RENTAL PROPERTIES

2000–01

TAXPACK REFERRED PUBLICATION

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How self-assessment affects most individuals

Self-assessment means the Australian Taxation Office (ATO) uses the information you give in your tax return to work out your refund or tax bill. You are required by law to make sure you have shown all your assessable income and claimed only the deductions and tax offsets to which you are entitled.

What are your responsibilities?

Even if someone else—including a tax agent—helps you to prepare your tax return, you are still legally responsible for the accuracy of the information.

What if you lodge an incorrect tax return?

Our computers continually check for missing or wrong information. We have audit programs designed to detect where taxpayers have not declared all of their assessable income or where they have incorrectly claimed deductions or tax offsets. If you become aware that your tax return is incorrect, you must contact us immediately.

Initiatives to complement self-assessment

There are a number of initiatives administered by the ATO which complement self-assessment. Examples include:

- a change in penalty provisions so that if you take reasonable care with your tax affairs, you will not receive a penalty for honest mistakes—but please note that interest on omitted income or overclaimed deductions and tax offsets could still be payable
- the process for applying for a private ruling
- your entitlement to interest on early payment or overpayment of a tax debt
- the process for applying for an amendment if you find you left something out of your tax return.

Do you need to ask for a private ruling?

If you have a concern about the way a tax law applies to your personal tax affairs, you may want to ask for a private ruling. A private ruling will relate just to your situation. Write to the ATO describing your situation in detail and ask for advice. Include your tax file number. If you lodge your tax return before you receive your private ruling, be aware that the ruling may alter the accuracy of your return.

You can ask for a review of a private ruling decision if you disagree with it, even if you have not received your assessment. The ATO can give you more information about review procedures.

Copies of publications

To get a copy of any publication referred to in this book:

- visit our Internet site at **www.ato.gov.au**
- ring our Publications Distribution Service on **1300 720 092** for the cost of a local call or
- visit an ATO office.

Publications referred to in this book include:

- *Guide to depreciation* (NAT 1996—6.2001)
- *Guide to capital gains tax* (NAT 4151—5.2001)
- *TaxPack 2001 supplement* (NAT 2677—6.2001)
- *Guide to PAYG for individuals* (NAT 3112—3.2000)
- *Guide to PAYG for business* (NAT 3111—3.2000)
- *Taxation Ruling TR 93/32—Income tax: rental property—division of net income or loss between co-owners*
- *Taxation Ruling TR 97/11—am I carrying on a business of primary production?*
- *Taxation Ruling TR 94/8—Income tax: whether business is carried on in partnership (including husband and wife partnerships)*
- *Taxation Ruling IT 2316—Income tax: distribution of partnership profits and losses*
- *Personal investors guide to capital gains tax* (NAT 4152—5.2001)
- *Taxation Ruling IT 2685—Income tax: depreciation*
- *Taxation Ruling TR 2000/18—Income tax: depreciation effective life*
- *Taxation Ruling TR 95/25— Income tax: deductions for interest under subsection 51(1) of the* Income Tax Assessment Act 1936 *following* FC of T v. Roberts; FC of T v. Smith
- *Taxation Ruling TR 98/22—Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities*
- *Taxation Ruling TR 93/7—Income tax: whether penalty interest payments are deductible*
- *Taxation Determination TD 1999/42—Income tax: do the principles set out in Taxation Ruling TR 98/22 apply to line of credit facilities?*
- *Taxation Ruling TR 2000/2—Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities*
- *Taxation Ruling IT 2167—rental properties—non-economic rental holiday home, share of residence, etc. cases, family trust cases*
- *Taxation Ruling 97/23—Income tax: deductions for repairs*
- *TaxPack 2001* (NAT 0976—6.2001)
- *Taxation Ruling TR 97/25—property development: deduction for capital expenditure on construction of income producing capital works, including buildings and structural improvements.*

Rental properties 2000–01

Australian Taxation Office
Canberra

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About this publication

This publication is available free from the Australian Taxation Office (ATO). The ATO prohibits any party from selling it. We regularly revise our publications to take account of changes to the law.

If you have an enquiry relating to your circumstances which this publication does not cover, ring the Personal Tax Infoline on **13 2861** or get help from a tax adviser.

As part of our commitment to produce accurate publications, taxpayers will not be subject to penalties if they can demonstrate that they based a tax claim on wrong information supplied by the ATO.

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Rental income

Rental and other rental related income is the full amount of rent and associated payments that you receive, or become entitled to, when you rent out your property. You must include the full amount you earn—gross rent—in your tax return. Gross rent means the total amount paid by the tenant, either to you or to your agent.

Associated payments may also be in the form of goods and services. You will need to work out the monetary value of these.

Rental related income

You must include rental bond money as income if you become entitled to retain it—for example, where you derived it because a tenant defaulted on the rent, or because of damage to the property requiring repairs.

If you derived an insurance payout there may be situations where the payout needs to be included as income—for example, if you received an insurance payment to compensate you for lost rent. If you derive a letting fee you need to include this as part of your rental income.

Associated payments include all amounts which you receive, or become entitled to, as part of the normal, and repetitive and recurrent activities through which you intend to generate profit from the use of your rental property.

If you receive a reimbursement or recoupment for deductible expenditure you have incurred, you must include that amount as income—for example, if a tenant pays you an amount to cover the cost of repairing damage to some part of your rental property and you are entitled to a deduction for the repairs.

You can claim a deduction for some of the rental expenses you incur for the period your property is rented out or available for rent. For more information, read the section **Rental expenses** on page 3.

You must include assessable amounts relating to hire purchase and limited recourse debt arrangements in your rental income. For more information, read the section **Capital works deduction (special building write-off)** on page 9 and see the publication *Guide to depreciation*. To find out how to get this publication, see the inside front cover.

Multiple interests in property

Where there are multiple interests in an investment property the extent of each interest is determined differently, depending on whether or not the rental property activities constitute a partnership carrying on a rental property business.

Co-owners of an investment property

A co-owner of an investment property is regarded as an investor who is not carrying on a rental property business, either alone or in conjunction with the other co-owners. This is because of the limited scope of the rental property activities, and the limited degree to which a co-owner actively participates in rental property activities.

