RJ Sanderson
& ASSOCIATES PTY LTD
PUBLIC ACCOUNTANTS

RENTAL PROPERTY TAXATION GUIDE

This guide explains **HOW** to treat rental income & **WHAT** expenses you can claim

OUR MISSION STATEMENT

Minimise Your Tax

Maximise Your Wealth

Build Your Business

TAKE THE STRESS OUT OF TAX

CONTENTS

INTRODUCTION

This Rental Properties Taxation Guide will help you, as an owner of a rental property in Australia, to determine the following:

- Which rental income is assessable for tax purposes.
- Which expenses are tax deductible.
- Which records you need to keep.
- What you need to know when you sell your property.

Many, but not all expenses associated with rental properties are tax deductible. This guide will also explain:

- How to apportion expenses if only part of them are tax deductible.
- What expenses are not deductible
- When you can claim those expenses that are tax deductible. Some expenses you can claim in the year they are paid; others must be claimed over a number of years.

When you own a rental property, you may also need to know about Capital Gains Tax (CGT) and Goods & Services Tax (GST).

In this Guide we have supplied a worksheet which you may find as a very valuable resource when completing your income tax return. The items on this worksheet need to appear on your income tax return. Completion of this worksheet prior to visiting your Accountant may save you time and reduce the cost to complete your tax return.

DISCLAIMER

This Guide is just that, a guide. It should not be relied upon only and you should always seek the advice of your Tax Agent.

Tax regulations change regularly and although all effort has been made to ensure it is accurate at the time of printing, your tax agent will have current and up to date knowledge of changes related to property investment.

Please seek the advice of a Taxation Professional at R J Sanderson & Associates Pty Ltd.

NOTE

The examples given in this publication featuring Bob & Millie Aires are based on the assumption that the Aires own their rental properties as joint tenants who are not carrying on a rental property business.

RENTAL INCOME

Rental and other rental related income is the full amount of rent & associated payments that you receive, or become entitled to, when you rent out your property - whether it is paid to you or your real estate agent. You must include your share of the full amount of rent you earn in your tax return.

RENTAL RELATED INCOME

You must include rental bond money as income if you become entitled to retain it - for instance, because a tenant defaulted on the rent, or because of damage to your rental property, including repairs & maintenance.

If you received an insurance payout you may need to include this if the payout was to compensate you for lost rent.

If you received a letting or booking fee then this must be included as rental income.

If you received a reimbursement or recoupment for a deductible expense, you may need to include it as income. For Example:

- An amount received from the tenant to cover the cost of repairing the property is income, but the cost of the repair will be claimed as a deduction.
- A government rebate for purchasing a depreciating asset, such as a solar hot water system, will need to be declared as income (Taxation Determination TD 2006/31).

CO-OWNERSHIP OF RENTAL PROPERTY

The way rental income and expenses are divided between co-owners depends on whether the co-owners are joint tenants, or tenants in common, or operating a partnership, or carrying on a rental property business.

Co-owners of an Investment Property - Not in Business

A person who simply co-owns an investment property or a number of investment properties is usually regarded as an investor who is not carrying on a rental property business. This is because of the limited degree to which a co-owner actively participates in the rental property activities.

Dividing income & expenses according to legal interest

Co-owners must divide the income & expenses in line with their legal interest in the property

- Joint tenants - hold an equal share in the property.
- Tenants in Common - may hold unequal interest in a property - for example one may hold 20% interest and the other may hold 80% interest.

Rental income & expenses must be allocated to each owner in accordance with the legal ownership. This cannot be changed by any other agreement between the owners either verbally or in writing.

Example 1: Joint Tenants

Bob & Millie Aires own an investment rental property as joint tenants. (An equal share ownership of the property) Mr Aires telephones the tax office and asks if he can claim 80% of the rental loss. Mr Aires explains he is earning $67,000 per year and Mrs Aires is earning $21,000 per year. Therefore, it would be better if he claimed most of the rental loss and he would save more tax. Mr Aires also explained that it is only fair he claims more of the loss because more of the expenses come out of his income. He also backs this up by indicating that they have drawn up a partnership agreement allowing him to claim 80% of the loss.

