. Removing the house changed it from residential property to simply vacant land.

Commercial Rentals

GST - The main difference between domestic rentals and commercial property is that commercial rents are subject to GST and normally your tenant is registered for GST. You have to have more than $75,000 in GST turnover to be forced to register for GST but you can choose to voluntarily register for GST and that is probably the way to go. You see your tenant will be able to claim the GST back so it makes no difference to them and at least you will qualify to claim GST on your expenses such as repairs for the building. An alternative is to make sure the tenant is required to pay all the expenses. That way the tenant can claim the GST back and you still avoid having to prepare a BAS.

Purchase and Sale - If you are registered for GST then you can claim back any GST you paid on purchasing the premises but you will have to charge GST when you sell. If the sale or purchase is consider to be that of a going concern and both parties are registered the transaction can be free of GST. Other than cash flow considerations it makes no difference either way as the purchaser would have been able to claim the GST back anyway. But there may be a Stamp Duty saving in using the going concern concession. If you do use the going concern concession, make sure you get advice because there are a few traps most importantly you should be paying 1/11th below the market price.

CGT - The CGT is the same as with domestic properties unless the property has been used in your business or the business of an associate of yours. A property used primarily to earn rent can never qualify for the small business CGT concessions but if is used in a business by you or an associate, then you may qualify for these wonderful concessions that, if used correctly, could mean no tax is payable on the gain.

Structures - The asset protection, land tax threshold and flexible profit distribution issues that apply to domestic properties also apply to commercial properties. In addition you have to consider GST. If you are trying to avoid GST, the $75,000 threshold applies to each entity, so when calculating whether your GST turnover is more than $75,000 you do not have to consider the turnover of other entities connected with you. This is when you would consider holding each commercial property in a separate entity, certainly not worth the trouble just to avoid preparing a BAS but maybe a benefit of deciding to keep the properties separate so that if one property is subject to litigation the others are not exposed.

The $75,000 GST turnover does not include domestic rents. Nevertheless, there is a risk if you hold domestic properties, that you have constructed, in an entity that is registered for GST. If the domestic property is sold before it has been used as rentals for a continuous period of 5 years you will have to charge GST on its sale, simply because the entity that sold it is registered. The sale of such a property in an entity that is not registered for GST would not force it to be registered so GST would not apply.

Note superannuation funds can own a commercial property that is used in the business of a related party whereas domestic properties held by a superannuation fund can never be occupied by the members or

associates of the superannuation fund. Superannuation funds provide the best asset protection with tax bracket concessions.

Depreciation - The depreciation rate for commercial buildings varies depending on the use and construction date:

Short term traveller accommodation qualifies if constructed after 22-8-79 and the rate changes depending on when it was constructed ie:

22-8-79 to 21-8-84	2.5%
22-8-84 to 15-9-87	4%
16-9-87 to 26-2-92	2.5%
After 26-2-92	4%

Other commercial properties qualified as follows;

20-7-82 to 21-8-84	2.5%
22-8-84 to 15-9-87	4%
16-9-87 to 26-2-92	2.5%

After 26-2-92 Industrial properties qualify for 4% whereas other commercial properties continued at 2.5%

Warning properties that qualify for 4% will have nothing left to depreciate 25 years after they are constructed and properties that qualify for 2.5% have nothing left after 40 years. Further, if the property was constructed before 1st July, 1997 it must have been constructed for that purpose.

Don't assume anything when it comes to being able to depreciate the plant and equipment on the premises. Despite being fixed to the building it may still belong to the tenant.

Obviously there is a lot more to know about owning a rental property, this article just highlights the additional issues to consider if you are already very familiar with domestic rental properties but are considering branching out into commercial property.

Fees Paid for Financial Advice or Courses

TD 95/60 is an ATO determination on when fees paid to a financial adviser are tax deductible. It differentiates between an upfront fee and an ongoing management or annual fee.

The initial or up front fee to draw up a financial plan is considered to be capital in nature rather than relating to the ongoing management of the portfolio. This is considered to be the case even if the investor already has some investments but enters into a new financial plan. To quote the ruling:

> *"We do not think that the fee for drawing up the plan is deductible ......It is too early in time to be an expense that is part of the income producing process. It is an expense that is associated with putting the income earning investment in place".*
>
> *"Expenditure on drawing up the plan is incidental and relevant to outlaying the price of acquiring the investment, and is so associated with the making of the investment as to warrant the conclusion that it is capital or capital in nature"*
>
> *"The character of the outgoing is not altered because the existing investments fit in with the plan. It is still an outgoing of capital"*
>
> *"However, to be wholly deductible, all of a management fee must relate to gaining or producing assessable income. If the advice covers other matters or relates in part to investments that do not produce assessable income, only a portion of the fee is deductible"*
>
> *"Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."*

Possibly if the initial financial plan takes into account buying several properties each house acquisition may not be considered a new plan. If you are paying for training on how to find the right property it will probably be considered incurred at a point too soon to be deductible. In considering the deductibility of training, meetings and courses the best example of this is Petrovic's case which examines payments made to Henry Kaye. These payments were not considered deductible because they did not have a sufficient connection with assessable income and was an investment of capital made to prepare Petrovic for future

property investments. This is despite the fact he already owned property before attending the courses. Of particular interest is the end of paragraph 14 which states:

> *"At best, the incurring of that expenditure was itself an investment of capital to prepare him for the future commencement of a business property investment should he choose to do so and had the financial ability."*

Careful, if you try to argue that learning how to buy and sell properties is a business expenses ie you are buying the properties to sell for a profit, then the properties would be trading stock, not a passive investment and so the 50% CGT discount would not be available. Training in how to buy and improve properties would be capital in nature and unlikely to even qualify for inclusion in the properties cost base. Trying to align the purchase of your next property to being just like buying another share in you share portfolio, may work to argue that the advice you received regarding the property was part of the management of the original plan but certainly not if you don't already have one property. In Petrovic's case even having a couple of properties made no difference. The trouble with apply rulings like TD95/60 which is directed at share investing, to property investing is that the ATO will probably try to look at each property in isolation, something they would have no chance of with a share portfolio. The only saving grace appears to be this paragraph from TD95/60
"Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."

