INVESTMENT PROPERTY TAX PLANNING

CONTENTS

Disclaimer
Many of the comments in this publication are general in nature and anyone intending to apply the information to practical circumstances should seek professional advice to independently verify their interpretation and the information's applicability to their particular circumstances.

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February 2014

NEGATIVE GEARING - WHAT IS IT?

Negative gearing is all about losing money (at least in the beginning).

Why would anybody want to lose money - simple, to save tax!

How does it work?

Quite simply, something is negatively geared when the expenses paid (including interest) exceed the income earned.

This difference (or loss) is what can be claimed as a tax deduction.

Does this mean I get the entire "loss" back on my tax?

No - like any other tax deduction this loss is used to simply reduce your taxable income.

This means while you do get some back on your tax - this amount is restricted to your marginal rate of tax. For example, if you pay tax at the top marginal tax rate (i.e. your income is greater than $180,000 pa) then the most tax you can get back is 46.5% or $465 for every $1,000 lost.

Put another way if your rental property loses, say $3,000 pa, and you pay tax at the top marginal rate, after your tax saving the investment is still costing you $1,605 pa. If you pay tax at the average tax rate of 32.5% ($37,001 to $80,000) (plus Medicare) your cost is $1,980.

Why bother negatively gearing if it still costs you money?

There could be many reasons, however, there are two main reasons

1. While not justifiable on any real basis some people find simply saving money too hard - however, having the focus of paying off a debt tends to create a better savings incentive.

2. The main justification for losing money in relation to negative gearing is that the eventual sale price will result in a profit that will exceed the following: -

    - the total of all losses incurred over the period of ownership; and
    - the amount of capital gains tax paid in relation to the profit on the sale of the investment; and
    - an adequate return on your investment given the time held.

Is property the only investment that can be negatively geared?

Property is a very common investment to negatively gear. However, it is becoming increasingly popular to negative gear other forms of investment such as managed fund investments or shares.

What's the best thing to negatively gear?

Any assets that will provide a strong growth performance - remember to make the investment truly work your final profit must exceed all costs over the entire ownership of the investment.

Unfortunately, in many areas of Australia (with some notable exceptions e.g. Sydney Beach Suburbs) property growth has been very poor. Thus while achieving the first objective of saving some tax in the earlier years, the overall objective of making a profit may be difficult to achieve with property investments.

Also the negative gearing of property has become big business - with developers dedicating projects to the negative gearing market. Unfortunately, not all the projections of growth are being realised.

We have encountered a number of so-called negative gearing opportunities that are simply unrealistic in the property value projections. Not only are future growth prospects very limited in fact many are simply over-valued before the investment is commenced. Often these properties are located in the "glamour" parts of Australia (e.g. the Gold Coast or other so-called growth corridors) to entice unsuspecting investors.

Are there any risks?

Yes - you should always remember that the loss being made must be financed by your personal contributions.

Other issues should also be considered, for example:

- What if interest rates double?
- What if the rent stops coming?
- Is the rental guarantee amount realistic?
- Who underwrites the rental guarantee?
- What happens if the tenant damages your property?
- What happens if you lose your job?
- How do you access the capital in an emergency?
- What are the selling and exiting costs?
- Has the investment been structured to allow a partial sell down if needed?
- What happens if the share market crashes?

Let's do a simple example using property

We are assuming that your taxable income is $45,000 pa and you pay tax at the marginal tax rate of 34%. (including medicare)

General property assumptions:

INCOME		
Rent (say 52 weeks at $450 per week)		$23,400
EXPENSES		
Interest ($360,000 at 6% interest pa)	21,600	
Local Council & Water Rates	2,500	
Insurance	500	
Depreciation of Fittings *	2,000	
Building Write-Off Claim ($150,000 x 2.5%)	3,750	
Agents Fees ($23,400 x 8.0%)	1,872	
Other Expenses	1,000	33,222
LOSS FOR TAX PURPOSES		$9,822
The loss is funded as follows:		
The taxman (non-cash $5,750 + $3,340*)		9,090
From your pocket		732
		$9,822

* $9,822@34% = $3,340

' *These amounts are often somewhat over inflated by some promoters of investments and great care should be taken.*

OWNERSHIP OPTIONS

<u>Who should own the investment?</u>

A number of factors should be considered prior to determining who should own the investment. These include:

- The income levels of the persons involved
- The level of negative gearing
- The period the investment is anticipated to be held
- The potential capital gain on sale

Three different options are presented.

