BEYOND ACCOUNTANCY

Tax & investment properties

Ownership structures

Sole owner, co-owners, trust or super fund? Property investors have several choices of ownership structures. Here are the pros and cons of some of the common scenarios.

Structure	How does it work?	When is this structure used?
Sole owner	The owner declares all rental income, deductions and capital gains	Works well where one partner in a couple has a higher tax bracket and wants to negative gear.
Joint tenants	Joint ownership in equal proportions. Upon death the surviving partners take ownership of the property.	Only suitable for related couples due to the estate planning implications. Should not be used by business partners.
Tenants-in-common	Ownership split in any proportion agreed by the partners. Each partner can include their share in their will.	Works for unrelated joint investors (e.g. business partners) and for related couples who want to split in an uneven proportion (e.g. 80/20 or 60/40).
Unit trust	A trust owns the property and the investor owns units in the trust.	This structure is used where an investor wants to protect
Self Managed Super Fund (SMSF)	Property is purchased using your current super plus borrowing if required. Borrowing must be limited recourse.	A SMSF works best where the investor's objective is to save for retirement. Also used where a small business wants to buy their business premises.

What is negative gearing?

Even if you've never been a property investor you have probably heard the term negative gearing. So what is it, and how can it benefit you?

Gearing is where you **borrow to invest** in an income producing asset, in this case, property.

Most property investors will borrow to buy a property.

Negative gearing is where the cost of borrowing exceeds the income from the property.

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The life cycle of your property

Purchase

From a tax point of view when you are buying real estate you are buying three different things:

1. Land
2. Buildings
3. Assets within the building

Each has a different tax implication. Land and buildings are capital items and form part of your capital gains calculation.

Assets like stove or hot water service can be depreciated over a number of years.

Acquisition costs

The costs of <u>**acquiring**</u> a property generally <u>cannot be claimed</u> as a tax deduction.

They are considered <u>capital</u> items and form part of your <u>capital gains tax</u> calculation.

These include stamp duty for the transfer of land, legal fees, conveyancing and building inspections.

Borrowing costs are an exception. They can be writen off over five years.

Costs include loan establishment fees, <u>mortgage</u> stamp duty and lender's mortgage insurance.

Initial expenses

Expenses incurred before you find a tenant are generally deductible as long as the property is available for rent (on the market).

You can also claim a deduction for advertising costs to find a tenant.

Any repairs you do when you first own a property will be considered "initial repairs", even if the property is available for rent.

Unlike later repairs, which are tax deductible, initial repairs are considered capital and are only relevant for capital gains purposes.

Expenses while renting

Deductible expenses are claimed in the year they are incurred. This includes interest, rates, agent's fees, travel etc.

The cost of a **depreciating asset** such as appliances or furniture cannot be claimed immediately. It is written off over a number of years.

Capital items such as doors, built-in robes and extensions form part of the cost base of the property. A 2.5% capital works deduction may apply.

See page six for more detail on depreciation and capital works.

Pre-sale expenses

Prior to putting a property on the market most owners will incur costs in repairing or improving a property.

You can still claim a deduction for repairs after a tenant has vacated the property if the repairs relate to the period of rental.

This would usually include painting the property.

You cannot claim a deduction for improvements or capital items, such as a bathroom renovation.

These become part of the capital gains tax calculation.

Sale

As with purchase, there are three elements to the sale of the property: house, land and assets.

The sale of an investment property is a capital gains tax (CGT) event.

More detail on CGT can be found on pages 4 and 5.

In addition to calculating the CGT you must calculate the difference between the amount received the depreciating assets and the written down value of these assets.

What is negative gearing?

Taxable income	Rate
Up to $6,000	0.0%
$6,001 - $37,000	16.5%
$37,001 - $80,000	31.5%
$80,001- $180,000	38.5%
$180,001 and over	46.5%

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When your rental expenses exceed your rental income this creates a **net rental <u>loss</u>**.

This loss reduces your taxable income, and a lower taxable income means a l**ower tax liability**.

The tax benefit that the loss creates is only a percentage of the net rental loss.

The percentage depends on the marginal tax rate of the investor (see table).

A taxpayer earning $30,000 has a marginal tax rate of 16.5%, so a net rental loss of $1,000 provides a tax benefit of $165.

For a taxpayer with income over $180,000 the benefit would be $465.

So negative gearing is more advantageous for higher income earners.

Get your tax refund early

Using a negative gearing strategy will increase the size of your tax refund.

But you don't have to wait until July to get ask for your money back.

You can get the tax benefit early by reducing the tax that comes out of your pay cheque.