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

How the ATO Calculate Your PAYG Variation

When you lodge a PAYG variation form with the ATO they calculate the amount of tax that you should pay over the whole year on the amount of income you have told them you will have. They then deduct from this the tax you have paid so far this year, this could be zero if you have put your application in before 1st July. The ATO then divides the remaining tax it wants to collect from you by the number of pay periods left in the year. They then work out what percentage this amount is of your monthly, fortnightly or weekly pay then write to your employer and say that you have a flat tax rate of this percentage.

ITWV Or Not?

ITWV stands for income tax withholding variation. These forms are used by people, typically property investors, to organise to receive their tax refund during the year rather than waiting until they lodge a tax return. The ITWV is just an estimation of your next tax return which the ATO uses to calculate a flat tax rate for the rest of the financial year. It notifies your employer, then less tax is taken out of your pay.

This article is not intended to encourage you to have an ITWV done in fact quite the opposite. The ITWV is not going to increase the amount of tax you save, it is just going to give it to you earlier. Sure there is the time value of money but there is also the cost of having the ITWV prepared. You need to weigh these up. Certainly not worth it for a refund of a few thousand dollars.

If you do have an ITWV prepared by your Accountant make sure you have it done at the same time as you do your tax return as there are economies of effort that will lower the cost. Lodging an ITWV part way through the year is not that much of a disadvantage, it just means you will get a bigger reduction in your tax

over the remaining period of time. For example if you were entitled to $80 per week but don't lodge your ITWV till September you will get $100 per week for the remainder of the financial year.

Initial Repairs

There is much talk about delaying repairs to a rental property in order for them to qualify as a tax deduction. The truth is an initial repair is always an initial repair no matter how long you take to do the work. The waiting times bandied about are really just a hope that by then you may slip under the ATO radar. For the repair to qualify as an outright tax deduction you would actually have to lie to the ATO and say that the repair didn't need doing when you purchased the property.

In PBR 73017 a property had been owned and rented for 2 years before the owner got around to repairing the balcony and stairs that were suffering from dry rot and rust at the time of purchase. Nevertheless, repairing the balcony was still an initial repair.

All is not lost though. Initial repairs, other than landscaping, generally qualify for building write off. Even painting, refer ID 2003/795. So you will get to claim the costs at 2.5% a year and include them in your cost base for CGT purposes, though the cost base will be reduced by the building depreciation claimable.

The bonus is that if the repair results in the destruction of part of the building and it was constructed after 16th September, 1987 then you can scrap it. This means taking that part of your original building write off out of your depreciation schedule and claiming it as an outright deduction.

Apportioning Deductions on a Holiday Home

You are looking for trouble if you use your holiday home in the peak period but make it available for rent at other times in an attempt to claim a deduction for all expenses attributed to the period you are not using it. The ATO says in these circumstances simply being available for rent is not enough.

The question of genuinely available for rent was addressed in Bonaccordo v FCT 2009 AATA 385, where the AAT found that it was not sufficient just to have a sign out the front. In this case the taxpayer could not find tenants to his standard so the place remained vacant for 3 years.

In the case of a holiday house you cannot apportion the expenses on a days available for rent versus days used for private purposes when the peak rental times are being used for private purposes. In these circumstances the apportionment basis would be days actually rented out versus days not. Refer IT 2167.

Rental Property Record Keeping

How well are you prepared to visit your accountant? Did you resolve that this year you were going to keep better control of your records? To help with tracking rental property expenses we now have a spreadsheet available on our Property Investor and Shopping page that will streamline the process.

The spreadsheet runs on excel, allowing you to enter each item then it totals the information and transfers it into a summary report of all properties for you and another suitable for your accountant.

The spreadsheet only costs $49.95 and its use is unlimited. https://www.bantacs.com.au/shop-2/

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.

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.

Note this PBR has been removed from the ATO's ruling register.

Tax Treatment of Government Incentives

Government rebates on energy efficient items are an assessable recoupment, covered in TD 2006/31. They have the effect of reducing the amount you qualify to claim as a tax deduction but not necessarily in the way you would expect, the full amount you paid for the item is included as an expense or in your depreciation schedule depending on the type of asset. If you are entitled to claim all the expenditure this year then the rebate is to be included as income this year. On the other hand, if the item purchased is to be depreciated then each year you include as income a portion of the rebate that is equal to the amount of depreciation you are entitled to claim, until all of the rebate is used up. For example if you bought a solar hot water system for $3,000 and depreciated it over 15 years on a prime cost basis you would be entitled to a $200 deduction each year. If you received a $1,000 rebate then, for the first 5 years you would need to include $200 in your taxable income to offset the depreciation until the $1,000 is used up.

Government Energy Efficient Rebate

The rebate is an assessable recoupment. This is covered in TD 2006/31. It will have the effect of reducing the amount you can claim as a tax deduction. The full amount you paid for the item is included as an expense in your tax return then the rebate is included as income. If instead the item purchased is to be depreciated then you'll need to claim as income each year the amount of depreciation claimable until the whole rebate is used up. For example, if you bought a solar hot water system for $3,000 and depreciated it over 15 years on a prime cost basis, you'd be entitled to a $200 deduction each year. If you received a $1,000 rebate then for the first five years you'd need to include $200 in your taxable income to offset the depreciation.

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.

Rental Property Tax Returns Through The Mail

On the property investors page of our web site we have installed check lists to streamline the process of doing your tax returns through the mail. You will still receive the personalised service of e-mails or phone calls from the person preparing your tax return. These lists are just a method of data collection.

There is a checklist specifically designed for overseas residents who own a rental property in Australia. The link to the lists is at the top right hand side of the Property Investor's page which is http://www.bantacs.com.au/property.php

Building Depreciation Can Include Road Outside Boundary

In ID 2010/58 the ATO allowed a developer of cabins to include, in the amount allowable for building depreciation under Division 43, the cost of the access road which was constructed on public land. It was a condition of the development approval that road access work be undertaken on public land adjoining the land being developed.

This certainly opens up the question of whether items can be included in your depreciation schedule that don't actually relate to anything that exists within the boundaries of your property.