OPTION ONE- HELD BY THE HIGH INCOME INDIVIDUAL

<u>Advantages</u>

- Greater tax saving while negatively geared

<u>Disadvantages</u>

- Any future capital gains tax will be paid at a higher marginal tax rate
- As the property becomes positively geared (i.e. as the debt reduces) the income will be added to the higher income individual

OPTION TWO - HELD BY THE LOW INCOME INDIVIDUAL

<u>Advantages</u>

- Any future capital gains tax will be paid at a lower marginal tax rate
- As the property becomes positively geared the income will be added to the lower income individual

Disadvantages

- Much (if not all) of the initial advantages of negatively gearing may be wasted on the low income individual

OPTION THREE - JOINTLY OWNED

Simply, the advantages and disadvantages of Options One and Two are shared.

Often this option is considered the most appropriate for any long-term investment due to its more balanced nature.

Why not switch ownership?

Generally the costs of switching ownership far exceed the benefits derived by any switch. These costs include:

1. Stamp Duty on Transfer
2. Legal Costs on Transfer
3. Mortgage Re-documentation Costs
4. Exit Fees
5. Capital Gains Tax being prematurely triggered

JOINT TENANTS or TENANTS IN COMMON

When making an investment a number of ownership questions arise.

Should it be "joint tenants" or "tenants in common"?

Joint Tenants

If a property is owned as joint tenants the main features are:

- Each owner holds the property in equal shares (regardless of initial contribution etc)
- If one owner dies the property automatically passes to the surviving owner (regardless of any will).

This form of ownership is most often used for the family home

Tenants in Common

If a property is owned as tenants in common the main features are:

- The property may be held in any proportion (for example, one owner could own 99% and another owner could own 1 %)
- If one owner dies the property does not automatically pass to the surviving owner-the property is subject to the will of the deceased.

This form of ownership is most often used if the owners of the property are unrelated or for some reason it is not appropriate for the property ownership to be equal.

RENTAL PROPERTY DEDUCTIONS

What deductions can be claimed?

Expenses include:

Advertising for tenants
Bank Charges (excluding establishment fees)
Body Corporate Fees and Charges
Borrowing Expenses (generally only a pro-rata deduction is allowed)
Cleaning
Depreciation of Fixtures and Fittings
Gardening and lawn mowing
Insurance
Interest on Loans
Land Tax
Legal Expenses (excluding costs of purchase)
Pest Control
Property Agents Fees and Commissions
Repairs and Maintenance
Special Building Write-off
Stationery, telephone and postage
Travel Expenses
Water Charges
Sundry Rental Expenses

Some of these items require a little further explanation

Borrowing Expenses

Upon the establishment of a loan the financier will often charge some one-off fees to establish the loan. These expense are claimed on a pro-rata basis over the period of the loan or five years whichever the lesser. These expenses include:

- Establishment Fees
- Mortgage Documentation Fees
- Mortgage Stamp Duty

Depreciation

In recognition that the various fixtures and fittings within a rental property are depreciating in value and will ultimately require replacement, depreciation of these items is allowed.

Some of the more common items that are able to be depreciated include:

- Bedding
- Blinds, Venetians Carpets and Lino
- Curtains and drapes
- Electronic Security Systems
- Furniture (inc. freestanding wardrobes)
- Garbage Disposal Units
- Hot Water Systems
- Microwaves
- Rain Water Tanks
- Refrigerators
- Swimming Pool Pumps and Equipment
- Stoves
- Washing Machines

Some items are specifically not depreciable, including

- Built in cupboards and wardrobes
- Clothes Hoists
- Doors (including security doors)
- Electrical Wiring
- Fences and retaining walls
- Floor and wall tiles
- Garages and sheds
- Sinks and baths
- Wash basins and toilet bowls

Some of these non-depreciable items may qualify for the special building write-off

Interest

The mere fact that the bank holds the mortgage over an investment property does not necessarily mean the interest paid is tax deductible.

