

RENTAL PROPERTIES

2002–03



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- *Guide to capital gains tax* (NAT 4151—6.2003)
- *Guide to depreciating assets* (NAT 1996—6.2003)
- *Guide to thin capitalisation* (NAT 4661—6.2003)
- *Introduction to PAYG income tax instalments* (NAT 4637—5.2003)
- *Non-business depreciating assets costing \$300 or less* (NAT 7284—9.2002)
- *TaxPack 2003* (NAT 0976—6.2003)
- *TaxPack 2003 supplement* (NAT 2677—6.2003)
- *Thin capitalisation schedule 2003* (NAT 6458—6.2003)
- *Taxation Ruling TR 2000/18 – Income tax: effective life of depreciating assets*
- *Taxation Ruling TR 2000/17 (with the Addendum TR 2000/17A) – Income tax: deductions for interest following the Steele and Brown 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 TR 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- *Taxation Ruling IT 2685 – Income tax: depreciation (this ruling has been replaced by Taxation Ruling TR 2000/18)*

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CONTENTS

Rental income	1
Rental related income	1
Co-ownership of rental property	1
Co-owners of an investment property—not in business	1
Income and expenses divided according to legal interest	1
Partners carrying on a rental property business	2
Capital gains tax	3
Negative gearing	3
Property not located in Australia	3
Pay as you go (PAYG) instalments	3
Goods and services tax	3
Rental expenses	3
Claimable expenses	4
What you can't claim	4
Acquisition and disposal costs	4
Body corporate fees and charges	4
Borrowing expenses	5
Mortgage discharge expenses	6
Deduction for decline in value of depreciating assets (previously known as depreciation)	6
How do you work out your deduction?	6
Effective life	6
Replacements	7
Immediate deduction for depreciating assets costing \$300 or less	7
Low-value pooling	8
What happens if you no longer hold or use a depreciating asset?	8
Purchase and valuation of second-hand assets	9
Working out your deductions for decline in value of depreciating assets	9
Interest	10
Legal expenses	11
Repairs	11
Capital works deductions (formerly special building write-off)	12
Amount of deduction	12
Construction expenditure that can be claimed	13
Changes in building ownership	13
Estimating construction costs	13
Deductions affecting CGT cost base calculations	14
Cost base	14
Reduced cost base	14
Limited recourse debt arrangements	14
Prepaid expenses	14
Lease document expenses	14
Travel expenses	14
Apportionment of travel expenses	15
Apportionment of other expenses	15
Non-commercial rental	16
Keeping records	16
Completing a rental property worksheet	16

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 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 instance, because a tenant defaulted on the rent, or because of damage to your rental property requiring repairs or maintenance.

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 or booking fee you must 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, in relation to your rental activity, 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 page 3.

You must include as rental income any assessable amounts relating to hire purchase and limited recourse debt arrangements involving your rental property. For more information about the latter, 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.)

Co-ownership of rental property

The way that rental income and expenses are divided between co-owners varies depending on whether the co-owners are joint tenants or tenants in common or there is a partnership carrying on a rental property business.

Co-owners of an investment property—not in business

A person who simply co-owns an investment property or several investment properties is usually regarded as

an investor who is not carrying on a rental property business, either alone or 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.

Income and expenses divided according to legal interest

Co-owners who are not carrying on a rental property business must divide the income and expenses for the rental property in line with their legal interest in the property. If they are:

- joint tenants, they each hold an equal interest in the property.
- tenants in common, they may hold unequal interests in the property—for example, one may hold a 20% interest and the other an 80% interest.

Rental income and expenses must be attributed to each co-owner according to their legal interest in the property, despite any agreement between co-owners, either oral or in writing, stating otherwise. **Note:** Interest on money borrowed by only one of the co-owners which is exclusively used to acquire that person's interest in the rental property does not need to be divided between all of the co-owners.

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. If you are unsure whether your activities constitute a rental property business, read **Partners carrying on a rental property business** on the next page.

