

# DOMESTIC INVESTMENT PROPERTIES

## (RENTAL PROPERTIES BOOKLET)

An eBook from



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The following are just some of the matters you should consider when buying an investment property. Please discuss your particular circumstances with your accountant before you actually purchase a property, as these statements are generalised 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.

## Negative gearing

This is effectively running the property at a loss i.e the rental expenses (see below) are greater than the rent received. Note that the interest portion only of your loan repayment qualifies as a tax deduction, not the capital portion. This loss is then included in your tax return along with your other income, which reduces your total taxable income, probably resulting in a tax refund if you have paid tax at source on your other income. Your profit is then made when you sell the house. Capital gains tax may be payable but this is only payable on half the gain made and you would try to sell in a low income year, refer to discussion on capital gains tax. The costs associated with buying and selling property are high (i.e. stamp duty) so the investment would probably have to be long term to make a real profit. As time goes on you will pay more off the house or the rent will increase so the negative gearing may not be there any more. Ideally, you should be in a high tax bracket now and feel that properties are about to increase in value. Example of a negatively geared property:

Rental Income \$200 p.w.	\$10,400
Less Cash Flow Expenses Including Interest	<u>10,500</u>
Cash flow loss	100
Less Building Depreciation	<u>1,200</u>
	\$1,300 Loss @ 46.5% tax Equals a Refund of \$604.50.

**Note** the refund of \$604 has only cost you \$100 in real cash because the building depreciation is just a book entry. Building depreciation reduces your cost base for CGT purposes, if the property was purchased after 13<sup>th</sup> May, 1997. Not many properties stack up as well as the above example. Refer evaluating a rental property for more detail.

**Note** if you earn less than \$21,600 your tax bracket is only 15% plus 1.5% Medicare levy. Accordingly, a loss of \$1,300 would result in a tax refund of only \$214.50. By 2007 the 48.5% tax bracket is expected to only apply to 10% of the population so make sure you crunch the numbers for your tax bracket.

## Example of deductible expenses

Building depreciation for properties built after 17<sup>th</sup> July, 1985 refer to section headed Building Depreciation.

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 How To Claim Your Motor Vehicle Booklet. The most popular method is to claim a rate set each year by the tax office of approximately 60 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. Note 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 and accommodation if the property is in another state. A travel diary and receipts meeting the substantiation requirements would be required if away for more than 5 nights.
- Agent’s Commission to manage 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 can 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.

# 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. IT 180 is a very old ruling and a 2005 case called Ormiston will change this. Ormiston 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. 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.

## Claimable loans

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 where 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 times. 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 manage them yourself.

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 capitalized interest was not deductible. More details of the High Court's decision in *Hart's Case* and ways of capitalizing interest appear later in this booklet.

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 is 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 be \$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 transactions 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.

## **Principal place of residence CGT exemption**

Basically if you make a capital gain when selling your home it is exempt from capital gains tax but there are some catches and extra benefits. Ensuring that you qualify for the exemption is now more important than ever because indexing for inflation no longer applies. If you hold the property for 20 years it would not be unreasonable to expect it to double in value but with no exemption you could lose 25% of that increase in value in tax. This would mean you would not have the money to buy a similar house elsewhere or possibly not be able to afford to move.

However, if you acquired your Principal Place of Residence (PPR) after 20<sup>th</sup> September, 1985 and used it as your PPR until some time after 20<sup>th</sup> August, 1996, when it became income producing you can use the market value of the property at the time it becomes income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after it ceased to be your PPR.

For more detail on Capital Gains Tax download the free booklet from our web site [www.bantacs.com.au](http://www.bantacs.com.au)

## Depreciation on a building

Residential buildings constructed after 17 July 1985 can be depreciated at 2.5% per year (4% if constructed between 18 July 1985 and 16 September 1987) when they are income producing (Div.10D: Sec. 124ZF-124ZLA now Section 43 & 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. With the new Capital Gains Tax laws only taxing half the gain it would be unusual to end up paying more tax on the gain than what you would have received in refunds 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. 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.10D depreciation. You can claim Div.10D 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. 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. If this law is interpreted literally by the ATO, foregoing the deduction in years of a low or zero tax bracket will not prevent you having to “pay back”, when you sell, what you could have claimed and probably at a higher tax rate. 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.

## GST

Properties rented to households will be input taxed. This means that the rent does not need to be increased to include GST. But an input credit cannot be claimed for the GST paid on expenses relating to the property.

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

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

## Evaluating a rental property

**By: Julia Hartman B.Bus CPA – Tax Accountant**

Firstly, I would like to point out this article is not intended to encourage you in any way to buy a rental property. It is simply a tool you can use to consider the potential of the property away from all the selling hype. Before you actually sign a contract please get an accountant to check your workings as the following is a generalisation and there may be specific issues with your particular property.

### **Data You Will Need:**

- (a) Amount borrowed
- (b) Interest rate of loan. Note: unless you have no personal debt the loan should be interest only and the worksheet is based on this.
- (c) The tax bracket applicable to the taxable loss or taxable profit on the property. The tax brackets for 2007 are \$6,001 to \$25,000 16.5%, \$25,001 to \$75,000 31.5%, \$75,001 to \$150,000 41.5%, over \$150,000 46.5%. So if before buying the property you were earning \$75,000pa the tax rate applicable would be 31.5% if negatively geared or 41.5% if positively geared. You need to consider whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
- (d) Building depreciation claimable per year if property built after 17th July 1985.

- (e) Depreciation on any plant and equipment.
- (f) Original purchase price of the property.
- (g) How much you think the property will go up in value per year. If this is too difficult, don't worry as the worksheet will give you a bare minimum required and you can just decide whether it is likely to be more than that amount.
- (h) The tax bracket that will be applicable to the capital gain you make when selling the property i.e. you may have retired by then and be in a lower tax bracket. You need to consider here whether the net profit or loss will move you into another tax bracket and split your calculation accordingly.
- (i) Annual actual out of pocket costs of holding the property such as insurance, body corporate fees, repairs, borrowing expenses (amortised over the first 5 years of the loan), rates, property management fees and sundry expenses such as travel, stationery, phone calls etc.
- (j) Rental Income per annum
- (k) Estimated future selling costs such as real estate commission, auction fees, solicitor, advertising etc.
- (l) Cost of purchasing the property i.e. stamp duty, solicitors fees etc.

### Worksheet

#### Tax Calculation:

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

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

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

#### Cashflow Analysis:

Tax Refund as calculated above		\$
Rental Income (j)		\$
		-----
		(m)\$
Less Expenses:		
Interest Expense on Loan (a) x (b)	\$	
Out of pocket running expenses (i)	\$	
	-----	(n) \$
		-----
Net Cash Inflow or Cash Outflow (o)		\$

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

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

#### Capital Gain:

To calculate the gain after tax on the sale of the property take your cost base, which is either the amount you purchased the property for plus holding costs not already claimed plus stamp duty, solicitor's fees and

improvements. If you lived in the house before you rented it and it was first rented after 20<sup>th</sup> August, 1996 you must use the market value of the property at the time it became income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after you ceased to live in it. Calculate your capital gain as follows:

The cost of the property i.e. (f) + (l) + improvements you have not claimed

or market value if first rented after 20<sup>th</sup> August, 1996 and improvements made since then

Reduce by building depreciation claimed (d) x years held

Sub Total

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

Cost Base

Less Selling Price

Capital Gain

	\$		
	\$	-----	
	\$		
	\$	-----	
	\$		
	\$	-----	
	\$		(p)

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

**Breakeven Point**

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

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

**Cash Out Flow:**

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

$$(o) / (f) \times 100 = \quad \%(q)$$

**Reduction in Cost Base:**

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

$$(d) \times (h) \times 50\% = \quad / \quad (f) \times 100 = \quad \%(r) \text{ (Careful probably less than 1\%)}$$

**After Tax Dollars Translation:**

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

$$(q) + (r) = \quad / 75.75 \times 100 = \quad \%(s)$$

**Conclusion:**

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

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

## **Warning if you decide to rent out your home**

Section 118-192 of ITAA97 deems you to have sold and repurchased your home at market value if you first rent it out after 20<sup>th</sup> August 1996. Most people thought section 118-192 was a concession to help out if they hadn't been keeping records because they never intended to rent it out. Very few people realised that this was not an optional election but binding on everyone. The depressed state of the property market when this provision was introduced has meant that some people are up for capital gains tax even when they sell the their home for less than they paid for it.

Imagine the situation where a person buys at \$100,000 with a respectable 20% deposit but \$5,000 is used up in stamp duty, legal fees, bank fees and searches so the bank loan is for \$85,000. Very little is paid off the principle as at the start of the loan it just doesn't happen. He or she is then transferred so decides to rent out the house because the market has dropped and the house cannot be sold for as much as was originally paid for it. As it is now a rental property the logical move is to change the loan to interest only. The market recovers a little and he or she finally sells for \$90,000 but the price had dropped by 20% (it happened around 1996) when the property was first rented out. He or she has made a notional capital gain of \$10,000 less selling costs of say 4,000 equals \$6,000 less the discount taxable income will be \$3,000. This gain could push many people into the maximum tax bracket so tax could be as much as \$1,455 (let alone child support and loss of Centrelink benefits and possible surcharges) on a loss! So out of the \$90,000 the bank gets \$85,000 the Real Estate and solicitor \$4,000 and the tax man \$1,455. Not only has he or she blown their \$20,000 deposit (life savings) but they now have to find another \$455 over the top of the selling price to pay the tax man. This is also a double tax because the original stamp duty paid on the purchase is ignored when setting the cost base on only the market value without acquisition costs.

