

INTRODUCTION



Buy land. They've stopped making it.

Mark Twain

The great Australian dream is to own property. Around three quarters of all adult Australians either have their own homes or are purchasing them and on average they have some 60% of their wealth tied up in the family home. This strong affinity towards property flows over into the investment property market. Prior to the 1997 initial public float of Telstra, many more Australians had an interest in investment property of one form or another than in shares and other investment mediums.

Perhaps this strong affinity with property has a lot to do with people preferring to retain direct control over their investment. They like the physical reassurance of seeing the property that they own. After all, it is difficult to load mum and the kids into the family car and drive past your shares.

Post Telstra, the level of private share ownership in Australia has risen to one of the highest levels in the world and, according to the Australian Stock Exchange's (ASX) "Share Ownership Study 2004", we have the highest reported level of share retail ownership in the world. This study found that 44% of adult Australians own shares. Whilst this level of participation is high, recent ASX research found that around 50% of direct shareowners have only one or two stocks in their portfolios and have not traded in the previous 12 months.

Against this backdrop and the continued periodic capital growth in the property market, interest in property as an investment medium continues to be a popular option.

Having an interest in property sounds simple enough, however this interest may be held in a number of ways. For starters, you may choose to have a direct interest in property (ie. by directly acquiring the property in your own name) or indirectly by holding the property by way of a managed fund or a listed property trust.

The typical property investor has a number of property investment options available:

- Residential Property Investments;
- Commercial Property Investments;
- Unlisted Property Trusts;
- Listed Property Trusts (LPTs);
- Property Securities Funds; and
- Property Syndicates.

The investment options don't stop with this list.

Broadly, you may decide whether you wish to invest in residential or commercial property. Put simply, residential property describes where people live, while commercial property describes where they work. However, it does get a little more complex from there. Residential property investment encompasses the home on the suburban block of land, residential units and apartments of varying room sizes and numbers, town houses of numerous configurations, blocks of flats, etc.

Commercial property broadly includes any property that is not residential property. When we look at the asset class in finer detail, we find that we can invest in industrial premises, retail outlets, rural property, offices, hotels and various tourism assets.

Property is topical and residential property in particular. Although house prices, according to Australian Property Monitors, have fallen by an average of 10% since their market peak in 2004, on average the last five years have seen price rises in all states and major cities in Australia. In some cases these rises can only be described as staggering. Lifestyle type television programs have mushroomed in number over the same period of time, leading us all to believe that with a trusty hammer, a chisel, a nail or two and some elbow grease each of us can demolish an internal wall and build a spiral staircase over the next long weekend and double the price of our homes.

A trip to your local bookstore will disclose row upon row of books abounding with property-related topics as diverse as where best to buy, buying tips and traps, Feng Shui, and how best to present a home for resale. This publication will not attempt to replicate that type of information. Instead, we will concentrate on the taxation side of investing in property as well as expanding on some of the ways and means in which property can be held.

WHY INVEST IN PROPERTY?



“Banks have a new image. Now you have ‘a friend,’ your friendly banker. If the banks are so friendly, how come they chain down the pens?”

Alan King

Advantages

Generally, investing in property gives you access to two benefits - income and some measure of capital growth. Others may argue that a third benefit is the tax advantages associated with negative gearing but we will save that topic for discussion later in this publication.

Income is received in the form of rent if the property is directly held, or in the form of distributions if the property is held indirectly. Capital growth on a directly held property is the money you make as the value of your property appreciates. Capital growth on an indirectly held property is realised by way of an increase in the value of your units or interest in the investment medium that you have chosen.

No matter which way you choose to invest in property, the investment fundamentals are unchanged. You have made money on the property if the after tax gain on disposal of the property plus the after tax income received during the time you have held the property is greater than the after tax costs of holding and financing the property during that same time period. If you haven't achieved the foregoing then you have lost money. It goes without saying that we are talking about inflation-adjusted figures.