The ruling found that as the building permit required the road access works then the amount met the definition of capital expenditure in respect of the construction of capital works for the purposes of section 43-70(1)

Overseas Fly-In Fly-Out Workers

When the Rudd Government removed the exempt income status of wages earned overseas by Australian residents it made little difference to taxpayers working in countries where the tax rate is high anyway.

For example in PNG workers who live in Australia are taxed at a flat rate of 40%. So if they earned $200,000 per year they would lose $80,000 of it in tax to PNG. In their Australian tax return they would declare the full $200,000 and receive a non refundable tax credit for the tax paid in PNG. Now in Australia the tax on $200,000 is $64,850 so the $80,000 tax credit from PNG would cover this but the balance of $15,150 would not be refundable by the Australian government nor can it now be carried forward to offset against foreign income in future years. Further if the taxpayer had other income in Australia the foreign tax credits cannot be used to pay the tax on that income. The only concession offered is that the foreign income is considered the last piece of income you earn therefore subject to the highest marginal tax rate, maximizing the amount of foreign tax credits that can be utilised.

A negatively geared rental property is not going to help a resident taxpayer whose income is taxed highly in a foreign country where it is earned.

Going back to the PNG worker with $200,000 in foreign income, the $5,000 property loss will make their Australian income $195,000 tax on which is $62,600 but all this means, is that the wasted foreign tax credits are now $17,400. Worse still when they start working back in Australia they may no longer be able to afford to subsidise the rental property so have to sell it realising a capital gain in a year when they don't have excess foreign credits. Foreign tax credits can only be used to offset tax on foreign income so even if they are still working overseas when they sell the best case scenario is that the capital gains tax is recognised first so benefits from the tax free threshold and lower rates. Nevertheless, the losses during ownership do not provide any tax benefit and the capital gain cannot utilise the wasted foreign tax credits. This is a very strong argument for finding someone or something else to own the property.

Usually choosing what name to purchase a property in involves a bit of crystal ball gazing but in the above case unless the property is going to be negatively geared for a long time and the owner is only going to work overseas for a very short period it is not hard to work out that there is no reason to hold it in their name. Alternatives are to hold it in a low income spouse's name or a discretionary trust. A SMSF is unlikely to be the best choice due to salary sacrifice problems, individually taxpayers should consider the SMSF option but as it is very unlikely to be the best outcome and a complex issue it is ignored in this discussion.

Holding it in a low income spouse's name may also waste the negatively geared property losses. If the spouse has a low income the tax refund resulting from the loss is minimal, if they have no income then the loss can be carried forward but must first be reduced by exemption income such as Centrelink family

payments. There is also the risk that by the time a capital gain is realised, the low income spouse may have returned to full time work and be on a high income.

A slightly complicated and costly alternative is to hold the property in a discretionary trust. We get a bit defensive about recommending trusts because it is certainly a revenue generator for accountants and we do not want to appear to be giving a sales pitch. This is a situation where a discretionary trust can give you a better outcome if your crystal ball is a bit foggy, simply because a discretionary trust gives you more options later down the track. But it is going to cost you to set it up and each year you will need to lodge a trust tax return. Also consider land tax considerations, good or bad depending on which state you are in.

The benefit is that in a discretionary trust the losses can be safely quarantined until the capital gain is realised as there is no risk of exempt income reducing them, low income soaking them up at a minimal tax rate, or the losses reducing foreign income on which tax has already been paid. Having safely protected these losses through the years, when the property becomes positively geared or sold for a capital gain then they can reduce the profit before it is distributed to any beneficiaries and provide you with the choice of which family member any remaining profit is distributed to, depending on the circumstances at the time. In short a discretionary trust eliminates the need for a crystal ball so unless you are very certain of your circumstances during the whole period of ownership the discretionary trust will give you the best tax outcome.

Renovating and Scrapping

Scrapping is when items are removed from a rental property and dumped as they have no value. Of course, quite a bit of this happens when a property is renovated. If the plant and equipment have not been fully written off for tax purposes, the balance of any unclaimed depreciation can be completely written off in the year of the renovation, that is if the property is considered to be producing income before the renovations take place. The situation with building depreciation is not so easy. You have to look at the whole period of time since the building was originally built and apportion the remaining unclaimed depreciation on the same ratio as number of days used as a rental property to number of days not. This will probably mean you will have to assume not for previous owners. Reference ID 2010/36.

The belief that you can claim a tax deduction for items scrapped on a property you buy to renovate, and afterwards rent out, still seems to persist. Apparently some quantity surveyors are advising clients that they should just advertise the property for rent for a couple of weeks, then start the renovations, or list it with a real estate agent, even though it is not actually liveable during the renovation. You should not rely on this without a ruling from the ATO.

What I find most alarming about this, is that if the ATO decides that merely advertising the property is not sufficient for it to be considered income producing, then the taxpayer has lost any chance of ever being able to claim a scrapping deduction. It would seem prudent to actually rent the property out before the renovation rather than take the risk. And I do think it is a risk, in fact I am of the opinion, especially in these times of high rental demand, that you will not be able to legitimately claim that the property has been used to produce income unless you actually have a tenant in the property before you renovate.

Now for the detail. Firstly, there are two types of depreciation, the following link will take you to the ATO rental booklet which, at the back, has a detailed list of all relevant items dissected into Div 40 and Div 4 www.ato.gov.au/content/downloads/IND00270214N17290611.pdf

Division 40 of ITAA 1997 is for plant and equipment, for example, carpets, stoves, dishwashers, hot water systems and curtains, generally the items that are not that fixed to the building. You can estimate the value of these items yourself.

Division 43 includes the actual building, tiles, kitchen cupboards, bath tub, doors, windows etc. Unless you have evidence of the original building costs, you need to have them estimated by a quantity surveyor or similarly qualified person and usually they will estimate your division 40 depreciation at the same time. Division 43 depreciation is written off evenly over a 40 year period from the date of original construction, 25 years in very limited circumstances.