The key question to be answered to determine if the interest is deductible is - Why was the money borrowed?

Some typical examples include:

- The money was borrowed to buy an investment rental property (for immediate rental). - *Interest deductible*
- Some money was "re-drawn" from the loan to buy a car - *Interest on the re-drawn amount is not deductible*
- The family home is sold and rental property debt paid off and new loan is taken with a mortgage once again on the rental property to buy a new family home - *None of the interest is deductible*

Great care needs to be taken in relation to the use of split loan and re-draw facilities and we have devoted a specific section to this issue.

Legal Expenses

The legal expenses incurred to buy a rental property are not immediately deductible but are used to offset against any future capital gain.

Repairs

Great care needs to be taken when determining if a repair to a rental property is deductible or not.

A number of issues will cause "repairs" to be considered as non-tax deductible repairs, as follows:

Initial Repairs

If repairs are carried out immediately upon the acquisition of a property, they may be considered to form part of the initial cost of the building and not a separate deductible repair.

The concept is that if the repair was necessary at the time of buying the property, the need for the repair was not caused during the time of ownership of the property.

We recommend avoiding any major repairs to any property within at least the first 12 to 18 months of ownership.

Repairs that are Improvements

Any addition or improvement will generally not be considered to be a repair. A repair must
be the replacement of like with like.

Special Building Write-off

A special building write-off is simply the ability to depreciate the building itself.
However, this write-off is only available in relation to newer builders.

To claim a special building write-off two key pieces of information need to be obtained, as follows:

- The date the construction of the building commenced
- The original cost of construction

It is not appropriate to simply guess or estimate these items. If the information is not readily obtainable it may be necessary to engage the services of an appropriately qualified person to estimate these items e.g. a quantity surveyor.

Based upon the date of the construction of the building, the following claims are allowed for residential buildings: -

Up to 18 July 1985	no claim
19 July 1985 to 14 September 1987	4% of cost
15 September 1987 onwards	2.5% of cost

<u>Unfortunately, for any property acquired after 13 May 1997 the claiming of this special write-off will impact upon the ultimate amount of capital gains tax payable.</u>

THE RIGHT TYPE OF LOAN

What is the right type of loan?

That question is almost impossible to answer. However, you can be sure about two items:

1. Something new (but not always better) is always available
2. Try to focus on your purpose (negative gearing) and keep it simple

Some of the more common basic loan forms include:

Principal and Interest Loans

This is the traditional loan product where every repayment includes a portion of interest and a portion of the loan principal.

The interest portion being the greater in the earlier stages of the loan and then reduces to nil with the final repayment.

This form of loan is very suitable when no other non tax-deductible debts exist. The reason for this is the additional savings incentive it creates.

Interest Only Loans

This form of loan is structured so no principal payments are made at all.

Obviously, at some point in time it will become necessary to restructure this form of loan to repay the debt.

If a private debt still exists (e.g. a private home loan) it is clearly favourable to concentrate all savings efforts towards the non-deductible debt while making interest only repayments in relation to an investment loan.

Split or Linked Loans (Accruing Interest on Interest)

Quite popular for a short time - this form of loan extended the principal to maximise the amount of tax-deductible debt. The method applied meant all repayments are made to the non tax-deductible portion of the loan and no repayments are made to the tax-deductible portion of the loan and the interest was simply allowed to accrue.

The Taxation Office has examined this form of borrowing and will deny any deduction caused by the accrual interest.

This means that interest must at least be paid - back to interest only loans.

Loan Redraw Facilities (including the attachment of credit cards)

This form of loan has become very popular for all the wrong reasons. By providing the borrower with a simple method of accessing funds the banks are encouraging people to borrow more money.

However, what people forget is that every time the redraw facility (or credit card) is used for any purpose other than a deductible purpose (regardless of what is mortgaged) a proportion of the loan interest is denied from being an allowable deduction.

<u>What is the best option?</u>

Two loans!

<u>Loan One - Private Loan</u>

The first loan for non-deductible purposes (e.g. your home, your private car etc). Every effort should be made to repay this loan as quickly as possible (i.e. banking your salary against the loan).

