

Rental properties

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2001-02

TAXPACK REFERRED PUBLICATION

NAT 1729—6.2002



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The ATO publishes on its website all private rulings issued. What we publish will not contain anything which could identify you.

You can ask for a review of a private ruling decision if you disagree with it, even if you have not received your assessment. Details of the review procedures are sent to you when the private ruling decision is made. For more information on private rulings, visit the ATO website at <www.ato.gov.au>.

Publications

To get any publication referred to in this book:

- visit the ATO website 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 or an ATOaccess site.

Publications referred to in this book include:

- *Deductions for prepaid expenses* (NAT 4170—6.2002)
- *Guide to capital gains tax* (NAT 4151—6.2002)
- *Guide to depreciating assets* (NAT 1996—6.2002)
- *Guide to thin capitalisation* (NAT 4661—6.2002)
- *Personal investors guide to capital gains tax* (NAT 4152—6.2002)
- *TaxPack 2002* (NAT 0976—6.2002)
- *TaxPack 2002 supplement* (NAT 2677—6.2002)
- *Thin capitalisation schedule 2002* (NAT 6458—6.2002)

- *Application for a private ruling for individuals* (NAT 4106—3.2001)
- *Do I need to pay PAYG income tax instalments* (NAT 3990—3.2001)
- *PAYG annual income tax instalments* (NAT 4200—4.2001)
- *PAYG instalments for individuals* (NAT 4269—5.2001)
- *Taxation Ruling TR 2000/18—Income tax: depreciation effective life*
- *Taxation Ruling TR 2000/17—Income tax: deductions for interest following the Steele and Browne decisions*
- *Taxation Ruling TR 2000/2—Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities*
- *Taxation Ruling TR 98/22—Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities*
- *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*
- *Taxation Ruling 97/23—Income tax: deductions for repairs*
- *Taxation Ruling TR 97/11—Income tax: am I carrying on a business of primary production?*
- *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 94/8—Income tax: whether business is carried on in partnership (including husband and wife partnerships)*
- *Taxation Ruling TR 93/32—Income tax: rental property—division of net income or loss between co-owners*
- *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 IT 2167—Income tax: rental properties—non-economic rental holiday home, share of residence, etc. cases, family trust cases*
- *Taxation Ruling IT 2316—Income tax: distribution of partnership profits and losses*
- *Taxation Ruling IT 2685—Income tax: depreciation*

Rental properties 2001–02

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ISBN 0 642 30873 X

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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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ERRATUM



This erratum applies to the publication *Rental properties* (NAT 1729—6.2002).

The headings in Table 1 at the top of page 12 should read as follows:

Table 1

<i>Date construction started</i>	<i>Type of construction for which deduction can be claimed</i>
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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—whether it is paid to you or your agent. You must include the full amount of rent you earn in your tax return.

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 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 can claim a deduction for the repairs.

You can claim a deduction for certain 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 pages 3–4.

You must include assessable amounts relating to hire purchase and limited recourse debt arrangements in your rental income. For more information about limited recourse debt arrangements, read the section **Limited recourse debt arrangements** on page 14 and see the publication *Guide to depreciating assets*. 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 for the property in line 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. Interest on money borrowed by only one of the joint tenants which is exclusively used to acquire that person's interest in the rental property does not need to be divided between joint tenants.

EXAMPLE

Joint tenants

Mr and Mrs Hitchman 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 Hitchman telephones the ATO and asks if she can claim 80 per cent of the rental loss. Mrs Hitchman says she is earning \$67 000 a year, and Mr Hitchman is earning \$31 000. Therefore, it would be better if she claimed most of the rental loss, as she would save more tax. Mrs Hitchman 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 Hitchmans, Mrs Hitchman is supposed to claim 80 per cent of any rental loss.

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

Any agreement that the Hitchmans 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 Hitchman 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 Hitchman.

Tenants in common must also divide the income and expenses of the property in line 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 Hitchmans held their property interest as tenants in common in equal shares, Mrs Hitchman would still be able to claim only 50 per cent of the total property deductions.