Joint tenants must divide the income and expenses in accordance with their legal interest in the property. With joint tenancy, each joint tenant holds an equal interest in the property. A partnership agreement, either oral or in writing, cannot change this.

Example

Joint tenants

Mr and Mrs Johnson are joint tenants in an investment rental property. Their activity is insufficient for them to be characterised as carrying on a rental property business. In the relevant year, Mrs Johnson telephones the ATO and asks if she can claim 80 per cent of the rental loss. Mrs Johnson says she is earning $67 000 a year, and Mr Johnson is earning $31 000. Therefore, it would be better if she claimed most of the rental loss, as she would save more tax. Mrs Johnson thought it was fair that she claimed a bigger loss because most of the expenses were paid out of her wages. Under a partnership agreement drawn up by the Johnsons, Mrs Johnson is supposed to claim 80 per cent of any rental loss.

Mrs Johnson was told that where 2 people are joint tenants in a rental property, the net rental loss must be shared in accordance with their legal interest in the property. Therefore, the Johnsons must each include half of the total income and expenses in their tax returns.

Any agreement that the Johnsons might draw up to divide the income and expenses in proportions other than equal shares has no effect for income tax purposes. Therefore, even if Mrs Johnson paid most of the bills associated with the rental property, she would not be able to claim more of the rental property deductions than Mr Johnson.

Tenants in common must also divide the income and expenses in accordance with their legal interest in the property. However, with a tenancy in common, the tenants in common may hold different proportionate interests in the property. A partnership agreement, either oral or in writing, cannot change this.

Example

Tenants in common

In the example above, if the Johnsons held their property interest as tenants in common in equal shares, Mrs Johnson

would still be able to claim only 50 per cent of the total property deductions.

However, if Mrs Johnson's legal interest was 75 per cent and Mr Johnson's legal interest was 25 per cent, Mrs Johnson would be required to include 75 per cent of the income and expenses on her tax return and Mr Johnson would be required to include 25 per cent of the income and expenses on his tax return.

If you don't know whether you hold your legal interest as a joint tenant or a tenant in common, read the title deed for the rental property.

Example

Multiple property owners who are not partners at general law

The Tobins own, as joint tenants, 2 units and a house from which they derive rental income. The Tobins occasionally inspect the properties and also interview prospective tenants. Mr Tobin performs most repairs and maintenance on the properties himself, although he generally relies on the tenants to let him know what is required. The Tobins do any cleaning or maintenance that is required when tenants move out. Arrangements have been made with the tenants for the weekly rent to be paid into an account at their local bank. Although the Tobins devote some of their time to rental income activities, their main sources of income are their respective full-time jobs.

The Tobins are not partners at general law—they are only co-owners of several rental properties. Therefore, they must each include half of the total income and expenses on their tax returns—that is, in accordance with their legal interest in the properties.

For more information, read the following section, **Partners at general law**.

Partners at general law

Where you have a partnership at general law that is carrying on a rental property business, you should divide the net rental income or loss in accordance with the terms of the partnership agreement. This is so whether or not the legal interests in the rental properties are different to the partners' entitlements to profits and losses under the partnership agreement.

Example

Partners at general law

The Johnsons' neighbours, the D'Souzas, own a number of rental properties, either as joint tenants or equal tenants in common. They own 4 houses and 3 apartment blocks—each block comprising 6 residential units—a total of 22 properties.

Although the D'Souzas use the services of estate agents, they actively participate in the management of their properties. They devote a significant amount of time to these activities, have regular contact with the agents, accompany the agents on property inspections from time to time, and personally attend to financial planning and decision making.

The D'Souzas are carrying on a rental property business. This is demonstrated by:

- the significant size and scale of the rental property activities
- the business-like manner in which the activities are planned, organised and carried on, and
- the D'Souzas' extensive involvement in the activities.

Mr and Mrs D'Souza have a written partnership agreement in which they agreed to carry on a rental property business. They have agreed that Mrs D'Souza is entitled to a 75 per cent share of the partnership profits or losses and Mr D'Souza is entitled to a 25 per cent share of the partnership profits or losses.

The D'Souzas are partners at general law. This means that the net profit or loss generated from their rental business is divided between them in proportions of 75 per cent and 25 per cent, even though the legal interests in the rental properties are held equally—that is, 50 per cent each.

For more information about dividing net rental income or losses between co-owners, see *Taxation Ruling TR 93/32—Income tax: rental property—division of net income or loss between co-owners*.

For more information about whether a business is being carried on, whether it is being carried on in partnership, and the distribution of partnership profits and losses, see:

- *Taxation Ruling TR 97/11—Income tax: am I carrying on a business of primary production?*
- *Taxation Ruling TR 94/8—Income tax: whether a business is carried on in partnership (including husband and wife partnerships)* and
- *Taxation Ruling IT 2316—Income tax: distribution of partnership profits and losses.*

Paragraph 13 of TR 97/11 lists 8 indicators to determine whether a business is being carried on. Although this ruling refers to the business of primary production, these indicators apply equally to activities of a non-primary production nature.

If you are unsure of whether:

- your rental property activities amount to a partnership at general law
- you are carrying on a rental property business or
- you are in both categories

contact your professional adviser or the ATO.

Capital gains tax

If you acquired your rental property, or plant used in relation to your rental property, after 19 September 1985, capital gains tax may apply when you dispose of the property and the plant.

The law relating to the treatment of capital gains tax was amended with effect from 11.45 a.m. Australian Eastern Standard Time (AEST) on 21 September 1999. The amendments and proposed amendments alter the way in which capital gains and losses are, or will be, treated for taxation purposes.

For more information, see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside front cover.

Negative gearing

A rental property is negatively geared when it is purchased with the assistance of borrowed funds, and the net rental income, after deducting other expenses, is less than the interest on borrowings.

The overall taxation result of a negatively geared property is that a net rental loss arises. In this case, you may be able to claim a deduction for the full amount of rental expenses against your rental and other income—such as salary, wages or business income—when you complete your tax return for the relevant income year.

Property not located in Australia

If your property is located outside Australia, special rules apply to the deductibility of your rental property expenses. Question 19 in *TaxPack 2001 supplement* contains further information on foreign source income. If you are unsure of your obligations, contact your professional adviser or the ATO.

Pay As You Go (PAYG) instalments

If you make a profit from renting your property, you will need to know about the PAYG instalments system.

