THINGS YOUR ACCOUNTANT NEVER TOLD YOU ABOUT INVESTING IN PROPERTY

ARMSTRONG M & WAUGH T

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Michael has been in public practice for over 10 years and has been helping property investors and property developers work through the complex tax and structuring maze during that time. He has had the opportunity to experience a few different property cycles and seen firsthand the strategies employed by many of his clients and those that have been successful in their investment journey and those who haven't been as fortunate.

Michael started his career as an auditor before working for one of the Big 4 accounting firms and ultimately moving into public practice.

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PURPOSE OF THE BOOK

Australians have a love affair with property. It is an area that most Australians, and our clients, feel comfortable investing in.

Of course, along with the challenges that come with choosing the right type of property whether it be commercial, industrial or residential there are also the many tax and structuring issues that come with owing an investment property.

We hope that we can share some of the many questions we get from clients and help you determine what structures are available for the property investor, how the tax system works for property investors and help unravel the confusion that confronts many new and even seasoned property investors.

WHAT IS NEGATIVE GEARING ?

Negative gearing occurs where the tax-deductible expenses associated with owning an investment property including interest and depreciation exceeds the income generated from that same property. This net tax deduction allows the taxpayer to claim a deduction against their other assessable income e.g. income from their main occupation.

The following example illustrates how negative gearing works in practice. Bob has income of $ 100,000 from his work as an engineer and his employer has made tax installments of $ 25,717 for the 2020 financial year.

Bob purchases an investment property 100% in his own name with the following income and expenses for the 2020 financial year.

Rental Income	$ 20,000
Property Costs	$ 10,000
Interest	$ 15,000
Depreciation	$ 5,000
Investment Tax Loss	**$ 10,000**

The $10,000 is then claimed as a deduction against Bob's other income of $ 100,000. This brings his taxable income down to $ 90,000. The tax on Bob's adjusted taxable income is now $ 21,537. As Bob's employer has already made tax installments of $ 25,717 he will be entitled to a refund from the ATO of $ 4,180.

WHAT HAPPENS TO ALL THE INITIAL COSTS?

Obviously the first expenses you will have when you purchase an investment property are things such as the actual price you paid for the property, stamp duty, legal expenses, etc. A common question we get asked by clients is what happens to all those expenses you paid up-front?

We will go through each of the expenses you have when you purchase an investment property and outline what happens for tax purposes.

Purchase Price

The purchase price is obviously the largest cost. This is not a tax deduction, but it is included in a tax term called the 'cost base'. What this means is that it is used to calculate the capital

gain or capital loss you make when you eventually sell the property.

Stamp Duty on Property

This cost is included in the 'cost base'.

If the stamp duty relates to a lease, then the expense is tax deductible. Section 25-20 ITAA 1997 provides a deduction for the costs of preparing, registering or stamping a lease of a property where the property is used solely for the purpose of producing assessable income. For example in the Australian Capital Territory (ACT) a lot of the land is on a crown lease and therefore the "stamp duty" paid on the purchase of property in the ACT will in all likelihood be a tax deduction as it relates to the cost of preparing a lease on Crown Land which is granted for definite period of time.

Legal Fees and/or conveyancing fees

This cost is included in the 'cost base'. It is not tax deductible.

If the legal expenses related to reviewing loan documents or specifically related to the loan documentation, then this would be deductible as borrowing expense.

Real Estate Agent’s Commission

This cost is included in the ‘cost base’. It is not tax deductible.

Building and Pest Inspection Reports

This cost is included in the ‘cost base’. It is not tax deductible.

COMMON MISTAKES

- Claiming the stamp duty paid on transfer as a tax deduction where the property is not a crown lease.
- Claiming borrowing expenses in the first year rather than apportioning them.
- If the loan has a private component and investment component not making an adjustment to the borrowing expenses for the private component.

WHAT CAN I CLAIM?

So, you've just purchased your investment property and you are now wondering what you can claim on your tax return. Following are some of the common and some overlooked deductions that are available.

Property must be available for rent

It is important that the property is available for rent. This doesn't mean that the property has to have been rented but you have taken reasonable efforts to try and rent the property. Negotiations with agents, advertising in local papers and other such things go toward proving that you have made the property available for rent. This can be extremely important where you had the property vacant for some period and must prove to the ATO that the property was available for rent. If the property was not available for rent, then the expenses will need to be apportioned. You also need to be careful that the rent is not set so high that the property would generally not attract a tenant for the area in which it is located as the ATO could argue you have set the rent so high so as not to attract a tenant and therefore it was not available for rent.

If you merely intend to make the property available for rent and don’t take any steps to make it available for rent, then this will probably mean the expenses won’t be deductible until such steps are taken.

Even if the property has been taken off the market as you intend to do some repairs to the investment property then interest expenses and other costs such as council rates, etc. will still be deductible provided

- You don’t leave the premises vacant for such a long period of time
- The expenses are incurred with the view to gaining future income; and
- You continue to make efforts to undertake repairs on the property.

If you merely intend to make the property available for rent but don’t actually take any steps to do so then the ATO does not consider this to be sufficient. Steps that will help you in arguing that you have made the property available for rent include

- Listing the property with an agent or on a website such as ozstays.com etc.

- Making sure the rent is set at a commercial rate considering the area in which it is located, age of the building, restrictions (e.g.no pets), etc.
- Ensuring that you don't limit the times that the property can be used. E.g. a beach house which you don't list or make available for rent during the holiday season e.g. Christmas so you and family and friends can spend time there.