## **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 - refer next paragraph.

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

## **Developers who decide to rent out house built for resale**

Newsflash number 33 outlined the extreme GST consequences if a developer decided to rent out a property before it is sold. The problem arose because no GST input credits are allowed for a property used for domestic rental. The entitlement to input credits was pro rataed on a time basis. As in these sorts of cases about 95% of the time the property was held and it was rented out, only 5% of the GST input credits on the land and building costs are claimable yet full GST (subject to use of the margin scheme) is payable on the sale because it is the first sale of a new home.

In the Property and Construction Industry Partnership Issues Register item number 4 the ATO has now agreed to pro rata the input credits 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:

Note the above explains the calculation but spares you the details of how this is dealt with in each adjustment period as these changes do not change the article in Newsflash 37 on adjustment periods.

You should also consider reading our How Not To Be A Developer Booklet available on our web site, [www.bantacs.com.au](http://www.bantacs.com.au) under free publications.

## **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. It is only your wages earned overseas and that meet the requirements of 23AG i.e. 91 days work, that are exempt in Australia. The interest on the overseas bank account, that your overseas wage is paid into, is taxable in Australia even if the wage isn't. 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.

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.

### **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 and even if their wages income is exempt under section 23AG.

**Dividend Royalty and Interest Income from Investments Overseas** – Under our double tax agreements this 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.

**Rental Properties** – If your net rent income is taxed in the country the property is located in 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. Section 43 depreciation is available for buildings, alterations etc which began after 21<sup>st</sup> August, 1990 section 43-20(1) or 26<sup>th</sup> February, 1992 section 43-20(2).

The foreign tax credit can only be used to offset tax payable in Australia on foreign income

Residents of Australia will be subject to capital gains tax on any assets acquired after 19<sup>th</sup> 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 IT2562. 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.

## **Reader's question**

Due to the recent increase in property prices a reader has a nice problem in that the value of their rental property has nearly doubled in the year they have owned it. They are now in a position to sell their own home and the rental property to build their dream home debt free. That was until they realised the huge CGT liability on the rental property.

If they move into the rental property for 12 months until their new home is completed and then sell the rental property, they have halved the portion of capital gains that will be taxable on the sale. But there are even further benefits available from section 118-140 as discussed in Newsflash 50:

**Section 118-140** Your main residence exemption applies to two homes for a period of up to 6 months. This is intended to allow you time to sell your old home after purchasing a new one. To qualify:

- 1) The first home must have been your residence for a continuous period of at least 3 months in the 12 months immediately preceding the date of sale.
- 2) If you were not living in the first home at any time during the 12 months preceding the date of sale it can not have been used for producing income (i.e. rented out or used as a place of business).

Note section 118-140 is not optional it must apply so if you have made a capital loss during the period of overlap you cannot claim it

The above does not put any restrictions on the new home so it is not relevant that it was owned for more than 12 months before the sale of the original home or that it was rented out for the first 12 months. The reader is still entitled (in fact it is compulsory) to the 6 month overlap that exempts from CGT the new home for the 6 months before they move in. Accordingly, if they sell after owning the property for 2 years and living in it for 1 year, they will now only be taxed on one quarter of the capital gain and that will then be halved to allow for the CGT discount on properties held for more than 12 months.

Tens of thousands of dollars saved by getting the right information first. This just emphasises the need to talk to an accountant before you do anything.

## **The 50% CGT discount**

### **Newsflash 60**

As you are probably aware you need to hold onto a property for over 12 months from the date of signing the agreement to purchase to the date of signing the agreement to sell in order to qualify for the 50% CGT discount. Some clients have been making a very quick gain on properties and are impatient to sell in case prices fall. The choice is sell now and lose a lot of the profit in tax or hold on and take a risk on future prices. From the buyers point of view they are probably more concerned that prices will continue to escalate but are not in a rush to start paying interest on the loan. In fact the chance to fix a contract at today's prices but not have to pay anything for several months could be very attractive to some buyers.

ATO ruling TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option.

Of course an option gives a purchaser the chance of avoiding entering into the contract to buy the property so you must charge a large enough amount for the option to ensure that the purchaser will exercise it after the date you specify. The ATO is currently trying to argue that if the option price is so high that the buyer will definitely exercise it then the contract is really entered into at the time the option is granted.

## **Depreciation – Rental properties**

### **Newsflash 68, October 03**

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. Further make sure the quantity surveyor you use is aware of the changes in depreciation rates for plant and equipment since 1st July, 2004.

# Demolishing a rental property

## Newsflash 71, December 03

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).

# Ultimate secret plan and clever trick with rental properties

Newsflash 73, 1<sup>st</sup> February 04

In Newsflash 55 (available from our Web site) we covered National Australia Bank v FCT 1993 ATC 4914. The case resolved that a loan provided jointly to an employee and associate was 100% exempt from fringe benefits under the otherwise deductible rule even though the employee would have only been entitled to 50% because the other 50% was in regard to an associate of the employee i.e. a spouse.

Not only does this allow a high income earner to maximise the negative gearing benefits but when the property is sold at a profit the capital gains will still be apportioned on the basis of ownership. Therefore the low income spouse receives an equal share of the gain despite the fact he or she did not claim an equal share of the expenses. Further this provides brilliant flexibility in that if the low income earner becomes the higher income earner simply change the person who participates in the salary sacrifice arrangement.

There were many doubters that such a golden opportunity has existed since 1993 without being brought to public attention. To prove our point we applied to the ATO for a ruling. They took many months as they were reluctant to concede the case has set a precedent. Eventually, under threat of taking the matter to the problems resolution unit they issued their ruling and it accepted that this case was valid.

Now this ruling is a private ruling so can only be enforced on the ATO by the individual applicant. Accordingly, each employee wishing to utilise this case needs to pursue his or her employer to accept the case or apply for their own ruling to be safe. There will be a major problem with employers as they get no real benefit from the arrangement yet would be made to pay FBT if the ATO takes a narrow view or have to pay their accountants to apply for a ruling. This is probably why the concept has not yet taken off which is a shame as it can save employees thousands of dollars per year.

To solve this we have prepared a kit to present to your employer. The kit explains the whole concept in detail. There is a page for the employer, the employee and the employer's accountant. There is also a checklist of dos and don'ts to make sure you stick within the bounds of the precedent case, a worked example, suggested issues for the employment agreement, an employee declaration and booklets of advice on CGT and Rental Property Taxation Issues. The kit includes a copy of the ruling we have received and all the paperwork necessary for the employer to apply for their own private ruling by simply putting in their personal details, signing and posting. At \$150 (tax deductible) the kit is considerably cheaper than your employer going through the ruling process from scratch. But more importantly it will help you explain it to your employer and your employer's accountant how simple it is for you to save tax every year. More details are available on our web site [www.bantacs.com.au](http://www.bantacs.com.au) or phone 07 5497 6777 for a copy.

# Wraps – Vendor finance arrangements

Newsflash 74, 15<sup>th</sup> February 04

If the Vendor Finance arrangement has the following features the income stream received, once the wrap arrangement has begun, is considered to be principle and interest by the ATO. The income stream received before the wrap arrangement is entered into is considered rent. Reference ID2003/968.

#### Typical Features of a Wrap (Vendor Finance Arrangement)

- 1) The purchaser pays a deposit at the time of entering into the arrangement.
- 2) The settlement (change of the title deed to the purchaser) does not take place for several years after the arrangement is entered into.
- 3) The purchaser has the right to occupy the property prior to settlement
- 4) The purchaser pays a weekly amount (regardless of the name it is given in the arrangement) for the right to occupy the property
- 5) As part of the arrangement the purchaser pays the rates, taxes and insurances on the property.
- 6) The balance of the purchase price to be paid on settlement of the arrangement is reduced by the weekly installments.
- 7) If the purchaser fails to complete the arrangement the deposit and weekly installments are forfeited.

Now what about the profit on the sale of the property? Is that normal income or capital gain and when is it taxable? Assuming an agreement similar to that described above the answer to this question revolves around whether the vendor is in the business of selling houses or an investor just realising an investment. The key issues in differentiating here, according to ID2004/25, 26 & 27 are:

- 1) The Vendor did not use the property for any other purpose than to enter into the wrap. A straight rental of a property before entering into a wrap arrangement would avoid this point.
- 2) The property was sold at a profit
- 3) The wrap arrangement was entered into within 6 months of the vendor purchasing the property.
- 4) The Vendor is in the business of purchasing properties to resell. It would be difficult for the ATO to argue this case if the Vendor only bought and sold one property.