However, if Mrs Hitchman's legal interest was 75 per cent and Mr Hitchman's legal interest was 25 per cent, Mrs Hitchman would be required to include 75 per cent of the income and expenses on her tax return and Mr Hitchman 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 line 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 line 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 Hitchmans' neighbours, the D'Souzas, own a number of rental properties, either as joint tenants or equal tenants in common. They own 8 houses and 3 apartment blocks—each block comprising 6 residential units—a total of 26 properties.

The D'Souzas actively manage all of the properties. They devote a significant amount of time—an average of 25 hours per week each—to these activities. They interview prospective tenants, organise for repairs and maintenance to be done, have regular property inspections, and personally attend to minor repairs, financial planning and decision making. Apart from income Mr D'Souza earns from shares, they have no other sources of income.

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 number of hours the D'Souzas spend on the activities
- the D'Souzas' extensive personal involvement in the activities, and

- the business-like manner in which the activities are planned, organised and carried on.

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

The law relating to the treatment of capital gains tax was amended with effect from 11.45 a.m. by legal time in the Australian Capital Territory on 21 September 1999. The amendments alter the way in which capital gains and losses are, or will be, treated for tax purposes.

Generally, you do not make a capital gain or capital loss if you dispose of a depreciating asset after 11.45 a.m. on 21 September 1999.

NOTE An amount may still be included in assessable income or a deduction allowed in the income year in which the asset is disposed of under the rules dealing with depreciating assets (see *Guide to depreciating assets*).

If you disposed of a rental property and you have claimed capital works deductions for construction expenditure (see **Capital works (special building write-off) deductions** on page 11), those deductions may be excluded from the cost base or reduced cost base of the property. See **Deductions affecting capital gains tax cost base calculations** on page 13.

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 if 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 2002 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 commenced on 1 July 2000 and replaced 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 \$1000 or more of business or investment income—such as rental income—and the debt on your income tax assessment is more than \$250.

If you are required to pay PAYG instalments the ATO will notify you. You will usually be required to pay the instalments at the end of each quarter. There are two options if you pay by quarterly instalments:

- pay the instalment amount calculated by the ATO (as shown on your activity statement), or

- pay the instalment amount you work out, based on your instalment rate multiplied by your investment and business income.

However, you may be able to pay an annual PAYG instalment 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.

For further information, see the publications *Do I need to pay PAYG income tax instalments?*, *PAYG instalments for individuals* and *PAYG annual income tax instalments*. To find out how to get these publications, see the inside front cover.

Goods and services tax (GST)

If you are registered for GST and GST was payable in relation to rental income you derived, do not include the GST in the amounts you show as income in your tax return.

Similarly, if you are registered for GST and entitled to claim input tax credits for rental expenses, you do not include the input tax credits in the amounts of expenses you claim. If you are not registered for GST or the rental income was from residential premises, you include any GST in the amounts of rental expenses you claim.

For further information, call the Business Tax Reform Infoline on **13 2478**.

Rental expenses

You can claim a deduction for certain 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.

There may be situations where you need to apportion 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 actually incurred them. Some of these deductions are examined in more detail on the following pages.

Borrowing expenses, decline in value of depreciating assets (previously known as depreciation) and capital works (special building write-off) deductions may be deducted over a number of income years.

Expenses you are not able to claim include:

- acquisition and disposal costs
- 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 use 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, advertising expenses and stamp duty on the transfer of the property (but not stamp duty on a lease of property—read the section **Lease document expenses** on page 14). 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 Hitchmans purchased a rental property for \$170 000 in July 2001. 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 Hitchmans' rental income. However, in addition to the \$170 000 purchase price, the incidental costs of \$350 and \$750, totalling \$1100, are included in the cost base of the property.

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

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 you incur for your rental property.

Body corporate fees and charges may be incurred to cover the cost of day-to-day administration and maintenance 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 able to claim a deduction for that portion of the fees and charges that relate to the cost of day-to-day administration and maintenance. This is because payments to a special purpose sinking fund are usually to cover the cost of capital improvements or major repairs and are therefore not deductible. See *Taxation Ruling TR 97/23—Income tax: deductions for repairs*. To find out how to get this publication, see the inside front cover. You may be able to claim a capital works deduction for the cost of capital improvements or capital repairs once the cost has been charged to the sinking fund—see **Capital works (special building write-off) deductions** on page 11.