Mr Aires was told that despite all the above, where two people own the property in joint names (or joint tenants) then the rental loss must be split in accordance with the legal interest in the property. Mr & Mrs Aires must each include 50% of the total income and expenses on their income tax return.

NOTE

Interest on borrowed money by only one person as tenants in common which is used exclusively to purchase that person's interest in the rental property does not need to be divided between all co-owners.

Example 2: Tenants in Common

If Bob & Millie Aires had instructed their solicitor when they purchased the property that the Title & purchase should be as Tenants in Common, then they could have decided to have Mr Aires own 80% and Mrs Aires 20%.

RENTAL EXPENSES

You can claim a deduction for certain expenses you incur for the period your property is rented or available for rent. However, you cannot claim expenses of a capital nature or a private nature - although you may be able to claim decline in value (depreciation) for certain capital expenditure.

TYPES OF RENTAL EXPENSES

There are three categories of rental expenses:

- Cannot claim a deduction
- Can claim an immediate deduction
- Can claim over a number of years

Some expenses may need to be apportioned, each of these are discussed in more detail below.

Apportionment of Rental Expenses

There may be situations where you need to apportion the expenses:

- Your property is available for rent for only part of the year.
- Only part of your property is used to earn rental income.
- You rent your property at non-commercial rates.

Property available for part year rent

If you use the property for both private and income producing purposes, you cannot claim a deduction for the portion which relates to private use. An example might be a holiday home.

You cannot claim a deduction for the time the property was used by you, your relatives or your friends for private purposes. In this case expenses like Council Rates would be apportioned on a time basis to calculate the private non-deductible amount.

Example 3: Apportionment - Property rented part year

Mr Aires' brother, Zillion, owns a cottage in Tasmania. He rents out his property during the period 1 November to 30 March - a total of 150 days. He lives in the house the rest of the year.
The Council rates for the year are $1000.
He apportions the rates as follows:

Rental expense x portion of year = deduction

$$\$1,000 \quad \times \quad \frac{150 \text{ days}}{365 \text{ days}} \quad = \$411$$

Other costs like Water rates, interest and insurance would also need to be apportioned.

Property only part used to earn rent

If only part of your property is used to earn rent, you can claim only that part of the expenses that relates to the rental income. As a general rule, apportionment should be made on the basis of floor space.

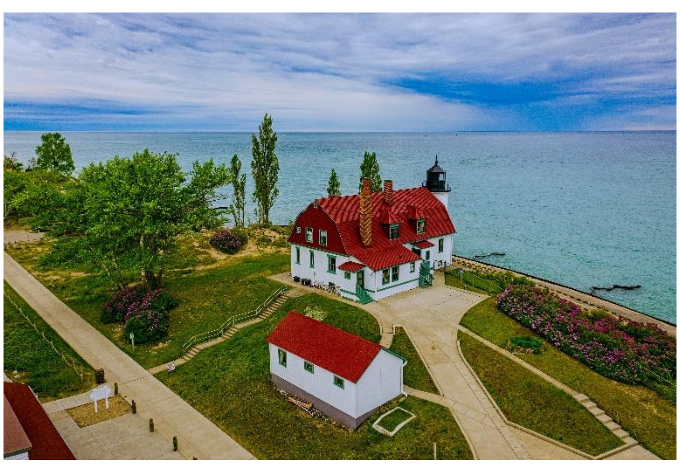
Example 4: Rent part of property

Mr Aires' neighbour, Bill, has a property with a self-contained flat. The floor area of the flat is one third of the total residence.

Bill rents out the flat for 6 months at $100 per week. For the other 6 months he allows his niece to live in the property rent free. His interest, insurance and other costs for the year are $9,000. Bill only had the property available for rent for six months so he can only claim half the eligible expenses. The calculation is;

Gross Rent	$2,600 (26 weeks x $100)
Less Expenses	$1,500 ($3,000 x 50%)
Net Rent	$1,100

The Expenses were calculated as $9,000 by one third based on floor space = $3,000 by 50% because it was rented for 6 months.



Non-commercial rental

If you let a property or part of a property at less than the normal commercial rates this may limit the amount of deductions you can claim.