The PAYG instalments system operates from 1 July 2000 and replaces the former provisional tax system. This system requires you to pay instalments during each income year to meet your expected tax liability for that year. You will generally be required to pay PAYG instalments if you earn more than $999 of business or investment income—such as rental income.

The amount of your instalments will generally be worked out by applying an instalment rate, which the ATO will give you, to your business and investment income for the previous financial year.

You will usually be required to pay PAYG instalments shortly after the end of each quarter of the financial year. However, you may be able to pay annually if your notional tax is less than $8000. Your notional tax is generally the equivalent of the tax you would have paid on your business and investment income, excluding any capital gain, based on your last income tax assessment.

If you have previously paid provisional tax, the ATO should have sent you information concerning your rights and obligations under the PAYG system, including information explaining how you can choose to pay your PAYG instalments—annually or as a set amount—and when you must make that choice.

For further information, see the publications *Guide to PAYG for individuals with investment income* or *Guide to PAYG for business*. To find out how to get these publications, see the inside front cover.

Rental expenses

You can claim a deduction for some of the expenses you incur for the period your property is rented or is available for rent. However, you cannot claim expenses of a capital or private nature.

When you claim a deduction for expenses incurred in gaining your gross assessable rental income, there may be situations where the expenses need to be apportioned between deductible and non-deductible expenses. Examples include:

- If the property is not available for rent for the full year, you may need to apportion some of the expenses on a time basis.
- If only part of the property is used to earn rent, you can claim only that part of the expenses that relates to the rental income. As a general guide, apportionment should be made on a floor area basis—that is, by reference to the floor area of that part of the residence solely occupied by the tenant, together with a reasonable figure for tenant access to the general living areas, including garage and outdoor areas.
- If you combine travel to inspect or maintain your rental property with travel for private purposes, you may need to apportion your travel expenses.

Expenses that you may be able to claim include:

- advertising for tenants
- bank charges
- body corporate fees
- cleaning
- council rates
- electricity and gas
- gardening and lawn mowing
- in-house audio/video service charges
- insurance:
  - building
  - contents
  - public liability
- interest on loans
- land tax
- legal expenses
- lease costs:
  - preparation
  - registration
  - stamping
- pest control
- property agent's fees and commission
- quantity surveyor's fees
- repairs and maintenance
- secretarial and bookkeeping fees

- security patrol fees
- servicing costs—such as servicing a water heater
- stationery and postage
- telephone calls and rental
- tax-related expenses
- travel and car expenses:
  – rent collection
  – inspection of property
  – maintenance of property
- water charges.

You can claim a deduction for these expenses only if you have actually incurred the expenditure. Some of these deductions are examined in more detail on the following pages.

Borrowing expenses, depreciation on plant and capital works deductions (special building write-off deductions) may be allowable as deductions over a number of income years.

Expenses that you are not able to claim include:

- stamp duty on conveyance of a rental property
- expenses not actually incurred by you such as water or electricity charges borne by your tenants
- expenses that are not related to rental of a property, such as expenses connected to your own usage of a holiday home that you rent out for part of the year.

Acquisition and disposal costs

You cannot claim a deduction for the costs of acquiring or disposing of your rental property. Examples of expenses of this kind include the purchase cost of the property, conveyancing costs and advertising expenses. However, if you acquired the property after 19 September 1985, these costs may form part of the cost base of the property for capital gains tax purposes. See also **Capital gains tax** on page 2.

Example

Acquisition costs

The Johnsons purchased a rental property for $170 000 in July 2000. They also paid surveyor's fees of $350 and stamp duty of $750 on the transfer of the property. None of these expenses is deductible against the Johnsons' rental income. However, in addition to the $170 000 purchase price, the incidental costs of $350 and $750, totalling $1100, will be included in the cost base of the property.

This means that when the Johnsons dispose of the property, the cost base of $171 100 ($170 000 + $1100) will be taken into account in determining the amount of any capital gain.

For more information, see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside front cover.

Body corporate fees and charges

You may be able to claim a deduction for body corporate fees and charges that you incur for your rental property.

Body corporate fees and charges may be incurred to cover the cost of day-to-day administration or they may be applied to a special purpose sinking fund.

If the fees and charges you incur include a contribution to a special purpose sinking fund you will only be entitled to claim a deduction for that portion of the fees and charges that relate to the cost of day-to-day administration. This is because payments to a special purpose sinking fund are considered to be capital, or of a capital nature, and are not an allowable deduction.

If the body corporate fees and charges that you incur are for things like the maintenance of gardens, incidental repairs and building insurance, you cannot also claim for these expenses as part of other outgoings. For example, you cannot claim for garden maintenance as an expense separate from the total body corporate fees and charges if that expenditure is already included in those fees and charges.

Borrowing expenses

These are expenses directly incurred in taking out a loan for the property. They include establishment fees, valuation fees, title search fees and costs for preparing and filing mortgage documents. Interest expenses do not qualify as borrowing expenses.

If the total cost of these items is over $100, the deduction is spread over 5 years or the term of the loan, whichever is the lesser. If the total cost is $100 or less, it is fully deductible in the first year.

If you repay the loan early, and in less than 5 years, you can claim a deduction for the balance of the borrowing expenses, in the year of repayment.

If you obtained the loan part way through the income year, the deduction for the first year will be apportioned according to the number of days in the year that you had the loan.

Example

Borrowing expenses

In order to secure a 20-year loan of $209 000 to purchase a rental property for $170 000 and a private motor vehicle for $39 000, the Johnsons paid a total of $1670 in establishment fees, valuation fees and stamp duty on the loan. As the Johnsons' borrowing expenses are more than $100, they must be apportioned over 5 years, or the period of the loan, whichever is the lesser. Also, because the loan was to be used for both income producing and non-income producing purposes, only the income producing portion of the borrowing expenses is deductible. As they obtained the loan on 17 July 2000, the borrowing expense deduction for the first year would be worked out as follows:

$$\text{Borrowing expenses} \times \frac{\text{rental property loan}}{\text{total borrowings}} \times \frac{\text{number of relevant days in year}}{\text{number of days in 5 years}}$$

Year 1

$$\$1670 \times \frac{\$170\,000}{\$209\,000} \times \frac{349 \text{ days}}{1826 \text{ days}} = \$260$$

Depreciation

There have been many changes to the way in which depreciation can now be claimed as a tax deduction—for example, accelerated rates of depreciation have been replaced with rates based solely on effective life, the practice of allowing deductions on a replacement basis for certain items such as crockery, bedding and linen, no longer applies and the concept of a low-value pool being treated as a separate item of plant has been introduced. All these changes are fully explained in the publication *Guide to depreciation*. To find out how to get this publication, see the inside front cover.