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

Borrowing expenses

These are expenses directly incurred in taking out a loan for the property. They include loan establishment fees, title search fees, costs for preparing and filing mortgage documents, stamp duty charged on registration of a mortgage and valuation fees if the lender required a valuation be obtained as a condition of them lending you the money. Interest expenses are not 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 less. 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 Hitchmans paid a total of \$1670 in establishment fees, valuation fees and stamp duty on the loan. As the Hitchmans' borrowing expenses are more than \$100, they must be apportioned over 5 years, or the period of the loan, whichever is less. 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 2001, the borrowing expense deduction for the first year would be worked out as follows:

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

Year 1

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

Mortgage discharge expenses

The costs of discharging a mortgage are deductible in the year they are incurred to the extent that you gave the mortgage as security for the repayment of money you borrowed that was used to produce assessable income.

For example, if you used a property to produce rental income for half the time you held it and used it as a holiday home for the other half, 50% of the costs of discharging the mortgage are deductible.

Penalty interest payments are amounts paid to a lender, such as a bank, to agree to accept early repayment of a loan—including a loan on a rental property. The amounts are commonly calculated by reference to the number of months interest payments would have been made had the premature repayment not been made.

Penalty interest payments relating to a rental property are deductible:

- if the loan moneys borrowed are secured by a mortgage over the property and the payment effects the discharge of the mortgage, or
- if payment is made in order to rid the taxpayer of a recurring obligation to pay interest on the loan.

Where penalty interest is paid to rid a taxpayer of a burdensome property or is otherwise incidental to the sale of the property, the payments are not deductible.

Deduction for decline in value of depreciating assets (previously known as depreciation)

From 1 July 2001, the uniform capital allowance system (UCA) applies to most depreciating assets, including those acquired before that date. The UCA consolidates a range of former capital allowance provisions, including those relating to plant and equipment. It does this by providing a set of general rules that applies across a variety of depreciating assets and certain other capital expenditure. It maintains some concessional tax treatments such as those applying to primary production capital expenditure and primary production depreciating assets and also introduces new deductions for certain types of capital expenditure that did not previously attract a deduction.

You now calculate deductions for the decline in value of your depreciating assets using these new rules. You can deduct an amount equal to the decline in value for an income year of a depreciating asset that you held at any time during that year. However, your deduction is reduced to the extent you use it or have it installed ready for use for other than the purpose of producing assessable income—for example, a private purpose.

How do you work out your deduction?

You work out your deduction for the decline in value of a depreciating asset using either the prime cost or diminishing value method. Both methods are based on the effective life of the asset.

The **diminishing value method** assumes that the decline in value each year is a constant proportion of the remaining value and produces a progressively smaller decline over time. The formula is:

$$\text{Base value} \times \frac{\text{days held}}{365} \times \frac{150\%}{\text{asset's effective life}}$$

For the income year in which an asset is first used or installed ready for use for any purpose, the **base value** is the asset's cost. For a later income year, the base value is the asset's opening adjustable value plus any amounts included in the asset's second element of cost for that year.

Adjustable value of a depreciating asset is its cost less its decline in value since you first used it or installed it ready for use for any purpose, including a private purpose. The term 'adjustable value' replaces the previous terms 'written down value' and 'undeducted cost'.

The prime cost method assumes that the value of a depreciating asset decreases uniformly over its effective life. The formula for the prime cost method is:

$$\text{Asset's cost} \times \frac{\text{days held}}{365} \times \frac{100\%}{\text{asset's effective life}}$$

If you use a depreciating asset for more than one purpose—for example, you use the same lawn mower at both your rental property and your private residence, you are allowed only a partial deduction for decline in value, based on the percentage it was used at your rental property.

Effective life

In broad terms, the effective life of a depreciating asset is how long it can be used by you for any purpose, including a taxable purpose, having regard to the wear and tear you reasonably expect from your expected circumstances of use and assuming reasonable levels of maintenance. Effective life is expressed in years, including fractions of years. It is not rounded to the nearest whole year.

You can either make your own estimate of the effective life of the asset 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 depreciating assets*.