If you are caught by all of the above then CGT cannot apply to the sale of the property as the profit on the sale is revenue in nature. If a transaction is caught as income, CGT does not apply or in other words CGT is the last option if income tax doesn't catch it. But even if you weren't caught by the above and CGT applied there would be no discount if the property was held for under 12 months. If you did hold the property for less than 12 months before entering into the wrap it is better to argue that you are in business and caught by the above because the profit on sale would be revenue in nature and as a result not assessable until settlement which could be 25 years away (ID2004/27). If you hold the property for less than 12 months but it is subject to CGT you don't qualify for the discount but would be assessable on the profit in the financial year of entering into the wrap. Note you do not actually have to pay the tax on the gain until settlement but it will be calculated as part of your taxable income in the year that you signed the agreement to sell. You have 30 days from the date of settlement to go back and amend the old return. Refer chapter 6 of the ATO's 2004-2005 rental property booklet.

Section 104-15(1) of ITAA 1997 states that a CGT event happens when the owner of a property enters into an arrangement with another party to allow them to live in the property and title may transfer at the end of the arrangement. Section 104-10(3) states that the time the CGT event happens is the time of entering into a contract for the disposal of the asset, not when settlement (title passes) takes place.

For example this means that the vendor who enters into a wrap on a property that has been previously used as a rental and held for more than 6 months will be subject to CGT on the property in the financial year the wrap agreement is entered into. Accordingly, if at this stage the property has not been held for 12 months no CGT discount will be available even if they eventually end up holding the property for 25 years under the arrangement.

If you are not subject to CGT on the property because it is considered trading stock ie caught by all 4 points above, you are not entitled to claim building depreciation. Reference ID 2003/377.

## **Confusion over rollover relief because U.S. different**

**Newsflash 75 Article, 1<sup>st</sup> March 2004**

No rollover relief is available on investment properties in Australia. The only rollover relief is available to active assets of a business and it specifically excludes assets that have been used to produce rental income section 152-40(4)(e).

# **CGT – 50% discount – Timing**

**Last Updated: 2004, June 6<sup>th</sup>**

In order to qualify for the 50% CGT discount you must hold an asset for more than 12 months. That is 12 months and at least one day from the date of the agreement to buy to the date of the agreement to sell. TD 94/D92 and Case 9451 (1194) 28 ATR state that a simple condition in the contract such as subject to finance will not delay the date of the contract. Only a condition precedent to the formation of the contract delays the date that the contract is deemed to be entered into. Most conditions on contracts are conditions subsequent so will not delay the contract date. To be a condition precedent it really has to be a condition that must happen before the contract comes into being. Accordingly, it would be difficult to use a condition precedent to delay a contract yet have a binding sale.

## **Year end tax planning for rental property owners**

**Last Updated: 2004, May 1<sup>st</sup>**

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 30<sup>th</sup> 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 as discussed in detail last week.

Investors who pay the bank next year's interest before 30<sup>th</sup> 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. Businesses do not qualify for this concession unless they elect to enter the simplified tax system. If your business is in the simplified tax system you may want to consider making 12 months lease payments in advance also.

**As this arrangement is only moving tax deductions from next year into this year it could work against you if you are in a higher tax bracket next year than this year.**

## **Hart's case decided for the ATO – Linked split loans**

**Last Updated: 2004, June 15<sup>th</sup>**

On Friday 27<sup>th</sup> May, 2004 the High Court handed down its decision on Linked Split Loans in favour of the ATO.

I do not find it too surprising that they found that these types of loans were a scheme with the dominant purpose of a tax benefit therefore caught by Part IVA. This case was a clay pigeon for the ATO and yet it still needed to go all the way to the High Court. It was a clay pigeon because the banks marketed these arrangements on the basis of the tax savings. Therefore it was difficult for the taxpayer to argue a different motive.

It is important to remember this case does not change the deductible nature of interest or for that matter interest on interest. Gleeson & McHugh specifically stated that the question of the deductibility of interest

upon interest does not need to be addressed because the issue was already decided on the basis that there was a scheme to gain a tax benefit.

The moral of the story is not to get involved with mass marketed tax schemes unless they have an ATO ruling. This is because the ATO has no trouble proving your primary motive was a tax benefit as there is always an abundance of marketing propaganda to prove this.

On the other hand don't lose sight of the fact that you are not obliged to pay more tax than necessary. In IT 2330 the ATO states:

"Notwithstanding that an arrangement may not be capable of explanation by reference to ordinary business or family dealing and even though it may be entered into to avoid tax, it will not attract the operation of section 260 (now Part IVA) if its purpose is to take advantage of a specific or particular provision in the Income Tax Assessment Act and complies in every respect with the requirements of the specific or particular provision, i.e., the choice principle."

This approach is supported in Harts case where the judges stated;

"If such a taxpayer took out two separate loans, and the terms of the loan for the investment property were different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then ordinarily that would give rise to no adverse conclusion under [Part IVA]. It may mean no more than that, in considering the terms of the borrowing for investment purposes, the taxpayer took into account the deductibility of the interest in negotiating the terms of the loan. How could a borrower, acting rationally, fail to take it into account?"

Unfortunately the judges concluded that such a loan was not normally available so it was not reasonable to argue it was a normal arrangement apart from the tax benefit. Ultimately it was the linking of the loans that sunk them. This should not discourage investors seeking similar loans that stand on their own merits rather than being linked to a non deductible loan.

Fine tuning this theory in relation Part IVA we need to recognise that this test has two elements. Firstly there has to be a scheme and secondly it needs to have a dominant purpose of a tax benefit. In Hart's case it was recognised that a scheme as per 177A(1)(b) can basically include any .... course of conduct. So there is no point in poking around here for a gap other than to say the legislators could not have intended this section to be so wide or it would catch everything.

So now let's look at the dominant purpose of a tax benefit test. Which must also be present for Part IVA to apply. No this does not mean that if you walk into a newsagency to buy an invoice book your dominant purpose was to gain a tax deduction for the book and as it was a "course of conduct" that is it no tax deduction because this is a tax scheme. We have to be more realistic than that. Nevertheless the High Court found that Hely J was correct in stating:

"A particular course of action may be both tax driven, and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine in favour of the taxpayer whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit".

So finding another reason to justify the arrangement is not enough. It is all about the dominant purpose. The simpler the arrangement the better, the more artificial it becomes the more it meets the definition of a scheme.

The court having disallowed the capitalised interest because it was part of a tax scheme did not have to rule on whether capitalised interest itself was tax deductible. I feel that the capitalised interest would normally be deductible providing it has not been created as part of a scheme with a dominant purpose to save tax.

Say for example you have a line of credit on your rental property and a separate loan on your home. Your tenant may pay you a couple of months rent in advance which you pay off your home loan as everything is up to date and cash flow looks good at the time. Over the next two months you have quiet a few personal expenses that take up all of your wages. Then the rates and some repairs are due on the rental property. You need to draw the funds to cover the rates and repairs from the line of credit on the rental property and due to lack of funds the interest that month has to be capitalised. Luckily you just manage to make the P&I payment required on your home loan. This scenario is not a scheme. Events just happened that way and it is not for the ATO to tell you how to manage your affairs. Linking the two loans or a systematic approach to the increase in the loan on the rental property may point towards a scheme. Just watch out for spare funds to make extra repayments on your home and don't prop up the rental property with your spare cash if you can use the equity in your rental property instead.

This principle can also work with a business instead of a rental property.

## **The struggle of getting your tax right**

**Last Updated: 2004, 15<sup>th</sup> July**

I had a bit of fun with our Rental Property experts at the ATO this week.

Many rental property owners have just 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, in February 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 shortfall. 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.

## **Rental property CGT audits**

**Last Updated: 2004, 1<sup>st</sup> August**

Each year around this time there is much talk about an ATO hit list. In my 12 years in practice not many of the threats filter through unless they can be simply generated by a computer.

Most taxpayers know to be very careful with their interest income because the ATO's computer cross matches with the banks. The same reverence should be paid to capital gains made on rental properties. The ATO is well aware that the property boom will be a huge boost to revenue.

The ATO computers have two ways of catching you out. Firstly, the ATO computer will automatically send you a questionnaire if you stop declaring rent income without completing the CGT section of the tax return. If that doesn't catch you out then the ATOs data matching with the titles office is sure to get you.

Unlike audits involving human intervention these computer generated questionnaires will happen 100% of the time so it is not just a case of are you feeling lucky.

## **Losing interest deductibility**

Imagine how you would feel if you borrowed \$100,000 to invest in shares. Then when it came time to do your tax return your Accountant told you the interest is not tax deductible because the money went from your loan to your cheque account in order to write a cheque to your broker. A recent AAT case decided that if loan funds are intermingled with other funds before being used for income producing purposes they are no longer considered to have their source in the loan.