To scrap an item subject to Division 43 depreciation, the legislation states:

SECTION 43-40 Deduction for destruction of capital works 43-40(1)

*You can deduct an amount if all or a part of *your area is destroyed in an income year and:*

(a) *you have been allowed, or can claim, a deduction under this Division, or former Division 10C or 10D of Part III of the Income Tax Assessment Act 1936, for your area; and*
(b) *there is an amount of *undeducted construction expenditure for your area; and*
(c) *you were using your area in the way that applies to it under Table 43-140 (Current year use) immediately before the destruction or, if not, neither you nor any other entity used your area for any purpose since it was last used by you in that way.*

Notice the use of the word "and" between (b) and (c), this means all these points must apply. It is my opinion that (c) is intended to make sure you don't live in a property that used to be your rental, then apply (a) above because it is destroyed while it is your home simply because at some stage depreciation had been claimed.

Table 43-140 describes the current year use as "for the purpose of producing assessable income". Section 43-160 extends this to merely having the property available to produce income.

43-160 Your area is used for a purpose if it is maintained ready for use for the purpose

*A part of *your area is taken to be used, for use or available for use for a particular purpose or in a particular manner at a time if, at that time:*
(a) *it was maintained ready for use for that purpose or in that manner; and*
(b) *it was not used or for use for any other purpose or in any other manner; and*
(c) *its use or intended use for that purpose or in that manner had not been abandoned*

Starting to get a bit dodgy isn't it? Certainly worth applying for a ruling in my opinion. There is an ATO interpretive decision (ID 2010/35) disallowing a scrapping claim because the owner lived in the house for a short time before demolishing it. Certainly if you live in the house while renovating it you have blown any chance of scrapping. This ID also implied that the preparation for destruction meant that the use of producing income had been abandoned. This may even affect people who do rent the property out first but probably not if they rent it out again after the renovations. Here is a quote from ID 2010/35

" In the context of paragraph 43-40(1)(c) of the ITAA 1997, immediately before refers to a relatively short period of time between the last use of your area and its destruction. In this case, the house was not let in the last few months before it's destruction. This and the activities undertaken in preparation for its destruction as well as the taking up of residence prior to destruction show that the taxpayer's use, or intended use, of the house for the purpose of producing assessable income had been abandoned in the period leading up to the destruction. Therefore, the house was not used for the purpose of producing assessable income immediately before the destruction. For the same reasons, the house cannot, under section 43-160 of the ITAA 1997, be taken to be used for the purpose of producing assessable income immediately before its destruction."

Now to ID 2010/36 where you have to look at the use of the building over its life not the period you owned it. The tax deductions associated with scrapping items you destroy or remove while renovating might not be as great as all the publicity makes out. There is a good chance it might not be worth the costs of a quantity surveyors report.

If you have just bought a property to renovate and then rent out you are not going to qualify at all because section 43-40(c) ITAA 1997 requires the property to be used to produce income immediately beforehand.

If you have been using the property as a rental before the renovation then you will qualify for some deduction for the unclaimed building depreciation, assuming the area being removed was constructed after 16th September, 1987. You should already have a QS report but you will need the QS to come out and look at the area you will be demolishing so its portion of the original construction costs can be calculated.

Let's say this amount was $40,000 and the property is now 25 years old at the 2.5% rate of special building write off that leaves $15,000 in unclaimed depreciation that can potentially be claimed. Your next problem is section 43-250 ITAA 1997 which requires you to work out the number of days the property has been used to produce rental income as a percentage of the total days from construction to destruction. Unless you have owned this property for the last 25 years you will have to find out what the previous owners used it for or assume it was not a rental during that time. So if you have owned the property as a rental for the last 5 years that is 20% of the time or $3,000 of the remaining unclaimed depreciation you are entitled to. In this scenario it is worth the cost of the QS mainly because the property is only 25 years old when the renovations are undertaken.

Doing Up A Rental Property Before You Move In Or Sell

IT 180 allows you to claim a deduction for repairs to a rental property that became necessary while the tenant was living there. If the tenant has moved out and you do not intend renting the property again it is important you undertake those repairs before the end of the financial year.

The catch with IT 180 is that the repairs can only be claimed in a year that the property has earned income so it is a bit of a rush if your tenant moves out in June. This problem can be overcome by incurring the expense even though the work is not actually done. As long as you have accepted the quote and advised the tradie to go ahead before 30th June you should be ok.

If you intend renting the property out again after the repairs are completed there is not quite the same rush, just make sure you do not use the property for private purposes during the gap between tenants. For example don't live there while doing the repairs.

Borrowing To Pay Rental Property Expenses

Recently I was invited to appear before the General Anti Avoidance Rules Panel regarding a client's ruling application to capitalise interest. This panel consists mainly of ATO officers with a few independent members of the legal profession. We do not have a full answer regarding capitalizing interest yet but I would like to inform readers of what the ATO is thinking and this page on the web site has much more detail https://www.bantacs.com.au/topics/property-investors/capitalising-interest/

The ATO officer presenting the ATO's argument was called Robert. He gave very little away but one point he made perfectly clear was that it is not just capitalizing interest they are chasing but any interest on borrowings incurred for rental property expenses. He would not be drawn into borrowings for repairs or renovations but he clearly stated that if you borrow to pay the rates or insurance on your rental property and have other non deductible debt with an offset account attached (or for that matter a redraw facility or LOC) then it may be considered a scheme with the dominant purpose of a tax benefit to not use your savings or income including wages to pay the rental property expenses. This is the case even if the rental property expenses exceed the rent received. Robert also point blank refused to be drawn on where the money was to come from considering the amount of the rates may well exceed the person's wages and whether other personal expenses such as food or money set aside for an emergency are required to be used to make this payment.

It appears that the ability or inability to make the rates payment is not relevant it is simply the action of choosing to borrow to pay expenses that is a scheme with a dominant purpose of a tax benefit. What the ATO are saying is that interest incurred on borrowings for rental property expenses (if you have non deductible debt) is no longer deductible by virtue of threats to apply Part IVA, not by any legal precedent or legislation. But it is still ok to capitalise the interest on a margin loan for shares or run or claim interest on an overdraft for a small business. I would certainly like to see the ATO try to defend this in the courts.

Following that meeting we received a letter from the ATO http://www.bantacs.com.au/docs/Latest-word-from-the-ATO-on-Interest-Deductions.pdf Well the plot is thickening and we are certainly no closer to some clear guidelines. The following is an extract that letter in relation to some questions we asked about borrowing to pay rental property expenses. While it gives two examples of when Part IVA would not apply, they are so extreme that you can see it is their intention to push Part IVA as far and wide as they can.