Travel Expenses

From 1 July 2017 travel expenses in relation to a residential investment property are no longer tax deductible. However, the change to legislation does not impact those individuals who hold commercial properties or are carrying on a business of property investing.

Note as well if the residential investment property is held by a company or a unit trust (and the units are held by a company) then the travel expenses can still be claimed.

For those excluded entities they can claim travel associated with

- inspecting the property during and at the end of the tenancy
- maintaining the property
- collecting the rent
- visiting the agent to discuss the property
- undertaking repairs to the property

If the trip also included some element of private purposes, then it is extremely important to understand what can be claimed and what cannot. If you have travelled for a holiday and on that holiday, you visited your property then the cost of travelling to the destination and returning will be incidental

to the inspection of the property and none of the travel will be deductible. You may however be able to claim a proportion of accommodation expenses and so documentation will be extremely important.

There are two methods they can use to claim travel expenses if you are eligible to claim them (see above). These include

1. **Cents per kilometre method**. You can use this method to claim up to a maximum of 5,000 investment related kilometres per car even if you have travelled more than 5,000 related kilometers. For example, if you travelled 6,000 kilometres, you can only claim the cost of travelling 5,000 kilometres with this method. You cannot claim for the extra 1,000 kilometres.

   You do not need written evidence, but you may need to be able to show how you worked out your kilometres.

If the motor vehicle is owned by two people, they each get to claim up to 5,000 kilometers for the same vehicle.

2. Logbook method

If you use this method your claim is based on the investment use percentage of each car expense.

You need to keep:

- a logbook to calculate the business use percentage
- odometer readings for the start and end of the period you owned or leased the car, and
- written evidence for all car expenses, except for fuel and oil costs.

Your logbook is valid for five years. You must have kept a logbook during the first year this method is used. The logbook must cover at least 12 continuous weeks.

If you started to use your car for business purposes less than 12 weeks before the end of the income year, you can continue to keep a logbook into the following income year so that your logbook covers the required 12 weeks. If you want to use the logbook method for two or more cars, the logbook for each car must cover the same period.

Your logbook must contain the following information:

- when the logbook period begins and ends
- the car's odometer readings at the start and end of the logbook period the total number of kilometers that the car travelled during the logbook period
- the number of kilometers travelled for work during the log book period based on journeys recorded in the logbook. If you make two or more in a row on the same day, they can be recorded as a single journey, and
- the investment use percentage for the logbook period.

What about travelling to inspect the property before or soon after purchase?

If you have travel expenses such as motor vehicle expenses, airfares or accommodation expenses for inspecting a property for a potential purchase then this will be a capital expense and not immediately deductible.

A double whammy is that the travel expenses also do not form part of the cost base of the asset even if you eventually buy

the property. Unfortunately, this one is just a sunk cost of acquisition. No tax benefits at all here.

Interest Expenses

This can be quite a complex area and probably causes the most confusion and disagreements amongst advisers.

The ATO look at the 'use test' to determine the deductibility of interest. FC of T v Munro[1] established this principle and looks at the application of how the funds are used to determine interest deductibility. Taxation Ruling 95/25 says that generally, the starting point for determining the essential character of an interest expense is to determine the 'use' to which the borrowed funds have been put, i.e., you trace the borrowed funds.

We will try and go through a few examples and common questions asked by clients to give you an idea of the deductibility of interest in each of those scenarios.

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[1] *Federal Commissioner of Taxation v. Munro* (1926) 38 CLR 153

Can you claim an interest deduction for vacant land on which you intend to build an investment property?

Prior to 1 July 2019 things were a little different. Changes that were introduced into law have changed the landscape for deductions for interest deductions (and other costs which we will discuss below).

Prior to these changes we had seen several advisers who suggested that the interest expense should be capitalised (i.e. added to the cost base of the property and used to reduce the capital gain or increase the capital loss on sale) as no income has been earned at this stage. However, the relevant case was Steele v FC of T[2] and this case confirmed that provided certain things occur then the interest will be deductible despite no income having been received during the construction phase. The case says that the interest will be deductible provided that

- The interest is not incurred 'too soon', is not preliminary to the income earning activities and is not a prelude to those activities
- The interest is not private or domestic

[2] *Steele v. FC of T* 99 ATC 4242; (1999) 41 ATR 139

- The period of interest outgoings prior to the derivation of relevant assessable income is not so long, considering the kind of income earning activities involved, that the necessary connection between outgoings and assessable income is lost
- The interest is incurred with one end in view, the gaining or producing of assessable income, and
- Continuing efforts are undertaken in pursuit of that end.

Well from 1 July 2019 things have changed.

The costs associated with holding vacant land (this will include interest, council rates, land tax) will no longer be deductible. Unfortunately, there are no 'grandfathering' provisions in the legislation. So what this means is that if you held vacant land prior to 1 July 2019 you are still denied these deductions going forward. Ouch !!

These costs will however be able to be included in the cost base. What this means is that when you eventually sell the property these costs will reduce the capital gain you make on sale.

If the vacant land is held by a company, a superannuation fund THAT IS NOT an SMSF, a public unit trust, managed investment trust or a partnership or unit trust which is made up of those type of entities then the new law doesn't prevent you from claiming these holding costs.

There is also an exclusion if you are **carrying on a business.** So, if you are a property developer and hold vacant land as part of your property development business then the legislation won't affect you.

What is considered to be vacant land ?