Other reasons for incorporating property into an investment portfolio that are often put forward by the financial press include:

- **Forced Savings** - Some people find it difficult to save and consequently never have enough spare cash to invest. Borrowing to buy an investment property and then having to pay off a mortgage is an enforced savings program giving the investor discipline he or she would not otherwise have.
- **Direct Control** - If the investor directly owns the investment property, then he or she has a greater say over what happens to the property than say over a share portfolio. The investor can set the level of rent but can't set the dividend policy of a share in his or her portfolio.
- **Regular Income** - Rents are charged and collected on a regular (weekly, fortnightly etc.) basis so you can extract income from your property frequently, whereas with shares you are paid dividends usually only once or twice a year. Indirect property investments usually provide quarterly distributions. Regular cashflow leads to peace of mind for many investors.
- **Low Volatility in Price Movements** - Share prices move around and can rapidly increase in value and conversely rapidly decrease in value. Listed Property Trusts (LPTs) inherit some of this price volatility in the short to medium term. Other forms of property ownership are less volatile than shares. Property cycles tend to have longer durations than share market bull and bear cycles.
- **High Levels of Income** - Quality property tends to produce higher levels of income than shares and investments in other asset sectors. Recent research suggests, on average, property trusts are yielding around 8% per annum, property syndicates from around 8.5% to as high as 11%, and many residential property investments will achieve around the 5% mark. Shares typically yield at 4% or less and interest on term deposits and other fixed interest securities will struggle to provide 5%. Note there will always be exceptions to the rule.
- **Security -Tangibility.** Bricks and mortar. Property is a physical asset and not just a piece of paper. These attributes make investors feel more secure with property than with other forms of investment. Whether the property market is running hot or cold, property can be used as security for a loan. In the worst case scenario, the property can be sold or it can be lived in.
- **Tax Advantages** - In many respects, the Australian taxation system is skewed towards property ownership. Many property-related expenses, including depreciation on the property, capital allowances and interest on borrowings

are tax deductible against the rental income produced. Net rental losses can be offset against other sources of income. Similar benefits flow through to investors who hold property indirectly.

- **Purchase Assistance** - The residential property purchaser who wishes to live in the property as a home is assisted with his or her purchase by the First Homebuyers Grant and by stamp duty concessions. The homeowner can enjoy tax-free capital gains as his or her home appreciates in value. The homeowner can be absent from the home for a considerable period of time and still enjoy capital gains tax concessions (provided certain conditions are met).

Disadvantages

It wouldn't be fair to consider the advantages of property ownership without considering some of the disadvantages:

- **High Entry and Exit Costs** - In the case of direct property holdings, the acquisition costs to enter the market can be quite substantial and include stamp duty, legal costs, etc. Selling the property attracts agent commissions and legal costs that are normally far greater than the transaction costs relating to shares and managed funds etc.
- **Upfront Purchase Price** - A portfolio of shares can be purchased incrementally as and when surplus funds become available. The deposit to purchase a direct interest in property has to be paid up front with the major bulk of the purchase price due a relatively short time after. For most property investors this will mean borrowing a significant sum of money. Some investors aren't comfortable with large debt exposure, especially when the security may be against the family home.
- **Il-liquidity** - If you need some ready cash, it is a relatively simple matter to sell some listed shares or redeem some units in a managed fund. Direct property tends to be an "all in / all out" proposition. You can't merely sell off the verandah to get your hands on some cash. You have to sell the property to access the capital.
- **Uncertainty** - There are no guarantees of having good tenants and there are no guarantees of having your property tenanted as often as you would like or your cashflow demands require. You are susceptible to zoning changes, council by law changes, major developments nearby and other matters beyond your control, all of which can affect the value of your property.
- **Ongoing Expenses** - Once you have purchased shares you have no further maintenance costs. As a landlord, you will have ongoing repairs and maintenance expenses as well as a raft of recurring fees, charges and agent's commissions.
- **Long Investment Timeframe** - Property ownership requires a substantial commitment of income over a long timeframe (15 to 30 years in some cases) to maintain the property and service any associated debt, hopefully with the prospect of a capital gain when you sell.
- **Loss of Disposable Income & Lifestyle Adjustment** - If the property is negatively geared, even though the Tax Office and the tenant fund part of the loss, the investor still has to find the extra cash to service the net rental loss. This has to be funded by a cut back in lifestyle or working harder to make up the cash shortfall.
- **Risk of Rising Interest Rates** - Perhaps the greatest risk facing an investor are rising interest rates, particularly if the property has been highly geared with borrowed funds. In 2006 there have already been three separate interest rate rises of 0.25%.