> "When taxation considerations constitute at least a substantial purpose of a taxpayer, it is practically inevitable that Part IVA must be considered and cannot simply be ruled out or in.
>
> However, I offer the following observation. There appeared to be a theme to some of your questions; they dealt with an unexpected change in circumstances. In determining whether there is a scheme to which Part IVA applies it will often be necessary to consider whether there has been an unexpected substantial change in the taxpayer's financial situation.
>
> For example:
>
> - If a taxpayer has an unexpected illness that means that they can no longer use their salary to pay the difference between the interest on their investment loan and the rent

from the investment property, then the taking out of a line of credit to fund this difference would generally be viewed as weighing against there being a scheme to which Part IVA applied, particularly if the use of the line of credit ceased once the taxpayer went back to work; or

- if it was necessary for a taxpayer to make unexpected repairs to their rental property which they were unable to fund from non-loan sources, then the taking out of a line of credit to fund the repairs would generally be viewed as weighing against there being a scheme to which Part IVA applied."

Surprise, surprise the ATO officer who wrote this letter has requested that I do not identify him. I will say he is very high up at the ATO so this needs to be taken very seriously.

Am I over reacting or does the above say that the ATO will apply Part IVA to deny an interest tax deduction when money has been borrowed to undertake repairs that the taxpayer should have known would need doing or even if they were unexpected but the taxpayer had other funds available (you know that money you keep aside to save up to pay your annual bills or as a safety against unexpected medical expenses)? Your emergency savings must be used to fund the unexpected repairs because the ATO will use Part IVA to claim that a choice to borrow the money instead is a scheme with the dominant purpose of a tax benefit. Further, if you have no income because you are ill then you are allowed to borrow the difference between the rent and the interest on your investment property but only until you go back to work then propping up the rental property must come first, no consideration of any other more important bills.

Hart's case made it clear that it was ok to borrow to pay deductible expenses when you were having trouble meeting your commitments there was no mention of supporting investments before other more personal needs. This concept is also backed by case law and rulings. Part IVA is only supposed to apply when the dominant purpose of the arrangement is to gain a tax benefit. In the above this has been reduced to "substantial purpose".

It is time to go back to the courts or someone at the ATO makes them more accountable for their opinions. The ATO does not make the laws they must play by the rules like the rest of us and cannot just dream up their opinions, they must have a basis of law. To apply Part IVA in the case of a 'substantial purpose' would mean that choosing to walk into a newsagency and buy an invoice book then ask for a receipt thus showing an intention to claim it as a tax deduction could be considered a scheme caught by Part IVA. Fortunately the law says dominant not substantial!

If you would like to read the rest of this letter go to
www.bantacs.com.au/docs/Latest-word-from-the-ATO-on-Interest-Deductions.pdf

If you would like to read the minutes of the meeting we had with them where these and other questions were raised go to: www.bantacs.com.au/docs/Minutes-from-GAAR-Panel-Meeting.pdf

If you think it is going too far for the ATO to say that you are not allowed to claim a deduction for borrowings to pay interest on your rental property, repairs (possibly renovations) rates and insurance unless you have no other income at all (no consideration for your living expenses) and do not have any savings then please send a copy of this to your local Federal member.

Available for Rent and Substantiation of Rental Expenses

In AATA 174 2012 the ATO tried to argue that a property was not available for rent so certain expenses were not tax deductible. The property was in a remote area and had been vacant for 5 years. The owner had rejected one potential tenant because "she had it on good authority that they were undesirable". There was no local town or property manager and real estate agents further afield were not interested in listing it. She found the internet to be more useful than newspaper advertising and word of mouth the most effective. The AAT found that the property was available for rent even though attempts to find a tenant were not "vigorous", the reason for the long vacancy was the remoteness of the location.

The taxpayer ran into trouble when it came to substantiating her expenses. For example she claimed that even though she went out to the property to maintain it three times she was only claiming two lots of $500 for those costs, which was considerably less than what she actually incurred. Nevertheless, reasonable or not she was not entitled to just pull a figure out of the air.

There were also problems with apportioning of expenses. The phone account at the rental (necessary because the area was too remote for mobiles) was mixed in with her home account and as it could not be apportioned no deduction was allowed. Stay tuned on this topic there will be more about using diaries in the next edition of Newsflash.

Claims for amounts paid to Woolworths were not allowed because she could not show what was actually purchased. While a claim for carpet was rejected because it was capital in nature it is important to note that the AAT member, Ms G Ettinger, was also ready to reject it because it was not obvious which of the rental properties the carpet receipt was for. This is an interesting heads up even if you have one rental property you still need to be able to prove that the expenses was not incurred for your own home. So whenever possible make sure your documentation states the location the goods were delivered to.

I want to draw particular attention to the interest on her $50,000 line of credit. As she could not show what the amounts were drawn down for she was denied a deduction for the interest.

If you are interested in reading this case go to http://www.austlii.edu.au/au/cases/cth/aat/2012/174.html