The effective life of a depreciating asset 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 depreciating asset. 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 are not treated as separate assets in their own right. However, a capital works deduction may be allowed for some of these items—see **Capital works (special building write-off) deductions** on page 11. Examples of items that are not treated as separate assets in their own right 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 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.

Low-value pooling was introduced on 1 July 2000 and the \$300 immediate write-off for depreciating assets used predominantly in deriving non-business income (including rental income) has been retained with some changes for assets acquired after 1 July 2001. The replacement basis for deductions is no longer available for assets you first use (or have installed ready for use) to produce income after 30 June 2000.

Immediate deduction for depreciating asset costing \$300 or less

You can claim an immediate deduction for a depreciating asset costing \$300 or less if you use the asset predominantly to produce assessable income that is not from carrying on a business—including rental income.

If the asset was acquired on or after 1 July 2001, there are two additional tests that must be met before an immediate deduction can be claimed:

- the asset must not be one that is part of a set of assets that you started to acquire in the same income year where the total cost of the set is more than \$300; and
- the total cost of the asset and any other identical, or substantially identical, asset that you start to acquire in an income year must not be more than \$300.

EXAMPLE

Immediate deduction

In November 2001, Terry purchased a toaster for his rental property at the cost of \$70. He can claim an immediate deduction as he uses the toaster to produce assessable income, but not from carrying on a business.

EXAMPLE

No immediate deduction

Paula is buying a set of four identical bedside drawers for her rental property that cost \$90 each. She cannot claim an immediate deduction for any of these because they are identical and the total cost is more than \$300.

Low-value pooling

From 1 July 2000, an optional low-value pooling arrangement for plant was introduced. It applied to certain plant costing less than \$1000 or having an undeducted cost of less than \$1000. This plant could be allocated to a low-value pool and depreciated at statutory rates.

The UCA adopts most of the former rules for low-value pools. From 1 July 2001, the decline in value of certain depreciating assets can be calculated through a low-value pool.

A low-value pool created before 1 July 2001 continues and is treated as if it were created under the UCA. The closing balance of the pool worked out under the former rules is used to start working out the decline in value of the depreciating assets in the pool under the UCA rules.

Under the UCA, you can allocate low-cost assets and low-value assets to a low-value pool. A **low-cost asset** is a depreciating asset whose cost as at the end of the year in which it is first used, or installed ready for use, for any purpose is less than \$1000 (after GST credits or adjustments). A **low-value asset** is a depreciating asset that is not a low-cost asset but:

- which has an opening adjustable value of less than \$1000, and
- for which you have calculated any available deductions from a decline in value determined under the diminishing value method.

Once you choose to create a low-value pool and a low-cost asset is allocated to the pool, you must pool all other low-cost assets you start to hold in that income year and in later income years. However, this rule does not apply to low-value assets. You can decide whether to allocate low-value assets to the pool on an asset-by-asset basis.

Once you have allocated an asset to the pool, it remains in the pool.

Once an asset is allocated to a low-value pool it is not necessary to work out its adjustable value or decline in value separately. Only one annual calculation for the decline in value for all of the depreciating assets in the pool is required.

The deduction for the decline in value of depreciating assets in a low-value pool is worked out using a diminishing value rate of 37.5 per cent.

The deduction for low-cost assets you allocate to the pool for the income year is worked out at a rate of 18.75 per cent, or half the pool rate. Halving the rate recognises that assets may be allocated to the pool throughout the income year and eliminates the need to make separate calculations for each asset based on the date it was allocated to the pool.

For further information about low-value pooling, including the treatment of assets used only partly to produce assessable income and the treatment on disposal of assets from a low-value pool, refer to the *Guide to depreciating assets*.

NOTE If you are an individual who owns or has co-ownership of a rental property, you claim your low-value pool deduction for rental assets for 2002 at question **D7** of *TaxPack 2002* (not question **20** of *TaxPack 2002 supplement*).

What happens if you no longer hold or use a depreciating asset?

Under the UCA rules, if you cease to hold or to use a depreciating asset a balancing adjustment event may occur. If there is a balancing adjustment event, you need to calculate a balancing adjustment amount to include in your assessable income or to claim as a deduction.

