

## Renovators' Booklet

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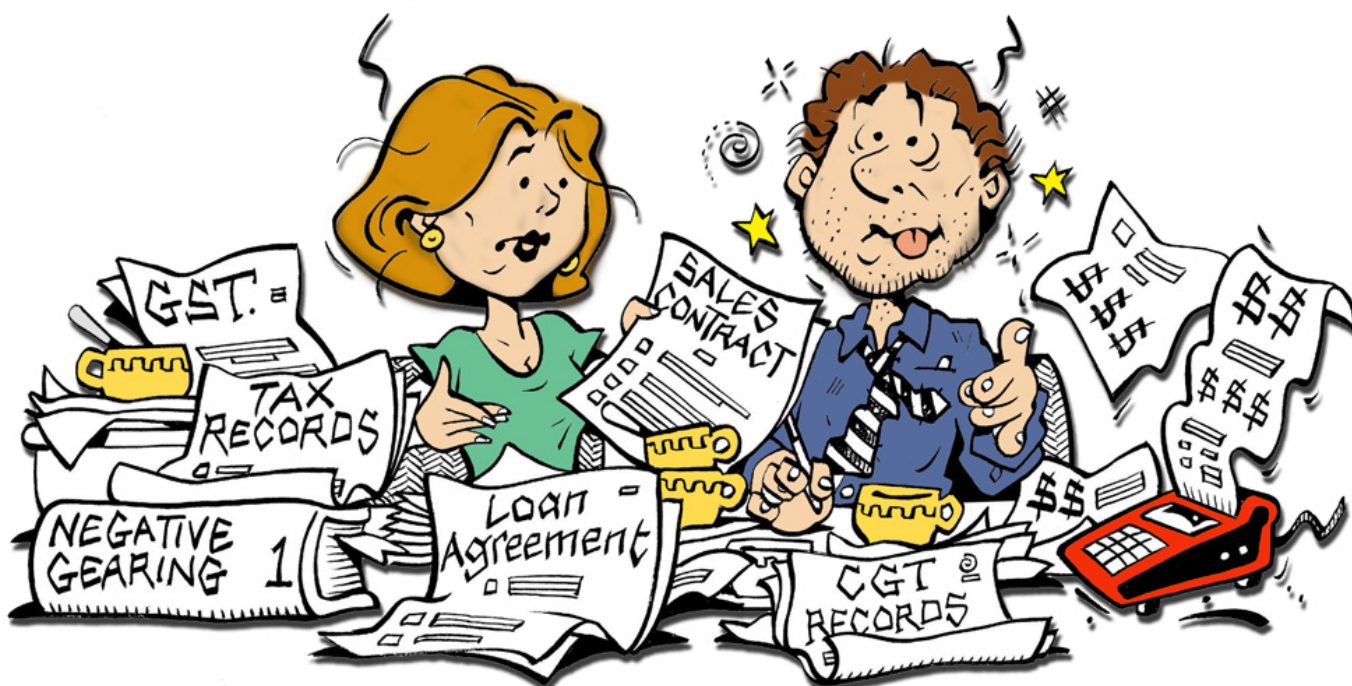
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Darl, an Accountant would explain all this in a jiffy...

OMG, that's a tax-deductible jiffy. too.



## Introduction

Welcome to the BAN TACS renovators' booklet. This is certainly no substitute for advice from your Accountant on your particular circumstances but our experience is that your Accountant is generally the last person you tell. After reading this you will understand why they should be the first person you talk to and identify the important topics for your discussions. It is important that you visit your Accountant before you sign a contract.

More general information about buying properties can be found in the following BAN TACS booklets:

Before You Buy [http://www.bantacs.com.au/booklets/Before\\_You\\_Buy\\_A\\_Rental\\_Property.pdf](http://www.bantacs.com.au/booklets/Before_You_Buy_A_Rental_Property.pdf)  
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For a fun way of learning more about property tax related issues and instant updates, like our facebook page <https://www.facebook.com/BANTACSpropertypage/>

## Tax on The Profit

It is all about your thoughts. If you buy a property with the primary intention of selling it for a profit then this is a business venture. It will be taxed as normal income just like your wages or interest income.