The following is a summary of the more important depreciation provisions as they relate to claims for depreciation in respect of items of plant used to produce rental income.

How are depreciation deductions calculated?

For all plant acquired after 21 September 1999 the depreciation deduction is determined solely by reference to effective life as determined by the taxpayer or by the Commissioner. Accelerated rates of depreciation no longer apply except for certain small business taxpayers.

There are two methods of calculating depreciation:

- the diminishing value method and
- the prime cost method.

Under the diminishing value method the deduction is calculated as a percentage of the balance you have left to deduct. The formula for calculating depreciation using the diminishing value method is:

$$\text{Opening undeducted cost} \times \frac{\text{days owned}}{365} \times \frac{150\%}{\text{plant's effective life (in years)}}$$

Under the prime cost method the deduction for each year is calculated as a percentage of the cost. The formula for determining the amount of depreciation deduction under the prime cost method is:

$$\text{Cost} \times \frac{\text{days owned}}{365} \times \frac{100\%}{\text{plant's effective life (in years)}}$$

If you use a depreciable item of plant for more than one purpose—for example, you may use the same lawn mower at both your rental property and your private residence, you are allowed only a partial depreciation deduction, based on the percentage it was used at your rental property.

Effective life

You can either make your own estimate of the effective life of the plant or adopt the effective life determined by the Commissioner. The matters you need to take into account if you decide to make your own estimate of effective life are explained in the *Guide to depreciation*.

The effective life for an item of plant as determined by the Commissioner is found in *Taxation Ruling IT 2685—depreciation* and *Taxation Ruling TR 2000/18—Income tax: depreciation effective life*. IT 2685 was issued on 11 June 1992 and remained in force until it was replaced by TR 2000/18 which came into force on 1 January 2001. If you decide to use the effective life determined by the Commissioner you generally use the effective life contained in the particular taxation ruling that was in force at the time you entered into a contract to acquire the plant. To find out how to get these publications, see the inside front cover.

Extracts from Taxation Ruling IT 2685 and Taxation Ruling TR 2000/18 showing changes in the effective lives of some commonly used items in rental properties

Item	*Effective life in years given in*	
	IT 2685	*TR 2000/18*
Blind, venetian	20	20
Carpets	10	10
Curtains and drapes	7	$6\,^2/_3$
Electric bed	15	$13\,^1/_3$
Electric clock	15	$13\,^1/_3$
Electric heater	10	10
Furniture and fittings	15	$13\,^1/_3$
Garbage unit, compacting	7	$6\,^2/_3$
Hot water service	20	20
Lawn mowers—motor	7	$6\,^2/_3$
Lawn mowers—self-propelled	5	5
Linoleum and similar floor covering	10	10
Microwave ovens	7	$6\,^2/_3$
Radios	10	10
Refrigerators	15	$13\,^1/_3$
Stoves	20	20
Television sets	10	10
Vacuum cleaners	10	10
Washing machines	7	$6\,^2/_3$

Some items found in a rental property are regarded as part of the setting for the rent producing activity and do not qualify as separate items of depreciable items of plant in their own right. However, a deduction may be allowed for some of these items under the **Capital works deduction—special building write-off provisions**, see page 9. Examples of such items are:

- built-in kitchen cupboards
- clothes hoists
- door and window fittings
- driveways and paths
- electrical wiring
- fencing and retaining walls
- floor and wall tiles
- garages and non-portable sheds

- in-ground swimming pools, saunas and spas
- plumbing and gas fittings
- reticulation piping
- roller door shutters
- roof top ventilators and skylights
- security doors and screens which are permanently fixed to the the building
- sinks, tubs and baths, and
- wash basins and toilet bowls.

Replacements

It has been the longstanding practice to treat the initial purchase of certain assets as not depreciable but to allow claims for an immediate deduction for the cost of their replacement. The practice principally related to low cost items that had very long or indeterminate lives, were difficult to keep track of, and were subject to frequent replacement through loss or breakage—for example, crockery, bedding, linen.

With the introduction, as from 1 July 2000, of low-value pooling and the Government's intention to reinstate the $300 write-off for depreciating assets used by taxpayers predominantly in deriving non-business income (that is, includes rental income), the replacement basis for deductions is no longer available for assets you first use (or have installed ready for use) for the purpose of producing assessable income after 30 June 2000.

Low-value pooling

From 1 July 2000, an optional low-value pooling arrangement for plant has been introduced. It will apply to:

- low-cost plant—individual items of plant you acquired on or after 1 July 2000 that cost less than $1000 and
- low undeducted-cost plant—items of plant you held in the previous year of income that you have already (or could have) depreciated using the diminishing value method to an undeducted cost of less than $1000.

The low-value pool is depreciated using the diminishing value method. Items of plant in the pool have an effective life of 4 years. The pool is depreciated using the following 2 statutory rates:

- for low-cost plant that has been allocated to the pool for the first time in that income year—18.75 per cent of the total cost of that plant allocated, regardless of when during that year the item was actually acquired. This eliminates the need to calculate a pro-rata depreciation deduction for each item of plant, based on the actual date it was pooled, and
- for all other plant in the pool (that is, plant that has been allocated to the pool in a previous year and low undeducted-cost plant allocated to the pool in the year of income)—37.5 per cent of the sum of:
  - the pool closing balance from the previous year, and
  - the total undeducted cost of any low undeducted-cost plant allocated to the pool in the year of income.

Once you choose to create a low-value pool and an item of low-cost plant is allocated to the pool, all other low-cost plant acquired in that year and later years must be allocated to the low-value pool.

For further information about low-value pooling, including the treatment of plant used only partly for income producing activities and the treatment on disposal of plant from a low-value pool, refer to the *Guide to depreciation*.