A **balancing adjustment event** occurs for a depreciating asset when:

- you stop holding it—for example, if the asset is sold, lost or destroyed
- you stop using it and expect never to use it again
- you stop having it installed ready for use and you expect never to install it ready for use again
- you have not used it and decide never to use it, or

- a change occurs in the holding or interests in an asset which was or is to become a partnership asset.

The **balancing adjustment amount** is worked out by comparing the asset's termination value and its adjustable value at the time of the balancing adjustment event. If the termination value is greater than the adjustable value, the excess is included in your assessable income (if you are an individual who owns or has co-ownership of a rental property, you show such assessable amounts at *TaxPack 2002 supplement* question **22** 'Other income'—not question **20**).

If the termination value is less than the adjustable value, you can deduct the difference.

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

Purchase and valuation of second-hand assets

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

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

Generally, independent valuations that establish reasonable values for depreciating assets 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 asset compared to the total purchase price of the property.

EXAMPLE

In this example, the Hitchmans bought the property part way through the year—on 20 July 2001. Depreciating assets sold with the property were assigned separate values in the purchase contract that reflected their respective arm's length values at the time. Therefore the amounts shown in the contract can be used by the Hitchmans as the opening adjustable values of the assets. They can claim a deduction for decline in value for 346 days out of the 365 in the 2001–02 income year. The deduction for each asset is calculated using the diminishing value method as shown below:

Description	Cost	Opening adjustable value	Part-year claim	150% divided by effective life (yrs) from Guide to depreciating assets	Deduction for decline in value	Closing adjustable value
Furniture	\$2000	\$2000	$\frac{346}{365}$	$\frac{150\%}{15}$	\$190	\$1810
Carpets	\$1200	\$1200	$\frac{346}{365}$	$\frac{150\%}{10}$	\$171	\$1029
Curtains	\$1000	\$1000	$\frac{346}{365}$	$\frac{150\%}{7}$	\$203	\$797*
Totals	\$4200	\$4200			\$564	\$3636

NOTE *As the closing adjustable value of the curtains is \$1000 or less, the Hitchmans may choose to transfer this asset to the low-value pool for the year ended 30 June 2003.

EXAMPLE

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

<i>Assets held before 1 July 2001</i>	<i>Total adjustable value of pool at 30 June 2001</i>	<i>Low-value pool rate</i>	<i>Deduction for decline in value</i>
Various	\$1679	37.5%	\$630
Value of low-value pool at 30 June 2002:			
1679 - 630 = \$1049			
1050 - 197 = \$853			
= \$1902			
<i>Assets purchased 1 July 2001–30 June 2002</i>	<i>Purchase price</i>		
Television set (11/11/2001)	\$747		
Gas heater (28/2/2002)	\$303		
Totals	\$1050	18.75%	\$197
Total deduction for year ended 30 June 2002			\$827

You should use **Worksheet 1—depreciating assets** and **Worksheet 2—low-value pool** to help you work out your deductions for decline in value of depreciating assets. These worksheets are contained in the publication *Guide to depreciating assets*. To find out how to get this publication, see the inside front cover.

Interest

If you take out a loan to purchase a rental property, you can claim the interest charged 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.

If you take out a loan to purchase land on which to build a rental property, the interest on the loan will be deductible from the time you took it out. However, if your intention changes and the property is not used to produce rent or other income, you cannot claim the interest after your intention changes.

You may also claim interest charged on loans taken out:

- to purchase depreciating assets, or
- for renovations, or
- for repairs to the property required due to you using it to produce 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 parts 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 the next 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 that applies to the rental property portion of the loan; that is, you must separate the interest that relates to the rental property from any interest that relates to the 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 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 the 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 loan.

If a loan is taken out to purchase a rental property and you start to use the property for private purposes, you cannot claim any interest expenses you incur after that time.

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

EXAMPLE**Apportionment of interest**

The Hitchmans 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:

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

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

If you prepay interest on money borrowed that covers a period of 12 months or less AND the period ends on or before 30 June 2003, you can claim an immediate deduction. Otherwise, your deduction may have to be spread over 2 or more years under the prepayment rule if the expense is \$1000 or more—see *Deductions for prepaid expenses*.

For information about penalty interest payments, read **Mortgage discharge expenses** on page 5.

