

Rental Property

Is a Rental Property Investment for you?

**What can you claim?
What records do you need?**



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Residential Rental Property Guide

Rental Property as an Investment

Purchasing a rental property is a major investment decision. Like all major decisions, careful thought should be given to the worthiness of the investment prior to signing the contract. As a minimum you should consider the following issues:

- 1) Rental Returns – what is the current state of the rental market?**
- 2) Capital Growth – what are the long term prospects for the property?**
- 3) Funding Capacity – can you manage rental expenses including loan repayments if the property is untenanted for a period?**
- 4) Liquidity – how long will it take you to sell the property if you need to realise your equity?; and**
- 5) Comparison - how does the investment compare with alternatives such as shares, managed funds, listed property trusts etc?**

Negative Gearing

An investment property that's negatively geared is one where initially the annual rental income amount is less than the annual interest paid on the loan. Any deductible expenses incurred in maintaining the rental property will further increase this loss.

You may get a tax benefit in this situation as your rental expenses are greater than your rental income, and the net loss can be offset against other income you may have. In general terms, your taxation benefit is equal to the net tax loss on the property multiplied by your marginal tax rate. The higher your marginal tax rate, the higher your tax benefit from negative gearing.

As tax is only paid as a percentage of your income, the difference between the tax benefit gained and the actual loss on the property comes out of your pocket. In order to break-even each year, the property must be growing in value by at least your out-of-pocket costs.

Variation of Pay As You Go (PAYG) Withholding

If you have employment income and your property will be negatively geared, you have the ability to vary the PAYG Withholding Tax amounts deducted from your pay by your employer. This variation allows you to obtain your tax benefits through higher take home pay rather than waiting until you receive a refund when you lodge your income tax return.

PAYG Instalments

If your rental income is greater than your rental expenses, the net rental income generated by the property will be added to any other income you may have and be taxed at your marginal tax rate.

If this net rental income is greater than \$2,000, you may be required to pay an annual PAYG instalment or quarterly PAYG instalments towards your expected income tax liability for the current income year.

If you are in receipt of salary and wages, which is subject to PAYG withholding, extra tax can be paid through your wages to cover your likely tax liability. This may eliminate the need for you to pay PAYG instalments and can be done by completing a 'Withholding declaration – upwards variation' form for your employer.

Property Ownership

Where more than one person owns the property as co-owners, income declared and deductions claimed are based on each co-owners' legal ownership of the property. If the title deed shows that you are a part owner of the property, you only include your share of the income and deductions in your income tax return. For example if A owns 70% and B owns 30%, then A would declare 70% of the income and claim 70% of the expenses. B would have to declare 30% of the income and be entitled to a deduction for 30% of the expenses.

Joint property owners will need to individually record their financing deductions (eg interest, borrowing costs, and bank charges) if they have been sourced differently.

Financing

You may be entitled to claim a deduction for borrowing costs and interest you have incurred on purchasing or constructing a rental property. A deduction is not available for the loan repayments, only the interest component and any other charges on the loan.

The costs of obtaining finance (known as borrowing costs) for the rental property are claimed either:

- immediately if the total costs are under \$100; or**
- over five years, or the term of the loan, whichever is the shorter period.**

Borrowing costs include legal expenses, valuations, title search fees and mortgage insurance.

The deductions available may be reduced where some or all of the proceeds of the loan are used for private purposes, for example, where a further loan advance is used to pay for personal home improvements. Deductions are only available where the funds obtained are directly connected with the rental property.

We recommend that any loan obtained for the purchase or construction of a rental property is kept separate from any other loans you may have, for example a personal line-of-credit. This will assist in maintaining the future income tax deductibility of any loan interest and charges, as well as simplifying your record-keeping.

If you have personal debts, you could employ the following strategy to increase your tax deductions while keeping your overall debt level the same:

- 1) take out an interest only loan for the rental property rather than the standard principal and interest loan; and**
- 2) the money saved on the principal portion of the loan repayments of the rental property loan should be paid off your personal debts.**

This enables your tax-deductible debt to remain at a higher level and your non-tax deductible debt to reduce at a greater rate. Bank fees and charges and available interest rates need to be considered prior to engaging in this strategy.

Rental Income

Only rental income actually received during the year is assessable. If a real estate agent manages the rental property, any rental income that the agent receives in a particular month is assessable for that month, not when you receive the rental statement. Money received from the tenant for a bond on the property, is not assessable income, except where the money has been used to cover costs such as repairs and maintenance or rent in arrears.

Other income may include compensation received from insurance companies or reimbursements made from tenants.

Rental Expenses

You can claim expenses relating to your rental property but only for the period your property was rented or available for rent.