Example 5: Renting to family member

Mr & Mrs Aires were charging the previous Queensland tenants $180 per week. They then allowed their son to live in the property for a nominal rent of $40 per week. Their son, Jonny, lived in the property for four weeks, after which the property was advertised for tenants.

Although Jonny was paying rent, the amount was not a normal commercial rate. The result is that Mr & Mrs Aires cannot claim any expenses for the period that Jonny was living in the property. Generally, the ATO will allow deductions up to the amount of the rent received from a non-commercial arrangement. For example, if Mr & Mrs Aires had incurred costs for Rates, Insurance and Interest of $1,000 for the 4 weeks, they would only be allowed to claim up to $160 (which equals 4 weeks x $40) If Jonny lived in the property rent free, no costs could be claimed.

Prepayment of Rental Expenses

If you prepay a rental property expense such as insurance or interest, on the basis that the prepayment is for 12 months or less, you can claim the amount in the year you spend the money.

Expenses you can NOT claim

Expenses which are not able to be claimed as a deduction include:

- Acquisition & disposal costs.
- Expenses not incurred or paid by you, such as water paid direct by your tenant
- Expenses which are not related to the rental property.

Acquisition & disposal costs

You can NOT claim a deduction for the costs of acquiring or disposing of your rental property. Examples of these costs are Conveyancing costs, legal fees on purchase or sale, stamp duty on the transfer of property, advertising expenses, commission on the sale. However, all these costs form part of the calculation for Capital Gains Tax.

Example 6: Acquisition & disposal costs

Mr & Mrs Aires purchased a rental property for $170,000 in July 2008. They also paid surveyors fees of $350 and stamp duty on the transfer of the land of $750.
The cost base on the property now becomes $171,100 and this will be included when calculating a Capital Gain or a Capital Loss

Expenses you can claim - Immediately

Expenses you can claim immediately include the following:

- Advertising for tenants
- Bank charges
- Body corporate fees *
- Cleaning
- Council rates
- Electricity & Gas
- Gardening & lawn mowing
- In house audio/video charges
- Insurance
- Interest on loans *
- Land tax
- Lease document expenses
- Legal expense (conditional) *
- Mortgage discharge fees
- Pest control
- Property agents' fees & commission
- Quantity surveyors' fees
- Repairs & maintenance *
- Secretarial & bookkeeping services
- Security patrol services
- Stationery & postage
- Telephone calls
- Travel & car expenses *
- Water charges

You can only claim these expenses if you actually incur them and pay them. They are not deductible if they are paid by the tenant

Deductions marked with an asterisk *
are discussed in detail on the following pages.

Body Corporate Fees & Charges

Body corporate fees often relate to either the day to day administration and maintenance or to a special purpose fund.

Payments you make to the body corporate administration fund and general-purpose sinking fund are tax deductible.

However, payments to a special purpose fund to pay for particular **capital expenditure** are not deductible. Payments to cover the cost of capital improvements are not tax deductible.

A **general-purpose sinking fund** is to cover a variety of unspecified expenses, some which may be capital in nature, but generally these are deductible.

A **special purpose fund** is one that is established to cover a specific item and generally these are capital improvements and therefore not deductible

Interest on Loans

If you take out a loan to purchase a rental property then you can claim the interest as a tax deduction. You cannot claim interest for the period of time the loan is used for private purposes. Loans to purchase the property, complete repairs or for renovations will all allow the interest to be deductible.

If a loan is taken out partly for the rental property and partly for a private matter, such as to purchase a new car, only a proportion of the loan will be tax deductible.

The ATO consider the "**use of the money**" to establish if the interest is a tax deduction, not what the loan is called or what property is used as security.

Example 7: Apportionment of Interest

Bob & Millie Aires decide to purchase a rental property for $270,000 including costs and at the same time they want to buy a new family car for $30,000.

To arrange the finance, they use the new property which has cost them $270,000 and the family home as security. Because only $270,000 of the total $300,000 loan is used to purchase the income producing asset (rental property) then only 90% of the interest on this loan will be tax deductible. If it is one loan then the 90% will remain unchanged for the life of the loan (and when a refinance takes place) as it is not possible to repay only the non-deductible portion of the loan.