15 Points You Should Know About Depreciation

1) Items that are plant and equipment and have a value of less than $300 can be written off immediately when you first buy the property. This is $300 per owner so if the item is worth $500 and two people own the property it can be written off immediately.
   But like items must be added together to pass the $300 test so 5 sets of curtains valued at $200 each will not qualify unless that are at least 4 owners of the property.
2) The ATO's rental property guide has a detailed list on its back pages that will tell you what is plant and equipment, and what is part of the building. You are only required to use a quantity surveyor if you do not know the original cost of constructing the building, in fact if you know the cost, then you are not allowed to use a quantity surveyor's report.
3) You are allowed to estimate the value of the plant and equipment yourself. All accountant's tax return software has a schedule that can easily calculate the depreciation each year from your first estimate.
4) If you buy a property to renovate before you rent it out there is no point in getting a quantity surveyor to do a depreciation schedule before you renovate because you will not be entitled to scrap anything. The property must first be used as a rental and immediately before the item is destroyed or removed. Note that until that property becomes a rental you will not be entitled to claim any depreciation, even during the renovation period.
5) You cannot utilise a quantity surveyor to claim a higher amount than the actual cost of the item, you must use the price you paid. When you know the price you paid you do not need a quantity surveyor's report to make a claim.
6) If the item qualifies as plant and equipment and its original value is less than $1,000 (per owner of the property) then it qualifies to go into a low value pool. In the first year you effectively claim half the depreciation you would have been entitled to had you owned the item for the full year. This is the case whether you buy the item at the start or end of the financial year. You do not need a quantity surveyors report to do this.
7) Review your depreciation schedule for any items of plant and equipment that originally cost more than $1,000 but are now written down, using the diminishing value method, to $1,000 these can now be placed into the low value pool which will probably result in a faster rate of depreciation.
8) If you do not know the original building cost of a house you will need a quantity surveyors report to claim building depreciation but if the house was constructed before 16th Sept 1987 and has not since been renovate, there will be no depreciation left to claim.
9) Initial repairs (things that needed doing when you purchased the property) are not tax deductible but can be depreciated under building depreciation at 2.5% a year, even if they are not structural.
10) Fixtures to the building are not considered plant and equipment. For example bathroom fittings attached to the wall. The $1,000 and $300 concessions only apply to plant and equipment not fixtures to a building. Fixtures can only be claimed as part of the building depreciation at 2.5%.
11) Garbage bins are generally owned by the council so you can't depreciate them.
12) If the property is in a block of units you may be entitled to depreciate some of the common property. The body corporate may be able to give you a list of the items and their original cost and for that

matter the relevant information for your unit. Not only will this save you the cost of a quantity surveyors report but if this list is available then you are not entitled to use a quantity surveyors report for anything on the list.

13) If the property you are buying has been used as a rental the seller is required by law to provide you with their depreciation schedule and supporting material. When this is available you must use these amounts not a quantity surveyors' report.
14) When it comes to building depreciation it is the original cost to build that is relevant not the price you paid. In the case of plant and equipment in an established house it is the second hand value.
15) On the other hand if you buy a house and land package from a builder then this original cost cannot include the builders profit because he or she is also the first owner of the property.

Spending Money on Your Rental Before Year End

If you have a bit of spare cash and feel you pay too much tax you may be considering spending it on your rental property before 30th June. Here are some of the basic strategies explained.

Payments in advance:

This is simply borrowing deductions from next year to claim in this year. It is not good if you will be in a higher tax bracket next year, in those circumstances waiting the extra year for the benefit will mean a bigger refund.

You can only pay a maximum of 12 months in advance. In the case of interest payments you could get one year ahead and keep it that way but it is best to save this for when you need it most because it can only be used effectively once. And if you don't keep on paying interest in advance from that point onwards, you will have a year with no interest deduction. It is really a tool for evening out fluctuating incomes.

Check if the bank will let you do this and that they do take it as an interest payment not just let it reduce the loan balance. If you have recently purchased a property consider organising your quantity surveyors report before the end of the year so that you get tax deduction for the cost in that tax return.

Repairs and maintenance:

You need to make sure you at least incurred the expense before the end of this financial year. This means organising for the work to be done even if you have not paid for it yet. This is particularly important if your tenants have moved out and you do not intend re letting the property. If you don't "incur" the repairs now you will not be entitled to a tax deduction next year because the property has not earned any rental income in that year.

Buying plant and equipment:

As these items are usually depreciated over many years buying them towards the end of the financial year could mean you only qualify for one month's depreciation which would be a very small fraction of what you have spent. Items costing $300 or less can be written off immediately. Like items must be added together when applying the $300 test so it may be better to buy one set of curtains this year and wait until July before you buy the next set. Items costing under $1,000 will qualify for depreciation of 18.75% in the first year, regardless of when you purchase them. Both these thresholds are per owner so a $1,900 hot water system for a property owned by 2 people would qualify as under $1,000.

Repairs That Replace Something In Its Entirety

A repair by definition means that the item being repaired still remains in use after the repair. You cannot repair something by replacing it.

A replacement in its entirety so can only depreciate, 2.5%pa if it is part of the building but plant and equipment such as stove, range hood, dishwasher and hot water system would get a higher rate of depreciation. To avoid being classed as a replacement in its entirety look at what still exists. For example in Domjan's case 2004 AATA 815 a vanity was not considered to be a replacement in its entirety because the same pipes were still used. It is only considered a repair when part of the original item is still left. Though this is a messy area because in TR97/23 (the ATO's ruling on this topic) the ATO claims if you replace almost all of something it is still an improvement. TR 97/23 was released before Domjan's case and case law has precedent, nevertheless the ATO have not corrected TR 97/23 so they will probably still try this line of argument, when it suits them.

Another trap is identifying the original item. For example replacing a whole roof is not a replacement in its entirety because it relies on the 4 walls to hold it up. Yet ripping out all the kitchen cupboards rather than just a few damaged doors is a replacement in its entirety

About to repair a fence? First take a serious look at just what is holding it up. You see you are not entitled to an outright tax deduction when you replace something in its entirety. Completely replacing a roof is not a replacement in its entirety because it relies on the house walls to hold it in place. It is the whole building that is the entirety. Likewise completely replacing one boundary's fence may not be a replacement in its entirety if the corner post relies structurally on both the side and back fence.

Interesting Case on Rental Property Tax Deductions

YPFD vs Commissioner of Taxation AAT 2014 covered claims for property investment seminars, interest deductions, payments to spouses and substantiation of expenses but of particular interest to me was the question of whether the taxpayer was in business or merely an investor. .

YPFD worked full time and owned, with her husband, 9 properties which were managed by a real estate agent yet she was successful in arguing they were in business, not just investors. Part of her argument was that she spent a considerable amount of time managing the properties and due to the inefficiency of the agents she had to do much of their job.

This is only an AAT case but it may help people with nine or more properties distribute the profit or loss differently to the title and allow them to borrow to repay their equity. There may even be the possibility of challenging the SMSF restrictions on acquiring residential property owned by members.