Interest is not deductible on a loan unless the proceeds of the loan have been used to purchase or relate to an income producing investment. The link can be simply lost by paying some spare cash off the loan and drawing it back later, or not being able to trace the flow of the funds to the investment. The ATO's own ruling states "a rigid tracing of funds will not always be necessary as appropriate." Yet in Domjan and Commissioner of Taxation [2004] AATA 815 the ATO successfully argued that the placing of borrowed money into a savings/cheque account with other personal funds broke the link necessary to prove the funds were borrowed for tax deductible purposes.

The AAT is not the highest court in the land but relevant nevertheless. The sitting AAT member stated: "I accept the Commissioner's submissions. Where the funds have been intermingled it is impossible to determine the use to which they have been put. In other words the purpose of the borrowing cannot be ascertained. It cannot be said that the expenditure – that is the payment of interest – has been incurred in the course of gaining or producing assessable income"

Mrs Domjan also tried to argue that when she deposited private funds into her loan account they were quarantined from the loan so when she drew money from the loan for private purposes it was simply a redraw of those funds, not a separate loan for private purposes. She also contended that any private funds put back into the loan after the redraw should go only towards reducing the loan for private redraws. Further she should not be penalised for using her private funds to temporarily reduce the interest on the loan and as a result reduce her tax deduction. The AAT found that the funds could not be divided so all repayments were to be spread equally over the loan and she could not choose the character of the funds she was redrawing from.

Mrs Domjan was in for a penny in for a pound. She even claimed that as the bank required her to insure her home because it was security on the loan, the insurance should be tax deductible. No luck here either.

The AAT also found that when Mr Domjan used a lump sum he personally received to pay off his half of the loan, the amount had to still be split equally between them as they were co debtors on the loan. Therefore even though he had paid his share back he was still entitled to claim half the interest that related to Mrs Domjan's share. As a result of this it would now be prudent, when only one member of a couple is borrowing to buy their share of an income producing jointly owned investment, the loan should only be in his or her name, not both. Trying to get a bank to agree to this may be a problem. If the bank will accept the non borrowing partner only giving a guarantee and his or her name does not actually appear on the loan, the problem may be avoided.

What was alarming was the fact that Mrs Domjan, who prepared her own tax return received, a 25% penalty on the basis she had been careless in claiming the interest in relation to the redraws. The ATO's argument being she had been careless in relying on a draft ruling after the final ruling had been issued. In the ATO's world taxpayers preparing their own tax returns should have a knowledge of the thousands of ATO rulings available and check regularly for updates. The AAT agreed with the ATO. I have quiet a problem with this conclusion because unlike the draft ruling the final ruling did not cover redraws. So the ATO's argument is really that Mrs Domjan should have followed up the daft to read the final ruling and then realise that by omitting parts of the draft but not issuing a counter view the ATO was really saying they no longer held the view expressed in the draft. The issue of redraws was eventually addressed in another ruling 2 years after Mrs Domjan had lodged the returns in questions.

Probably Mrs Domjan greatest mistake was representing herself before the AAT. Though I have no answer as to how the average taxpayer can afford to be equally represented against the ATO and its unlimited, taxpayer funded, resources.

## **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. The contents of this article has our full support though we would like to point out if a roof is replaced in its entirety it would not be considered a repair but an improvement.

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 advice 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.

## **Travel costs and initial repairs for a rental property**

If a repair was necessary when you purchased a rental property it cannot be claimed as a tax deduction because it improves the property beyond that state it was in when you purchased it. These repairs are referred to as initial repairs. The cost of initial repairs can be included in the cost base of the property so you do receive some benefit when the property is sold. Note the cost of your travel and accommodation cannot be claimed as a tax deduction at the time the initial repair is carried out nor can it be included in the cost base when the property is sold. In ID 2004/732 the ATO states that travel and accommodation do not meet the definition of capital improvements.

## **Caution with rental property interest**

You are only allowed to claim interest if the money borrowed was used to buy something that was income producing. Accordingly, if you use a line of credit to pay off your credit card that you have been living off then that amount was borrowed for non tax deductible purposes. This makes an awful mess of a normally tax deductible loan and can reduce it to 100% non tax deductible within 5 years because any repayments have to be pro rataed between the loan for the Rental Property and the loan for the Credit Card this of course means a larger portion of the repayments pay off the Rental Property and the portion of Credit Card debt increases each month.

We also now have Domjan's case to contend with. Unless there was a clear connection between the monies borrowed and the expense the interest is not deductible. In Domjan's case the placing of borrowed funds into a personal cheque account to pay Rental Property expenses broke the nexus and the interest on the borrowed funds was not deductible. The ATO is not enforcing Domjan yet but it does give them the precedent if they ever want to.

A substantial part of the ATO argument in Hart's case was the fact the bank marketed the arrangement as a tax minimisation scheme. If you can't afford the interest payment that month because of financial hardship and the bank lets you add it to your loan balance you will not be caught by the precedent in Hart's case.

So generally, what should you do? Note there may be better ways, looking at an individual circumstances:

- 1) Only use a Line Of Credit with a Credit Card used for private purposes, on a non deductible Loan
- 2) 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.
- 3) Compound interest only when financially necessary.
- 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 rental property 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) An offset arrangement is far better than a Line of Credit as it leaves the funds available for private purposes if needed.

## **Building a spec or a rental?**

### **Building a Spec Home:**

GSTR2003/3 states at paragraph 10 “The sale of new residential premises by a registered entity in the course or furtherance of an enterprise it carries on, is a taxable supply for GST purposes.” Unlike the rental property situation discussed above if you build a spec home it’s sale is part of your normal business turnover so it will cause you to be registered for GST. Section 9-20(1) (b) includes as an enterprise an adventure or concern in the nature of trade. MT 2004/D3 states at paragraph 170 that an adventure or concern may be a one-off transaction that does not amount to a business. At paragraph 187 MT 2004/D3 states that the realisation of an investment does not amount to trade. So if you did not build the property to sell but only to rent then when you sell it, it is not part of a normal sale in your enterprise of rental properties and as such does not force your taxable supplies over \$50,000 if all you are involved in is domestic rentals thus you are not required to be registered for GST. Even though the sale of the house would be the first sale of a new residence and therefore subject to GST you are not registered for GST so you are not caught.

If you buy land with the intention of building a home on it to sell then the proceeds of the sale are normal business income, the 50% CGT discount is not available to you and GST will apply. You are entitled to claim GST credits for the cost of building the home and purchasing the land if it was not purchased under the margin scheme. As your buyer is unlikely to be in the business of buying and selling houses they will not be able to claim the GST back.

### **To Rent Out Domestic Accommodation on the Land:**

If you buy land with the intention of building a home on it to rent, when you eventually sell the profits on the sale are a capital gain and subject to the 50% CGT discount if it is more than 12 months between the time you agreed to purchase the land and the time you agreed to sell the house and land.

Steele’s case created the precedent that interest can be claimed as a tax deduction while you hold land with the intention of building a rental property on it.

Be careful here if you sell the home within 5 years of it being built GST will apply to the sale if you are already registered for GST in the enterprise that owns the home. To be more specific, income from domestic rental properties is not normally subject to GST so the owner is not normally registered unless they have another reason such as the enterprise also has commercial rental properties. MT 2004/D3 states at paragraph 170 that an adventure or concern may be a one-off transaction that does not amount to a business. At paragraph 187 MT 2004/D3 states that the realisation of an investment does not amount to trade. When I refer to the enterprise I am quarantining transactions in relation to the enterprise. So if you are a sole trader accountant registered for GST but you also own a rental property in your own name, the sale of that rental property is not

in the furtherance of your business as an accountant. Even though they are both owned by the same person they are not part of the same enterprise. If an enterprise's turnover of supplies subject to GST exceeds \$50,000 the enterprise must register for GST. As domestic rental income is not subject to GST an enterprise that only receives domestic rents is not required to be registered for GST. While the sale of the rental property will exceed \$50,000 this is not part of the normal turnover of the enterprise so it will not create the need for it to be registered. So to get back to my original point. If your enterprise is registered for GST and you sell a new rental property within 5 years of it being built you will be required to charge GST, if you are not registered for GST the sale of a new rental property in less than 5 years will not force you to be registered providing of course you can prove that you built the property to rent not to profit from its resale.

## **GST and sale of properties held for rental**

Even holding domestic rental properties is considered an enterprise and qualifies for an ABN but normally landlords don't bother as they are not required to charge GST on rent on residential properties. So even if their turnover is more than \$75,000 it is not for supplies to which GST applies so they are not required to be registered. The eventual sale of the rental property will turnover more than \$50,000 but this is not included in the \$75,000 test unless they are in the business of selling rental properties. So if you are just a normal investor in domestic rental properties your turnover of GST supplies in the course of your business is never likely to exceed \$75,000. At paragraph 186 of MT 2004/D3 states that the realisation of an investment does not amount to an enterprise in its own right. Even though the sale of the property is for more than \$75,000 it is not part of your turnover so will not force you to be registered for GST. If you are not registered for GST, you will not have to remit GST on the sale of a rental property. If you are registered for GST the sale of a domestic rental property will still not be subject to GST providing it is not considered the sale of a new home. Refer above.