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% 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% of any rental loss.

Mrs Hitchman was told that where two 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.

Example

Tenants in common

In the preceding example, if the Hitchmans held their property interest as tenants in common in equal shares, Mrs Hitchman would still be able to claim only 50% of the total property deductions.

However, if Mrs Hitchman's legal interest was 75% and Mr Hitchman's legal interest was 25%, Mrs Hitchman must include 75% of the income and expenses on her tax return and Mr Hitchman must include 25% of the income and expenses on his tax return.

Example

Co-owners who are not carrying on a rental property business

The Tobins own, as joint tenants, two 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 carrying on a rental property business—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.

Partners carrying on a rental property business

Most rental activities are a form of investment and do not amount to carrying on a business. However, where you are carrying on a rental property *business* in partnership with others, you must divide the net rental income or loss according to the partnership agreement. You must do this whether or not the legal interests in the rental properties are different to the partners' entitlements to profits and losses under the partnership agreement. If you do not have a partnership agreement, you should divide your net rental income or loss between the partners equally.

Example

Partners in a rental property business

The Hitchmans' neighbours, the D'Souzas, own a number of rental properties, either as joint tenants or tenants in common. They own eight houses and three apartment blocks—each block comprising six 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 undertake all financial planning and decision making in

relation to the properties. They interview all prospective tenants and conduct all of the rent collections. They carry out regular property inspections and attend to all of the everyday maintenance and repairs themselves or organise for them to be done on their behalf. 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% share of the partnership profits or losses and Mr D'Souza is entitled to a 25% share of the partnership profits or losses.

The D'Souzas are carrying on a rental property business. This means that the net profit or loss generated from their rental business is divided between them according to their partnership agreement—in proportions of 75% and 25%, even though their legal interests in the rental properties are equal—that is, they each own 50%.

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 rental property business is being carried on, whether it is being carried on in partnership, and the distribution of partnership profits and losses, see:

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

Paragraph 13 of TR 97/11 lists eight 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.

Contact your professional adviser or the ATO if you are unsure whether:

- your rental property activities amount to a partnership carrying on a rental property business
- you are carrying on a rental property activity as a joint tenant or a tenant in common, or
- you are in both categories.

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.

You do not make a capital gain or capital loss if you dispose of a depreciating asset after 11.45am (by legal time in the ACT) on 21 September 1999 unless the asset was also used for purposes other than producing income—for example, if you used it partly for private purposes. **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 **What happens if you no longer hold or use a depreciating asset?** on page 8).

If you disposed of a rental property and you have claimed capital works deductions for construction expenditure (see **Capital works deductions [formerly special building write-off]** on page 12), those deductions may be excluded from the cost base or reduced cost base of the property. See **Deductions affecting CGT cost base calculations** on page 14.

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 the 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 2003 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 \$2,000 or more of business or investment income—such as rental income—and the debt on your income tax assessment is more than \$500.

If you are required to pay PAYG instalments the ATO notifies 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.

You may be able to pay an annual PAYG instalment if your notional tax is less than \$8,000. 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 publication *Introduction to PAYG income tax instalments*. To find out how to get this publication, see the inside front cover.

Goods and services tax

If you are registered for goods and services tax (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 28 66**.

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 – although you may be able to claim decline in value deductions or capital works deductions for certain capital expenditure or include certain capital costs in the cost base of the property for capital gains tax purposes.

There may be situations where not all your expenses are deductible and you need to work out the deductible portion. To do this you subtract any non-deductible expenses from the total amount you have for each category of expense; what remains is your deductible expense. This situation may arise if, for instance:

- The property is not available for rent for the full year – you may need to apportion some of the expenses on a time basis.
- 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.

- You combine travel to inspect or maintain your rental property with travel for private purposes – you may need to apportion your travel expenses.

Claimable expenses

Expenses 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
 - stamp duty
- pest control
- property agent's fees and commission
- quantity surveyor's fees
- repairs and maintenance
- secretarial and bookkeeping fees
- security patrol fees
- servicing costs – for example, 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 incur 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 deductions (formerly special building write-off) may be deducted over a number of income years.