Immediate deduction for plant costing $300 or less

The situation at the time of publication of this booklet is that for all taxpayers other than small business taxpayers, the immediate deduction for plant costing $300 or less has been repealed and replaced with the option to depreciate plant through a low-value pool (discussed above).

However, the Exposure Draft of the New Business Tax System, (Capital Allowances) Bill 2000 contains a proposal to reinstate the immediate write-off for plant costing $300 or less for certain taxpayers who use the plant predominantly to produce assessable income that is not derived from carrying on a business (that is, rental income) in the 2001 income year. Additional information about this proposal is contained in the *Guide to depreciation*.

What happens if you no longer own an item of plant

You may need to calculate a balancing adjustment where you have disposed of an item of plant or it is lost or destroyed. When making your calculation you must compare the termination value on disposal, loss or destruction, with the undeducted-cost of the asset and its written down value. If the termination value on disposal, loss or destruction is more than the written down value, the difference is generally included in your assessable income.

Refer to the *Guide to depreciation* for further information about balancing adjustments.

Purchase and valuation of second-hand items

If you purchase a second-hand item of plant you can generally claim a depreciation deduction based on the cost of the item to you.

Where you purchase a rental property, the most effective means of establishing your cost of plant is to have the separate value of depreciable items, calculated on an arm's length basis, specified in the sale agreement. If separate values for depreciable items of plant

are not included in the sale agreement for your rental property when you purchase it, then you may be required to demonstrate the basis of your valuation of the depreciable items.

Generally, independent valuations that establish reasonable values for depreciable items of plant satisfy ATO requirements. In the absence of an independent valuation, you may need to demonstrate that your estimate provided a reasonable value. Considerations would include the market value of the plant itself compared to the total purchase price of the property.

Worksheets for calculating depreciation and low-value pools are contained in the publication *Guide to depreciation*. To find out how to get this publication, see the inside front cover.

Example

In this example, the Johnsons bought the property part way through the year—on 20 July 2000. The opening undeducted costs are taken to be equal to the contract puchase prices that the Johnsons paid for the items at the time the property was acquired. They are entitled to a depreciation deduction for 346 days out of the 365 in the 2000–01 income year. The depreciation deduction for each item is calculated using the diminishing value method as show below:

Description	*Original cost*	*Opening undeducted cost*	*Part-year claim*	*150% divided by effective life (yrs) from* Guide to depreciation	*Depreciation deduction*	*Closing undeducted cost*
Furniture	$2000	$2000	346/365	150%/15	$190	$1810
Carpets	$1200	$1200	346/365	150%/10	$171	$1029
Curtains	$1000	$1000	346/365	150%/7	$203	$797*
Totals	*$4200*	*$4200*			*$564*	*$3636*

*Note: As the closing undeducted cost of the curtains is $1000 or less, the Johnsons may choose to transfer this plant to the low-value pool for the year ended 30 June 2002.

Example

In this example, the Johnsons allocated various items of plant into a low-value pool. The low-value pool comprised plant that had an undeducted cost of less than $1000 (because of previous depreciation claims using the diminishing value method) and some new plant that they had purchased during the year.

Plant held before 1 July 2000	*Undeducted cost at 30 June 2000*	*Pooled depreciation rate*	*Depreciation deduction*
Hot water system	$486		
Refrigerator	$389		
Stove	$518		
Washing machine	$286		
Totals	*$1 679*	*37.5%*	*$630*
Plant purchased 1 July 2000–30 June 2001	*Purchase price*		
Television set (11/11/2000)	$747		
Gas heater (28/2/2001)	$303		
Totals	*$1 050*	*18.75%*	*$197*
Total depreciation for year ended 30 June 2001			**$827**

Value of pool at 30 June 2001:

1679 – 630	=	$1049
1050 – 197	=	$853
	=	*$1902*

Interest

If you take out a loan to purchase a rental property, you will generally be entitled to claim the interest on that loan, or a portion of the interest, as a deduction. However, the property must be rented, or available for rental, in the income year for which you claim a deduction.

You may also claim interest on loans taken out to purchase items of plant, for renovations, or for repairs to the property occasioned by your use of the property to produce assessable rental income.

Banks and other lending institutions offer a range of financial products which can be used to acquire a rental property. Many of these products permit flexible repayment and redraw facilities. As a consequence, a loan might be obtained to purchase both a rental property and a private car. In cases of this type, the interest on the loan must be divided into deductible and non-deductible components according to the amounts borrowed for the rental property and for private purposes. A simple example of the necessary calculation is shown in the example ***Apportionment of interest*** on this page.

If you have a loan account that has a fluctuating balance, due to a variety of deposits and withdrawals and it is used for both private purposes and for rental property purposes, you must keep accurate records to enable you to calculate the interest applicable to the rental property portion of the loan; that is, you must separate that interest which relates to the rental property from any interest applicable to private use of the funds. An example of this type of arrangement is a line of credit where your salary is paid into the mortgage account.

If you have difficulty calculating your entitlement to a deduction for interest, contact your professional adviser or the ATO.

If you restructure your rental property borrowing arrangements, and you incur a charge for a penalty interest payment—that is, interest that would otherwise have accrued on those borrowings—you may be able to claim a deduction for the amount of that charge. Such a situation could arise where you renegotiate a loan agreement that has a fixed interest rate to provide for a variable interest rate, and you are required to pay an amount which represents interest that the lender would have otherwise charged under the terms of the original borrowing arrangement.

If a loan is taken out to purchase an income-producing property and the property ceases to be used for income-producing purposes, you are not entitled to claim for any ongoing interest expenses you incur after that time.

Some rental property owners borrow money to buy a new residence and then rent out their previous residence. If there is an outstanding loan on the old residence and that property is used for income-producing purposes, the interest outstanding on the loan, or part of the interest, will generally be deductible. However, an interest deduction cannot be claimed on the loan used to buy the new residence because it is not income producing. This is so whether or not the loan for the new residence is secured against the former residence.

Example

Apportionment of interest

The Johnsons decide to use their bank's 'Mortgage breaker' account to take out a loan of $209 000 from which $170 000 is to be paid for a rental property and $39 000 is to be used to purchase a private car. The bank officer advises them that they will need to work out each year how much of their interest payments is tax deductible. The officer gives them the following whole year example based on a loan interest rate of 6.75 per cent per annum, and assuming that the property is rented from 1 July.