Landlords are required to charge GST on rent for commercial premises if they are registered for GST. They are required to be registered for GST if their rents for the year exceed \$75,000. Now the \$75,000 is in turnover so it doesn't include the sale of capital assets but if you are registered for GST when you sell it you may be required to remit 1/11<sup>th</sup> of the selling price in GST. If you have built or substantially renovated the rental property within 5 years before you sell, you need to read the above article about new houses.

MT2004/D3 at paragraph 214 points out that an asset purchased as an investment and therefore not subject to GST when it is sold can become subject to GST by being applied to an enterprise in the way it is sold ie subdividing or building on it. If this is the case you need to read the section above of Does GST Apply to the Sale?

## **ATO is Processing Rulings on Rental Property Kit**

Over a year ago we created a kit that provided a simple method for employers to obtain a binding ruling from the ATO that they could pay their employee's rental property interest as an exempt fringe benefit. The ATO was refusing to answer these ruling applications but has finally started to respond, conceding that the arrangement is legal.

Any readers who have lodged an application and not yet received a response should chase it up with the ATO office that sent them the letter saying the matter was under review. If you still don't receive a response please e-mail [julia@bantacs.com.au](mailto:julia@bantacs.com.au)

Those not familiar with the concept should read the following, if they jointly own a rental property with their spouse and they are in different tax brackets. In short the kit effectively moves income from the high income earner to the low income earner.

The National Australia Bank (1993 ATC 4914) case resolved that the interest on a loan provided jointly to an employee and associate was 100% exempt from fringe benefits under the otherwise deductible rule even though the employee would have only been entitled to a deduction for 50% because the other 50% was in regard to an associate of the employee i.e. a spouse.

Not only does this allow a high income earner to maximise the negative gearing benefits but when the property is sold at a profit the capital gains will still be apportioned on the basis of ownership. Therefore the low income spouse receives an equal share of the gain despite the fact he or she did not claim an equal share of the expenses. Further this provides brilliant flexibility in that if the low income earner becomes the higher income earner, simply change the person who participates in the salary sacrifice arrangement.

There are many doubters that such a golden opportunity has existed since 1993 without being brought to public attention. To prove our point we applied to the ATO for a ruling. They took many months as they were reluctant to concede the case had set a precedent. Eventually, under threat of taking the matter to the problems resolution unit they issued their ruling and it accepted that this case was valid.

Now this ruling is a private ruling so can only be enforced on the ATO by the individual applicant. Accordingly, each employee wishing to utilise this case needs to pursue his or her employer to accept the case or apply for their own ruling to be safe. There will be a major problem with employers as they get no real benefit from the arrangement yet would be made to pay FBT if the ATO takes a narrow view or have to pay their accountants to apply for a ruling. This is probably why the concept has not yet taken off which is a shame as it can save employees thousands of dollars per year.

To solve this we have prepared a kit to present to your employer. The kit explains the whole concept in detail. There is a page for the employer, the employee and the employer's accountant. There is also a checklist of dos and don'ts to make sure you stick within the bounds of the precedent case, a worked example, suggested issues for the employment agreement, an employee declaration and booklets of advice on CGT and Rental Property Taxation Issues. The kit includes a copy of the ruling we have received and all the paperwork necessary for the employer to apply for their own private ruling by simply putting in their personal details, signing and posting. At \$150 (tax deductible) the kit is considerably cheaper than your employer going through the ruling process from scratch. But more importantly it will help you explain it to your employer and accountant how simple it is for you to save tax every year.

More details of the kit are on our web site. The calculator has been up dated for the 2006 tax rates. If you wish to purchase a kit please ring the Ningi office on 07 5497 6777. You may also like to visit the ATO web site and read ID 2005/219 which is a summary of a response to an application along the lines of the kit.

## **Lease options**

A lease option is a rental agreement where the tenant has the option to buy the premises at a time set in the future at an already agreed price. You may recall a Newsflash article on wraps in February 2004. This article pointed out that unless a wrapped property had been used for rental purposes, before the current tenant then the sale of the property would not be subject to CGT and the 50% discount. Instead the profits would be taxed as ordinary income but the tax would not be payable until settlement. On the other hand if the property had previously been rented then CGT and possibly the 50% discount applied but the catch was that the tax would have to be paid in the year of the wrap not on settlement.

Lease options remove this problem. The exercise of an option not the granting of it, is the trigger of a CGT event. Further the house being subject to a rental arrangement before the exercise of the option may satisfy the ATO that the primary purpose of owning the property was to derive rent not for resale at a profit. A property purchased to rent out will be subject to CGT on the sale and possibly the 50% discount. On the otherhand where a property is purchased with the intention of resale at a profit it would be subject to normal tax rates with no 50% discount.

Section 104-15 states that tax the CGT event happens when the prospective purchaser has the right to the use and enjoyment of an asset and there is an agreement that the title will eventually pass to that person. The section is stated as intending to apply to hire purchase agreements but does not exclude other arrangements. The ATO in TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option. These two statements can only be reconciled by the assumption that an option is not an agreement where the title will eventually pass because the event is uncertain.

Lease Options certainly seem to be an improvement on wraps from a taxation point of view. If you are new to the whole concept of wraps and lease options have a look at our article on Wraps in our Capital Gains Tax booklet under free publications on the web site. For more information on Lease Options visit

[www.naked-investor.com](http://www.naked-investor.com)

Please do not take the above as a recommendation of Lease Option arrangements or support of the information on the naked investor web site. We are simply advising on the tax consequences.

## **Reader's question**

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 2003-2004 publication NAT 1729. The booklet, on page 9 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.

## **Considering repairing your rental property before June 30<sup>th</sup>**

You will not be entitled to a tax deduction for the expenses you incur if you replace something in its entirety. For example 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.

## **Div 43 building depreciation**

If your rental property was constructed after 17<sup>th</sup> July, 1985 then you are entitled to claim building depreciation but it is not all good, you also have considerable responsibilities under the legislation.

Back on 13<sup>th</sup> May 1997 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. In many cases this meant that they had to incur the cost of a quantity surveyors report to calculate the original building costs.

It is nearly 9 years later but the ATO has finally acted to make this situation a bit fairer. As announced in Newsflash 118 taxpayers who have not claimed building depreciation while owning the property 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. This seemed a little fairer as it allows the taxpayer to recoup some of the costs of the QS report by amending previous years and only having to reduce the cost base by the depreciation you can claim. Nevertheless, taxpayers were still trapped into incurring the expense of a QS report.

PSLA 2006/1 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. Accordingly, 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 as they show 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 26<sup>th</sup> 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 26<sup>th</sup> 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 over the last 14 years 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! Lucky the Governments policy is to minimise the red tape created by legislation.

## Just why houses are so expensive

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



### Government fees cost more than land

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

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

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

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

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

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

Elliott says the escalating government costs are forcing some developers to shy away from housing projects. "A significant concern is that developer margins are now getting squeezed to the point where developing new estates in some areas is no longer feasible," he says. "This is contrary to the often-expressed view by governments that developers will simply absorb additional costs.

"This will not only add to concerns about housing affordability because of diminished supply, but it may also create a new problem – that of housing availability.

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## Property investors

In addition to the Newsflash issues discussed in the lead up to the end of the financial year, property investors should note the following:

**Repairs** - If you are considering doing repairs to your rental property before the end of the financial year, take care to make sure they will qualify for a full tax deduction. This will not be the case if you replace something in its entirety. For example 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.

If you are looking to do some repairs to your rental property to reduce your taxable income before the end of the year make sure they qualify as repairs not improvements. For example if the house needed painting when you bought it then painting it would be an improvement or if the house did not have a garden hose then purchasing one would be an improvement and therefore not deductible. On the other hand if during the time of your ownership the hose wears out and you replace it or the paint starts to peel and you repaint, these expenses 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

**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 around 60 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.

**Interest etc** - 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.

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.

Last year 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.

**Depreciation** - If your domestic rental property was built after 17<sup>th</sup> July, 1985 you are entitled to claim building depreciation. The rate is 4% for properties constructed before 16<sup>th</sup> September, 1987 and 2.5% for properties built after that date. This rate is applied to the building costs of the original owner of the building. This information is required by the act to be passed on by each seller of the property. If, and only if you can't find out the original cost of the building you can have it estimated by a quantity surveyor. Many investors think that they will have a quantity surveyor estimate the cost in the hope of getting a higher base for the depreciation. Don't waste your money if you have the original costs as you cannot use the quantity surveyors report. Unlike building depreciation, you can estimate the value of the plant and equipment in a house when you first purchase it. You do not need to use a quantity surveyors report, the ATO will accept a reasonable estimate of the second hand value of items such as carpets, stoves, hot water systems, air conditioners, light fittings, fans, curtains etc

**Capital Gains** - If you have a purchaser interested in buying your rental property but you don't want the gain to be included in this year's taxable income yet are concerned they may buy elsewhere if you wait till July, give them an option to buy the property after June 30<sup>th</sup>. Make sure the option price is high enough that they will not back out. They will probably be glad to secure the property at today's prices with settlement date in the future. This strategy also works if you are delaying selling until you have held the property for 12 months to qualify for the 50% discount.