What you can't claim

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, and
- 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 3.

Example

Acquisition costs

The Hitchmans purchased a rental property for \$170,000 in July 2002. 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 \$1,100, are included in the cost base of the property.

This means that when the Hitchmans dispose of the property, \$171,100 (\$170,000 + \$1,100) 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 capital 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 deductions (formerly special building write-off)** on page 12.

If the body corporate fees and charges you incur are for things like the maintenance of gardens, deductible 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 – including mortgage broker fees and stamp duty charged on registration of a mortgage. They also include other costs that the lender requires you to incur as a condition of them lending you the money for the

property – such as the costs of obtaining a valuation or lender's mortgage insurance if you borrow more than a certain percentage of the purchase price of the property.

If you take out an insurance policy that provides for your loan on the property to be paid out in the event that you die or become disabled or unemployed, the premiums are not borrowing costs. Interest expenses are not borrowing expenses.

If your total borrowing expenses are more than \$100, the deduction is spread over five 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 five 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 \$1,670 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 five years, or the period of the loan, whichever is the lesser. Also, because the loan was to be used for both income producing and non-income producing purposes, only the income producing portion of the borrowing expenses is deductible. As they obtained the loan on 17 July 2002, the borrowing expense deduction for the first year would be worked out as follows:

Year 1

Borrowing expenses	×	$\frac{\text{number of relevant days in year}}{\text{number of days in 5 years}}$	=	maximum amount for the income year	×	$\frac{\text{rental property loan}}{\text{total borrowings}}$	=	deduction for year
\$1,670	×	$\frac{349 \text{ days}}{1,826 \text{ days}}$	=	\$319	×	$\frac{\$170,000}{\$209,000}$	=	\$260
Borrowing expenses remaining	×	$\frac{\text{number of relevant days in year}}{\text{remaining number of days in the 5 years}}$	=	maximum amount for the income year	×	$\frac{\text{rental property loan}}{\text{total borrowings}}$	=	deduction for year

Year 2 (leap year)

\$1,351	×	$\frac{366 \text{ days}}{1,477 \text{ days}}$	=	\$334	×	$\frac{\$170,000}{\$209,000}$	=	\$272
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Year 3

\$1,017	×	$\frac{365 \text{ days}}{1,111 \text{ days}}$	=	\$334	×	$\frac{\$170,000}{\$209,000}$	=	\$272
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Year 4

\$683	×	$\frac{365 \text{ days}}{746 \text{ days}}$	=	\$334	×	$\frac{\$170,000}{\$209,000}$	=	\$272
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Year 5

\$349	×	$\frac{365 \text{ days}}{381 \text{ days}}$	=	\$334	×	$\frac{\$170,000}{\$209,000}$	=	\$272
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Year 6

\$15	×	$\frac{16 \text{ days}}{16 \text{ days}}$	=	\$15	×	$\frac{\$170,000}{\$209,000}$	=	\$12
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Mortgage discharge expenses

Mortgage discharge expenses are the costs involved in discharging a mortgage other than payments of principal and interest. These costs are deductible in the year they are incurred to the extent that you took out the mortgage as security for the repayment of money you borrowed to use to produce assessable income.

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

Mortgage discharge expenses may also include penalty interest payments. 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.

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

Since 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 deductions for certain types of capital expenditure that did not previously attract a deduction.

You now work out deductions for the decline in value of your depreciating assets using these rules. You can deduct an amount in relation to a depreciating asset that you held for any period during an income year, equal to its decline in value over that period. However, your deduction is reduced to the extent you use the asset – or have it installed ready for use – for purposes other than that 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 for decline in value using this method 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. The second element of cost is the amount you are taken to have paid to bring the asset to its present condition (such as the cost of capital improvements to the asset).