Interest for year 1 = $209 000 X 6.75% = $14 108

Apportionment of interest payment related to rental property:

$$\text{Total interest expense} \times \frac{\text{rental property loan}}{\text{total borrowings}} = \text{deductible interest}$$

$$\$14\,108 \times \frac{\$170\,000}{\$209\,000} = \$11\,475$$

For more information about the deductibility of interest, see the following taxation rulings and determination:

- *TR 95/25—Income tax: deductions for interest under subsection 51(1) of the* Income Tax Assessment Act 1936 *following* FC of T v. Roberts, FC of T v. Smith
- *TR 98/22—Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities*
- *TR 93/7—Income tax: whether penalty interest payments are deductible*
- *TD 1999/42—Income tax: do the principles set out in TR 98/22 apply to line of credit facilities?*
- *TR 2000/2—Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities.*

To find out how to get these rulings, see the inside front cover. If you need help to calculate your interest deduction, contact your professional adviser or the ATO.

Legal expenses

Some legal expenses incurred in gaining or producing your assessable rental income are deductible—such as the cost of evicting a non-paying tenant.

Most legal expenses, however, are of a capital nature and are therefore not deductible. These include:

- purchase or disposal of your property
- costs of resisting land resumption
- defending your title to the property.

Non-deductible legal expenses may, however, form part of the cost base of your property for capital gains tax purposes. For more information see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside front cover. See also **Capital gains tax** on page 2.

Example

Legal expenses

In May 2001, the Johnsons' tenants moved out owing 4 weeks rent. The Johnsons retained the bond money and took the tenants to court to terminate the lease and recover the balance of the rent. The legal expenses incurred for this are fully deductible. The Johnsons were seeking to recover assessable rental income, and they wished to continue earning income from the property. The Johnsons must include the retained bond money and the recovered rent in their assessable income in the year of receipt.

Repairs

Expenditure for repairs you make to the property may be an allowable deduction. However, the repairs must relate directly to wear and tear or other damage that occurred as a result of your renting out the property.

Repairs generally involve a replacement or renewal of a worn out or broken part—for example, replacing some guttering damaged in a storm or part of a fence that was damaged by a fallen tree branch.

However, replacement of an entire structure or unit of property, such as a complete fence or building, is not a repair. Expenses of this type are of a capital nature and are not deductible.

Expenditure you incur on initial repairs—for example, in remedying defects, damage or deterioration that existed at the date of acquisition of a property—is capital expenditure and not deductible. However, the expenditure may form part of the cost base of the property if you incur it to enhance the value of the rental property and it is reflected in its state or nature when you later dispose of the property.

Example

Repairs prior to renting out the property

The Johnsons needed to do some repairs to their newly acquired rental property before the first tenants moved in. They paid an interior decorator to re-paint dirty walls, replace broken light fittings and repair 2 bedroom doors. They also discovered white ants in some of the floor boards. This required white ant treatment and replacement of some of the boards.

These expenses were incurred to make the property suitable for rental and did not arise from the Johnsons' use of the property to generate assessable rental income. The expenses are considered to be capital in nature. Therefore, the Johnsons are not able to claim a deduction for these expenses.

Repairs to a rental property will generally be deductible where:

- the property continues to be rented on an ongoing basis
- the property remains available for rental but there is a short period when the property is unoccupied—for example, where unseasonable weather causes cancellations of bookings or advertising is unsuccessful in attracting tenants.

If you no longer rent the property, the cost of repairs may still be deductible provided:

- the need for the repairs is related to the period in which the property was used by you for income production and
- the property was income producing during the income year in which you incurred the cost of repairs.

Example

Repairs when the property is no longer rented out

After the last tenants moved out in May 2001, the Johnsons discovered that the stove didn't work, kitchen tiles were cracked, and the toilet window was broken. They also discovered a hole in a bedroom wall that had been covered with a poster. In June 2001 the Johnsons paid for this damage to be repaired so they could sell the property.

As the tenants were no longer in the property, the Johnsons were not using the property to produce assessable income. However, they could still claim a deduction for repairs to the property because the repairs related to the period when their tenants were living in the property. The repairs were also completed before the end of the income year in which the property ceased to be income producing.

Improvements, extensions and alterations are capital in nature and are not considered to be repairs. You cannot claim for expenses of this nature. However, the expenditure may be taken into account for special building write-off purposes. For more information, read the section **Capital works deduction (special building write-off)** below.

Expenses considered to be for repairs which you can claim as deductions include:

- replacing broken windows
- maintaining plumbing
- repairing electrical appliances.

Expenses considered to be for improvements which you cannot claim as deductions include:

- landscaping
- insulating the house
- adding on another room.

Although you may not be able to claim a deduction for expenditure as a repair, or as part of a capital works deduction (special building write-off deduction), the expenditure may form part of the cost base of the rental property for capital gains tax purposes. For more information, see the publication *Guide to capital gains tax* and *Taxation Ruling TR 97/23—Income tax: deductions for repairs*. To find out how to get these publications, see the inside front cover. See also **Capital gains tax** on page 2.

Capitals works deduction (special building write-off)

You can deduct certain kinds of construction expenditure. In the case of residential rental properties, the deductions would generally be spread over a period of 25 or 40 years. These are referred

to as capital works deductions (special building write-off deductions). The deduction is limited to 100 per cent of the construction expenditure.

Deductions based on construction expenditure apply to capital works such as a building or an extension—for example, adding a room or garage; alterations—such as removing or adding an internal wall; or improvement to a building—for example, erecting a pergola, patio or carport. Deductions are allowable only for the period the property is rented or is available for rent.

Where you are entitled to capital works deductions (special building write-off deductions), the construction expenditure on which those deductions are based cannot be taken into account in working out any other types of deductions to be claimed, such as depreciation.

Amount of deduction

The following rules apply for residential rental properties:

- If construction of the building started before 18 July 1985, you cannot claim a capital works deduction (special building write-off).
- If construction of the building started between 18 July 1985 and 15 September 1987, the annual capital works deduction (special building write-off) allowable is 4 per cent of the construction expenditure.
- If construction of the building started after 15 September 1987, the annual capital works deduction (special building write-off) allowable is 2.5 per cent of the construction expenditure.