## 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.

## Reader's Question – Managed Apartments

A reader was concerned about an announcement in The Australian saying that the government had changed the laws to allow the ATO to retrospectively claw back GST credits legitimately claimed by investors who owned managed apartments.

Before I explain I would like to point out that I am never likely to lift a finger (except maybe the middle one) to help the ATO at the best of times but the Article in The Australian has twisted things a bit. Really the ATO should never have argued the case the way they did in Marana Holdings as it was against their stated opinion in their own ruling.

Instead of implying the ATO was attacking investors the real point of the article should have been that the ATO has no idea how to interpret the tax law. So the idea of taxpayers being responsible, under self assessment, to interpret the law themselves before lodging their tax returns, is the biggest social injustice facing Australia.

Taxpayers who have always organised their affairs according to the ATO's stated opinion in GSTR 2000/20 will not have to pay anything back so I doubt the \$100m claim in the article. When the ATO won its

case based on an argument contra to its own ruling, taxpayers started to apply for a GST credit on the purchase of their managed apartments etc. The ATO panicked and decided it liked its first opinion better so now needs to go back and change the legislation to override this case. The ATO will be damned if they do and damned if they don't but hopefully public pressure will mean they give taxpayers the benefit either way.

Having finished my little soap box I will now attempt to explain the concepts in layman's terms but to do this succinctly I will ignore a few of the twists and turns along the way.

This is a classic case of the ATO issuing a ruling saying one thing and then when it goes to court arguing the contra because it suites them at the time. GST law says that residential premises supplied for sale or rent are input taxed (ie GST does not apply to expenses or income) unless it is the first sale of new residential premises. Now to the big question is the definition of residential premises. The GST Act says at section 195-1 defines residential premises as a building occupied as a residence or intended and capable of so being. Section 40 - 65 states that premises used predominately for residential accommodation are input taxed but the input tax concession does not apply to commercial residential premises. This leaves a bit of doubt in regard to motels with self contained units or serviced apartments.

Back when GST started the ATO issued GSTR 2000/20 which stated: "to be used for residential accommodation ... premises do not have to be a home or a permanent place of abode. To be residential premises as defined, a place need only provide sleeping accommodation and the basic facilities for daily living even if for a short term. On this basis when investors bought serviced apartments etc they did not claim the GST back nor charge GST when they sold the property.

The trouble arose when the ATO wanted to collect GST on the sale of a motel that had been converted to apartments. The ATO argued it was the first sale as a residential property. The taxpayer argued no when they purchased it as a motel that was a purchase of residential property so it wasn't the first. The ATO then went to court to effectively argue against the statements contained in GSTR 2000/20.

The court found in Marana Holdings that the accommodation had to be long term to be classed as residential, so serviced apartments and motels would not qualify.

After winning the case the ATO advised the GST subcommittee meeting on 8th March, 2005 that it would review its statements in GSTR 2000/20 but in the meantime they could be relied on. Any subsequent changes would be addressed as an implementation issue. Then on the 27th February, 2006 Peter Dutton announced that the law would be changed to meet the statements in GSTR 2000/20 and that the changes would apply retrospectively from the start of GST.

How does this effect you? If you have a piece of residential accommodation that provides sleeping accommodation and the basic facilities for daily living, whether you rent it long term or short term it is input taxed therefore you cannot claim the GST back on the purchase price nor expenses associated with it and you do not have to include GST in the rent. You do not have to charge GST when you sell it unless you were the one who built it or converted it to residential premises. If you have done anything contrary to the above, when the legislation changes you, in theory will have to amend your BAS return but lets hope some concessions apply. Personally I think it will apply to very few taxpayers as they would have acted on in accordance with the statements in GSTR 2000/20. Those that were quick off the mark to claim the GST back after Marana Holdings are the only ones who will have to worry whether they need to repay it.

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

With the housing shortage in Mining towns it is very tempting to rent out part of or a room in your home. The trouble is the rent you receive will be taxable and it will mean that part of your home is not protected by your main residence exemption. The 6 year rule will not protect you here because you are still living there, it only applies if you are absent. IT2167 discusses when you are considered to be renting out part of your home. If your tenants pay you more the just their share of expenses such as electricity, phone and food then you are in a profit making arrangement and should declare the rent you receive. If your tenants make a contribution towards your mortgage this is not part of sharing the expenses this crosses the line to having to declare the income.

## **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.

### **Timing**

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 repairs would be claimable between tenants even if the repairs took all of the financial year.

## 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.

## **CGT Small Business Concessions When Earning Rent**

Paragraph 152-40(4)(e) of the 1997 Act excludes from all the lovely CGT small business concession any asset whose main use is to derive rent. TD 2006/78 gives examples of when the main use is considered to be to derive rent. Industrial sheds leased for over a year were considered to be deriving rent and not entitled to the concession but self storage sheds with a manager, a boarding house and managed holiday units were considered not to be used mainly for the purpose of deriving rent.

Factors that are considered relevant are the length of the tenancy, whether cleaning services are provided, where the owner or manager lives or works, whether the owner or manager retains the right to enter the premises at any time, the selling of other items to tenants such as boxes, equipment hire etc. It does not matter that the rentals are on such a large scale that they are considered to be a business, for income tax law purposes, rather than an investment.

In the case where the same piece of land is used for two different purposes apportionment is not necessary. It is what the main use is that will determine the fate of the whole property. For example a business owns commercial premises that it operates the business from but rents out part of the premises that it does not use. Providing the part of the premises used by the business is substantial, but it can be less than half, the decision is made on the basis of the amount of income generated. So if the rent you receive is less than the turnover of the business the premises are mainly used to derive business income not rent so the CGT concessions are available.

## **So Why Choose A Hybrid Discretionary Trust?**

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

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

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

in the trust. Whether the units are redeemed at their original cost, the market value of the future cash flows or at an amount equal to the units share of the trust's assets, each outcome has its own self-defeating problems.

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

If on the other hand the units can be redeemed for the amount that was originally invested, the investor never made a profit on the investment and with the advantage of hind sight the ATO can say the investor never intended to do so. In TR 95/33 particularly paragraphs 30 to 35 and 47 to 51 the ATO discusses how arrangements that have no chance of making a profit cannot be negatively geared. Paragraph 34 discusses how in Fletchers case the AAT found that the taxpayers never intended to stay in the arrangement for until it became profitable. Further with all the PR about HDTs giving a tax advantage the ATO could use Part IVA to claim the whole arrangement void as a scheme to avoid tax.

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

Now the final blow to HDTs. Their objective is to stream negative income streams to the high income earner and later positive income streams to the low income earner. For this to be necessary in a family arrangement it normally means the high income earner is a wage earner. If the family was in business they have probably utilised other methods of income streaming. In a wage earner situation our salary sacrifice kit is a much better and cheaper solution than a HDT. Not only has it been proven in the courts, you can easily apply for an ATO ruling giving you confidence about the arrangement. The salary sacrifice kit is intended for rental properties owned by a couple where one spouse is on a high income and the other on a low income. The high income earner salary sacrifices all the cash flow rental property expenses such as interest, rates, insurance, agents fees and repairs. The high income earner's employer does not pay FBT on these reimbursements because of the otherwise deductible rule. All that is required is that the high income earner be jointly liable for the expense with their spouse. So the spouse could own 99% of the property yet the high income earner would get 100% of the deduction. The couple then only return in their tax return their individual share of the rental income of the property, the depreciation expenses and anything not reimbursed by the employer. This will probably make the property positively geared in both tax returns but the high income earners taxable wages will now be considerably less. As the reimbursement is an exempt fringe benefit it is not included in the reportable benefits box on the high income earners PAYG summary and as the property is no longer running at a loss it does not have to be added back for Centrelink purposes. Also your employer would be entitled to claim a GST input credit for any GST on the expenses the employer reimburses, something you could not do if it is a domestic rental property, so your costs are less.

The kit explains and helps you enter into this arrangement correctly and with an ATO ruling. Yet it only costs you \$150 probably less than the cost of the initial interview regarding a HDT.

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

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

Note in both the last two examples the rental property kit can still have an improved tax situation when a HDT wouldn't, but the property would have to be held in the name of two spouses who are in different tax brackets.

## **Renting Out Your Old Home & Building Your Dream Home**

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

## **Owning Your Home in a Trust**

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

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

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

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

2) Hold your home in your spouse's name. Your main residence exemption can apply to a house held in your spouses name only, so if you have a spouse who is unlikely to be sued, this is an even simpler method.

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

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

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

1) The AAT found that the interest was incurred to provide a family residence and not expected to produce assessable income.

2) When the taxpayers tried to argue that they did not set up the trust for the tax advantage but for asset protection purposes the AAT would not accept this because they were employees so the need for asset

protection was minimal. This point should be noted by anyone considering setting up an entity that provides both asset protection and tax benefits. Many accountants will argue that if the dominant purpose was asset protection, Part IVA cannot apply just because there was also a tax advantage. Now that the relevance of the need for asset protection is considered, it cannot be assumed that asset protection will shield a tax benefit if you are not exposed to any real risk.