Business income takes precedent over capital gains tax. So there is no opportunity to cover the property with your CGT main residence exemption or qualify for the 50% CGT discount even if you live in it and/or keep it for over a year, reference TD 92/135. On the other hand if you have a buy, renovate and hold strategy CGT can apply. If you live there the main residence exemption can apply. If you rent the property out and one day in the future decide to sell you will be entitled to the 50% CGT discount.

The onus of proof, as to what your intentions were when you purchased, is on you. It would be very difficult to prove anything other than a business motive if you turn the property over quickly. Even if you live in it. Don't think you will slip under the radar. The ATO data match with the titles office. It is important to keep all your records.

## **The Latest in Withholding Traps When You Buy a Property**

Buying a property has now become a mine field of withholding tax responsibilities for the purchaser and if you don't withhold you still have to pay the amount to the ATO. From 1<sup>st</sup> July 2018, the purchaser has to withhold GST when buying vacant land or a new home. This should not concern renovators but if you want to know more, all the detail is in this blog <https://bantacs.com.au/Jblog/heads-up-must-knows-for-buying-a-property-after-30th-june-2018/#more-186>

What should be of concern to renovators is the ATO clearance certificate requirements that are already in place. All sellers must be able to produce a clearance certificate from the ATO. If they don't and the property is worth more than \$750,000, then the purchaser must withhold 12.5%. The clearance certificate is intended to prevent non-resident sellers from taking the money out of the country without paying any CGT. It does not matter if you are certain the seller is an Australian resident you still need the certificate.

## **Claiming Expenses While Renovating**

From 1<sup>st</sup> July, 2019 you will not be able to claim a tax deduction for expenses relating to a property until it is listed and ready to rent out. No grandfathering provisions here, it is just a question of what is tax deductible after 1<sup>st</sup> July, 2019.

All these expenses will now only be relevant to calculating the profit or capital gain when you sell. This is very important when you are planning the cash flow for your renovation. The cost will have to come out of after tax dollars.

Another consideration is that you will need to keep receipts for a very long time so invest in a photocopier as protection against fading.

## **Webinars for Renovators**

<https://www.bantacs.com.au/media-library/webinars/renovations/>

## **Depreciation and Scrapping**

It would rarely be worth the cost of a depreciation report for the purpose of scrapping in a recently purchased property. Firstly, the property has to be used as a rental immediately before the scrapping happens, reference ID 2010/35. Secondly, the scrapped value has to be apportioned over the whole life of the asset, reference ID 2010/36. The claim can only be made for the percentage of the time the property was used to produce income. If you don't know how the previous owners used the property you will need to assume it wasn't used to produce income. If you purchased the property after 9<sup>th</sup> May 2017 or it wasn't used to produce income before 1<sup>st</sup> July 2017 or you have lived in the property after that date you are not entitled to claim depreciation on plant and equipment or scrap anyway so it can only create a capital loss.

Note if you live in a property while renovating, even if you don't use the plant and equipment while there it will still be considered second hand when you move out so if you rent it out you can't claim depreciation. Even if you are not living in the property, if the builder buys the plant and equipment going into the renovation it will be considered second hand when you pay the builder for it. The only exception here is in brand new properties or substantial renovations as per the GST discussion below.

If you are buying to renovate and sell then there is no point at all in obtaining a depreciation schedule as you are not entitled to claim depreciation.

Even if you intend holding it as a rental after the renovation it will only be the new plant and equipment you buy that you will be allowed to depreciate and as you have the receipt you don't need a quantity surveyors report for that.

For renovators a quantity surveyor's report is only likely to be useful if you will hold it as a rental and then only in relation to building depreciation which only applies if the house was built or previously renovated after 16<sup>th</sup> September 1987. You do not need a quantity surveyor report to even depreciate the renovations you undertake as it is just a matter of keeping receipts for the work you do.