TAX TIP

If Bob & Millie had got advice before arranging the loan, they would have been advised not to take out one loan for $300,000. They should have split the loan or taken out 2 separate loans which would have allowed repayment of the non-deductible portion of $30,000 before they started repaying the other loan where the interest is tax deductible.

Legal fees

Some legal fees are tax deductible, for example the cost to evict a non-paying tenant or to have rent paid. Most legal fees are capital in nature and not deductible, but form part of the cost base for Capital Gains Tax, these include:

- Purchasing or selling your property.
- Resisting land resumption claim.
- Defending your title or ownership.

Repairs & Maintenance

Expenditure on repairs you make to the property may be deductible if they relate to wear, tear and damage on the property which occurred as a result of you renting out the property.

An example may be to replace some broken guttering caused by a storm or replacing part of a fence.
However, expenses classified as capital in nature will not be deductible and will form the cost base for the purchase of capital gains tax or be depreciated.
Examples that are not deductible:

- Replacement of any entire structure, such as replacing the fence or guttering in full.
- Replacing a stove, a kitchen, a bath, kitchen cupboards.
- Improvements, renovations, extensions and alterations.
- Initial repairs, such as painting, which you incur when remedying defects when you purchase the property and prior to it being rented.
- Landscaping.
- Insulation.
- Adding another room.

Repairs will be deductible where you need to complete the work between tenancies. They will also be deductible if you need to make repairs after the tenant has vacated and you want to move into the property to make it your residence. These are deductible because they relate to the period the property was a rental property as long as the expense is incurred in the same financial year.

You can claim repairs for items like replacing broken windows, plumbing maintenance and repairing electrical appliances.

Example 8: Repair prior to renting

Bob & Millie Aires decided when they purchased the new property for $270,000 that it needed some work completed. They discover the floor boards are rotten so they replace these, arrange the house to be painted and replace some light fittings & windows which were broken. All these expenses were incurred to make the property suitable for rental and at this stage they had not rented the property.

These expenses are considered capital in nature and they are not able to claim them as a tax deduction. They will however form part of the cost base for Capital Gains Tax when they sell the property.

TAX TIP

If Bob & Millie had incurred some of these costs after the property was rented for the first time, then some would have been deductible immediately.

Travel & Car Expenses

From 2017, travel expenses relating to a residential investment property are not deductible.
A residential premise (property) is land or a building that is:

- occupied as a residence or for residential accommodation
- intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation.

Borrowing Costs

These are expenses directly related to taking out a loan for the property.
They normally include the following:

- Establishment fees.
- Title search fees.
- Legal fees to file mortgage documents.
- Finance broker fees.
- Stamp duty on the mortgage.
- Valuation fees incurred for the loan.
- Mortgage protection insurance.

If your expense is more than $100 then the Borrowing Cost is written off over 5 years.
If you obtained the finance part way through the year the borrowing cost is apportioned according to the number of days in the year you had the loan.

Example 9: Apportioning Borrowing Costs

When Bob & Millie Aires purchased the property on the 17th July for $270,000, they also paid Borrowing Costs of $1,670. In the first year of ownership the loan was in existence for 349 days so this first year it is apportioned as 349/365 days.

The loan was for $300,000 but only $270,000 was related to the rental property. $270,000 divided by $300,000 is 90%. This means they can only claim a deduction for 90% of $1670 = $1503.

Year	Days	Claim
1	349	$ 287
2	365	$ 301
3	365	$ 301
4	365	$ 301
5	365	$ 301
6	16	$ 12
Total		$1503

Decline in Value - Depreciation

Decline in value can be claimed at a particular rate as determined by the effective life of the depreciating asset. The ATO have extensive guidelines on effective life that your taxation advisor will use to determine this.

If items cost $300 or less then you are permitted to claim the cost outright as a tax deduction and it does not form part of the Depreciation schedule.
If you purchase a set of assets that individually cost less than $300 but as a set exceed this limit, you do not get the immediate deduction. (Eg. A set of 4 dining chairs costing $100 each = $400)

Example 10: $300 Immediate deduction

Bob & Millie Aires jointly owned a rental property and contributed $300 each for the purchase of a new oven with a cost of $600. Accordingly, both taxpayers are entitled to a deduction of $300 provided the remaining requirements for an immediate deduction are satisfied.