The **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 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 calculating decline in value using the prime cost method is:

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

The formula under the prime cost method may have to be adjusted if the cost, effective life or adjustable value of the asset is modified. For more information, see the publication *Guide to depreciating assets*. To find out how to get this publication, see the inside front cover.

Under either method, the decline in value of an asset cannot amount to more than its base value in any income year.

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 the mower's decline in value, based on what percentage of the mower's total use occurred at your rental property.

Effective life

The **effective life** of a depreciating asset is how long it can be used by any entity for a taxable purpose, or for the purpose of producing exempt income:

- having regard to the wear and tear you reasonably expect from your expected circumstances of use
- assuming reasonable levels of maintenance, and
- having regard to the period within which it is likely to be scrapped, sold for no more than scrap value, or abandoned.

Effective life is expressed in years, including fractions of years. It is not rounded to the nearest whole year.

For most depreciating assets, you can either make your own estimate of its effective life or adopt the effective life determined by the Commissioner. The sorts

Rental properties

of information you could use to make your own estimate of effective life are listed in the *Guide to depreciating assets*.

Taxation Ruling TR 2000/18—Income tax: effective life of depreciating assets lists the Commissioner's determination of effective life for various depreciating assets. TR 2000/18 came into force on 1 January 2001 and replaced *Taxation Ruling IT 2685—Income tax: depreciation*. To find out how to get these publications, see the inside front cover.

Because the Commissioner reviews the determinations of effective life, the determined effective life may change from the beginning of, or during, an income year. If you decide to use the effective life determined by the Commissioner you generally use the effective life that applies at the time you entered into a contract to acquire the depreciating asset.

An extract from *Taxation Ruling TR 2000/18* (as at 1 January 2003) showing the effective lives of some depreciating assets commonly used in rental properties is shown below.

Item	Effective life in years given in TR 2000/18 (as at 1 January 2003)
Blinds, venetian	20
Carpets	10
Curtains and drapes	6 $\frac{2}{3}$
Electric clock	13 $\frac{1}{3}$
Electric heater	10
Furniture and fittings	13 $\frac{1}{3}$
Garbage unit, compacting	6 $\frac{2}{3}$
Hot water installations	20
Lawn mowers – motor	6 $\frac{2}{3}$
Lawn mowers – self-propelled	5
Floor coverings (linoleum and vinyl)	10
Ovens – microwaves	6 $\frac{2}{3}$
Refrigerators	13 $\frac{1}{3}$
Stoves	20
Television receivers	10
Vacuum cleaners (electric)	10
Washing machines	6 $\frac{2}{3}$

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 deductions (formerly special building write-off)** on page 12. Examples of items that are not treated as separate assets in their own right are:

- built-in kitchen cupboards
- 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 was the longstanding practice to treat the initial purchase of certain assets as not depreciable but to allow 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.

However, the replacement basis for deductions is no longer available for assets you first use (or have installed ready for use) to produce income after 31 December 2000.

An immediate deduction is available for depreciating assets costing \$300 or less which are used predominantly in deriving non-business income (including rental income) if certain conditions are met – see the next section, **Immediate deduction for depreciating assets costing \$300 or less**. Also, assets costing less than \$1,000 may be written off through a low-value pool – see **Low-value pooling** on the next page.

Immediate deduction for depreciating assets 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 – for example, rental income where your rental activities do not amount to the carrying on of a business. If you own an asset jointly with others, your interest in the asset is treated as the relevant depreciating asset – this means you may be able to claim an immediate deduction for your share of the cost of an asset you acquire jointly if your share is \$300 or less (see **Partners carrying on a rental property business** on page 2).

If you acquired the asset or your interest in it on or after 1 July 2000, there are two additional tests that must be met before an immediate deduction can be claimed:

- the asset must not be 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, assets that you start to acquire in an income year must not be more than \$300.

Example

Immediate deduction

In November 2002, Terry purchased a toaster for his rental property at a 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 costing \$90 each for her rental property. She cannot claim an immediate deduction for any of these because they are identical and the total cost is more than \$300.