The deduction can be claimed for 25 years from the date construction was completed in the case of a 4 per cent deduction, and 40 years from the date construction was completed in the case of a 2.5 per cent deduction.

Deductions may also be allowable for structural improvements undertaken after 26 February 1992. Examples of structural improvements include sealed driveways, retaining walls and fences.

Eligible construction expenditure

Construction expenditure is the actual cost of constructing the building or extension. A deduction is allowed for all expenditure incurred in the construction of a building where you are an owner-builder or you contract a builder to construct the building on your land. This includes the component of your payments that represents the profit made by individual tradespeople, builders and architects.

However, if you purchase your property from a speculative builder, the component of your payment that represents the builder's profit margin is not allowable as a capital works deduction (special building write-off).

Changes in building ownership

Where ownership of the building changes, the right to claim any undeducted construction expenditure for capital works (special building write-off) passes to the new owner. A new owner should confirm that the building was constructed during one of the appropriate periods outlined above, and to be eligible for the deduction, must continue to use the building for income-producing purposes.

Estimating construction costs

Where a new owner is unable to determine precisely the construction expenditure associated with a building, an estimate provided by an appropriately qualified person may be used. Appropriately qualified people include:

- a clerk of works, such as a project organiser for major building projects
- a supervising architect who approves payments at stages of projects
- a builder who is experienced in estimating construction costs of similar building projects
- a quantity surveyor.

Unless they are otherwise qualified, valuers, real estate agents, accountants and solicitors generally have neither the relevant qualifications nor the experience to make such an estimate.

Costs you can claim

Some costs that may be included in construction expenditure are:

- preliminary expenses such as architects' fees, engineering fees and the cost of foundation excavations
- payments to carpenters, bricklayers and other tradespeople for construction of the building
- payments for the construction of retaining walls, fences and in-ground swimming pools.

Costs you cannot claim

Some costs that are not included in construction expenditure are:

- the cost of the land on which the rental property is built
- expenditure on clearing the land prior to construction
- expenditure on landscaping.

Some of this expenditure may form part of the cost base of the property for capital gains tax purposes. For more information, see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside front cover.

Example

Capital works deduction (special building write-off)

The Perth property acquired by the Johnsons on 20 July 2000 was constructed in August 1991. At the time they acquired the property it contained the following structural improvements.

Item	*Construction date*
Retaining wall	September 1991
Concrete driveway	January 1992
In-ground swimming pool	July 1992
Protective fencing around the pool	August 1992
Timber decking around the pool	September 1992

In a letter to the Johnsons, a supervising architect values the construction cost of the rental property for special building write-off purposes at $115 800. This includes the cost of the house, the in-ground swimming pool, the protective fencing and the timber decking. Whilst the retaining wall and the

concrete driveway are structural improvements, they were constructed before 26 February 1992 and were not included in the $115 800 valuation. Therefore, they cannot form part of the construction cost.

The Johnsons can claim a 2.5 per cent per annum deduction based on the construction costs for capital works deduction (special building write-off) purposes. As they did not acquire the property until 20 July 2000, the deduction is allowed for the 346 days from 20 July 2000 to 30 June 2001. The maximum deduction for 2000–2001 would be as follows:

Construction cost	X	rate	X	portion of year	=	deductible amount
$115 800	X	2.5%	X	346/365	=	$2745

For more information about construction expenditure and capital works deductions (special building write-off), see *Taxation Ruling TR 97/25—Income tax: property development: deduction for capital expenditure on construction of income producing capital works, including buildings and structural improvements*. To find out how to get this ruling, see the inside front cover.

Deductions affecting capital gains tax cost base calculations

In working out a capital gain in respect of a rental property you acquired after 13 May 1997, the cost base does not include any expenditure you have claimed or are entitled to claim as a tax deduction.

If you acquired land before 13 May 1997 but constructed a rental property on the land after that date, the cost base will not include any expenditure on the rental property incurred on or after 1 July 1999 for which you have claimed, or are entitled to claim, a deduction.

Example

The Coulsons purchased a rental property on 1 July 1998 for $150 000. The property was built in March 1992 for $65 000. Therefore the Coulsons are entitled to claim a capital works deduction (special building write-off) at the rate of 2.5 per cent per annum from the date of purchase.

If they sell the house on 30 June 2001, the cost base will be calculated as follows:

*$160 000 – [($65 000 X 2.5 %) X 3]

= $160 000 – $4875 [equates to 3 years capital works deductions (special building write-off)]

= $155 125

*Note: For the purpose of this example the cost base is taken to be $160 000.

See also **Capital gains tax** on page 2.

Limited recourse debt arrangements

When construction expenditure is financed in whole or in part by a limited recourse debt arrangement which terminates after 27 February 1998, and part of the principal debt remains unpaid, an adjustment to assessable income will be required. The adjustment must be equal to the excess of the total amount of the capital works deduction allowed over the total amount of the deductions which would be allowable if based on actual outlays. If you are not sure how to work out your adjustment to assessable income, contact your professional adviser or the ATO.

Travel expenses

If you travel to inspect or maintain your property or collect the rent, you may be able to claim the costs of travelling as a deduction. You are allowed a full deduction where the sole purpose of the trip relates to the rental property. However, in other circumstances you may not be entitled to a deduction or you may be entitled to only a partial deduction.

If you fly to inspect your rental property, stay overnight, and return home on the following day, all of the airfare and accommodation expenses would generally be allowed as a deduction.

Example

Travel and vehicle expenses

Although their local rental property was managed by a property agent, Mr Johnson decided to inspect the property 3 months after the tenants moved in. During the income year Mr Johnson also made a number of visits to the property in order to carry out minor repairs. Mr Johnson travelled 162 kilometres during the course of these visits. On the basis of a cents per kilometre rate of 51.9 cents for his 2.6 litre car—see *TaxPack 2001* for the appropriate rates— Mr Johnson is entitled to claim the following deduction:

Distance travelled	X	rate per km	=	deductible amount
162 km	X	51.9 cents per km	=	$84

On his way to golf each Saturday, Mr Johnson drove past the property to ‘keep an eye on things’. These motor vehicle expenses are not deductible as they are incidental to the private purpose of the journey.

Apportionment of travel expenses

Where travel related to your rental property is combined with a holiday or other private activities, you may need to apportion the expenses.