3) The trust was a unit trust and as the taxpayers owned the units in the trust the AAT pointed out that no asset protection existed because creditors could access the assets of the trust because they were entitled to the units should the taxpayers become bankrupt. On this basis only a discretionary trust would provide effective asset protection but the losses from the property would be locked into a discretionary trust so unless other income can be channelled into it to offset the losses there is no tax benefit in holding the house in a discretionary trust.

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

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

## **Selling Your Rental Property**

GST legislation requires that the first sale of a new residential property is subject to GST, if the seller is registered for GST. So GST could apply to a rental property if the landlord was the one who built or contracted with the builder to build the property. There is an exception and that is if the property has been used as a rental for a continuous period of 5 years.

Note the owner of the property has to be registered for GST for him, her or it to be required to charge GST. If the owner's annual turnover is less than \$75,000 they are not required to be registered for GST even though they may sell a capital asset for more than \$75,000. Section 188-15 excludes input taxed supplies from the annual turnover and section 188-25 excludes the sale of capital assets used in the enterprise from the annual turnover. As the rental property was not built for resale at a profit but was built to hold as a capital asset its sale is not included in the annual turnover nor is the rental income because it is input taxed. So even though the sale of the rental property in under 5 years is a taxable supply the owner is not required to charge GST because he, she or it are not required to be registered.

## **Asset Protection**

Discretionary trusts may lose their asset protection ability if the person being sued is considered to be in control of the trust. This has come from Richstar Enterprises Pty. Limited V Carey (No.6) [2006] FCA 814 where a single judge made an interim decision to preserve the assets of a trust pending further court decisions on whether the assets could be distributed to a creditor. The matter is far from certain. Nevertheless, you should avoid setting up a trust where the person likely to be sued or their spouse is both the appointer and the trustee or a director of the trustee company. Further the person likely to be sued should not be a default beneficiary. The best strategy is wait and see but if you can't and you are concerned we recommend you choose the appointer to be, have no default beneficiary in the trust deed and find someone other than your spouse to be the trustee or the director of the corporate trustee. As appointer you still have the right to remove the trustee so retain some control.

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

would be entitled to the shares which would give them control of the company allowing them to liquidate the assets and distribute the proceeds to shareholders.

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

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

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

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

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

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

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

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

Setting up a mortgage trust that has priority over possible creditors on any properties you or your entities own is a form of asset protection that works whether you are protecting your assets from a tenant or another outside party but it takes maintenance. The idea is that you set up a simple trust then in a round robin of cheques in your bank managers office you gift that trust the value of the equity available in the properties you wish to protect. The mortgage trust then lends you the same amount which you use to pay back your bank manager. No doubt he or she will be so full of warm fuzzies from the whole experience of helping you that he or she will neglect to charge you any fees for the transactions. The mortgage trust takes a second mortgage on the rental property as security for the loan. Now this arrangement is not going to help you if you are already or will soon be in trouble because the bankruptcy trustee can claw it back. As the property goes up in value the mortgage will have to be increased by the same round robin of cheques in the bank manager's office. There is no need for the mortgage trust to charge you interest and as a result there is no need for the trust to lodge a tax return. As there are no tax consequences of this arrangement there is no need to consider whether it would be caught by Part IVA.

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

Another form of asset protection for properties held in personal names, if you have a spouse that is not at risk, is holding the property in the spouses name. I know, that wasn't rocket science but let's take that one step further. Assuming the high income earner is the one at risk of being sued (if not reevaluate your priorities). Own the property 1% in the name of the high income earner and 99% in the name of the low income earner. At first this may seem to have a negative gearing disadvantage but there is more. The ownership ratio will determine how the rent, depreciation and capital gain are claimed for tax purposes, but not necessarily the expenses such as interest, rates, insurance, repairs and maintenance. The high income earner can salary sacrifice these expenses and their employer does not have to pay FBT because they are otherwise deductible to

the employee and an associate. Note the employee has to be jointly (not necessarily equally) liable for the expenses hence the 1%. Your employer will reduce your gross (before tax wages) by the amount salary sacrificed which is a good as a tax deduction for the whole amount. Much more detail about this arrangement is available on our web site, look to the bottom right of the home page for rental property salary sacrificing kit.

## **Another Nail In The Coffin For Contrived Artificial Structures**

It has long been the talk at the pub, just set up a company or a trust so you can distribute your income to other family members and save heaps in tax. Eagerly many accountants have gone along with this, after all there is a quick profit for the new entity and another tax return to lodge each year. Or they feel obligated to set their clients up this way because their clients doubt whether they are pro active enough if they don't. The trouble is entering into such an arrangement is automatically a scheme to reduce tax. It is just a question of whether that was your dominant purpose and whether the arrangement is explicable by reference to ordinary business or family dealings. Sometimes asset protection can justify the arrangement but in Tabone's case the judge decided that as the taxpayer was an employee there was no need for asset protection so that was not the dominant purpose. It is important to identify the reason you need asset protection if you want to argue that the dominant purpose for setting up the company or trust was not tax benefits.

There is not a problem if the income of the company or trust is from something other than the personal services of an individual. For example profits from sale of goods or even personal services provided in conjunction with an asset such as a truck, can be distributed through a company or trust to other family members. But if you are trying to divert income from personal services, a company or a trust gets you past the first test of Part IVA in that in the ATO's view you have a scheme to avoid tax. Now it is just a question of your dominant purposes in entering into that scheme. In a paper issued by the ATO called Refocus of the income Splitting test case program, the ATO concedes that it couldn't really argue that a partnership is entered into with the dominant purposes of a tax benefit as it can be explained by normal ordinary business or family dealings. It is the simplest and most basic way for a husband and wife to enter into a business and the corresponding tax benefit of being able to split the income on a 50:50 basis is a result of the provisions of the Partnership Act in each state, not a contrived arrangement.

So if you are looking for a structure that will allow you to split income look at a partnership first. It does not provide any asset protection but it is a very cheap method of starting a business. Note some professions will not allow you to operate in partnership with another person who does not belong to that profession.

Don't forget to question whether you really need to split income after all, if you and your spouse are in the same tax bracket you have saved as much tax as you would if you split your income equally. Most taxpayers are in the 31.5% bracket and this spans from \$25,000 to \$75,000pa.

The above discussion is only relevant to taxpayers who are not caught by the Personal Services Income Legislation. For example they pass the results test. Much more about this is in our Alienation of Personal Services Income booklet on the web site under free publications.

## **Help For Home Buyer's**

The office of fair trading has set up a Home Buyers Guide on [www.dftwid.qld.gov.au](http://www.dftwid.qld.gov.au) to provide anyone purchasing a house with independent information to help them make the right decision. It covers home loan options, valuations, how to make an offer and advice on the real estate market. It also helps you plan how to save for and pay off a home. A Home Buyer's Kit is available by calling 13 13 04.

## **Rental Auctions**

Apparently formal rental auctions held by licensed auctioneers are legal in Queensland. It is also legal for potential tenants to offer to pay a higher rent in order to secure a property. Information on the rules covering the Rental Auctions can be found on [www.fairtrading.qld.gov.au/oft/oftweb.nsf/Web+Pages/628FB2A431C2904B4A2572B400147631?OpenDocument](http://www.fairtrading.qld.gov.au/oft/oftweb.nsf/Web+Pages/628FB2A431C2904B4A2572B400147631?OpenDocument)

## **Inheriting a Rental Property Trick**

If you inherit a house that was a rental property of the deceased and he or she purchased after 19<sup>th</sup> September, 1985 it probably has a large capital gain attached to it. If you are in business or can think of a business you would like to dabble in, move the business into the rental property. This will make the rental property a small business active asset which qualifies you for additional CGT concessions if you elect to operate the business in the simplified tax system or you and associates have net business assets of less than \$6,000,000.

As long as more than 12 months has passed since the deceased purchased the property you will qualify for the 50% CGT discount when you sell the property. As a result of moving a business into the property you will qualify for further 50% discount if the property is considered an active asset (refer section 152 1997 Act). To be an active asset the inherited house needs to be used in your business for at least half the time you own the house or 7.5 years whichever is the shortest. The period starts from the time you inherited the property not from the time the deceased purchased it so it will not be hard to use it in the business for half the time you own it.

By the time you utilise the 50% CGT discount and the 50% active asset discount you are left with only 25% of the gain taxable. If you are over 55 years old you can utilise the retirement exemption to receive the remaining 25% tax free. If you are under 55 and you don't want to pay tax on this remaining 25% you can roll it over into another active asset for your business or contribute it to a superannuation fund until you are 55. Note this contribution will not be taxable in the hands of the superannuation fund.

## **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.
- 3) Capitalise interest when financially necessary.
- 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) 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.
- 9) Read Australian Property Investor Magazine

## **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 maybe 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 20<sup>th</sup> 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 – Part of the cost base for CGT purposes section 110-25(4) if the property was purchased after 20<sup>th</sup> 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.

## **How to Pay Your Home Off Sooner**

Here is an example of just how knowing the latest tax laws can help you build your wealth through decreasing non deductible debt. Bare with the story it has some very exciting numbers in it. This is based on a recent ATO ruling PBR 69725.