TAXATION



"If it isn't the sheriff, it's the finance company: I've got more attachments on me than a vacuum cleaner."

John Barrymore

Irrespective of how an investment property is held, there will be several taxing points along the road from acquisition to disposal. Broadly, any income the property produces will be included in the landlord's assessable income and any expenses incurred in holding the property may be allowed as tax deductions.

Along the way, the Goods and Services Tax (GST) will have a nibble here and there.

On disposal of the property any profit will be subjected to capital gains tax. We will consider the nitty gritty of property taxation as it relates to the most commonly held form of investment property - the residential rental property.

Rental Income

The gross amount of rent and rental-related income that the landlord receives when the property is tenanted is assessable income and must be included in an annual income tax return for the particular financial year.

There are two methods of returning assessable income for tax purposes:

- The cash basis, which recognises income as it is received; and
- The accrual basis, which recognises income as it is earned.

Rental and rental-related income is normally returned on a cash basis. This means that rental income is returned for tax purposes in the year in which it is either received or constructively received.

Rental income or rental-related income that has been constructively received during the financial year must be included as well. Take the example of a landlord who has appointed a real estate agent to manage the rental property and the agent collects rents from the property during June. Even though the landlord didn't receive a cheque from the agent for the net rental income until sometime in July, the landlord must still include the rental income in his or her tax return for the previous financial year.

Rental Related Income

Apart from rent, the landlord may also receive rental-related income which includes forfeited bonds, reimbursements of various rental expenses and insurance recoveries.

Rental bond money when first received is not income - it is capital thus it is not taxable. Consequently, when bond money is refunded back to a tenant, the refund cannot be claimed as a deduction. If the landlord becomes entitled to retain the rental bond money, for example where a tenant defaulted on the rent or caused damage to the property requiring repairs, then the retained rental bond money must be included in the tax return as income.

If the landlord receives a reimbursement or recoupment of deductible expenditure previously incurred, then that amount must also be included as income. For example, if a tenant pays an amount to cover the cost of repairing damage to some part of a rental property and the landlord can claim a deduction for the repairs, then the landlord must return the amount received from the tenant as income.

It is common practice for many commercial premises to be let for a set rent plus "outgoings". The definition of "outgoings" will be set out in the lease, but often includes items like council rates, cleaning charges, fire levies etc. These recovered amounts have to be returned by the landlord as income.

Insurance recoveries, in many instances, will need to be included as rental-related income. For example, an insurance recovery for lost rent is income just like an insurance recovery for tenant damage to the property where a deduction is allowable for the cost of the repairs.

Rental Expenses

Deductions may be claimed for expenses relevant and incidental to the production of rental income earned by a landlord.

Expenses relating to a rental property that are of a capital or private nature cannot be claimed as tax deductions. However a wide range of rental property-related expenses could be claimed as tax deductions during the time the property is rented or is available for rent.