Let's look at each of these issues in turn:

Profit or Loss Distribution:

If you are in business and jointly in receipt of income you can distribute the profit or loss of the business according to your partnership agreement which can, very conveniently change each year. Reference TR 93/32

Borrowing to repay yourself:

In Roberts and Smith's case (1992 ATC 4380) a business was allowed to borrow funds to pay back to the partners some of the original capital they had invested in the firm. The ATO argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners, the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of businesses or property because technically they cannot owe money to themselves. The ruling goes on to say:

> "The refinancing principle" in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships."

If you are in business then you are a common law partnership, this means that joint owners of rental properties may be able to borrow to repay themselves their initial deposit or principle repayments on the loan. Very, very useful if you decide to rent out your old home when you purchase a new one.

Transferring Your Residential Rental to a SMSF

This is all about section 66(5) of SISA (Superannuation and Insurance Supervision Act?) where it states that a SMSF can acquire real estate from a member:

> "where the real property is used wholly and exclusively in one or more businesses"

SMSFR 2009/1 in paragraphs 279 to 282 gives an example of a SMSF member being allowed to transfer residential flats into his SMSF because they are considered to be used "wholly and exclusively" in a business. He owns 20 flats in total and his sole occupation is managing them. Perhaps now this bar could be lowered to 9 properties while still working full time. When it comes to SMSFs it is best not to do anything like this without an ATO ruling as the consequences of getting it wrong are just not worth it.

Now this is a lot to conclude from one case in the lowest court and certainly shouldn't be relied upon but it is certainly an area worthy of more test cases and ruling applications.

Other issues YPFD's case addressed,
Courses:
YPFD claimed for many courses in property investment and share trading. The share trading one was disallowed because it was considered she was not a share trader having only made 5 trades in a year. There was a Henry Kaye 10 module course costing $55,000 which was analysed for modules that were relevant to the income producing side of property investing not the buying and selling of properties. Only three modules qualified as deductible because they dealt with the management of current properties, namely:
Advanced Renovations for Established Properties,
Advanced Rental System – Create long term positive gearing through maximised rental
Equity lease Rental System
No deduction was allowed for courses on asset protection and tax minimisation. Note in the latter case that was probably because they were not conducted by a registered tax agent.
Even if the course was tax deductible YPFD was denied a tax deduction for her husband's ticket.

Interest:
The taxpayer was denied a deduction for part of the interest on a loan because she could not prove that all the money drawn from the loan had gone towards the construction of a rental property. In particular there were payments to credit cards which she argued was to cover expenses charged to the card for materials for the property but then refused to produce the credit card statements.
She also had a rather contribed arrangement where a trust borrowed money and on lent it to YPFD who then claimed a tax deduction for the interest on the loan, which was denied because YPFD could not show that this was a direct cost of earning income.
Substantiation
YPFD was also found to be careless with what she put into her tax return, for example claiming all of the expenses for properties she owed together with her husband, double claiming some bills and not having any receipts to prove others.
YPFD claimed tax agent fees that were for the trust and her son's tax return, accordingly, these were denied.

Paying Her Spouse
YPFD claimed a deduction for paying her husband to prepare her tax information which was denied because he was not a registered tax agent, the invoice was date after the year in question and there was no evidence that it was paid. She also claimed for gardening he did, this was denied because there was no evidence that it had been paid but it was also questioned whether this was appropriate considering he owned half the property.

Making Superannuation Contributions from Your Investment Trust

If you hold property or shares in a trust you may be considering having the trust make a contribution to a superannuation fund on your behalf. You need to be a common law employee of the trust for this to be possible. Being a director of the trustee company is not enough reference TR 2010/1. This ruling also states that to be a common law employee you must be engaged in producing the assessable income of the trust or its business.

Now just for starters this will mean that the trust will have to pay you wages which you need to declare as income, make sure that the trust deed allows for you to be paid wages and the wages should not be paid for your services as a director of the trustee company. You will need to find something else to justify the wage.

The next hurdle is that you must be engaged in producing the assessable income of the trust or its business. In an investment trust it is the investments that produce the income, the ATO is unlikely to consider that there is anything you can do to produce income for the trust, paperwork is not enough. The next limb is to be engaged in the trust's business. As discussed in Newsflash 282 in the article on YPFD vs Commissioner of Taxation AAT 2014 it is difficult for an investment trust to be considered in business, there would need to be at least nine properties that you manage yourself. Even if you think you qualify you

should first obtain a ruling from the ATO. It would be a waste to have your money locked away in a superannuation fund and not have got a tax deduction for it going in there.

There would also need to have the appropriate employment set up i.e. PAYG withholding deducted from wages and workers compensation insurance if applicable (note in QLD directors of trustees cannot be covered by work cover). A contract setting out the terms of employment would be helpful.

If you want to make superannuation contributions for other family members the trust would still have to be able to convince the ATO it is in business but also these family members would have to work in the business and receive all the employment conditions discussed above.

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.

Holiday Rentals

If you own a unit or a house that you rent out as short term accommodation it is still considered a residential rental property. It would be different if you controlled the whole block i.e. a motel like organisation.

As a residential rental property you are not entitled to charge GST or claim GST input credits on expenses associated with the property or its purchase. You are entitled to hold an ABN but unless you have some other form of income you are not required to register for GST. It is important to note that if you are not registered for GST you must not provide tax invoices. Your invoices must not be described as tax invoices and they should not state or imply that GST has been charged. The second item on this page makes it clear that you must not provide a tax invoice if you are not registered for GST
http://www.ato.gov.au/Business/Bus/GST-for-small-business/?page=5

Be careful if you let your holiday rental out through an agent. You need to check that they understand this and are not issuing tax invoices on your behalf. As they are merely your agent you could be liable for any GST they imply has been charged and rightly so because if the traveller is on business they will be claiming this GST back.

Short term accommodation may not always be for private holidays, it may be used by someone travelling for business and they may want a tax invoice thinking they will be entitled to the GST back. You need to point out that you are not registered for GST so cannot issue a tax invoice, maybe refer them to the above link.

The trap for your business tenants is, that as part of an attempt to control the cash economy the government requires all businesses to obtain an ABN from anyone they pay or withhold 47% in tax from the payment. Refer
http://www.ato.gov.au/General/Contractors/In-detail/FAQs/No-ABN-withholding---questions-and-answers/?page=3#2__If_I_buy_supplies_or_services_from_a_business_that_does_not_quote_an_ABN__what_do_I_have_to_do_
Accordingly, if you own a holiday rental, it may be better if you apply for an ABN but not register for GST. Give them the ABN and avoid an argument.