For further information about immediate deductions for depreciating assets costing \$300 or less, refer to the publication *Non-business depreciating assets costing \$300 or less*. To find out how to get this publication, see the inside front cover.

Low-value pooling

You can allocate low-cost assets and low-value assets relating to your rental activity to a low-value pool. A **low-cost asset** is a depreciating asset whose cost at the end of the year in which it is first used, or installed ready for use, for a taxable purpose is less than \$1,000 (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 \$1,000, and
- for which you have worked out any available deductions for decline in value under the diminishing value method.

Once you choose to create a low-value pool and allocate a low-cost asset to it, 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%.

The deduction for low-cost assets you allocate to the pool during the income year is worked out at a rate of 18.75%, 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.

When you allocate an asset to the pool, you must make a reasonable estimate of how much of your use of it is for producing assessable income (the asset's 'taxable use percentage'). Only the taxable use percentage of the asset's cost or opening adjustable value is written off through the low-value pool.

For further information about low-value pooling, including how to treat assets used only partly to produce assessable income and how to treat the disposal of assets from a low-value pool, refer to the *Guide to depreciating assets*. To find out how to get this publication, see the inside front cover.

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 at *TaxPack* question **D6** (not question **20** of the *TaxPack 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 will occur. If there is a balancing adjustment event, you need to work out 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 if:

- 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** (such as the proceeds from the sale of the asset) 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 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. To find out how to get this publication, see the inside front cover.

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 objective means of establishing your cost of depreciating assets acquired with the property is to have their value, as agreed between the contracting parties, 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, 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.

Working out your deductions for decline in value of depreciating assets

The *Guide to depreciating assets* contains two worksheets (**Worksheet 1 – depreciating assets** and **Worksheet 2 – low-value pool**) that you can use to work out your deductions for decline in value of depreciating assets. To find out how to get this publication, see the inside front cover.

Example

In this example, the Hitchmans bought a property part way through the year – on 20 July 2002. In the purchase contract depreciating assets sold with the property were assigned separate values that represented their arm's length values at the time. The amounts shown in the contract can be used by the Hitchmans as the cost of the assets. They can claim deductions for decline in value for 346 days out of the 365 in the 2002–03 income year. If the Hitchmans use the assets wholly to produce rental income, the deduction for each asset using the diminishing value method is worked out as shown below:

Description	Cost	Base value	No. of days held divided by 365	150% divided by effective life (yrs)	Deduction for decline in value	Adjustable value at end of 2002–03 income year
Furniture	\$2,000	\$2,000	$\frac{346}{365}$	$\frac{150\%}{13\frac{1}{3}}$	\$213	\$1,787
Carpets	\$1,200	\$1,200	$\frac{346}{365}$	$\frac{150\%}{10}$	\$171	\$1,029
Curtains	\$1,000	\$1,000	$\frac{346}{365}$	$\frac{150\%}{6\frac{2}{3}}$	\$213	\$787
Totals	\$4,200	\$4,200			\$597	\$3,603

NOTE As the opening adjustable value of the curtains for the 2003–04 income year is less than \$1,000, the Hitchmans may choose to transfer this asset to the low-value pool for that year.

Example

In the 2002–03 income year the Hitchmans' daughter Leonie, who owns a rental property in Adelaide, allocated some depreciating assets she acquired in that year to a low-value pool. The low-value pool already comprised various low-value assets. Leonie expects to use the assets solely to produce rental income.

	Taxable use percentage of cost or opening adjustable value	Low-value pool rate	Deduction for decline in value
Low-value assets			
Various	\$1,679	37.5%	\$630
Low-cost assets			
Television set (purchased 11/11/2002)	\$747		
Gas Heater (purchased 28/2/2003)	\$303		
Total low-cost assets	\$1,050	18.75%	\$197
Total deduction for decline in value for year ended 30 June 2003			\$827
Closing pool value at 30 June 2003:			
Low-value assets: $1,679 - 630 = \$1,049$			
Low-cost assets: $1,050 - 197 = \$853$			
= \$1,902			

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 or to finance renovations to a property you intend to rent out, the interest on the loan will be deductible from the time you took the loan out. However, if your intention changes – for example, you instead use the property for private purposes and the property is not used to produce rent or other income, you cannot claim the interest after your intention changes.