The Explanatory Memorandum provides some guidance and says that Land is vacant, for the purpose of these amendments, if there is no building or other structure on the land that is **substantial and permanent in nature** and in **use or ready for use.**

In this context, land does not have to refer to the whole of the land on a property title but could refer to part of the land on a property title. For example, if a property title includes two areas of land, one containing a factory and the other undeveloped, the part of the property title containing the

factory has ceased to be vacant land, while the undeveloped area remains vacant land.

Chelsy owns a block of land. She intends to eventually build a rental property on the land. However, while the block of land is fenced and has a large retaining wall, it currently does not contain any substantial or permanent building or other structure. As the property does not have a substantial permanent building or structure on it, it is vacant land and Chelsy cannot deduct any holding costs she may incur in relation to the land.

VACANT LAND AND INTENTION TO CONSTRUCT RESIDENTIAL RENTAL PROPERTY

Peter and Jim acquire vacant land with an intention to construct a new residential property which they will rent out.

Peter and Jim will not be able to claim a deduction for interest, council rates, land tax or maintenance costs until :

- The construction of the residential investment property is complete

- Approval has been granted to occupy the property ;

AND

- The property is genuinely available for rent.

Can you claim an interest deduction for a redraw from a line of credit ?

The interest deduction on the redraw always depends on the 'use test'. If you had an investment property loan and you redrew the funds for private purposes e.g. living expenses, then the redrawn component will be non-deductible.

If, however the redrawn funds were used for investment purposes then the interest on the redraw will be deductible.

Taxation Ruling TR 2000/2 examines the treatment and consequences of payments to lines of credit (LOC) more than the required amount and the subsequent redrawing or withdrawal of these funds.

It is considered that a repayment to a LOC more than the required amount is a permanent reduction to this debt. Repayments of an amount to a LOC do not create a debt due to the borrower, but simply allows the borrower to then draw funds from the LOC to an agreed limit. These redrawn funds therefore constitute new lending and as such, the purpose or use of these drawings is relevant.

If you have an LOC which contains some deductible and non-deductible components, then apportionment of the interest

deduction may need to be undertaken. Paragraphs 19-20 of TR 2000/2 contain formulas which can be used to calculate the income producing portion of interest. The ruling accepts that it would be unnecessarily onerous to require a manual daily apportionment calculation.

It is accepted that the interest accrued in a month is deductible where it is calculated using an apportionment approach based on the average outstanding principal used that month for income producing purposes.

The formula uses opening and closing balance for each month of outstanding principal used for income producing purposes. The closing balance amount includes any repayments and withdrawals transacted on the LOC during that month.

It isn't acceptable where you have one loan with private and investment debt to allocate specific amounts to specific portions of the debt. For example, if you had a total loan of $300,000 and $200,000 of that debt was used to purchase an investment property and $100,000 was used for a motor vehicle and you subsequently made a $50,000 repayment on the total loan you couldn't say the $50,000 related to the repayment of the loan for the motor vehicle. You would need to apportion the $50,000 repayment across both the

investment property debt and the motor vehicle debt as it is one consolidated loan.

Can you claim a deduction for fees on a bank guarantee or deposit bond?

Bank guarantees or deposit bonds are generally used in lieu of a deposit. ATO ID 2003/113 Rental Property Expenses - bank guarantee in lieu of deposit - deductibility of fees says that you cannot claim a deduction for the fees associated with a bank guarantee or deposit bond.

Can you claim a deduction for interest on a loan taken out to purchase a share of a property held by your partner?

Let's say you have an investment property held 50/50 by you and your partner. You decide that you would like to purchase the 50% interest held by your partner and obtain a loan to fund that purchase. ATO ID 2001/79 Interest Expense: Borrowed Funds says that provided that the property is used for income producing purposes e.g. an investment property then the interest on the loan to buy out the partner's 50% share will be deductible.

Can you claim a deduction for interest on a loan taken out to reimburse you for a deposit paid from your savings account?

We frequently see some poor advice from brokers advising their clients to pay for the deposit on their investment property from equity in their existing home or from their savings account and once the investment property loan has been approved to reimburse them for the deposit paid from the other account.

The problem is that any interest on the funds used to reimburse the person will not be deductible.

The reason goes back to the use test. The purpose for which the funds were put have been to deposit money into a savings account. The funds being borrowed are not being used for investment purposes despite the original funds being used for that purpose. It sounds pedantic but like everything in tax it's the fine details that matter.

Repairs and Maintenance

Non capital expenditure incurred on repairs to a property held for investment purposes is generally deductible under Section 25-10 of the ITAA 1997.

It is important to distinguish between a repair and an improvement as the deductibility is very different. If something is classified as a repair, it is immediately deductible. If something is classified as capital expenditure or a capital improvement, then it is not immediately deductible but you may be eligible to depreciate the item over a number of years and claim a deduction for the depreciation every year.

Taxation Ruling TR 92/3 Income Tax: Deduction for Repairs states that

> *15. Repair for the most part is occasional and partial. It involves restoration of the efficiency of function of the property being repaired without changing its character and may include restoration to its former appearance, form, state or condition. A repair merely replaces a part of something or corrects something that is already there and has become worn out or dilapidated. Works can fairly be described as 'repairs' if they*

are done to make good damage or deterioration that has occurred by ordinary wear and tear, by accidental or deliberate damage or by the operation of natural causes (whether expected or unexpected) during the passage of time.

What does the ATO consider to be the difference between a repair 'deductible immediately' and a capital improvement 'potentially deductible under the depreciation and capital allowance provisions'?

TR 97/23 states that with a repair, the work restores the efficiency of function of the property without changing its character. An improvement, on the other hand, provides a greater efficiency of function in the property. It involves bringing a thing or structure into a more valuable or desirable state or condition than a mere repair would do.