Some Quantity Surveyors will suggest you get them to calculate the value of the plant and equipment in a property so you can claim a capital loss when you scrap them. A capital loss can only be offset against a capital gain not other income. You can spare yourself the cost of the report by waiting until you sell when it will all work out in the wash.

When you throw out or scrap the old piece of P&E its value, when you purchased the property, is removed from the original purchase price of your house for the house's CGT cost base. You also get a

capital loss for that value of the P&E which you can offset against capital gains you have that year or in the future.

The scrapping of the old P&E is CGT event K7 section 104-235 ITAA 1997. CGT event K7 is not new, it is just being widened to make sure that it is clear it includes P&E that is not tax deductible under the new laws. CGT event K7 has always applied to non tax deductible P&E in a house. We have always just chosen to ignore it because it all comes out in the wash. Capital losses are quarantined and can only be used to offset a capital gain, not other income anyway. A quantity surveyor report on plant and equipment is fine if you need on for the building anyway and they provide the plant and equipment for free. Otherwise you have to way up the cost of being able to recognise the capital loss now rather than when you sell the property and also that you could simply estimate the second hand value of the plant and equipment yourself.

Here is an example of how you would calculate a capital gain strictly according to K7 when you scrap a piece of equipment worth \$200, for which you could not claim a tax deduction, in a house you bought for \$500,000. Then the next year you sell the property with no other CGT events in between.

Scrapping Year:

In your CGT records reduce the cost base of the property to \$499,800

In your tax return carry forward a capital loss of \$200.

Sale Year:

Sell property for \$600,000 with cost base of \$499,800 so \$100,200 capital gain but as have a carried forward capital loss of \$200 from the scrapping year then capital gain is reduced to \$100,000.

How it works in the real world:

Ignore anything to do with the scrapping of the P&E so when you sell the property for \$600,000 the cost base is still \$500,000 and there is no carried forward capital loss. This gives you a capital gain of \$100,000.

You Accountant can help you decide whether you need a quantity surveyor report.

## GST

Yes, GST can apply to a property that is not brand new, if it has been substantially renovated. Cosmetic changes such as painting or re carpeting through out would not be substantial. Even replacing the bathroom and kitchen while more than just cosmetic would not be enough to make it a substantial renovation because it does not affect the whole or a substantial part of the house. On this basis you could double the size of a house by extending it but if you only painted and re carpeted the original part of the house it would not be caught as a substantial renovation as not all the house was renovated. The fine line would be replacing all the floor boards. Re carpeting would not be structural but the floor boards would be so if that is all the way through the house the renovation could be substantial and you would have to charge GST if you sell rather than hold as a rental.



The ATO go to ruling on substantial renovation is GSTR 2003/3. It is important to read it with your particular circumstances in mind. It may even influence what you decide to do with the property. The following paragraph is from GSTR 2003/3

70. Structural work may give rise to substantial renovations in its own right. Structural work includes such work as:

- altering, or replacing of, foundations;
- replacing, removing or altering of floors or supporting walls, or parts thereof (interior or exterior);
- lifting or modifying of roofs;
- replacing existing windows and doors such that it is necessary to alter brickwork (for example, replacing a single door with a double sliding door).

Here is an interesting example from the ruling:



111. *Mary-Anne, a builder, acquires a dilapidated bungalow that has 3 bedrooms and one bathroom. Mary-Anne intends to renovate and sell the bungalow as part of her enterprise. She lives in the bungalow while she carries out the following renovations.*

112. *Mary-Anne adds an upstairs extension which creates a new bedroom and a bathroom. As part of the extension, the roof of the bungalow and all ceilings on the lower level are replaced. The renovations to the lower level include rewiring, repairing cracked walls by removing and replacing all of the gyprock and cement rendering the exposed bricks in the combined family room and kitchen. The installation of stairs necessitated the removal of two walls and replacement of the floor in two of the ground floor rooms. Mary-Anne also does some cosmetic work by repainting, polishing floorboards, and replacing all the fittings in the kitchen and bathroom.*