NOTE Thin capitalisation

New rules—known as the thin capitalisation rules—apply in 2001–02. If you are an Australian resident and you (or any associate entities) have certain overseas interests, or you are a foreign resident, these rules may apply if your debt deductions, such as interest (combined with those of your associate entities), for 2001–02 are more than \$250 000. If the thin capitalisation rules apply to you, your debt deductions, including interest, may be reduced. Refer to the publication *Guide to thin capitalisation* (NAT 4461—6.2002) and complete the *Thin capitalisation schedule 2002* (NAT 6458—6.2002). These publications are available on the ATO website at <www.ato.gov.au>. Go to 'Business Tax Reform' in the Tax Reform website.

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

- TR 2000/17—*Income tax: deductions for interest following the Steele and Brown decisions.*
- TR 2000/2—*Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities*
- TR 98/22—*Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities*
- 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 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?*

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 producing your 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 costs of:

- purchasing or selling your property
- 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 Hitchmans' tenants moved out owing 4 weeks rent. The Hitchmans 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 Hitchmans were seeking to recover assessable rental income, and they wished to continue earning income from the property. The Hitchmans 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 deductible. 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, the following expenses are capital, or of a capital nature, and are not deductible:

- replacement of an entire structure or unit of property (such as a complete fence or building)
- improvements, renovations, extensions and alterations
- initial repairs—for example, in remedying defects, damage or deterioration that existed at the date you acquired the property.

You may be able to claim capital works deductions for these expenses—for more information, read the section **Capital works (special building write-off) deductions** below. Expenses of a capital nature may form part of the cost base of the property for capital gains tax purposes (see the publication *Guide to capital gains tax*)—but not to the extent that capital works (special building write-off) deductions have been or can be claimed for them.

EXAMPLE

Repairs prior to renting out the property

The Hitchmans 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 Hitchmans' use of the property to generate assessable rental income. The expenses are capital in nature and the Hitchmans are not able to claim a deduction for these expenses.

Repairs to a rental property will generally be deductible if:

- 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 to produce income 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 Hitchmans 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 Hitchmans paid for this damage to be repaired so they could sell the property.

As the tenants were no longer in the property, the Hitchmans 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 and the repairs were also completed before the end of the income year in which the property ceased to be used to produce income.

Examples of repairs for which you can claim deductions are:

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

Examples of improvements for which you cannot claim deductions are:

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

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.

Capital works (special building write-off) deductions

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 (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
- improvements to the property—for example, erecting a pergola, patio or carport.

Deductions can be claimed only for the period the property is rented or is available for rent.

If you can claim capital works (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 deductions for decline in value of depreciating assets.

Amount of deduction

The amount of the deduction you can claim depends on the type of construction and the date construction started.

Table 1 shows you the types of rental property construction that qualify—if the type of construction you own (or partly own) does not appear next to the relevant 'Date construction started' in the table, no deduction can be claimed. If the type of construction qualifies, Table 2 shows the rate of deduction available.

Table 1

<i>Date deduction can be claimed</i>	<i>Type of construction for which construction started</i>
Before 22 August 1979	None
22 August 1979 to 19 July 1982	Certain buildings intended to be used on completion to provide short-term accommodation to travellers*
20 July 1982 to 17 July 1985	Certain buildings intended to be used on completion to provide short-term accommodation to travellers* Building intended to be used on completion for non-residential purposes (for example—a shop or office)
18 July 1985 to 26 February 1992	Any building intended to be used to produce income on completion
27 February 1992 to 18 August 1992	Any building intended to be used to produce income on completion Structural improvements intended to be used to produce income on completion
19 August 1992 to 30 June 1997	Any building intended to be used to produce income on completion Structural improvements intended to be used to produce income on completion Environment protection earthworks* intended to be used to produce income on completion
After 30 June 1997	Any capital works used to produce income (even if, on completion, it was not intended that they be used for that purpose).

*For more information, contact our Personal Tax Infoline on 13 2861.

Table 2

<i>Date construction started</i>	<i>Rate of deduction per income year</i>
Before 19 August 1979	nil
19 August 1979 to 21 August 1984	2.5%
22 August 1984 to 15 September 1987	4%
After 15 September 1987	2.5%

NOTE

For buildings used to provide short-term accommodation for travellers that commenced construction after 26 February 1992, the rate of deduction was again increased to 4%.