It is acknowledged in TR 97/23 that to repair property improves to some extent the condition it was in immediately before repair. A minor and incidental degree of improvement, addition or alteration may be done to property and still be a repair. However, if the work amounts to a substantial improvement, addition or alteration, it is not a repair and is not deductible under section 25-10 of the ITAA 1997.

A repair replaces a part of something or corrects something that is already there and has become worn out or dilapidated. It's usually occasional or partial and restores something to its original efficiency. Repairs make good damage which has occurred through normal wear and tear, or by accidental or deliberate damage or the effects of natural causes. Note however that repairs are generally partial. Replacing a faulty filter in a dishwasher may be a repair; replacing the dishwasher generally is not.

Expenditure on a thing or structure that is a renewal, replacement or reconstruction of the entirety is an improvement rather than a deductible repair.

Example extracted from **Private Binding Ruling Authorisation Number 1011238209812**

"**Fences**

Three sections of fence totalling 29 metres out of a 120 metre perimeter were in disrepair and subsequently replaced. One section of fence consisting measuring 20 metres was replaced with galvanised steel mesh. The original material consisted of hardwood staves on a hardwood rail connected to a galvanised pipe. The other two sections of fence (6 metres and

3 metre lengths) were replaced with CCA pine on CCA pine rails and CCA treated hardwood posts and / or galvanised pipe. The original material used treated pine on hardwood rails and galvanised pipe. The 20 metre section of fence will have the advantage of longer life than the original untreated hardwood. You undertook the repairs to the fences yourself. Your neighbour contributed $155 towards the costs of repairing their 6 metre portion of the side fence. This amount has been deducted from the claim amount. You are not entitled to any claim from insurance for the repair of the fences. You have written evidence to support your claim.

ATO Response

“In your case you repaired 29 meters of a total 120 meters of perimeter fence. Even though you repaired part of the original fence with a different material it only represents a replacement of something that was already there with its modern equivalent and does not change the character but merely restores its function.

Under section 25-10 of the ITAA 1997 you are therefore entitled to a deduction for your share of the expenses incurred in repairing the fences.”

Costs incurred for replacing asbestos materials may be deductible under Section 40-755 of the ITAA 1997 even if they involve the entire replacement of an item. For example, a roof which has asbestos which is replaced in its entirety with new materials would normally be classified as a capital improvement and not eligible for an immediate deduction under Section 25-10 of the ITAA 1997. However, if the replacement of the roof was done to remove the pollution risk to the property then the cost of removing and replacing the roof would be deductible under Section 40-755 of the ITAA 1997.

The cost of replacing worn carpet and polishing the underlying floorboards is not considered to be an improvement but is a deductible repair which is confirmed in ATO ID 2002/330 Rental property repairs – replacing worn carpet by polishing existing floorboards.

This is an area which causes a lot of confusion and an area which many people get wrong.

Depreciation and Capital Allowances

Depreciation

Division 40 of the ITAA 1997 allows a deduction for the decline in value of capital assets over their useful life. The useful life of various assets is provided by the ATO.

Division 40 provides three methods that a taxpayer can use to depreciate an item. These include

1. **$300 immediate write off.** Under Section 40-80(2) ITAA 1997 an asset that costs less than $300 can be claimed as an immediate deduction in the year that the expense was incurred.
2. **Effective life deduction.** The ATO provides a list of effective lives for various assets (the most current one is TR 2013/4 Effective Life of Depreciating Assets. This allows you to depreciate an asset over its effective life as determined by the Tax Office.
3. **Low Value Pool otherwise known as the LVP.** Subdivision 40-E of the ITAA 1997 allows you to deduct an asset less than $1,000 (either its cost or written down value) using a rate of 18.75% in the first year and 37.5% every year thereafter until it has been written off.

This excludes any assets that cost less than $300 which can be immediately written off under Section 40-80(2) of the ITAA 1997.

Capital Allowances

Division 43 of the ITAA 1997 allows a deduction for capital expenditure incurred in constructing capital works, including building and structural improvements, where a residential property is used for income producing purposes.

This capital allowance can be claimed for

1. Costs to construct the building itself if the construction started on or after 18 July 1985 ; and
2. The deduction is available on the cost of constructing structural improvements or extensions, alterations or improvements to structural improvements if construction started on or after 26 February 1992.

Under Section 43-25 of the ITAA 1997 the deduction is based on when the construction commenced.

For capital works begun after 26 February 1992, there is a basic entitlement to a rate of 2.5% The rate increases to 4%

for parts used as described in Table 43-145 (called 'Use in the 4% manner').

For capital works begun before 27 February 1992 the rate is generally:

(a) 4% if the capital works were begun after 21 August 1984 and before 16 September 1987; or

(b) 2.5% in any other case.

This can be significant to the property investor as it allows you to claim a deduction against your income without having to pay out physical cash. We believe it is extremely important to obtain a quantity surveyors report (sometimes referred to as a depreciation schedule) to ensure you have claimed all relevant depreciation and capital allowance deductions.

Some of the depreciation companies our clients have used in the past and schedules we have found easy to read and the claims maximised but within the law include

Depreciator	www.depreciator.com.au
BMT & Associates	www.bmtassoc.com.au
Washington Brown	www.washingtonbrown.com.au

The cost of obtaining the depreciation schedule is also tax deductible.

RECENT CHANGES

From 9 May 2017 the depreciation landscape changed dramatically. These changes are effective from 1 July 2017.

You can no longer claim Division 40 depreciation deductions for second-hand or used depreciating assets whether they are purchased with the property or bought separately.