A redraw facility attached to this loan should only ever be used for nondeductible purposes (e.g. a holiday).

<u>Loan Two - Deductible Loan</u>

The second loan should only be used to purchase income-producing investments (e.g. rental properties, extensions to the rental property, share acquisitions etc). While a private loan exists this loan should be structured as a simple interest only loan.

A redraw facility attached to this loan should only ever be used for tax-deductible purposes (e.g. buying a share portfolio).

BUYING OR SELLING A RENTAL PROPERTY

BUYING AN INVESTMENT PROPERTY

What should I include in the contract?

Please arrange for a simple clause to be inserted in the contract that nominates a value for all of the fixtures and fittings being purchased.

This amount can then easily be used for depreciation purposes.

Clients often tell us that their real-estate agent said this was unnecessary - however, we strongly recommend a clause be included so both parties are protected.

What happens if a value for fixtures and fittings is not determined?

Somebody has to guess (and the Taxation Office is very reluctant to accept guesses) the value of fixtures and fittings.

The only other alternative is to engage of a third party (e.g. a quantity surveyor) to professionally cost the fixtures and fittings. The cost of this service will vary but may estimated at between $500 and $700.

Is there any other information I should obtain?

We recommend obtaining, prior to signing the contract (while the seller is the most motivated), the cost of construction of the building and the date construction commenced.

Obtaining this information will also avoid the need to appoint a quantity surveyor.

SELLING AND INVESTMENT PROPERTY

What should I include in the contract?

Once again, we recommend a simple clause be inserted in the contract that nominates a value for all of the fixtures and fittings being sold. Prior to nominating any value we suggest that you seek our assistance in determining a value that will deliver the best taxation advantage.

CAPITAL GAINS TAX

Capital Gains Tax is payable on the sale of most assets purchased after 19 September 1985
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What happens if I signed the contract before 19 September 1985 but settlement did not occur until after?

The critical date is always the date the contract was signed or in some circumstances the date the contract went unconditional (e.g. when finance was approved)

What is a capital gain?

A capital gain accrues when the sale price realised for an asset (after selling costs e.g. agents commissions) is greater than the purchase cost (after adding purchase costs e.g. stamp duty)

For example, using a rental property:

Date Purchased say	1 December 1998
Date of Sale say	1 March 2010
Purchase Cost (after stamp duty, legals, etc) say	$150,000
Sale Price (after agents commissions etc) say	$350,000
Capital Gain	$200,000

Do I pay tax on the entire capital gain?

Before, calculating what rate of tax is payable, some adjustments might need to be made:

1. Either the capital gain can be reduced for the affects of inflation (frozen to 30 September 1999) or for individual taxpayers the gain can simply be reduced by one-half, whichever, the greater advantage. (Note: - neither reduction applies if the asset is sold within 12 months)

2. If any Special Building Write-Off has been claimed for properties acquired after 13 May 1997 the gain is increased by this amount.

Using the example above:

Capital Gain (from above)	$200,000
Reduced by :	
The 50% of the gain	(100,000)
Increased by Special Building Write-Off applicable as property was acquired after 13 May 1997	35,000
Taxable Capital Gain	$135,000

What rate of capital gains tax do I pay?

This capital gain is simply added to your taxable income and taxed at your marginal tax rate (averaging of capital gains has been removed).

Using the example above

Taxable Income (excluding any capital gains)	$60,000
Taxable Capital Gain	$135,000

As the entire amount of the capital gain is subject to various marginal tax rate - tax payable (plus Medicare) will be $61,297.00, whereas previously the tax payable would have been $11,047.00.

NEGATIVELY GEARING INVESTMENT PORTFOLIOS

Some additional features exist in relation to negative gearing an investment portfolio, including:

- Various security options (including other property or the portfolio itself with differing gearing ratios)
- If the borrowing is secured over the investment portfolio a margin call risk is created
- Small initial investment (say $10,000) and loan advance (say $20,000)
- Regular additional contributions possible to increase portfolio
- Increased flexibility to partially redeem the investment
- Management simplification
- Generally considered more flexible

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