If you are one of the many people who have invested or are contemplating an investment in real estate for the purpose of deriving rental income, this article may assist you in understanding how the income tax system in Australia affects you.

It discusses the concept of negative gearing, the principle underlying the taxation of income from property that is rented out and the deductions that are allowable against rental income.

Negative Gearing

A rental property is negatively geared if it is purchased with the assistance of loan 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 offset the net rental loss against your other income, such as salary, wages or business income when you complete your tax return for the relevant income year. This has the effect of reducing your taxable income for the year and you may be entitled to a refund of a part of your PAYG tax that has been paid on your other income during the relevant income year.

Rental Income

If you own a property and it is rented out to tenants during the income year, the gross rental income you receive is taxable. You may have also received other rental related income such as rental bond money that is retained to cover outstanding rent, insurance payments to compensate for lost rent and reimbursements from tenants for expenses relating to the property. All these rental related receipts are also taxable. It should be noted that bonds are generally only taxable when the owner becomes entitled to retain the bond - not actually when they receive the bond.

Rental Expenses

Against that rental income, you can claim a deduction for certain expenses you incur for the period that your property is rented out or is available for rent. However you cannot claim expenses of a capital or private nature. If the property is not available for rent for the full year, an apportionment on a time basis will be required to limit the deduction to the period that the property is available for rent.

Expenses incurred in owning a rental property include advertising, agent's commission, maintenance contributions to a body corporate, cleaning, insurance, travel, inspection, lease preparation costs, repairs, council rates, water rates, land tax, gardening, pest control and interest charges on loans. These expenses are generally deductible in the period when they are incurred, provided the property is tenanted out or available for rent during that time. Some other rental expenses that you incur are subject to specific deduction rules in the income tax legislation.

Prepaid Expenses

If you prepay a rental property expense such as insurance or interest on loans, you need to be aware of specific rules regarding prepayments in the tax legislation. If the prepaid expense covers a period of 12 months or less and the period ends on or before the end of the next income year, you can claim an immediate deduction. Otherwise, your deduction may have to be spread over the period that the expense relates to.

Borrowing Costs

If you take out a loan to finance the purchase of the rental property, you will incur borrowing costs such as loan establishment fees, valuation fees, title search fees and mortgage document preparation and filing fees. If the total of these items exceeds $100, they are claimed over 5 years or the term of the loan, whichever is shorter. If the total costs are $100 or less, they are fully deductible in the year you incur them.

If you obtain the loan part way through the year, the deduction for the first year will be apportioned according to the number of days you had the loan.

Decline in value of depreciating assets
(previously known as depreciation)

If your rental property is furnished with items such as carpets, curtains, blinds, furniture and white goods, the costs of these items are not immediately deductible. Provided these items are used or installed ready for use for the purpose of deriving rental income, you can claim a deduction known as the 'decline in value' of these depreciable assets over a number of years representing the asset's effective or useful life. You can either make your own estimate of the asset's effective life or adopt the effective life determined by the Australian Taxation Office.

An immediate deduction applies to all depreciable/capital items of $300 value or less not used for business purposes. Some items that are fitted in a rental property such as built-in cupboards, fencing and retaining walls, are not regarded as separate assets in their own right. However, a capital works deduction may be allowed for some of these items.

Capital works (special building write-off) deduction

You may be entitled to claim a capital works deduction, which is an annual straight-line amount, based on the original costs of construction, alteration, extension or improvement to the income producing building. This is also known as the special building write-off. The annual rate, which is either 4% or 2.5%, is determined principally by when the construction commenced and by the type of building or improvement it is.

The deduction is based on the original construction costs and not the purchase price. Subsequent owners of an income producing property can only claim the balance of the undeducted original cost of the previous owner.

When you purchase a property for rental purposes, you should ask the vendor when the building was constructed, what the cost of construction was and when it was first used to earn income, to determine the amount of undeducted capital works deduction that you may be entitled to. If this information is not available from the vendor, the Tax Office allows you to engage a suitably qualified quantity surveyor or other expert to determine an estimate of the original construction costs.

Repairs

Expenditure on repairs to income producing property are tax deductible provided the repairs relate directly to wear and tear and other damage that occurred as a result of you renting out the property. However, if at the time of acquisition, the property was in need of repair, then the expenditure on initial repairs after acquiring a property are not deductible. Such initial repairs are considered to be capital expenditure and must be added to the cost of the property for tax purposes. This is an area where many investors can be caught out, especially when they have had a survey done of the building which sets out the repairs needed to the building at the time of acquisition, as the requirement of initial repairs is then well documented!

Acquisition and disposal costs

The acquisition and disposal costs of the rental property are not immediately deductible. Such costs include the purchase cost of the property, conveyancing costs and stamp duty on the transfer of the property. Expenses such as legal costs, etc reduce the capital proceeds received on sale and are not deductible. If the property is acquired after 19 September 1985, these costs form part of the cost base of the property for capital gains tax purposes and are taken into account in determining any capital gain or loss when the property is sold.

Note: The above article has been prepared for the exclusive use of Joyce Property Investments. As the specific circumstances of each property investor is different, no action should be taken by any investor in relation to any matters set out in the article without first obtaining professional advice in relation to their specific circumstances.