You can however claim Division 40 depreciation deductions for new items purchased and installed after 1 July 2017.

For properties that were purchased prior to 9 May 2017 **AND** were available for rent during the 2017 financial year (i.e. prior to 1 July 2017) then you will continue to be eligible for Division 40 depreciation deductions.

On the 5th August 2018 Peter purchased a two bedroom apartment that was constructed 2 years ago. The apartment had a number of depreciating assets (carpets, oven, air conditioner, etc) that were purchased and installed by the person who previously owned the property.

Peter installs

1. New blockout blinds in the lounge room purchased from Harvey Norman
2. A second hand television from a garage sale

Peter will not be able to claim a Division 40 capital allowance deduction for the depreciating assets that form part of the property as these were installed by the previous owner. He will also not be able to claim a Division 40 capital allowance deduction for the second hand television.

Peter will however be able to claim a Division 40 capital allowance deduction for the new blockout blinds as they are new and have not previously been used when he installed them in the property.

The changes have not impacted the ability to claim Division 43 Capital Works Deductions and, as this is usually a much more significant deduction over the longer term, it is still worth looking into whether it is worth obtaining a Depreciation Schedule at least for those deductions.

I had a property which was my main residence and had installed a lot of new items (air conditioner, carpets, blinds, etc) and moved out of the property in May 2020 and turned it into an investment property. Can I claim Division 40 capital allowances for those new items ?

No, you would not generally be able to claim depreciation deductions in relation to these items.

If the items are purchased on or after 7.30pm on 9 May 2017 then the rules prevent depreciation deductions from being claimed in relation to these assets from the 2018 income year onwards if any of the following apply:

- The asset has been used by another taxpayer (other than as trading stock) before the taxpayer started the hold the asset;
- The asset was used in the current year or a prior year in residential premises that were a residence of the

taxpayer at that time (doesn't need to have been their main residence); or

- The asset was used for a non-taxable purpose in the current year or a prior year, unless that use was occasional.

As the property, and the items in the property, have been previously used you would not be entitled to a depreciation deductions on those items.

Depreciation and New Residential Premises

For people who are purchasing new residential premises there is some relief from the changes that to apply.

If you have purchased a property that is new from a builder for example the depreciating assets will generally not be considered to be second hand assets and so are eligible for the Division 40 capital allowances deductions.

There are some conditions that apply however

1. The depreciating assets are sold to you as part of the sale of the new residential property; **and**
2. No one has been living in the property at a prior time in which the asset is installed before it was held by the current owner; **OR**

3. The assets were used by someone living in the property in which the asset is installed but from the date from which they became new residential premises to the date the property was sold to you no more than 6 months has elapsed.

This rule was designed to assist in situations where a builder might be renting out a new residential property for a few months before being able to find a buyer for the property.

Joan purchased a new residential apartment from Bob the Builder on 2nd December 2019. The apartment was completed on 2nd September 2019 and Bob rented the property to Peter and Jane. The depreciating assets that Joan has purchased with the new residential apartment

1. Have been installed in new residential premises purchased as part of the sale by Joan.
2. Bob the Builder has not been able to claim a deduction for those assets under Division 40
3. The assets installed in the apartment have been supplied to Joan within 6 months of the apartment becoming new residential premises

Therefore, Joan would be entitled to a deduction.

Borrowing Expenses

You can claim borrowing expenses greater than $100 over a five-year period or over the life of the loan whichever is the least. You can claim all the following borrowing costs

- stamp duty charged on mortgage (note this is not the stamp duty on purchase of the property)
- loan establishment fees
- title search fees charged by the lender
- costs for preparing and filing the mortgage documents
- mortgage broker fees
- valuation fees for loan approval
- lender's mortgage insurance

It is important in the first year that you don't claim the full amount of the borrowing costs, but you will need to apportion the first years borrowing costs over the number of days between the date you took out the loan and the end of that particular financial year. Another common mistake is either not claiming the borrowing costs at all or claiming them all in the first year the loan is taken out.

If a loan has been taken out and has a mix of private and investment/business components (something we recommend

you really try to avoid and work together with your accountant and mortgage broker to prevent getting into this sticky situation) then the borrowing expenses also need apportioned.

Apportionment of borrowing costs

Maxine borrowed $300,000 on 15 July 2019 for which 50% ($150,000) was used to acquire an investment property. She used the balance of $150,000 to buy a Porsche Cayman S ("lucky girl") so she could experience the wonders of the Great Ocean Road in her mean machine.

Her borrowing costs associated with the loan were $5,000. As 50% of her loan was used for income producing purposes only that portion of the borrowing costs will be deductible to her over a five-calendar year period.

Year	Total Expense $	Investment Portion (deductible) $	Private Portion (non deductible) $	Balance $
2020	961.12	480.56	480.56	4,038.88
2021	999.45	499.73	499.73	3,039.43
2022	1,002.19	501.10	501.10	2,037.24
2023	999.45	499.73	499.73	1,037.79
2024	999.45	499.73	499.73	38.34
2025	38.34	19.17	19.17	-
Total	**$ 5,000.00**	**$ 2,500.00**	**$ 2,500.00**	

Section 25-30 of the ITAA 1997 says that if you pay out the loan earlier than the five-year period then the remaining amount that has not been claimed can be fully claimed in the year that you pay out the loan.

Buyer's Agents Fees

As people are working longer hours and it is becoming more difficult to find properties with good yields it is becoming increasingly common for many people to use a buyer's agent. We have a few clients who are buyer's agents and some of the deals we have seen look very attractive.