113. *The work undertaken by Mary-Anne constitutes substantial renovations. All of the rooms in the house are affected by the work and several of the rooms have undergone structural renovation work. A substantial part of the bungalow is removed and replaced in undertaking the renovation work. The cosmetic work has not been taken into account when deciding whether substantial renovations have occurred.*

114. *When Mary-Anne sells the renovated house she will be making a taxable supply of new residential premises, which includes all the work done (whether structural, non-structural or cosmetic) to the house. Whether or not a person resides in the premises does not alter the analysis.*

Here is a link to a short webinar on an example of a substantial renovation

<http://www.bantacs.com.au/media-library/webinars/renovations/>

Of course, you are not going to get any more for the house whether you have to pay the ATO GST or not, so the GST is going to come out of your pocket. Now here is the kicker, the GST will be a full 1/11<sup>th</sup> of the selling price unless you put a margin scheme clause in the contract. A margin scheme clause will allow you to only have to pay GST on 1/11<sup>th</sup> of the difference (margin) between the price you paid for the property and the price you sold it for. A considerable saving for getting the right advice. Further, if you are going to have to pay GST on the sale you may as well claim the GST back on the renovations as you go. Check with your Accountant, maybe even get a ruling before you put the property on the market.

If you buy a property with the intention of subdividing either to just sell off the other block or build and sell, the sale will be subject to GST. Again, it is very important to have a margin scheme clause in the contract. This will be the case even if you decide to live in the part of the property you decide to keep.

### **Who's Name to Buy the Property In**

There are so many factors to be considered, you must discuss this with your Accountant before you sign. So much depends on your age, what you are going to do with the property and your time frame. Also your incomes, risk exposure (building sites are a dangerous place), whether you are likely to keep it as a rental or live in it. If you end up holding it as a rental then you need to consider whether it is going to make a loss or profit and how long that is likely to last for. Certainly not a one size fits all. The following simply explains the options available to prepare you for this discussion. Do not make the decision yourself.

Companies should not be considered unless you are sure you are going to sell after the renovation. Companies do not get the main residence exemption or 50% CGT discount. Further, companies where more than 80% of their income is passive will not be entitled to the reduce company tax rates

Hybrid trusts are just a scam that propert to give you tax benefits that the ATO just won't tolerate. Do not believe that you can combine both the benefits of negatively gearing the losses in the tax return of the high income earner with the tax benefits of distributing the capital gain to a low income family member.

Reference TR 95/33 and Fletcher's case [91 ATC 4950](#)

Discretionary trusts cannot distribute losses, they sit in the trust until there is income to offset against them. This means, if you keep the property or the renovation project makes a loss you cannot offset the losses against your own income unless you have another source of income that is not from personal services that you can hold in the discretionary trust or distribute in from another trust. The advantages of a discretionary trust are reasonably good asset protection if you have a corporate trustee and the flexibility to decide who in your family receives the profits each year. If you are reading this before the 2019 election then you have to also consider the possibility of a minimum 30% tax rate on distributions which is discussed below in Labor's policies.

Unit or fixed trusts can allow you to transfer the losses into your personal tax return if you borrow to buy units in the trust and the trust then uses that to buy the property. But they do not offer any real asset protection or discretion to distribute profits so similar to holding in your own name but more costly to run.

