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RENOVATING RENTAL PROPERTIES

It's a common scenario – you have found an ideal rental property as an investment and know with a lick of paint, a spot of cosmetic repair work, and a couple of eye catching improvements, you will get a good tenant and maximise your rate of return.

It's also common is this type of scenario for people to regard all of these costs as 'repairs' and think they are entitled to an upfront tax deduction for the lot.

This might seem reasonable to the man on the street, but unfortunately it's not necessarily how it might work for tax purposes.

From a tax point of view, managing a rental property can throw up a number of challenges that can catch out the unwary and leave a nasty tax aftertaste. Claiming tax deductions for the costs of repairing and improving your rental property is one of these challenge areas.

TIP
It pays to make your choices carefully before you start splashing paint about and tearing down walls if you want to maximise your tax deductions.

What's a repair?

It's difficult to give you a water tight definition to go by, but for tax purposes a repair typically replaces a part of something or restores it to its original working order. This will often involve the replacement of a broken or worn out part or piece of the item in question.

What's the significance of a repair?

Simple – if the cost of repairs relates directly to wear and tear that occurred as a result of you renting out the property, you should be entitled to a deduction for these costs.

Where's the problem?

The problems lies in trying to work out whether something will be categorised as a repair or a capital cost and this is where people often make mistakes. For instance, for tax purposes the following costs are usually considered to be capital (or of a capital nature) and are not deductible:

- replacement of an entire structure or unit of property;
- improvements, renovations, extensions and alterations; and
- initial repairs.

ALL IS NOT LOST, HOWEVER….
Expenses of a capital nature may form part of the cost base of your property for capital gains tax purposes. You also need to consider your entitlement to write off these capital costs over a period of time, either as depreciation or as a capital works deduction.

How does it work in practice?

Let's look at some common scenarios.

Scenario 1

When you buy your residential investment property, it's in reasonably good repair but the paint work is a bit grubby, some door handles are missing and the carpet is threadbare in the entrance hall. You fix up all these things before you put in your first tenants.

Result: the ATO is likely to argue that all the costs of the painting, replacing the door

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handles and worn carpet are capital (they are initial repairs because they remedy defects, damage or deterioration that existed at the date you acquired the property).

Scenario 2

Six months after your tenants move in, there is a terrible storm. The back fence, made of wood, is blown down and needs to be replaced and a tree falls against the house and knocks off a strip of guttering and a down pipe. You agree with all your neighbours to replace not only the old wooden back fence but all the fences with a metal storm fence that has a guaranteed life span four times that of a wooden fence. You simply replace the damaged guttering and down pipe with a similar product.

Result: the ATO is likely to argue that the new fence is a capital improvement. However, the cost of replacing the guttering and down pipe is deductible as a repair.

Scenario 3

A couple of years further down the track, you still have the same tenants; they are reliable, pay their rent on time and look after the property well. However, your tenants have remarked that some of the kitchen cupboards and bench tops are a bit worn. You would like to keep your tenants happy and decide to rip out all the kitchen cupboards and bench tops and replace the lot with something new. You also decide to repaint the kitchen walls, which are now damaged from tenant wear and tear, with a similar type of paint already on the walls.

Result: the ATO is likely to argue that the new kitchen cupboards and bench tops are a capital expense. However, the cost of repainting is deductible as a repair.

Scenario 4

When your dream tenants move out eighteen months later, you find at the time that the bedroom window is stuck shut, some tiles in the bathroom have cracked and your tenants accidentally put a small hole in the hallway wall when they were moving out their furniture. You engage an estate agent immediately to find you another tenant but the house sits empty for six months, so you decide to sell it. Only then do you decide to fix up these things to get the house ready for sale. Your tenants move out and the house is sold all within the same financial year.

Result: as we are dealing with the costs of repairs related to the period when your tenants were living in the house and the repairs were completed before the end of the income year in which the property ceased to be income producing, these repair costs are deductible.

THIS IS NOT AN EXACT SCIENCE
There are practical difficulties working out whether something is a repair or not for tax purposes. It's best to get advice about how your repairs and improvements will be treated for tax purposes before you part with your hard earned cash.

SOME TAX TIPS FOR SHAREHOLDERS

The recently announced Telstra T3 sell off is a timely reminder that more people these days are getting into the share market.

If you already own shares or are thinking about investing, let's have a look at some of the tax basics and current potential trouble spots.

Are you trading in shares?

You need to decide whether you are a share trader (or dealer) or simply holding the shares as an investor (a shareholder).

Working this out isn't always as easy as it might seem and it's important because it affects how the tax laws impact on you and your shares.

If you're considered to be a share trader:

- the shares you buy are treated as trading stock;
- you will usually get a tax deduction for the cost of the shares in the year you sell them;
- you may be entitled to deductions for other costs, e.g. brokerage;
- any dividends you receive and any profit you make when you sell shares are included in your assessable income;
- you can claim any losses from your trading as a deduction against your other assessable income.

If you're a straight forward investor:

- you don't get a tax deduction for the cost of your shares – they are a capital asset;
- any dividends you receive are included in your assessable income;
- you may also be entitled to some deductions against your dividend income

for other costs, such as interest on money borrowed to buy the shares;
- any profit on the sale of shares is a *capital gain* and any loss is a *capital loss*; and
- if you make a capital loss on the sale of your shares, you can't offset it against your other assessable income – only against other capital gains.

How are my dividends taxed?