Deductible Expenses include:

- Advertising;
- Agent's commission and charges for rent collection;
- Audit fees;
- Bank charges and fees;
- Body corporate fees for ongoing administration and general maintenance (but not special levies for capital improvements);

- Borrowing and mortgage discharge expenses;
- Computer costs (but see later);
- Council rates, fire levy and water charges;
- Electricity and gas;
- Environmental protection expenses (ie. removing asbestos;)
- Insurance premiums;
- Interest on borrowings;
- Land tax;
- Lease incentives (except in certain cases);
- Lease costs relating to preparation, registration, stamping, assignment and surrender;
- Legal expenses;
- Letting fees;
- Maintenance such as gardening, lawn mowing, cleaning and pest control;
- Management fees;
- Power guarantee payment made on a remote rental property;
- Quantity surveyor's fees for assessing depreciation or capital works claims;
- Rent paid where the lessor rents the property and sub-leases it to a tenant;
- Repairs;
- Safe deposit box used solely to hold the title documents to the property;
- Secretarial and bookkeeping expenses;
- Security patrol fees;
- Servicing expenses;
- Tax advice costs and tax return preparation fees;
- Telephone, stationery and stamps;
- Travel and motor vehicle expenses in connection with rent collection, inspection and maintenance of the rental property (but not in connection with the property's purchase); and
- Water charges.

Some of the listed deductions are examined in more detail in following paragraphs. Please note that the list is non-exhaustive.

Non-deductible Expenses include:

- Acquisition and disposal costs (may form part of the cost base for CGT purposes);
- Capital improvements;
- Expenses incurred during periods of private use;
- Expenses relating to non-arm's length rentals;
- Initial repairs and other costs of preparing a property for rental;
- Lease surrender payments; and
- Pre-purchase building and pest inspection report fees.

APPENDIX J: Property - Initial Repairs
 P: Rental Property Purchase
 T: Clarity for Rental Property Deductions

Apportionment of Expenses

If a rental property is not used solely to produce rental income in a particular tax year, then an apportionment of the rental expenses is required. Apportionment is commonly required when the property is used for private use (ie. a holiday home) or where property rental has ceased during the tax year. Apportionment is simply the process of allocating an expense claim over deductible and non-deductible use. There are a number of methods of

RENTAL PROPERTIES & CAPITAL GAINS TAX

Not all sales of property are subject to the Capital Gains Tax (CGT) provisions on disposal. Some property sales will be subject to normal income tax rules. Property that has been acquired in connection with a business undertaking, eg. property development or speculative building, will normally be taxed as income under ordinary concepts. Property that has been acquired with a long-term view of receiving income will generally be taxed as a capital gain. Property that was acquired before 19 September 1985 (the date CGT was introduced) may be exempt from the CGT provisions as long as there were not significant improvements to the property after this date.

The distinction between the two taxing possibilities is not always easy to make, particularly when a property has not been held for a long period of time or where development activities such as rezoning or subdivision has taken place.

It is important, however, to make this distinction to ascertain which of the taxing provisions (CGT or income tax) will apply. You should discuss the circumstances of your property holding with your accountant or financial advisor to ensure that you understand which provisions will apply to a disposal of property in your circumstances.

The basic thrust of the CGT legislation is to include in assessable income capital gains arising from the disposal of assets acquired (or deemed to have been acquired) on or after 20 September 1985. Capital losses can be carried forward indefinitely, but they can only be offset against capital gains.

Broadly, to calculate whether you have made a capital gain or loss on your property, you deduct the cost base of the property from the sale proceeds.

APPENDIX M: Selling Property - Capital Gain or Income?
S: Main Residence Refresher
U: Practical Tax Tips - The Main Residence 2 Hectares Rule
V: CGT and Your Family Home

Calculating the Cost Base of a Property

There are a number of factors that will add to the cost base of your property when ascertaining a capital gain. Typically, the cost of a property for CGT purposes will include:

- The contract purchase price of the property, less any items subject to depreciation;
- Incidental acquisition costs such as legal costs, stamp duty etc;
- Improvements made to the property;
- Expenditure on the property that did not constitute an improvement, but for which a tax deduction was unable to be claimed;
- Incidental selling costs such as legal costs, agent's commissions, advertising etc.