All you need to do is complete an ATO form called a *PAYG Withholding Variation.*

The form can be completed and submitted online.

In a matter of days the ATO will inform your employer's payroll department of the new, reduced rate of tax to take out of your pay.

Having the immediate additional cash flow can lessen the burden of your rental expenses such as loan repayments.

Cash flow is critical, especially for highly geared investors.

For more information go to ato.gov.au and search "00096541".

Less tax coming out of your pay cheque means more money in your pocket.

The right loan makes a difference

The right property investment loan is about more than just interest rate and features.

The astute investor also needs to consider the tax and cash flow implications of their loan product.

Interest only loans

Interest paid on a loan is tax deductible, but the principal repayments are not.

Many investors opt for interest only loans because:

(1) the loan repayments are smaller; and

(2) the loan repayments are fully deductible.

The comparison is more clear when you compare the *after tax* cash flow (see below).

The difference of $7,000 can be the difference between being able to afford a property or not.

Interest Only vs Principal & Interest

	Int. Only	Prin. & Int
Loan amount	$250,000	$250,000
Interest rate	7%	7%
Monthly repayments	$1,458	$1,767
Annual repayments	$17,496	$24,595
Interest component *	$17,496	$17,380
Tax deduction **	$5,511	$5,474
Cash flow after tax	($11,985)	($19,121)

* first year of loan ** assume 31.5% rate

Redrawing your investment loan

Investors should avoid using their investment loan for any non-investment purposes.

It sounds simple, but failure to do this can create a tax mess.

The reason is that the *tax deductibility* of loan interest depends on the *use of the loan.*

If only 90% of the loan funds are used for your investment, then you can only claim a deduction for 90% of the interest.

For example, an investor has an investment loan of $225,000 and redraws $25,000 to buy a new car.

The loan is now only 90% deductible ($225,000/ $250,000) and the interest calculation can become very complicated.

Tax tip:

When managing multiple debts you should pay them off according to the highest ***after tax*** interest rate.

If an investor has a home loan in addition to their investment loan they should **pay off the home loan first**.

This is because the investment loan is tax deductible and a percentage of the interest paid is refunded on your tax return.

You can re-draw the loan for **property related expenses** without affecting the deductibility of the loan, e.g. to pay for property related expenses, repairs or improvements.

Capital gains tax (CGT)

The sale of a rental property will usually create a capital gain or a capital loss.

Simply put, if you sell a property for **more than you paid for it** you have made a **capital gain**.

If you sell it for a **lower amount** you have a **capital loss**.

In addition to the sale price you can add other capital items such as:

- Purchase costs
- Selling costs
- Building works and improvements

These are set out in more detail below.

The total of the purchase price and any other capital amounts is the **cost base** of the CGT asset.

The amount received for the property is called the **capital proceeds**.

The difference between the two is your **gross capital gain** or **loss**.

Gains on assets held for over 12 months are **discounted by 50 per cent**. The after-discount gain is your **net capital gain**.

The net capital gain is included in your tax return and taxed at ordinary **marginal tax rates**.

The top tax rate for individuals is 46.5% so if you factor in the 50% discount the maximum tax you can pay on a capital gain is 23.25%.

The CGT formula:

Capital proceeds
Minus
Cost base

Equals
Gross capital gain

Minus Capital Losses
Minus 50% discount

Equals
Net capital gain

Tips for managing capital gains

1. Include all the elements of the cost base

The higher your cost base, the lower your capital gain.

Make sure you include:

Purchase costs such as stamp duty, legal fees, conveyancing, and building inspections;

Sale costs such the agent's fees, advertising and legal fees relating to the sale or title transfer;

Capital works such as building works, renovations and extensions. (This excludes *depreciating assets* as different rules apply to these.)

2. Take a shortcut on paperwork

If you don't have the paperwork to prove you incurred a capital expense you cannot include it in your CGT calculation.

Missing paperwork can mean a bigger capital gain and extra tax. So keeping good records is critical.

This can be a problem with an investment property that is held for several years, or even decades.

However, if your tax agent creates a **CGT Asset Register** for your property you don't need to worry about keeping paperwork.

In addition, having a clear record of your cost base allows better **tax planning** when you sell the property.

3. Use contract date

The date of sale for the purposes of CGT is the **contract date** not the settlement date.

If a property is sold in June 2011 and settled in August it is taxed in the 2010-11 tax year.