Dividends paid to you as a shareholder by an Australian resident company are taxed under a system known as 'imputation'. This means that where the company pays or credits you with dividends that have been *franked*, you may be entitled to a *franking tax offset* for the tax the company has paid on its income.

A *franked dividend* is one where the tax paid by the company is allocated to you by way of franking credits attached to the dividends you receive. It's possible for a company to issue you with dividends that are:

- *fully franked*, meaning the whole dividend carries a franking credit.
- *partly franked*, meaning only part of the dividend carries a franking credit.
- *unfranked*, meaning there is no franking credit attached to these shares.

All this information is on the company's *dividend statement* that you should receive. Make sure you always keep these statements ready for tax return preparation time!

When you are preparing your tax return, your total assessable dividend income is the sum of any franked and unfranked amounts plus any franking credits shown on your dividend statements. You may be entitled to a franking tax offset equal to the amount of franking credits included in your income. This offset:

- will cover or partly cover the tax payable by you on these dividends; and
- can be used to reduce your tax liability from all forms of income, not just dividends, and from taxable net capital gains.

THERE ARE SOME LIMITATIONS…
There are some rules that may limit your access to franking tax offsets. For example, you must generally own shares for at least 45 days, or 90 days for preference shares, before being entitled to any franking tax offset.

Potential trouble spots

Borrowing to invest

There is nothing wrong in principle with borrowing to invest. Your decision to do this should be made in the context of your overall investment strategies and your capability to service the loan, in addition to any tax issues.

As a general rule, if you borrow money to buy shares, you will be able to claim a tax deduction for the interest incurred on the loan, provided it's reasonable to expect you will get assessable dividends from your investment in these shares.

However, there are some things the ATO is on the look-out for at present, such as:

- if your loan was also used for private purposes, you will be able to claim only interest incurred on that part of the loan used to acquire the shares; and
- if you have leveraged your way into the sharemarket with protected equity loan products, you are only entitled to a deduction for the pure loan interest component and not for the capital protection component of any payments made.

Buying shares for your children

If you are planning to buy shares on behalf of your children, who pays the tax on any dividend income or any capital gain if the shares are sold at a profit?

The ATO is of the view that custodians (such as parents or grandparents holding shares on behalf of minors) should be treated as the owners of the shares unless the child is considered the genuine beneficial owner.

If you are in this custodian position, any dividend income would normally be included in your tax return. Similarly, when the shares are sold you need to declare any capital gain or loss.

If a child is considered to be the true beneficial owner of shares, any dividend income or gains/losses should be included in their return.

Example

You withdraw $2,500 from your bank account and purchase shares for your son, Declan,

who is only five years old. You formally hold these shares on trust for him. When you get dividends and any profit from the sale of these shares, you deposit the proceeds into a bank account in your son's name, with yourself as trustee. All funds from this account are only applied for Declan's benefit and welfare. In this case, any dividends and capital gains are included Declan's assessable income.

Capital gains tax

Whenever you buy or sell shares, you need to keep appropriate records so that any capital gains or losses can be correctly calculated.

In particular, it's not uncommon these days to find yourself in a situation where you hold shares in a company that has gone through a major reorganisation, or has merged with or been taken over by another company. In these cases, the way the tax consequences are dealt with is a little more complex than usual.

> **TIP**
> If this sounds like you, check with the company to find out the correct tax treatment. Also see whether the ATO has published its views on the tax consequences of situations likes this.

CLAIMING WORK RELATED EXPENSES

According to the ATO, claiming deductions for work related expenses is big business – around 7 million individuals collectively claimed $11.5 billion in deductions for work related expenses in 2004-05.

In our last newsletter, we outlined some of the basic rules that you need to follow to claim deductions for your work related expenses.

Since then, the ATO has released its Compliance Program for 2006-07 so we can now give you a bit more insight into what the ATO is looking at in this area.

Of course, even though the ATO is targeting these expenses, it doesn't mean there is anything wrong with claiming them. Knowing a bit more about what the ATO is looking at may even alert you to some opportunities for legitimate overlooked deductions.

Will I be targeted?

Hard to say, but we do know that you are more likely to be considered an "at risk" case by the ATO if your claim for deductions:

- seem high or excessive compared to the amount of salary and wages declared in your return; and/or
- are outside the regular pattern for a particular industry or occupation.

Is there an ATO occupation hit list?

Yes there is. The ATO selects different industries or occupations each year to have a closer look at. This year the ATO is more likely to be checking on you if you are:

- an employee business professional (especially lawyers and accountants).
- a hospitality industry service worker.
- a factory hand, store worker or process worker.
- a mechanical, automotive and electrical tradesperson.
- an information technology professional.
- a mining site employee.

This is the first time information technology professionals have been singled out for ATO attention.

If you're in this industry, you should be aware that the ATO is on the look-out in particular for:

- disguising claims for what are considered by the ATO to be entertainment expenses, which have essentially been ineligible as tax deductions since the early 1990s; and
- not apportioning expenses between work and private use when required, covering areas such as travel and home office expenses, including mobile phone calls, internet use and computer software and hardware. In the majority of cases involving home office expenses, there is likely to be some private element.

> **ARE YOU WORKING UNDER COVER?**
> The ATO no longer requires employees or agents of government law enforcement agencies working under assumed identities to produce tax invoices when seeking reimbursement from their employer for work related expenses. Let's face it, asking your informant to provide you with a tax invoice so you can provide it to your employer would have to look a bit suspicious!

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