Additionally, while the property is rented, or available for rent, you may also claim interest charged on loans taken out:

- to purchase depreciating assets
- for renovations
- for repairs.

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 this page.

If you have a loan account that has a fluctuating balance due to a variety of deposits and withdrawals and it is used for both private purposes and for rental property purposes, you must keep accurate records to enable you to calculate the interest 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.

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

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 you start using the property for private purposes.

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 used to buy 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 annum, and assuming that the property is rented from 1 July.

Interest for year 1 = \$209,000 × 6.75% = \$14,108

Apportionment of interest payment related to rental property:

Total interest expense	×	rental property loan total borrowings	=	deductible interest
\$14,108	×	$\frac{\$170,000}{\$209,000}$	=	\$11,475

If you prepay interest it may not be deductible all at once. Read the section **Prepaid expenses** on page 14.

NOTE Thin capitalisation

New rules – known as the thin capitalisation rules – apply from 1 July 2001. 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 2002–03 are more than \$250,000. See the publication *Guide to thin capitalisation*, complete the *Thin capitalisation schedule* attached to the guide and, if required under the thin capitalisation rules, only claim a reduced amount. These publications are also available on the ATO internet site at www.ato.gov.au

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

Taxation Ruling TR 95/25—Income tax: deductions for interest under subsection 51(1) of the Income Tax Assessment Act 1936 following FC of T v. Roberts, FC of T v. Smith

Taxation Ruling TR 98/22—Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities

Taxation Ruling TR 93/7—Income tax: whether penalty interest payments are deductible

Taxation Determination TD 1999/42—Income tax: do the principles set out in TR 98/22 apply to line of credit facilities?

Taxation Ruling TR 2000/2—Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities

Taxation Ruling TR 2000/17 (with the Addendum TR 2000/17A)—Income tax: deductions for interest following the Steele and Brown decisions.

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 – for instance, 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 3.

Example

Legal expenses

In September 2002, the Hitchmans' tenants moved out owing four 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 they incurred doing 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 falling 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, a stove or refrigerator)
- 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 deductions (formerly special building write-off)** on the next page. 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 generally to the extent that capital works deductions have been or can be claimed for them (see **Deductions affecting CGT cost base calculations** on page 14).

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 doors on two bedrooms. 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 September 2002, 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 October 2002 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 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 publications *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 3.

Capitals works deductions (formerly special building write-off)

You can deduct certain kinds of construction expenditure. In the case of residential rental properties, the deductions would generally be spread over a period of 25 or 40 years. These are referred to as capital works deductions (formerly special building write-off). Your total capital works deductions cannot exceed the construction expenditure. No deduction is available until the construction is complete.

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
- structural improvements to the property – for example, adding a pergola, patio, carport, sealed driveway, retaining wall or fence.

Landscaping is not a structural improvement.

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

If you can claim capital works 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 own jointly) 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 2

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

NOTE

Where construction of a building to provide short-term accommodation for travellers commenced after 26 February 1992, the rate of deduction was increased to 4%.

Table 1

Date construction started	Type of construction for which deduction can be claimed
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 (eg a shop or office)
18 July 1985 to 26 February 1992	Any building intended to be used on completion for residential purposes or to produce income
27 February 1992 to 18 August 1992	Certain buildings* intended to be used on completion to provide short term accommodation to travellers** Any other building intended to be used on completion for residential purposes or to produce income Structural improvements intended to be used on completion for residential purposes or to produce income
19 August 1992 to 30 June 1997	Certain buildings* intended to be used on completion to provide short term accommodation to travellers** Any other building intended to be used on completion for residential purposes or to produce income Structural improvements intended to be used on completion for residential purposes or to produce income Environment protection earthworks** intended to be used on completion for residential purposes or to produce income
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).

