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A tax guide to investing in residential property

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Introduction

The great Australian dream has always been to own your own home. Some people take this dream one step further and also own one or more residential investment properties, in addition to their home.

Our tax system offers generous incentives for property investment, though not everyone understands how these incentives work. There is also a lot of misinformation out there regarding property related tax issues.

Many people have an opinion regarding property investment, and will happily share those opinions over the back fence with the neighbour, in the lunch room with work colleagues, or at a BBQ with family and friends.

Unfortunately, as well intended as this advice may be, it is not always correct, nor does it take your own personal taxation situation into account. When people act on this advice, they can create very expensive problems for themselves, which could often have been easily avoided.

The golden rule when it comes to property taxation issues should always be to speak to a qualified tax professional with experience in the property sector. If you are thinking about investing in residential property however, and want to learn about some of the tax issues involved, this guide may be of benefit.

What this guide is designed to do

- Outline the main tax issues involved with owning an investment property
- Dispel some of the misinformation surrounding taxation of property investments
- Provide a plain English summary, based on real life examples
- Relate to residential property investments only, different rules can apply to commercial property and property developers

What this guide is *not* designed to do

- Tell you which property to buy or how much you should pay
- Tell you if the property you are looking at is a good or bad investment
- Cover every conceivable tax related issue that might arise
- Provide specific tax advice for your personal situation – always speak to your accountant

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1. Ownership

Before purchasing a residential investment property, it is important to establish exactly who should own the property. Issues to consider include:

- If more than one person is buying the property e.g. a couple, does either person work in a high risk profession with the potential to be sued e.g. doctor, lawyer, accountant (God forbid!). If so, you may want to consider holding the property in the name of the lower risk person.

- If more than one person is buying the property, you need to consider how much each person earns. The taxable income of each person is one of the primary drivers of any negative gearing benefits (see below) when you first buy the property, longer term tax payable when the property becomes positively geared and capital gains tax payable when the property is finally sold.

- If it is not appropriate to hold the property in your own name, you may want to consider setting up a separate structure e.g. an investment trust, to purchase the property. If so, you will need to consider the initial setup and ongoing costs from this structure, the potential loss of any negative gearing benefits, and the ways different taxes apply to different entities.

Investing in residential investment property through a Self Managed Superannuation Fund (SMSF) has become very popular in recent years. The taxation rules surrounding these investments are very specific and outside the scope of this report. If you are considering an investment within a SMSF, you should definitely seek specialist advice.

Once you have established *who* will purchase the property, you then need to determine *how* the property will be purchased.

Joint Tenants

Under a joint tenancy, each owner effectively owns the whole property or in other words, each owner shares ownership equally. If one owner dies, the other owner acquires the deceased owner's interest automatically. This is the most common form of ownership between couples.

Joint tenants are required to each report 50% of the income and expenses related to the property within their respective income tax returns, despite any agreement between the owners, either oral or in writing, stating otherwise.

Even if one owner pays a greater share of the expenses or receives a greater share of the income derived from the property, taxation reporting must follow the legal ownership of the property, which in the eyes of the Australian Taxation Office (ATO), is 50:50 for joint tenancy ownership.

Tenants in Common

Where two or more people own a property as tenants in common, each owner holds their share of the property outright. If a tenant in common dies, their interest in the property may be distributed in accordance with the directions in their will; that is, it does not pass automatically to the remaining tenant in common.

Under this ownership structure, there is no need for there to be ownership equality, and the owners may agree to an ownership ratio other than 50:50. The ratio chosen however, will apply to the property during the entire term of ownership, including the eventual sale. During the course of owning an investment property, uneven ownership proportion can have positive and negative benefits.

For example, consider a couple where one spouse has a much higher taxable income than the other and who choose to purchase a residential investment property as tenants in common, in a ratio of 90:10 (to the benefit of the higher earning spouse). The tax benefits switch between positive and negative during the different phases of ownership as follows:

- Assuming this property was negatively geared (see below) when first acquired, the initial tax saving for the higher earning spouse would be much greater owning 90% of the property than the standard 50%. Owning the property in a 90:10 ratio would have an overall positive tax affect.

- Over time however, as the debt related to the property was paid off and the property became positively geared, the higher earning spouse would need to report 90% of the taxable income generated by the property in his/her tax return. Given that the higher earning souse would have a higher marginal tax rate, owning the property during this positively geared phase would have an overall negative tax affect.

- Finally, on the eventual sale of the property, the higher earning spouse will need to report 90% of the taxable capital gain generated on the property in his/her tax return, again, an overall negative tax effect.

2. How Does Negative Gearing Work?

When investing in residential property, the investor usually aims to earn two different types of return on their investment:

A) Rental income – derived from the tenant paying rent to the owner for use of the property

B) Capital growth – increase in the value of the property over time

Separate to this income, the investor will incur costs related to their property such as rates, insurance, repairs, interest on borrowings, depreciation on fixtures and fittings and, in some cases, a special write off of the building and improvements.

All of these costs are tax deductible to the investor though only the rental income is required to be reported in the investor's tax return each year. Essentially, the investor is able to claim all the costs related to the property though only report a part of his/her income.