4. Reduce your other income to offset a capital gain

If you have a large capital gain to include in your next tax return here are some steps to improve your position:

- Salary sacrifice into superannuation (employees)
- Make a lump sum deductible super contribution (self-employed)
- Pre-pay expenses e.g. interest on an investment loan, insurance premiums
- Dispose of other CGT assets (e.g. shares) that are in a loss position.
- Lodge your return later in the lodgment cycle (i.e. 15 May) to improve your cash flow.

Repairs, replacements and improvements

Any work you do on a property has three possible tax treatments:

1. Deductible

A deductible amount can be claimed on your current year tax return

2. Depreciating asset

A depreciating asset is something which is an asset in its own right. You can part of the cost of the asset each year as **decline in value.**

3. Capital amount

Capital amounts are added to the cost base of your property (see page 4). In some cases a 2.5% capital works deduction can be claimed.

ATO attention

The ATO is careful to make sure landlord's are not claiming up front deductions for expenses which should be claimed over a number years.

What is a repair?

A **repair** is work that restores an item to its original condition.

Repairs must relate to damage or wear and tear during the period when the property is rented.

You cannot claim a deduction for:

a. Expenses for the **initial repairs** you incur when you first buy a property, even repairs necessary to make the property rentable.

b. The cost of **replacing an entire asset**

c. **Improvements** such as renovations and extensions.

Repairs are an area that the ATO monitors closely.

Examples of rental expenses

Removing carpet & polishing the boards	Deductible repair	The ATO released a specific "interpretive decision" on exactly this scenario. (see ATO ID 2002/330)
Floor coverings (removable without damage)	Depreciating asset	Floor coverings that are not fixed and can be removed, such as floating floorboards and carpet are an asset in their own right, not part of the structure of the building.
Floor coverings (fixed)	Capital works	Floor coverings like cork, floorboards or tiles are considered capital works as they form part of the building.
Fixed cupboards	Capital works	Any fixture that forms part of the property is considered capital works and a 2.5% deduction applies.
Free standing cupboards	Depreciating asset	A separate asset
Repairing foundations	Capital works	The foundations are part of the structure and are considered capital works.
Replacing a cracked glass in a window	Deductible repair	The work restores the window to its original function.
Window awnings, insect screens, louvers, pelmets, tracks	Capital works	The work is part of the building and are considered capital works.
Maintaining plumbing	Deductible maintenance	Preventing wear and deterioration is considered a deductible cost.
Installing pipes, sewerage system	Capital works	Major plumbing work is considered capital.
Repairing part of a fence	Deductible repair	If the fence is not replaced entirely the work merely restores the function of the original fence and is therefore a repair.
Replacing entire fence	Capital works	A fence is considered a capital work, not a depreciating asset. A 2.5% capital allowance is claimable each year.

Depreciation— boost your cash flow

Depreciation can make a big difference on the cash flow of your investment property.

But what is depreciation? It is simply a recognition of the decline in value of an asset over time.

As things get older, they becomes worn out, and their value decreases.

So the ATO allows you to claim for the decline in value of the assets used in earning income. This includes the assets in your investment property.

When you purchase real estate you are actually buying three things:

1. Land
2. Buildings
3. Assets in the buildings

Depreciation can be claimed on the assets of your property over the course of their "effective life", as set by the ATO.

For example, the ATO suggests a ceiling fan has a life of 5 years, and carpet 10 years.

Even the buildings themselves can be deducted over time. Buildings and fixtures attached to the building can be deducted at the rate of 2.5% per year.

What's so good about depreciation?

1. You can claim deductions for assets and buildings **even if you didn't pay for them**. When a property is sold the new owner inherits the unclaimed depreciation of the old owner.

2. Depreciation is **cash flow positive**.

Normally, to claim a deduction you first have to incur an expense.

With depreciation, you get the tax deduction without having to incur any cash outflow.

Unlike other expenses, **depreciation puts money back in your pocket**.

Depreciation reports

A **quantity surveyor** can produce a **depreciation report** for a property.

The report details all your assets, fixtures and buildings, and determines the deduction you can claim each year over a period of 40 years.

A depreciation report could save you thousands in tax, **especially if you have purchase a newly built property.**

Free ATO Seminar

The ATO provides an in depth two hour seminar on the tax issues facing for rental property investors. It provides a good outline of some important topics. The seminar does not provide the tax tips and strategies discussed in this document but is a useful source of information.

To find out more and register go to www.ato.gov.au and search "00154616"

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Beyond Accountancy is about trust, innovation and keeping things simple.

We make your tax affairs hassle free and we are pro-active in giving the kind of advice that gives you an advantage.

For property investors we go beyond simple tax preparation and provide you with the tips and