Capital Works Deduction

You can claim a deduction for various items over either a 25-year time frame or a 40-year time frame depending on when the property was constructed. Capital works deductions relate to:

- Construction of a property.
- Adding a room, garage, patio.
- Alterations - removing or adding a wall.
- Structural improvements - building a driveway, retaining walls, fencing.

Certain costs are not considered Capital works, including land, clearance of land, landscaping. A professional need to be engaged to arrange a schedule and calculate the deductions.

Arranging a schedule

Unless the owner of the property is the builder and has the exact costs for construction the ATO require a Registered Quantity Surveyor be contracted to compile the Depreciation Schedule.

The purpose of this regulation is to prevent unqualified people estimating construction costs, which in the past have been real estate agents, solicitors, accountants and home owners, all of which do not have the appropriate experience or qualification to do so.

TAX TIP

As Accountants we see hundreds if not thousands of depreciation schedules. Some are poorly constructed which limits the client's deductions. Please speak to one of the Accountants at R J Sanderson & Associates Pty Ltd and they will recommend the appropriate **Registered Quantity Surveyor** to complete the depreciation schedule. It can also be arranged that your accountant will receive an electronic copy of the report/schedule to assist with completing your income tax return.

TAX TRAP

Capital Works Deduction on Sale

Upon sale, the Capital work deductions claimed since purchase are added back as a negative cost for Capital Gains Tax calculation purposes.

TIP: The exemption to this is if the property was purchased before 13 May 1997

OTHER TAX CONSIDERATIONS

CAPITAL GAINS TAX

You may have a Capital Gain or Capital Loss when you sell the property if the property was purchased after 19 September 1985.

The Gain is calculated by comparing the cost base of the property and any other capital costs with the sale price. If the property is owned for more than 12 months then the tax will be payable on only half the Capital Gain. Your tax advisor will be able to assist with other methods to reduce capital gains tax based on income level, age and other deductions.

Example 11: Calculate Capital Gain

Bob & Millie Aires sold the rental property they had purchased in 2005. The capital gain was calculated as follows:

Cost of Property	$250,000
Add Legal fees on purchase	$1,000
Add Stamp Duty on purchase	$10,000
Add Legal fees on sale	$1,000
Add Commission on sale	$5,000
Add Renovation costs	$20,000
Total Cost	$287,000
Sale Price	$407,000
Capital Gain	$120,000
Taxable Capital Gain	**$60,000**
(after allowing for 50% discount)	

As the property was in joint names, both Bob & Millie will pay tax on $30,000 Capital Gain each.

Main Residence Exemption

Capital Gains Tax does not apply to the Principal Place of Residence. If the property ceases to be the main residence, the taxpayer can "elect" for the property to remain the Principal Place of Residence for up to 6 years.

The taxpayer can move back to the property again and then should they vacate, they are permitted another 6-year exemption period.

A taxpayer can only elect one property to be the Principal Place of Residence at any one point in time. The exemption is limited to 2 Hectares or 5 acres.

If throughout the ownership period of the property, the property was for some time the Principal Place of Residence and part an investment property there are 2 possible treatments.

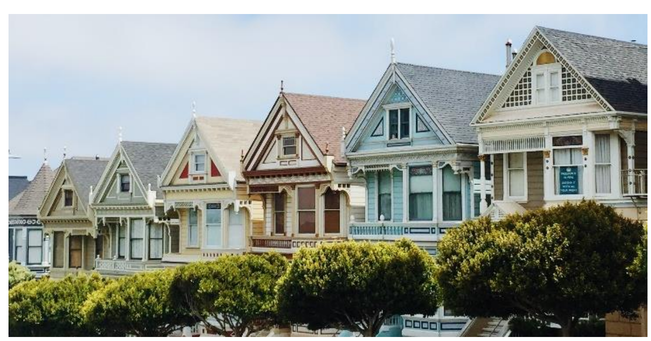
Pre 20 August 1996

If the property was income producing prior to this date then the capital gain is proportioned based on the number days the Principal Place of Residence exemption applies and the number of days it was an investment property.