If you travel to inspect your rental property and combine this with a holiday, you need to take into account the reasons for your trip. If the main purpose of your trip is to have a holiday and the inspection of the property is incidental to that main purpose, you are not entitled to a deduction for the cost of travel. However, you may be entitled to claim local expenses directly related to the property inspection and a proportion of accommodation expenses.

Example

Apportionment of travel expenses

The Johnsons also owned another rental property in a resort town on the north coast of Queensland. They spent $1000 on airfares and $1500 on accommodation when they travelled from their home in Perth mainly for the purpose of holidaying in the resort town, but also to inspect the property. They also spent $50 on taxi fares from the hotel to the rental property and return. The Johnsons spent one day on matters relating to the rental property and 9 days swimming and sightseeing.

No deduction is allowable for any part of the $1000 airfares.

The Johnsons can claim a deduction for the $50 taxi fare.

A deduction for 10 per cent of the accommodation expenses would be considered reasonable in the circumstances. That is, Mr and Mrs Johnson can each claim a deduction of $100—a total of $200—as shown below:

$50 + $150* = $200

* $150 = 10% x $1500

Apportionment of other expenses

Where you have both a private—non-income-producing—and an income-producing use for your property, you cannot claim a deduction for the portion of any expenditure that relates to your private use. Examples of properties where you may have both a private and income-producing use are holiday homes and time share units. In cases such as these you would not be entitled to claim a deduction for any expenditure incurred for those periods when the home or unit was used by you, your relatives or your friends for non-income-producing purposes.

In some circumstances it may be easy to decide which expenditure is private in nature. For example, council rates paid for a full year would need to be apportioned on a time basis according to rental and private use where a property is used for both purposes during the year.

In other circumstances where you are not able to specifically identify the direct cost, your expenses will need to be apportioned on a reasonable basis. For more information about situations where apportionment of expenses may be necessary, read the section **Rental expenses** on page 3.

There are a number of methods of apportionment. The following examples illustrate a basis for apportionment of some other rental property related expenses.

Example

Renting out part of a residential property

Michael's private residence includes a self-contained flat. The floor area of the flat is one-third of the area of the whole property.

Michael rented out the flat for 6 months in the year at $100 per week. During the rest of the year, his niece Fiona lived in the flat rent free.

The annual mortgage interest, building insurance, rates and taxes for the whole property amounted to $9000. Using the floor area basis of apportioning these expenses, one-third—that is $3000—applies to the flat. However, as Michael used the flat for income-producing purposes for only half of the year, he can claim a deduction for only $1500—half of $3000.

Assuming there were no other expenses, Michael would calculate the net rent from his property as:

Gross rent	$2600	(26 wks X $100)
Less expenses	$1500	($3000 X 50%)
Net rent	$1100	

Example

Apportionment of expenses where property is rented for part of the year

Mr Johnson's brother, Dave, owns a property in Tasmania. He rents out his property during the period 1 November 2000 to 30 March 2001—a total of 150 days. He lives alone in the house for the rest of the year. The council rates are $1000 per year. He apportions the council rates on the basis of time rented.

Deductible expenses X portion of year = deductible amount

He can claim a deduction against his rental income of

$$\$1000 \times \frac{150}{365} = \$411$$

If he incurred any other expenses, these too may need to be apportioned.

There is an example of ***Apportionment of interest*** on page 8.

For more information about the apportionment of expenses, see *Taxation Ruling IT 2167— Income tax: rental properties—non-economic rental holiday home, share of residence, etc. cases, family trust cases* and Taxation Ruling TR 97/23. To find out how to get these rulings, see the inside front cover.

Non-commercial rental

If you let a property—or part of a property—at less than normal commercial rates, this may limit the amount of deductions you can claim to the amount of rental income you earn.

Example

Non-commercial rental

Mr and Mrs Johnson were charging their previous Perth tenants $180 per week rent. They allowed their son, Tim, to live in the property at a nominal rent of $40 per week. Tim lived in the property for 4 weeks and, when he moved out, the Johnsons started advertising for tenants.

Although Tim was paying rent to the Johnsons, the arrangement was not based on normal commercial rates.

As a result, the Johnsons cannot claim a deduction for the total rental property expenses for the period Tim was living in the property. Generally, a deduction for rental property expenses up to the amount of rental income received from this type of non-commercial arrangement would be allowed.

Assuming that during the 4 weeks of Tim's residence the Johnsons incurred rental expenses of more than $160, these deductions would be limited to $160 in total—that is, $40 X 4 weeks.

If Tim had been living in the house rent free, the Johnsons would not have been able to claim any deductions for the time he was living in the property.

For more information about non-commercial rental arrangements, see Taxation Ruling IT 2167.

Keeping records

Please keep records of both income and expenses relating to your rental property for 5 years from the date you lodge your tax return.

For capital gains tax purposes you must start keeping records if you purchase or inherit assets, receive an asset as part of a divorce settlement or as a gift, or make improvements to property. You must keep records relating to your ownership and all the costs of assets for 5 years from the date you dispose of them.

You must keep records which set out in English:

- the date you acquired the asset
- the date you disposed of the asset and anything received in exchange
- any amount that would form part of the cost base of the asset. For more information about cost base, see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside front cover.

Do not send these records in with your tax return. Keep them in case the ATO asks to see them.

Completing a rental property worksheet

In the following example of a completed worksheet, some of the figures have been drawn from the examples in this publication. Others have been included for illustrative purposes.

Example

Rental property worksheet	***$***
Income	
Rental income	8 500
Other rental related income	800
Gross rent	*9 300*
Expenses	
Advertising for tenants	48
Body corporate fees and charges	500
Borrowing expenses	260
Cleaning	100
Council rates	700
Depreciation on plant	1 641
Gardening/lawn mowing*	350
Insurance*	495
Interest on loan(s)	11 475
Land tax	200
Legal expenses	150
Pest control	50
Property agent fees/commission	800
Repairs and maintenance	1 000
Capital works deduction (special building write-off)	2 745
Stationery, telephone and postage	80
Travel expenses	436
Water charges	350
Sundry rental expenses	95
Total expenses	*21 475*
Net rental loss ($21 475 – $9300)	**12 175**

*You can't claim for these items if the expenditure is already included in body corporate fees and charges.

Feedback

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