* 'Certain buildings' are apartment buildings consisting of at least 10 apartments, units or flats you owned or leased; or a hotel, motel or guest house that has at least 10 bedrooms

** For more information, contact the ATO on 13 24 78.

Rental properties

With regard to an apartment building, the 4% rate only applies to apartments, units or flats if you own or lease 10 or more of them in the building.

The deduction can be claimed for 25 years from the date construction was completed in the case of a 4% deduction, and for 40 years from the date construction was completed in the case of a 2.5% deduction. If the construction was completed part of the way through the income year, you can claim a pro-rata deduction for that part.

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 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 on page 12. To be able to claim the deduction, the new owner 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 deductions

The Perth property acquired by the Hitchmans on 20 July 2002 was constructed in August 1991. At the time they acquired the property it also 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 estimated the construction cost of the rental property for capital works deduction purposes at \$115,800. This includes the cost of the house, the in-ground swimming pool, the protective fencing and the timber decking. Although the retaining wall and the concrete driveway are structural improvements, they were constructed before 27 February 1992. Therefore, they do not form part of the construction cost for the purposes of the capital works deduction and were not included in the \$115,800 estimate.

The Hitchmans can claim a capital works deduction of 2.5% per annum of the construction costs. As they did not acquire the property until 20 July 2002, they can claim the deduction for the 346 days from 20 July 2002 to 30 June 2003. The maximum deduction for 2002–03 would be worked out as follows:

Construction cost	x	rate	x	portion of year	=	deductible amount
\$115,800	x	2.5%	x	$\frac{346}{365}$	=	\$2,745

The cost of obtaining an appropriately qualified person's estimate of construction costs of a rental property is deductible in the year it is incurred. You make your claim for the expense, or your share of the expense if you jointly incurred it, at *TaxPack* question **D10 Cost of managing tax affairs**.

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

Deductions affecting CGT 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

You must exclude from the cost base the amount of capital works deductions you claimed or were entitled to claim for a building, other structure or improvement if:

- In the case of a property (including vacant land) you acquired before 20 September 1985, the capital works deductions were for a building or other structure constructed on the property after 13 May 1997.
- In the case of a property (including vacant land) you acquired before 20 September 1985, the capital works deductions were for improvements (such as renovations) made to the property after 13 May 1997, and:
 - the cost base of the improvements is more than the improvement threshold (see the publication *Guide to capital gains tax*) for the income year in which the property was disposed of, and
 - the cost base of the improvements is more than 5% of the proceeds received from the sale of the property.
- In the case of property (including vacant land) you acquired during the period 20 September 1985 to 13 May 1997, the capital works deductions were for a building, other structure or improvements constructed on the property after 30 June 1999.
- In the case of a property (including vacant land) you acquired after 13 May 1997, the capital works deductions were for a building, other structure or improvements constructed on the property at any time.

Reduced cost base

The amount of the capital works deductions you claimed or were entitled to claim for a building, other structure or improvement is excluded from the reduced cost base.

Example

The Keilys purchased a rental property on 1 July 2000 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 annum from the date of purchase.

The property was sold on 30 June 2003 and the cost base (before any adjustment for the capital works deductions) was \$160,000. The adjusted cost base is calculated as follows:

$$\begin{aligned} & \$160,000 - [(\$65,000 \times 2.5\%) \times 3] \\ &= \$160,000 - \$4,875 \text{ [equates to 3 years' capital} \\ & \quad \text{works deductions]} \end{aligned}$$

$$= \$155,125$$

See also **Capital gains tax** on page 3.