Technically this 47% withholding rule does not apply to input taxed supplies so you may be able to persuade them not to withhold 47% by pointing out you do not own the whole block, you are not a business, just an investor so it is an input taxed supply. The last column on the first page of this booklet points out

that withholding does not apply when the supply is input taxed
http://www.ato.gov.au/uploadedFiles/Content/MEI/downloads/BUS38509n3346_5_2012.pdf

Underpinning and Restumping, Tax Deductible?

Good question. Ask two people and you will get two different answers but there are reasons for these contradictions.

The first issue to consider is whether the restumping is an improvement. This is a question of whether the restumping was necessary when you purchased the property regardless of whether you knew about it or not. The ATO guideline on this is TR 97/23 http://law.ato.gov.au/atolaw/view.htm?DocID=TXR/TR9723/NAT/ATO/00001 . If the restumping improves the property beyond the condition it was in when you purchased it then it is an improvement, no tax deduction but the cost can be depreciation at 2.5% over 40 years.

Now if you have owned the property (either as a rental or as your home or holiday property etc) for a number of years and it is within this time that the restumping becomes necessary it is a repair. If a repair is undertaken while the property is income producing and the repair became necessary during the period of ownership then the cost is tax deductible. If the property is only used to produce income for part of the year you may have to apportion the cost unless you can argue the restumping is a result of tenant damage (IT 180).

Some may be concerned that if all the stumps need replacing it would be considered a replacement in its entirety so really an improvement. To be a repair something of the old item must remain. The fact is the house is totally reliant on the stumps structurally the same as a roof relies on its walls, this means that the entirety is the whole building not the stumps alone. Reference paragraph 40 of TR 97/23.

There are ATO rulings that class underpinning as a capital improvement such as ID 2001/30 http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID200130/00001 The ID states:

> "In underpinning the entire foundations, the taxpayer inherently changed the nature and character of the income producing property (Case V2 88 ATC 107; AAT Case 4012 (1987) 19 ATR 3038 and ACT Construction Ltd v. Customs & Excise Commissioners [1979] 2 All ER 691). The underpinning goes beyond restoring the property to its original state and alters the character of the property. Accordingly the underpinning work is a capital improvement rather than a repair and therefore is not deductible in the year of income."

Yet case V2 88 ATC 107; AAT Case 4012 (1988); 19 ATR 3038 (referenced in ID 2001/30) it was considered that underpinning was a repair. There was only partial underpinning of a rental property due to excessive drying of the subsoil. It was found that the foundations were restored to their former efficiency in function without the essential character of the foundations being altered. The repairs to the foundations were not capital in nature, as they did not change the nature and character of the building and as such were deductible as repairs.

PBR 1011333688020 https://www.ato.gov.au/rba/content/?ffi=/misc/rba/content/1011333688020.htm states:

> "If you were to simply have the posts re-stumped and restore their efficiency of function, this would constitute a repair."

Re stumping by replacing timber stumps with brick ones may be an improvement not a repair. Having said that the ATO in PBR 17932 https://www.ato.gov.au/rba/content/?ffi=/misc/rba/content/17932.htm accepted replacing timber stumps with concrete stumps was still a repair because concrete was just the modern alternative.

Just for good measure PBR 45255 https://www.ato.gov.au/rba/content/?ffi=/misc/rba/content/45255.htm states:

> "In your case, you have owned the property for approximately eight to ten years and the property has been income producing up until the time restumping was commenced and was only untenanted until the works were completed. The need for repairs was occasioned by factors, which occurred during the period of income production. Only part of the foundation was underpinned which restored it to its original condition. As the essential character of the foundations was not altered, the work is therefore considered to be a repair and not capital in nature and any expenditure incurred is deductible."

Now as far as authority goes the case quoted has the strongest authority followed behind by TR 97/23 then ID 2001/30. The PBRs are just copies of private rulings made by the ATO which, unless you are the rulee, cannot be relied upon.

Great Website for Body Corporate Members

Michael Teys has created a new website with lots of management tools and practical advice for dealing with or running body corporate. Well worth a look. http://wiki.blockstrata.com.au/

Body Corporate Issues – Michael Teys To The Rescue

The owner of 3 dogs signed a contract for her new home unaware that there was a clause stating she could only keep one dog. By the time she found out it was too late. They were not even allowed to stay with her while she found two of them a new home.

Michael Teys from Teys Lawyers the strata plan specialist pointed out that the body corporate just can't do that. They must be reasonable in their response to requests from owners and that there was already a precedent that it would be unreasonable for a body corporate to limit the number or size of pets kept by the owners. Apparently all these rules are just bluff. If you think your body corporate is being unreasonable please contact Michael. The Teys website is http://www.teyslawyers.com.au/

2017 Budget Update – Plant and Equipment Depreciation

Any properties purchased after 9th May 2017 (budget night) will no longer qualify for depreciation on their plant and equipment. It will only be when the owner buys replacement items that depreciation will be allowed to be claimed on that item. The budget papers are not clear on what happens when an investor buys a property brand new. In other words whether they are technically the first owner of the plant and equipment in the house. This is the relevant sentence from the budget papers:
"From 1 July 2017, the Government will limit plant and equipment depreciation deductions to outlays actually
incurred by investors in residential real estate properties"
This suggests that the first owner of the home maybe ok but the first owner could be considered the builder because he or she initially buys the plant and equipment to put in the property.

2017 Budget Update – Travel Costs

Travelling costs to your residential rental property will no longer be tax deductible. At this stage we still suggest that you keep track of these expenses as there may be a chance they can be included in the cost base of the property under section 110-25(4). Further, make sure you still keep records of these expenses for commercial properties as they are still tax deductible.

It will also be interesting to see if, when you stay in your rental property while you are repairing it, whether you have to apportion out the costs associated with the property during that period ie interest, rates etc as a private expense. I bet this won't be clear before 1st July, 2017.

Selling A Rental Property

Please make sure you read this booklet next
http://bantacs.com.au/booklets/Selling_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: www.bantacs.com.au/shopping.php. 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.