A common question is “if these properties are so good then why doesn’t the buyer’s agent grab them for themselves?”. Well many times they do. But like all of us a buyer’s agent doesn’t have an unlimited source of funding and they frequently max out their ability to borrow or the timing isn’t right as they may have other deals underway at the time something very attractive comes along.

ID 2009/9 Deductibility of expenses: property buyer’s agent’s fee says that if someone engages a buyer’s agent to help purchase a rental property then this fee is not tax deductible. However, it doesn’t tell us whether the costs are a capital cost to be added to the ‘cost base’. Thankfully ID 2003/361 Capital gains tax: cost base - consultant's fees tell us that buyers agents fees are added to the cost base of the asset. However, this will only be relevant where a successful purchase has been made i.e. a buyer’s agent was engaged to find a property and eventually you purchased that property. If you paid a buyer’s agent to find a property and you didn’t eventually buy the property, then unfortunately those costs are not deductible and don’t get added to the cost base of any future property.

If the fee being charged is to evaluate a current portfolio and provide recommendations for improving the rental income stream on the current portfolio then this would be tax deductible as it relates to current investments.

Be careful of buyer's agents who have been advised by their accountants to load their invoices up (basically falsify them) for the difference in work performed. We have been informed of one buyer's agent who was really charging for sourcing a property but was increasing the invoice for reviewing the client's current portfolio presumably, so the client could obtain a tax deduction. The ATO can and will deny these deductions in an audit and require you to apportion them as they should have been in the first place.

Other Expenses

Other things to keep a record of for claims include

- advertising
- accounting fees
- bank charges
- body corporate fees
- cleaning
- commissions
- council rates
- electricity
- gardening
- insurance
- land tax
- letting fees
- linen
- postage
- printing
- telephone

CO-OWNERSHIP OF PROPERTY

Where you are not carrying on a rental property business Taxation Ruling TR 93/32 (TR 93/32) provides that the income or loss from rental properties must be shared according to the legal interests of the owners except in those very limited circumstances where there is sufficient evidence to establish that the equitable interest is different from the legal title.

The equitable interest will only be different if the owner shown on the title deed is holding a share of the property in trust for another person.

Terry and Mia purchase a rental property as tenants in common with Terry holding 75% and Mia holding 25%. Terry and Mia must apportion the income and expenses from the rental property in accordance with their legal interest which is 75% and 25% respectively. Even if Terry and Mia drafted an agreement which said they would apportion the income and expenses differently this would not be relevant for tax purposes unless they were operating a rental property business.

Taxation Ruling TR 97/11 provides some guidance as to what the ATO considers before classifying whether someone operates a rental property business.

SELLING YOUR MAIN RESIDENCE (PRINCIPAL PLACE OF RESIDENCE – PPOR)

Generally, when you sell your main residence, otherwise known as your PPOR (Principal Place of Residence), the sale is free from capital gains tax. But like everything in tax there are some tricks and traps for the unaware and it is possible that you need to consider capital gains tax when you sell your PPOR.

In our fast moving economy it is becoming more common for people to reside interstate or to be relocated once, twice or more during their lifetime. Many of these people have purchased a home for them or their family and are concerned about the taxation implications if they move and then later decide they want to sell.

There are quite a few scenarios to consider when trying to answer this question and we will endeavor to look at each of them and the taxation implications.

Main Residence Absences – '6 Year Rule'

Once you move out of your main residence there is a rule that allows you to continue to treat this property as your main residence for up to 6 years even though you are no longer living in it. Sounds weird right ?

If you do make this choice, it could allow you to reduce any potential future capital gain on the sale of the property.

This concession is sometimes referred to as the 'absence' provision or the 'six year' rule and does not just apply to moving interstate. It applies whenever you move from your main residence. Even if it's 'down the road'.

Where someone makes this choice to apply the absence provisions they cannot treat another property as their main residence. So, if the absence provisions are applied to a PPOR that becomes an IP and they then move into a new PPOR that new PPOR will be subject to CGT at some point in the future.

We have read on forums where some people think that once the six years is up and you go over that six-year period, and don't sell the property within the six year period, that the

absence provisions don't apply at all. Fortunately, this isn't true and merely an urban legend.

If you keep renting the property for more than 6 years, you don't lose the ability to use the six-year rule. Again, another misconception which is out there. You can apply the absence provisions for the first six-year period for which it was rented and then you will be subject to CGT on the remaining period.

CAUTION

> In order to apply the absence provisions, it is important that property was used as your main residence. You can't apply the absence provisions if you didn't ever live in the property.

The term election makes people think that there are some forms to fill in or they need to somehow tell the Australian Taxation Office that this property is their main residence. Nothing like that must happen. You just need to know in your own mind that this is what you want and that is adequate. Make sure your accountant also knows so they don't make mistakes when preparing your tax returns. It's how you lodge your return that determines that choice.

EXAMPLE

Troy and Mary purchased a home in 2015. They move in straight away and lived in it for 2 years. They then kept the property, moved interstate, rented a house interstate and rented their house. They now want to sell their house in 2020. Will they pay tax on the sale?

Ordinarily Troy and Mary would be deemed to have purchased their home for the market value on the date it first used to produce income which was the market value of the property in 2017. They would ordinarily then pay capital gains tax on the difference between the sales price and the market value of the property when it was first rented.

By using the 6 year absence rule the property will continue to be their main residence until the sale in 2020 and they will not need to pay capital gains on the sale. As they have no other main residence (they are renting another property interstate) they don't need to consider other properties.