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 at the time it ends, 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 2004, you can claim an immediate deduction. A prepayment that doesn't meet these criteria AND is \$1,000 or more may have to be spread over two or more years. This is also the case if you carry on your rental activity as a business and have not elected to be taxed under the simplified tax system for small businesses. For more information see the publication *Deductions for prepaid expenses*. To find out how to get a copy of 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 three 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 60 cents for his 2.6 litre car – see *TaxPack 2003* for the appropriate rates – Mr Hitchman can claim the following deduction:

Distance travelled	x	rate per km	=	deductible amount
162 km	x	60 cents per km	=	\$97

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

Apportioning travel expenses

The Hitchmans also owned another rental property in a resort town on the north coast of Queensland. They spent \$1,000 on airfares and \$1,500 on accommodation when they travelled from their home in Perth to the resort town, mainly for the purpose of holidaying, 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 nine days swimming and sightseeing.

No deduction can be claimed for any part of the \$1,000 airfares.

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

A deduction for 10% of the accommodation expenses (10% of \$1,500 – that is, \$150) would be considered reasonable in the circumstances. The total travel expenses the Hitchmans can claim are therefore \$200 (\$50 taxi fare and \$150 accommodation). Accordingly, Mr and Mrs Hitchman can each claim a deduction of \$100.

Apportionment of other expenses

If you use your property for both private and income-producing purposes, you cannot claim a deduction for the portion of any expenditure that relates to your private use. Examples of properties you may use for both private and income-producing purposes 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 page 3.

There are a number of methods of apportionment. The following examples illustrate a basis for apportionment of some other rental property related expenses. There is also an example of **Apportionment of interest** on page 10.

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 six 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 \$9,000. Using the floor area basis of apportioning these expenses, one-third – that is \$3,000 – 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 \$1,500 – half of \$3,000.

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

Gross rent	\$2,600	(26 weeks x \$100)
Less expenses	\$1,500	(\$3,000 x 50%)
Net rent	\$1,100	

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 2002 to 30 March 2003 – a total of 150 days. He lives alone in the house for the rest of the year. The council rates are \$1,000 per year. He apportions the council rates on the basis of time rented.

$$\text{Deductible expenses} \times \text{portion of year} = \text{deductible amount}$$

He can claim a deduction against his rental income of

$$\$1,000 \times \frac{150}{365} = \$411$$

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

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—Income tax: deductions for repairs*.

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 Queensland 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 four weeks. When he moved out, the Hitchmans advertised 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 four 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* referred to above.

Keeping records

Please keep records of both income and expenses relating to your rental property for five 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 five 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
- the parties involved
- 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)	597
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 deductions (formerly special building write-off)	2,745
Stationery, telephone and postage	80
Travel expenses	436
Water charges	350
Sundry rental expenses	95
Total expenses	20,431
Net rental loss (\$20,431 – \$9,300)	11,131

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

How self-assessment affects most individuals

Self-assessment means the Australian Taxation Office (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 your information.

What if you lodge an incorrect tax return?

Our systems continually check for missing, inaccurate or incomplete 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 straight away.

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 over-claimed deductions and tax offsets could still be payable
- the process for applying for private rulings
- your entitlement to interest on early payment or over-payment of a tax debt, and
- the process for applying for an amendment if you find you have left something out of your tax return.

Do you need to ask for a private ruling?

If you have a concern about the way a tax law applies to your personal tax affairs, you may want to ask for a private ruling.

A private ruling will relate just to your situation. Write to the ATO describing your situation in detail and ask for advice. To do this, complete an *Application for a private ruling for individuals*. You should lodge your tax return by the due date, even if you are waiting for the reply to your private ruling. You may need to request an amendment to your tax return once you have received the private ruling.

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**

Feedback

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

The Editor
Personal Tax Publishing Group
Australian Taxation Office
PO Box 900
CIVIC SQUARE ACT 2608

As this is a publications area only, any tax matters will be passed on to a technical area; alternatively you can phone our Personal Tax Infoline on **13 28 61** for help.

Lodge online via e-tax



Australian Taxation Office

If you are looking for an easy and convenient way to do your tax return, look no further than e-tax 2003. 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, seven 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 2003. For more information on e-tax, visit the ATO website at **www.ato.gov.au**

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