Firstly you need to understand the difference between good debt and bad debt. At its worse bad debt is that wide screen TV or expensive to run car that is not generating you any income. The debt on your home, while being part of a very worthwhile investment is also bad debt because it is not tax deductible. For example if you are earning over \$75,000 a year you will have to earn at least \$1.71 to pay your tax and then have \$1 left to pay the interest on your home mortgage. On the other hand if the interest you are paying relates to a loan for investments you receive a tax deduction for it so you only have to earn \$1 to pay \$1 in interest. I think you can already see the benefits of getting rid of non deductible debt.

Here is my dream situation.

Mum and Dad own a home worth \$560,000 on which they still owe \$150,000. Even at an 80% lend, so mortgage insurance does not apply, they have another \$250,000 available that they can borrow. So they go to the bank and arrange a line of credit for \$250,000 that is completely separate from their home loan but secured by the same property. They decide to invest \$200,000 into a managed fund from which they expect a return of 4% in fully franked dividends and conservatively estimate capital growth to be 5%.

Mum and Dad have a good income of over \$80,000 a year each but they have a lifestyle to match. This is why they chose to only invest \$200,000, it gives them further available credit of \$50,000 should they not be able to afford the interest repayments on the investment loan.

Having read Noel's book Making Money Made Simple they can see the advantage of compounding their investment return so they advise their financial planner to organise for the dividends to be reinvested. Further, in accordance with Noel's advice they arrange with the bank that the term of the loan, originally used to purchase their home be paid off over 10 years. Now if they paid their home off over 30 years at 7.5% it would cost them \$1,049 per month. Over 10 years the repayments are \$1,781 per month so they need to find another \$732 per month. But let's see what this \$200,000 investment can do for them.

Now to the affect the \$200,000 borrowing has on their tax refund. If the first year they will have a deduction for \$15,000 in interest with \$8,000 in dividends and \$3,429 in franking credits this gives them a tax loss of  $\$3,571 \times 41.5\% = \$1,482$  refund but wait there is more they also get the franking credits back  $\$1,482$  plus  $\$3,429 = \$4,911 / 12 = \$409$  per month. By applying to the ATO to have the tax instalments in their wages reduced to give them the tax benefit of their refund cheque during the year they already have an extra \$409 per month towards their \$732.

Now the trick here is they do not pay any interest off the \$200,000 investment loan. There is nothing wrong with this PBR 69725 says you don't have to use your private funds to pay for an investment loan and the dividends are being reinvested so there are no investment funds available to pay the interest. The interest is then capitalised and, assuming, for simplicity, they pay their interest annually next year they will be charged interest on \$215,000 all of which will be tax deductible. So in year two their tax return will include interest of \$16,125. Now as the dividend has been reinvested and we are expecting 5% capital growth the dividend received in year two is \$8,720 with franking credits of \$3,737. This will give them a refund of \$5,259 or \$438.25 per month. By year 10 the tax refund is exceeding the \$732 per month in extra repayments but even at

the start they only had to take an extra \$323 per month out of their household budget. The tax office is contributing more than they are.

So what have they got at the end of the 10 years. They have paid off all their non deductible debt ie paid off their house in 1/3<sup>rd</sup> of the time, 10 years rather than 30 years for only a small increase in the repayments. They now have an investment portfolio worth \$434,379 yet the investment line of credit has only increased to \$390,279 so they could sell off the portfolio and have \$44,100 which would cover the capital gains tax if they want to take that road. But a much better path would be to continue with the investment and salary sacrifice the money they had been paying off their house into superannuation so they could pay out the debt when they retire. By saving to repay the loan in superannuation they are saving at a tax rate of 15% while still getting a deduction on the loan at 41.5%.

I must point out at this stage that PBR 69725 is a private ruling so you cannot technically enforce it against the ATO. It is only published to give taxpayers an idea of what the ATO is currently thinking. If you want to be confident you should apply for a ruling of your own quoting PBR 69725.

It is important that these loans are independent of each other, no linked or split facility and that they are not organised through a lender who promotes the tax benefits of such loans.

## **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.

## **Tax Cuts and Rental Properties**

It may all be electioneering but very relevant if you are thinking of buying or selling a rental property. If you are going to make a large capital gain on the sale of a property waiting a few years could make a difference to the tax you pay on the gain. If you are buying a negatively geared rental property the refund cheque will play a big part in your ability to afford the property. A 3% shift in tax brackets is a 7.5% decrease in your refund cheque.

The promised tax rates are set out in the previous edition of Newsflash. If you are earning \$80,000 a year and, in addition, make a \$50,000 capital gain after the discount the tax on the capital gain will be \$20,000 in 2008 compared with \$18,500 if you wait until 2011 to sell. On the other hand if you have a taxable income of \$50,000 and make a \$30,000 capital gain the tax on the capital gain would be \$9,500 in 2008 compared with \$9,000 if you wait until 2011 to sell. Off course there are many other considerations.

If your rental property delivered you a \$1,000 refund cheque (excluding Medicare) in 2008 and your taxable income was \$90,000 the same taxable income will only give you a refund cheque of only \$925 in 2011. On the other hand if your taxable income was \$50,000 the \$1,000 refund cheque will increase from \$1,000 to \$1,133 because of the shading of the tax offset.

## **When You Have a Carried Forward Loss**

I am not talking about a capital loss. Just a normal revenue loss. This can happen if you have a negative rental property and take some time off work to travel or look after children. It is also applicable to non residents of Australia for tax purposes that own a negative geared rental property here, they save these losses for when the property becomes positively geared or they move to Australia.

Carried forward losses are reduced each year by exempt income. Basically exempt income is income that you do not have to include in your tax return. But this is more complicated than you would expect because income is a wide term. For example it can include Family Tax Benefits Part A payments received for your children. Here is a list of some typical payments that you may be concerned about:

#### **Does Reduce Your Carried Forward Losses**

Family Tax Benefit  
Child Care Benefit  
Child Care Tax Rebate  
Maternity Allowance  
Maternity Payment  
Baby Bonus  
Maternity Immunisation Allowance  
One-off Family Payments  
Defence Force Reserve Payments  
Educational Scholarship, Bursaries, Assistance etc  
Apprenticeship Wage Top-Up  
Exempt Payments to Overseas Defence Force Members  
Foreign Diplomats wages earned in Australia  
The Overseas Earning of Foreign Diplomats in Australia  
Australian Residents for tax purposes exempt overseas  
Overseas wages exempt in Australia because you worked 91 days or more

#### **Does Not Reduce Your Carried Forward Losses**

Government's Co Contribution to your Super  
- because it is income to the super fund not you  
Any capital gain not taxed due to CGT concessions  
- because this is not exempt income it is income but not actually taxed due to the concessions  
Reference ID 2004/120.  
Non resident income of a non resident of Australia  
- specifically excluded from the offset rules by section 36-20

The same conditions apply if you have a loss from a business.

## **Rental Property Insulation Rebate**

The details we have so far on the Labor Party promise of a tax incentive for Landlords who insulate their rental properties are as follows:

- A Rebate or Tax Offset of 30% of the cost of the insulation will be available for insulation costs incurred on a rental property up to the maximum rebate of \$500 per annum.
- The Rebate or Tax Offset will be available in the year the insulation costs are incurred.
- The actual cost of the insulation for depreciation purposes is not reduced by the amount of the rebate. Insulation qualifies to be written off at 2.5% per year.
- The amount of the Rebate or Tax Offset will not reduce your cost base for CGT purposes.

Note this information has been supplied to us by the Labor party but they make it clear that it is what they propose and there will have to be consultation with the ATO and Taxpayer representatives before the bill is drafted and then it will have to get through Parliament. So I guess the only clear advice we can give you at the moment is to delay installing insulation in your rental properties in case the rebate is only available from the start of next financial year. We will keep you posted.

## **Back Issues & Booklets**

To obtain free back issues of the fortnightly BAN TACS Newsflash or any of the following booklets visit our web site at [www.bantacs.com.au/publications.php](http://www.bantacs.com.au/publications.php). You can also subscribe to our Newsflash reminder.

*Alienation of Personal Services Income*

*Claim Your Trip Around Australia*

*Death and Taxes*

*Defence Forces [Military]*

*Goods and Services Tax*

*Insurance and Superannuation*

*Overseas Backpacker Fruit Pickers*

*Real Estate Agent*

*Secret Plans and Clever Tricks*

*Buying a Business*

*Claimable Loans*

*Divorce*

*FBT for PBIs*

*Home Loans*

*Investors*

*Overseas*

*Rental Properties*

*Selling a Business*

*Capital Gains Tax*

*Claiming a Motor Vehicle*

*Division 35*

*Fringe Benefits Tax*

*How Not To Be A Developer*

*Key Performance Indicators*

*Professional Practices*

*Retirees*

*Small Business*

*Solicitors Selection*  
*Wage Earners*

*Subcontractors*  
*With Attitude*

*Teachers*  
*Year End Tax Strategies*

**Disclaimer:** Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and 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.