Often these costs will exceed the rental income and the investor will generate a *taxable loss* on the rental property. If the property is held in the investor's personal name, this loss is included in the investor's annual tax return along with all their other forms of income. This loss will reduce the investor's overall taxable income and therefore their overall tax bill. Furthermore, if the investor's other income has already had tax withheld i.e. salary & wages the investor receives a refund for the tax already paid on their rental loss.

Example: An investor who has a gross salary of $80,000, owns a residential investment property. Rental income received from the tenant living in this property for the year is $10,000. The investor's accountant determines that the investor is entitled to claim $20,000 in deductions relating to the property. The taxable loss on the property therefore is $10,000. This taxable loss is reported in the investor's tax return along with his/her salary. The investor's overall taxable income for the year is $70,000 ($80,000 salary less $10,000 rental loss).

Tax on personal income in Australia is calculated based on a series of brackets with progressively higher rates the more you earn, as follows:

Income	Tax rate	
0 to $18,200	0	%
$18,201 to $37,000	19	%
$37,001 to $80,000	32.5	%
$80,000 to $180,000	37	%
Over $180,000	45	%

Different investors will generate different levels of tax saving from negative gearing, based on their income from other sources. Continuing our example above, the investor's tax income fell from $80,000 to $70,000 following the inclusion of the negative gearing loss. Based on the tax rate table above, this would generate a tax saving of $3,250 for the investor ($10,000 x 32.5%).

Assume the investor had a salary of $200,000, the same negative gearing loss would generate a tax saving of $4,500 ($10,000 x 45%). Conversely, an investor with a salary of $18,000 would receive zero tax benefit as their tax rate was already zero before applying the negative gearing loss.

3. Vary Your PAYG Withholding – give yourself a pay rise

Our tax system is designed in a way where employers become the government's main tax collectors during the year. All employers are required to withhold a certain amount of tax from their employee's salary & wages each pay period, in line with ATO regulations. This tax, known as PAYG Withholding, is then paid to the ATO by the employer either quarterly, monthly or weekly depending on the size of the employer.

Generally, the amount withheld will be slightly more than required each year, which is why most people receive a small refund when they prepare their annual tax return. Obviously claiming any work related tax deductions or a negative gearing loss, will increase the size of this refund.

If the taxpayer knows that they will have a negative gearing loss, and can reasonably estimate the size of this loss, they can apply to have their employer withhold less tax from each pay packet than normal. This is essentially a timing difference and results in the investor receiving more money each pay period, rather than a large refund at the end of the year.

To vary your PAYG Withholding, you need to submit the appropriate form to the ATO who will assess your application and contact your employer to advise of the reduced withholding rate applicable.

4. Repairs Versus Improvements

Perhaps one of the more contentious and heavily scrutinised deductions related to property investment is repairs. Many investors are often motivated to record a cost as a repair as this entitles them to an immediate deduction and tax saving.

A repair is generally seen as an action which brings something back to its original state and usually involves replacement or renewal of a broken, or worn out part. For example, fixing a leaking tap, replacing a broken window, re-laying cracked tiles with the same type of tiles.

Actions which restore something to a state better than the original, are generally seen as an improvement and no immediate deduction is available. For example extending a room, adding insulation, renovating a bathroom.

New additions to the property will almost always be classified as improvements e.g. installing air conditioning, building a shed or carport, adding a skylight. Replacing an entire structure or unit of property e.g. a complete fence, shed, stove, bathroom etc. will usually be classified as an improvement.

Initial repairs undertaken when you first purchase the property, though before you make the property available for rent, will be classified as improvements.

Generally, common sense will determine if an expense is a repair or improvement. The ATO will assess deductions for repairs on a case by case basis and examine the facts of the case. Asking the tradesman to simply write 'repairs' on the invoice is not sufficient and will not stand up to ATO scrutiny (I have seen $20,000 invoices with 'bathroom repairs' as the only description on the invoice).

If you determine that an item of expenditure is not a repair, you then need to determine if the expense relates to a depreciating asset or capital works.

Generally, items which are standalone and separate items and not part of the construction of the building e.g. stoves, curtains, furniture etc. will be classed as depreciating assets. Expenditure which forms part of the permanent structure will generally be capital works e.g. extensions, landscaping, new carport etc.

The ATO have issued a large amount of guidance on this area including a schedule of the appropriate tax treatment for a large list of common expenditure items (which we have reproduced for your benefit in schedule A). Further discussion on the tax treatment of depreciating assets and capital works is included below.

5. Depreciation Expense

Expenditure relating to the purchase of depreciable assets can be written off over a number of years.

The allowable depreciation expense is determined with reference to the 'useful life' of the particular item. The ATO provides a listing of what they have determined as the useful life of various items (see schedule A) e.g. ceiling fans – 5 years, electric hot water system – 12 years, stoves – 12 years. You can choose to work out the effective life of a particular item yourself our use the ATO guidance. If you choose to estimate the useful life yourself, you will need to be able to demonstrate how you determined the useful life of a particular item, with reference to ATO guidelines.

Depreciable asset purchases of less than $300 can be written off immediately.

In order to (supposedly) simplify depreciation, the ATO allow assets costing less than $1,000, or with a written down value of less than $1,000 to be added to a low value-pool and depreciated at a flat rate, rather than calculating depreciation on each particular item.

We look forward to meeting you and guiding you through the full version.

Call 02 4244 4054 to make an appointment, or email info@webbaccounting.com.au.