Rental expenses include:

<input type="checkbox"/> Accounting fees	<input type="checkbox"/> Advertising for tenants
<input type="checkbox"/> Bank charges (other than borrowing costs)	<input type="checkbox"/> Body corporate fees (excluding sinking fund payments for improvements)
<input type="checkbox"/> Bookkeeping	<input type="checkbox"/> Borrowing costs (spread over several years)
<input type="checkbox"/> Cleaning	<input type="checkbox"/> Council rates
<input type="checkbox"/> Depreciation*	<input type="checkbox"/> Capital works – Division 43**
<input type="checkbox"/> Gardening	<input type="checkbox"/> Insurance premiums
<input type="checkbox"/> Land tax	<input type="checkbox"/> Lawn mowing
<input type="checkbox"/> Legal fees regarding lease or rent recovery	<input type="checkbox"/> Property management fees
<input type="checkbox"/> Motor vehicle expenses	<input type="checkbox"/> Pest control
<input type="checkbox"/> Postage	<input type="checkbox"/> Repairs & maintenance***
<input type="checkbox"/> Stationery	<input type="checkbox"/> Tax agent fees
<input type="checkbox"/> Telephone expenses	<input type="checkbox"/> Travel expenses
<input type="checkbox"/> Water charges	

*Depreciation

You can claim a deduction for the decline in value of certain items, known as depreciating assets, that you acquired as part of the purchase of your property or that you subsequently purchased for your property. Examples of depreciating assets are freestanding furniture, stoves, washing machines and televisions.

If an individual's share of an asset is \$300 or less, you are entitled to claim the entire cost of the asset as a deduction in the year the asset was purchased. For example, if two people jointly owned a rental property, an outright deduction would be available for assets costing \$600 or less. This deduction is not available where:

- 1) the asset was part of a set and the total cost of the set exceeds \$300 per owner; or
- 2) the total cost of the asset and any identical or substantially identical items was greater than \$300 per owner.

Assets costing greater than \$300 and less than \$1,000 can be allocated to a low value pool. The low value pool may increase your deductions in the short term. However, all future assets costing greater than \$300 and less than \$1,000 must be allocated to the pool. There are also special rules in relation to how disposals of these assets are treated.

****Division 43 Capital Works Deduction**

You may be able to claim a deduction for the construction costs or capital improvements of your rental property over a 40-year period.

This deduction is available if the property was constructed after 17 July 1985, or structural improvements were carried out after 26 February 1992. Examples of structural improvements include; sealed driveways, a gazebo, carport, retaining walls or fences.

The deduction is not available until construction has been completed. The deduction is at the rate of 2.5% per annum.

The capital works deduction for construction of the property is based on what it cost to *build* the property and not what it cost to *purchase* the property. If you qualify for a capital works deduction for the rental property, you will need to know the construction cost of the property at the time it was built. The builder of the property may be able to assist you. If not, you will need to engage a Quantity Surveyor who can determine the details of the construction costs and assets in the property at the time of construction.

*****Repairs & Maintenance**

The correct classification of repairs and maintenance is imperative. While repairs and maintenance are eligible for an outright deduction, improvements to the property are not. A repair to a defective or worn-out part, or to return a deteriorated part to its former condition is normally considered repairs and maintenance and is deductible. For example, fixing a hole in the tiled roof with the same type of tiles, is repairs and

MAINTENANCE. In contrast, replacing a tiled roof with Colourbond roof would be classed as an improvement.

Initial repairs completed shortly after the acquisition of the property are not eligible for an outright deduction. They are of a capital nature and treated as an improvement to the property.

This is a complex area and we recommend contacting us for clarification of the treatment of a particular transaction prior to incurring the expense.

Capital Gains Tax

Capital gains tax is a tax on the capital gain upon sale of a property. The property must have been acquired after 19 September 1985 for capital gains tax to apply. A capital gain is derived when the proceeds from the sale of the asset are greater than the cost base of the asset (a profit is made on sale). A capital gain is included as assessable income (apportioned between owners of the property based on each owner's legal ownership of the property).

A capital loss occurs when the proceeds from the sale of an asset are less than the reduced cost base of the asset. A capital loss cannot be offset against any assessable income you may have, it can only be used to offset capital gains in the current year, or carried forward indefinitely until it can be offset against a future capital gain.

A 50% general capital gains tax discount is available to individuals and trusts where the property being sold has been held for at least a 12-month period. It is important to note that the capital gains tax provisions relies on contract dates for the purchase and sale of property, not the settlement dates. Any capital losses available will be offset against the capital gain before the discount is applied.

There are also some exemptions available in the event the rental property has been used as a principal place of residence for a period of the ownership. Please contact us for more information and advice if this is the case.

GST

A residential rental property is classed as "input taxed" for GST purposes. This means that:

- 1) No GST is charged on rent
- 2) No GST paid is claimable on expenses
- 3) No GST is required to be remitted on sale of the property (except when a builder first sells a new property) and
- 4) No GST registration or Australian Business Number is required.

Expense Substantiation

Please ensure that you retain all the necessary documentation to substantiate all claims that you make.

All records relating to expenses claimed must be retained for five years after lodging the returns.

For depreciation expenses, you must keep records for the entire period over which an item is depreciated. Those records must then be retained for a further five years from the date of lodgement of the last return in which a claim is made.

Renting your Property to a Relative

In the event the tenants of your rental property are family members or friends, you must ensure that market value rent is charged to the tenants. If a lower than market value rent is charged, it may affect your ability to claim a full deduction entitlement on the property, and the Australian Taxation Office can tax you on the market value of the rent rather than the rent actually received.

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