There are some issues to be mindful of in calculating your cost for CGT purposes. These issues have come about due to changes in legislation and interpretation of legislation and case law by the Tax Office. These issues include:

- **Initial repairs** incurred on a property are generally considered to be of a capital nature and will add to the cost base of a property rather than being outright tax deductible. As previously discussed, this is because a property's purchase price will reflect a poor state of repair and is thus of a capital nature. Additionally, the repair is not incurred as a consequence of the purchaser's period of ownership, rather it was incurred as a consequence of wear and tear during the previous owner's period of ownership;
- **Non-deductible property expenditure** incurred on a property may add to the cost base for CGT purposes. Importantly, for this expenditure to be included with the cost base, the property must have been acquired after 20 August 1991;
- **Previously Claimed Capital Works Allowances** will reduce the cost base of a property. This type of claim arises under Division 10 and is often referred to as building depreciation. Importantly, this adjustment is only required where the property was acquired after 13 May 1997;

- **Depreciable items** are excluded from the CGT calculation due to changes made under the Ralph Report Reforms that excluded all depreciable items sold after 21 September 1999 from the CGT provisions and subjected these items to income tax.

APPENDIX J: Property - Initial Repairs

Example: Calculation of Cost Base

Norm purchased a residential property for \$300 000 on 10 March 1998. Norm incurred legal costs of \$1 500, stamp duty of \$8 000 and penalty interest for late settlement of \$1 000. The contract for purchase included \$15 000 for depreciable fixtures within the building. The property was sold on 31 March 2004 for \$500 000 and he incurred agent's commission on sale totalling \$15 000 and legal costs of \$800. Norm initially spent \$12 000 to spruce up the property prior to it being rented on 1 April 1998, including painting and landscaping, and put an extension onto the property costing \$30 000 in March 1998. The house was initially built for a cost of \$150 000 in the six months up to June 1986 and Norm has claimed \$28 000 in Division 10D deductions for building depreciation. Norm has claimed \$12 000 in depreciation on the fixtures which have a written down value of \$3 000 at sale date. The contract apportioned \$10 000 to those fixtures.

Norm's cost base on the property is calculated as follows:

	\$
Contract Purchase price	300 000
Less Depreciable items	(15 000)
Cost of CGT Asset	<u>285 000</u>
Less Division 10D claim previously made	(28 800)
	<u>256 200</u>
Plus Purchase legal costs and stamp duty	9 500
Unclaimed costs settlement interest	1 000
Initial repairs not claimed	12 000
Extension	30 000
Selling legal costs and commission	15 800
Total Cost Base	<u>324 500</u>

Calculation and Taxation of the Gain

For disposals made after 21 September 1999 a CGT discount may be applied to exempt part of the capital gain from tax for individuals, trusts and superannuation funds provided the property has been held for a period of 12 months or more.

The discount for individuals and trusts is 50%, which effectively limits CGT to less than 25%. For superannuation funds the discount is 33 1/3%. Superannuation funds enjoy a tax rate of 15% so the CGT discount effectively reduces the capital gains tax to 10%. This reinforces the use of self-managed superannuation funds as a vehicle to hold growth assets such as property.

Companies are not entitled to a CGT discount. A capital gain on disposal of a property held by a company after 21 September 1999 forms part of the company's taxable income and is subject to the corporate tax rate without the benefit of a CGT discount.

A capital gain arising from the sale of a property acquired before 22 September 1999 can be calculated using one of two methods.

Individuals, trusts and complying superannuation funds can choose to apply the indexation of cost base (indexation method) or the CGT discount (discount method).

The indexation method indexes the cost base of the property for inflation so that the capital gain that is taxed is the "real" gain or the non-inflationary component. Indexation, for the purpose of CGT calculations, was frozen at 30 September 1999. The method also requires the property be held for a period of 12 months or more.