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. If the construction was completed part of the way through the income year, you can only claim a deduction for that part.

Examples of structural improvements include sealed driveways, retaining walls and fences.

Construction expenditure that can be claimed

Construction expenditure is the actual cost of constructing the building or extension. A deduction is allowed for expenditure incurred in the construction of a building if 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.

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.

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
- earthworks that are permanent, can be economically maintained and are not integral to the installation or construction of a structure
- expenditure on landscaping.

If you purchase your property from a speculative builder, the component of your payment that represents the builder's profit margin cannot be claimed as a capital works (special building write-off) deduction.

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.

Changes in building ownership

Where ownership of the building changes, the right to claim any undeducted construction expenditure for

capital works passes to the new owner. A new owner should confirm that the building was constructed during one of the appropriate periods outlined above. To be able to claim the deduction, they must continue to use the building to produce income.

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.

EXAMPLE

Capital works (special building write-off) deductions

The Perth property acquired by the Hitchmans on 20 July 2001 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 Hitchmans, 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 27 February 1992 and were not included in the \$115 800 valuation. Therefore, they do not form part of the construction cost.

The Hitchmans can claim a 2.5 per cent per annum capital works deduction for the construction costs. As they did not acquire the property until 20 July 2001, they can claim the deduction for the 346 days from 20 July 2001 to 30 June 2002. The maximum deduction for 2001–02 would be as follows:

$$\begin{array}{l} \text{Construction} \times \text{rate} \times \text{portion} = \text{deductible} \\ \text{cost} \qquad \qquad \text{of year} \qquad \text{amount} \\ \$115\,800 \times 2.5\% \times \frac{346}{365} = \$2745 \end{array}$$

For more information about construction expenditure and capital works (special building write-off) deductions, see Taxation Ruling TR 97/25. 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 capital works deductions you claimed, or were entitled to claim, may need to be excluded from the cost base or reduced cost base.

Cost base

- If you acquired the rental property after 13 May 1997 (this includes vacant land you acquired after 13 May 1997 on which rental premises were later constructed), the amount of the capital works deductions you claimed, or were entitled to claim, during the period you owned the property is excluded from the CGT cost base.
- If you acquired land before 13 May 1997 and incurred construction expenditure on a rental property after 30 June 1999, the amount of the capital works deductions you claimed, or were entitled to claim, for the construction during the period you owned the property is excluded from the CGT cost base.
- If you acquired a rental property before 13 May 1997 and incurred construction expenditure on the property after 30 June 1999, the amount of the capital works deductions you claimed, or were entitled to claim, for the construction is excluded from the CGT cost base.

Reduced cost base

The amount of the capital works deductions you claimed, or were entitled to claim, during the period you owned the property is excluded from the reduced cost base.

EXAMPLE

The Keilys purchased a rental property on 1 July 1999 for \$150 000. The property was built in March 1992 for \$65 000. Therefore the Keilys can claim a capital works deduction at the rate of 2.5 per cent per annum from the date of purchase.

The property was sold on 30 June 2002 and the cost base (before any adjustment for the capital works deductions) was \$160 000. The adjusted cost base is calculated as follows:

$$\begin{array}{l} \$160\,000 - [(\$65\,000 \times 2.5\%) \times 3] \\ = \$160\,000 - \$4875 \text{ [equates to 3 years capital works} \\ \qquad \qquad \qquad \text{(special building write-off) deductions]} \\ = \$155\,125 \end{array}$$

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

Limited recourse debt arrangements

If construction expenditure is financed in whole or in part by a limited recourse debt arrangement that ends after 27 February 1998, and part of the principal debt remains unpaid, an adjustment to assessable income is required. The adjustment is equal to the excess of the total amount of the capital works deductions allowed over the total amount that would have been deductible 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.

Prepaid expenses

If you prepay a rental property expense—such as insurance or interest on money borrowed—that covers a period of 12 months or less AND the period ends on or before 30 June 2003, you can claim an immediate deduction. Otherwise, your deduction may have to be spread over 2 or more years under the prepayment rule if the expense is \$1000 or more—see *Deductions for prepaid expenses*. To find out how to get this publication, see the inside front cover.