Post 20 August 1996

If the property was first income producing after this date then the Capital gain is calculated using a "deemed" market value as at the date the property became income producing.

Deemed market value will need sales evidence in the area and a letter from a local real estate agent. The property must be income producing for more than 12 months to get the 50% general discount.



Example 12: Principal Place of Residence - Used partly for income producing

Bob & Millie Aires sold the rental property they had purchased in 2005. The capital gain was calculated at $60,000.

If this property was the family home for the first 2 years and an investment the other 4 years then they could elect that the property was the Principal Place of Residence for the whole 6 years despite the fact they had rented it for 4 years. They can only have one property as the principal place of residence at any point in time. Under this election rule they could sell the property up to 6 years after moving out and pay no Capital Gains Tax.

On the other hand, Bob & Millie decide to elect the home they are residing in as the Principal Place of Residence and they will pay Capital Gains Tax on this property.

Because the property was first rented **after 20 August 1996**, they will need to establish the Valuation on the property in 2007 when they vacated the property and it first became an investment property. This valuation is the cost base instead of the actual cost.

It should be noted that friends of Bob & Millie had a similar situation as above, the only difference was the property was first income producing in 1993 (**before 20 August 1996**) In this case the friends were forced not to use a valuation for cost base, but the actual cost base. The capital gain is then proportioned based on the number of days as the family home and days as an investment property.

RECORD KEEPING

Records must be retained for a period of five years from the date you lodge your income tax return.
You should keep all receipts which must be in English and include details as follows:

- Name of supplier.
- ABN of supplier.
- Amount of expense.
- Date expense incurred.

If the document does not show the date of payment then you may be required to retain bank statements to prove date of payment.

NEGATIVE GEARING

A rental property is negatively geared if the expenses for the property are more than the rent received. The negative gearing loss is permitted to be used against other income which results in a larger tax refund.

TAX VARIATION

Based on the negative gearing amount, the value of your tax refund at the end of the year might be quite considerable. It is possible to lodge Tax Variation Form with the ATO which allows your employer to deduct less tax from your weekly or fortnightly pay. The result of the tax variation is to give you more money throughout the year to fund the property which is negatively geared. You should seek advice from your advisor to complete this form.

VACANT LAND

Prior to 1 July 2019, someone could potentially claim a deduction for interest and other holding costs relating to property if it was acquired with the intention of using it for future income producing purposes and certain conditions could be satisfied (e.g., continuing efforts are made towards producing income from the property). This often meant that clients who bought land with the intention of building a rental property on the land could claim deductions during the construction period.

From 1 July 2019, the new rules will generally prevent deductions from being claimed in a situation like this until a dwelling on the property can lawfully be occupied and it is either genuinely available for rent or is actually used to produce income.

These holding costs will generally be added to the cost base of the property asset for CGT purposes. This means that they can potentially reduce any capital gain made on disposal of the property in future. However, holding costs for CGT assets acquired before 21 August 1991 cannot be added to the cost base and these costs cannot increase or create a capital loss on sale of a property.

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WERRIBEE

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Phone: 03 9749 7333

RENTAL PROPERTY WORKSHEET

Complete details below and supply to your Tax Advisor to complete your income tax returns

NAME/S ON PROPERTY TITLE: ____

ADDRESS OF PROPERTY: ____

NUMBER OF WEEKS RENTED THIS FINANCIAL YEAR: ______________________________

DATE PROPERY FIRST EARNED INCOME: ______________________________________

INCOME	**$**
Rental Income	
Other Rental Income	
Total Gross Rent	
EXPENSES	
D - Advertising for Tenants	
E - Body Corporate Fees	
F - Borrowing Expenses	
G - Cleaning	
H - Council Rates	
I - Decline in Value - as per QS Report	
J - Gardening / Lawn mowing	
K - Insurance	
L - Interest on loans	
M - Land Tax	
N - Legal Expenses	
O - Pest Control	
P - Property Agents Fees	
Q - Repairs & Maintenance	
S - Stationery, Telephone, Postage	
U - Water charges	
V - Sundry rental expenses	
Total Expenses	
NET RENTAL INCOME OR LOSS	