What if I lived in the property and rented out one of the rooms. I then move out of the property and rent it for 4 years before selling. Can I use the six year rule to pay no tax on the sale ?

It does sound tempting. Rent out a room, move out and rent the property and then before the 6 years is up sell the property tax free.

Unfortunately this isn't the case.

If you use any part of your home to produce income before you stop living in it, you cannot continue to treat that part of the house as your main residence after you stop living in it. This means that you cannot get the main residence exemption for that part of the house either before or after you cease living it.

You will be able to apply the main residence six year absence rule to the portion of the property that wasn't used to produce income after that time.

Johan purchased a house on 1 July 1995 and he and a tenant moved in immediately. He used 75% of the house as his main residence and the remaining 25% was rented out to Jane.

On 1 July 2019 Johan and Jane both moved out of the property and Johan continues to treat the property as his main residence until it is sold on 1 July 2022.

Johan makes a $50k capital gain on the sale. As Johan had rented the property to Jane , 25% of the capital gain i.e $12,500 will be taxable.

What if I move back into the property again ?

EXAMPLE

As above except Troy and Mary have now been interstate for 5 years. They move back to their original state and move back into their house for another 2 years and then move interstate again, rented a house interstate and rented their house out again. Do they have only one year left for it to be tax free on sale ?

Thankfully the time started again when Troy and Mary moved back into the house. Therefore, when they move back from interstate they have another period of six years for the house to be their main residence and for it to be tax free. There is no limit to how many times you can use the absence provisions. So, if Troy and Mary went interstate 6 times, rented out the property while they were away, and every time they came back they moved back into the property as their PPOR. They could apply the six-year absence provisions 6 times. That's right a potential 36 years of tax free capital gains !!!

Main Residence – Renting First Then Moving In

Troy and Mary would have had to have moved into their investment property 'as soon as practicable' for it to have been their main residence. This means that even though it became their main residence when they moved into in 2007 it was not their main residence from the time they purchased it. Unfortunately for Troy and Mary the 'absence' provisions talked about earlier do not apply from the beginning and they will have to pay tax when they sell. But how do they calculate the amount of the capital gain (or sometimes it's not worth thinking about but a capital loss) ?

Troy and Mary are eligible for some relief. They are entitled to a partial exemption because they lived in the house. The capital gain or capital loss that Troy and Mary will make is calculated on the number of days the house was not lived in by them compared to the number of days they owned the house.

Let's work through a simple example. The house was purchased on 1 July 2005 for $300,000 inclusive of all associated costs such as stamp duty, etc. They rented it out from the day they purchased it (they had some great estate agents) and moved into the house on 1 July 2007. They sold

the house on 30 June 2017 (it's strange how Troy and Mary manage to align everything to the tax year) for $500,000 inclusive of all associated costs.

Troy and Mary will have a capital gain of $200,000. The amount that Troy and Mary will need to consider for tax purposes is calculated as

$$\text{Amount of capital gain} \times \frac{\text{Number of days rented out}}{\text{Number of days owned}}$$

This equals

$$200{,}000 \times \frac{731}{4{,}383} = 33{,}356$$

This amount will be eligible for a discount called the general capital gains tax discount which is currently 50%. This would reduce the capital gain to $ 16,678. This is the amount they would be taxed on.

Scenario Four

What if Troy and Mary lived in the house when they bought it in 2005, moved out in 2007, rented out the house in 2007 and purchased another house at the same time they rented out the old one?

You might think this is the same as Scenario Three but it is slightly different. Instead of calculating the capital gain or loss based on the number of days, Troy and Mary can calculate the capital gain or loss based on the difference between what they sell the house for and the market value when it first earned income.

If the market value when it first earned income was $400,000 and they then sell the house for $500,000 the capital gain for tax purposes will be $100,000.

As in Scenario Three Troy and Mary will be eligible for the general capital gains tax discount of 50% which will reduce the capital gain to $50,000. This is the amount they would be taxed on. This assumes that Troy and Mary have not applied the absence provisions to the previous property they have now sold.

SELLING YOUR INVESTMENT PROPERTY

When you sell your property, you will need to determine whether you have made a capital gain or capital loss on the sale. Many people think that there is some sort of separate capital gains tax, but this is not quite accurate. What happens is that you calculate the capital gain or loss you made on the sale and if you have made a capital gain it is added to your other assessable income to determine your tax liability. A capital loss can be used to offset any other capital gains you have made e.g. sold some shares at a profit and if you have no other capital gains to offset then the capital loss can be carried forward indefinitely to be used at a later stage to offset any future capital gains.

There are several things that need to be considered in working out the amount of the capital gain to include in your income tax return and hopefully the following will help you to understand this better. Firstly, it helps to determine which type of entity is holding the asset.

Individuals

If the investment property is held in an individual's name, then the capital gain will be reduced by 50% if the property has been held for more than 12 months.

For example, let's assume that Tony held an investment property for more than 12 months and he calculated his capital gain to be $50,000. The amount Tony will include in his income tax return as being assessable will be $25,000. So, although he made a gain of $50,000 he will only be taxed on the $25,000 at his marginal tax rate.

CAUTION

From 8th May 2012 non-residents for tax purposes are not eligible to reduce their capital gain by 50% for capital gains made after 8 May 2012 up when the property is sold. There is a calculation for non-residents to determine the amount of the gain eligible for the CGT concessions if any.

Trusts

Trusts also get the benefit of reducing the capital gain by 50% if the property has been held for more than 12 months. Note

that Self Managed Super Funds, which is a type of trust, does not get the 50% discount. For an SMSF it is 33.3%.