Lease document expenses

The costs of preparing and registering a lease and the cost of stamp duty on a lease are deductible to the extent that you have used, or will use, the property to produce income. This includes any such costs associated with an assignment or surrender of a lease.

For example, freehold title cannot be obtained for properties in the Australian Capital Territory (ACT)—they are commonly acquired under a 99 year crown lease. Therefore, stamp duty, preparation and registration costs you incur on the lease of an ACT property are deductible to the extent that you use the property as a rental property.

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 able to claim 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 Hitchman decided to inspect the property 3 months after the tenants moved in. During the income year Mr Hitchman also made a number of visits to the property in order to carry out minor repairs. Mr Hitchman travelled 162 kilometres during the course of these visits. On the basis of a cents per kilometre rate of 58.5 cents for his 2.6 litre car—see *TaxPack 2002* for the appropriate rates—Mr Hitchman can claim the following deduction:

Distance travelled x rate per km = deductible amount
162 km x 58.5 cents per km = \$95

On his way to golf each Saturday, Mr Hitchman 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 cannot claim a deduction for the cost of the travel. However, you may be able to claim local expenses directly related to the property inspection and a proportion of accommodation expenses.

EXAMPLE

Apportionment of travel expenses

The Hitchmans 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 Hitchmans spent one day on matters relating to the rental property and 9 days swimming and sightseeing.

No deduction can be claimed for any part of the \$1000 airfares.

The Hitchmans 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 Hitchman can each claim a deduction of \$100—a total of \$200—as shown below:

$\$50 + \$150^* = \$200$

* $\$150 = 10\% \times \1500

Apportionment of other expenses

If you have both private and income-producing use of 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 private and income-producing use are holiday homes and time share units. In cases such as these you cannot 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 private 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 pages 3–4.

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 residence.

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 to produce income 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 Hitchman's brother, Dave, owns a property in Tasmania. He rents out his property during the period 1 November 2001 to 30 March 2002—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 had any other expenses, these too may need to be apportioned.

There is an example of **Apportionment of interest** on page 10.

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.

EXAMPLE

Non-commercial rental

Mr and Mrs Hitchman were charging their previous Perth tenants the normal commercial rate of rent—\$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 Hitchmans started advertising for tenants.

Although Tim was paying rent to the Hitchmans, the arrangement was not based on normal commercial rates. As a result, the Hitchmans cannot claim a deduction for the total rental property expenses for the period Tim was living in the property. Generally, a deduction can be claimed for rental property expenses up to the amount of rental income received from this type of non-commercial arrangement.

Assuming that during the 4 weeks of Tim's residence the Hitchmans 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 Hitchmans 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 property, receive property 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 acquiring and disposing of property for 5 years from the date you dispose of it.

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
Deductions for decline in value (depreciation)	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 (special building write-off) deductions	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.



Lodge your tax return over the Internet using e-tax

If you are looking for an easy and convenient way to do your tax return, look no further than *e-tax 2002*. It is available **free** from the Australian Taxation Office. *e-tax* can estimate items such as capital gains and your tax refund or tax debt. *e-tax* allows you to complete your tax return confidentially and at your leisure, 7 days a week. Tax returns lodged using *e-tax* generally take only **14 days** to process. *e-tax* is available for use from 1 July 2002. For more information on *e-tax*, visit the ATO's website at <www.ato.gov.au>.

How self-assessment affects most individuals

Self-assessment means the ATO uses the information you give on 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 systems continually check for missing or wrong information. We have audit programs designed to detect where taxpayers have not declared all 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 straightaway.

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 a general interest charge on omitted income or overclaimed deductions and tax offsets could still be payable
- private rulings
- your entitlement to interest on early payment or overpayment of a tax debt
- the process of applying for an amendment if you find you left something out of your tax return.

Feedback

Reader feedback helps us to improve the information we provide. If you have any comments to make about this publication, please write to:

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As this is a publications area only, any tax matters will be passed on to a technical area; otherwise you can ring our Personal Tax Infoline on **13 2861** for help.

Rental properties
2001-02



Produced by

Personal Tax Publishing Group

Australian Taxation Office 2002