Self Managed Superannuation Funds can be a great way of keeping the tax to a minimum and providing excellent asset protection. They can even, if you decide to keep the property as a rental, effectively give you negative gearing benefits by making a contribution to your superannuation fund to offset the property loss. If you are under your \$25,000 cap, you can claim the contribution as a tax deduction yet it will not be taxed

going into the fund because of the rental losses offsetting it. Bringing your superannuation into play probably gives you more funds to work with but there are a lot of restrictions when you use a SMSF. You can't live in the property and you can only borrow against it once, when you buy. Which means you can't use the increased equity created by the renovation to help you buy another property unless you sell. The original borrowings can be to buy and repair the property to its original glory but not to improve it. If you borrow to buy the property inside of superannuation you cannot change the nature of the property for example demolish a house to build 3 units on the land, yet you can build a granny flat down the back, but only from cash held in the fund, no further borrowings. All the nitty gritty on this is in SMSFR 2012/1. SMSF loans are expensive to set up and the interest rate is generally higher. Until you retire and reach 60 profits are taxed at 15%, CGT at 10%. Once 60 and retired you can put up to \$1.6mil into pension phase where all the income and capital gains are tax free to the fund and to you. Creditors can't touch it providing you don't deliberately divert large amounts to the fund. The down side is your money is locked away with limited leverage so it is usually better suited to those well established and over 40.

## Changes Proposed by Labor

I think it is unprecedented that commentators are now taking so seriously opposition tax policies 6 months out from the expected elections. But it seems that so assured is Labor of a win that advisors are scrambling into damage control for the major changes Labor proposes. If you would like to read more detail on Labor's policies along with a lot of their rhetoric go to <https://www.alp.org.au/negativegearing>

**Negative Gearing** – It is proposed that investment losses will no longer be deductible against salary and wages income. There is an exception for properties that are brand new when they are purchased. Rental property losses can still be offset against other investments such as shares or a positively geared property.

If you are not wealthy enough have other invests to offset your losses against, maybe you are the nurse or police officer that Labor claims to represent but you are renting out your home because your job has moved you elsewhere. Then you will only be entitled to use those losses to reduce your capital gain on that property. Which is absolutely no use at all if you are renting out your home and it is still covered by your main residence exemption. Note this will only apply to property purchased after a yet to be advised date, after they win the election.

**Reducing 50% CGT Discount to 25%** - This only applies to individuals and trust who own property. The rate of capital gains tax remains the same for Self Managed Superannuation Funds which pay capital gains tax at a maximum of 10% maximum and companies which do not receive any CGT discount. This will only apply to properties purchased after the election at a yet to be advised date.

**Trust Income Minimum Tax Rate of 30%** - Regardless of how the trust earned its income the beneficiary will pay at least 30% tax on their distribution. No grandfathering here and could possibly apply from 1<sup>st</sup> July, 2019. Adding another level of uncertainty to the decision of what entity to use to buy the property. Confusion is further increase by the shadow treasurer's office explaining the way this will work in a way that is in direct contradiction to examples they have published. According to the example it will only be low income beneficiaries that will be penalised by these provisions. High income beneficiaries will be able to use the extra tax paid on their trust contributions to offset other income or to average out their tax rate to 30%. There appears also to be a avenue to avoid this by distributing to a bucket company and then receiving the 30% as a refundable franking credit. Though another of Labor's proposals is to stop franking credits being refundable unless you are a pensioner. This proposition is so unpopular it is less likely than the other changes listed to make its way through both houses of parliament.

## Sign Up To Newsflash

Considering the uncertainty of the above it is imperative that you keep the knowledge you have gained up to date by reading our free BAN TACS newsflash, you can sign up in the bottom right hand corner of this page <https://www.bantacs.com.au/media-library/newsflash/>

## Insurance



Renovating a property could well be the most dangerous time of your life. Not only are you pushing yourself physically but you have probably taken on more debt.

This is the time to review your insurance, life, total and permanent disability and income insurance. Many income insurance policies only cover you for a very

limited time such as 2 years but even worse still if they are held inside of superannuation it will be very difficult to actually receive any income without being considered not ever able to work again.

Our financial planning arm BAN TACS Financial Solutions can provide you with a free summary of the insurance cover you already have and discuss your options with you.

To find out more visit our web site [www.bantacsfinancialsolutions.com.au](http://www.bantacsfinancialsolutions.com.au) or ring 13000 22682 (13000 BANTACS).

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