Companies

Companies do not get the benefit of reducing the capital gain by 50% even if the property has been held for more than 12 months. The entire capital gain is taxed at a rate of 30% or 27.5% if the company is a Base Rate Entity. This is one of the reasons that most advisers will not recommend having an investment property held in a company. If the asset is development stock i.e. part of a property development, then a company may be appropriate and something we will discuss later.

Remember if you have a company acting as trustee for a trust it is the trust that is assessed and not the company acting as trustee.

The next thing that many people forget to do is allocate the purchase price between the land and buildings and the 'depreciating assets' and similarly allocate the sales proceeds between the land and buildings component and the 'depreciating assets'. It is a common misconception that the capital gain on sale is merely the sales proceeds less the purchase price. This simplistic approach will generally lead to

someone incorrectly reporting the capital gain in their tax return and if discovered during audit penalties and interest will apply. So, the question then is how do I calculate my capital gain on sale?

Well the first starting point is to work out what the 'cost base' is. As mentioned previously the tax act uses a term called the 'cost base' to help in working out the amount of the capital gain or loss.

It is very unusual for a contract for sale to allocate the price between the land and buildings and the depreciating assets being sold. TD 98/24 provides some guidance and it is recommended that the apportionment is based on the market value NOT the written down value of the depreciating assets. Of course, if the written down value is equal to market value then that apportionment is fine. A good quantity surveyor will be able to help with those values.

Once the purchase price and sale price has been apportioned you then need to work out the 'cost base'. The general rule is that there are five elements to the cost base of an asset.

First Element **Acquisition Cost**

This is the total of:

- the money paid or required to be paid for the asset; and
- the market value of any property given, or required to be given, in respect of acquiring the asset

Second Element **Incidental Costs**

There are incidental costs of acquiring the asset or which relate to any capital gains tax event. These include:

- stamp duty on acquisition or other similar type of duty
- costs of marketing or advertising to find a buyer or seller
- payments for the services of a valuer, auctioneer, accountant, broker, agent (including property buyer's agents) consultants or legal advisers. Any payments for tax advice can only be included if they have been provided by a recognised tax adviser.
- search fees relating to the asset (such as fees to check land titles and similar fees)
- the cost of a conveyancing kit
- the costs of transfer

- borrowing expenses which are otherwise not deductible
- the cost of making a valuation

Third Element Capital and Non Capital Costs of Ownership

These include any costs such as rates, land tax, interest, repairs and maintenance, insurance, etc. where you haven't already claimed it as a tax deduction.

Fourth Element Capital Improvements

This includes costs to increase or preserve the value of the asset.

Fifth Element Title Costs

This includes capital expenditure to preserve or defend your right to the asset.

I keep hearing from people and on forums that you need to reduce your capital gain by the amount of depreciation you have already claimed? Is this right?

As discussed previously you need to allocate the purchase price and the sale price between land and buildings and depreciating assets. Any gain or loss on the sale of the depreciating assets (e.g. ovens, carpets, furniture, etc.) is what is called in tax terms a 'balancing adjustment' and is treated

separately from the capital gain. The profit on sale is treated as assessable income not a capital gain and any loss on sale is treated as a deduction and not as capital loss. Depreciation already claimed on these depreciating assets are therefore not accounted in calculating the capital gain or loss on sale of the rest of the property.

However, Division 43 capital allowances, something referred to as the special building write off, do impact on the calculation of the capital gain. If you have claimed or could have claimed a deduction for capital allowances (usually the 2.5% building write off) and the rental property was purchased after 7.30pm on 13 May 1997 then the cost base of the property is reduced by this amount. This effectively increases the capital gain on sale or reduces the capital loss on sale. Things are slightly different if a capital loss is made in that the cost base is reduced by these Division 43 capital allowances no matter when the property was purchased.

Peter purchased a rental property on 1 July 2009 for $500,000.

The quantity surveyor’s report obtained by Peter showed that the depreciating assets on purchase came to $30,000. It also showed that the construction expenditure eligible for the Division 43 capital allowance was $150,000. Peter is entitled to an annual tax deduction of $3,750 ($150,000 x 2.5%) on the construction expenditure.

On 30 June 2017 Peter entered into a contract to sell the property for $600,000.

The quantity surveyor’s report obtained by Peter showed that the depreciating assets had an estimated market value of $10,000 at the date of sale.

Capital Proceeds	$ 590,000	($600,000 - $10,000)
Cost Base		
Purchase Price	$ 470,000	($500,000 - $30,000)
Less : Division 43 write off ($3,750 x 8 years)		$ 30,000
Adjusted Cost Base		$ 440,000
Capital Gain before 50% discount		**$ 150,000**

STRUCTURING YOUR ACQUISITION

A very common question we get every week from people is how should I structure my property purchase? Should I purchase the property in my own name, 50/50 with my partner, through a discretionary trust, a unit trust or a company?

As with many things there is no right or wrong answer, but a good accountant and lawyer should be able to work through the pros and cons of each structure and explain how the various structures will impact on them both now and in the future.

As every person's situation is different we will try and cover some of the common scenarios and discuss how structuring could be implemented based on that scenario. Probably the most important part of determining whether a structure is right or not is to look at the overall costs of setting up and administering the structure and ensure that those costs are less than the benefits that can be derived from that same structure. This isn't always easy as circumstances can change but it a useful starting point.

The most common ways to hold property include

- individual name
- joint tenants or tenants in common
- discretionary trust
- unit trust
- hybrid trust (both unit and discretionary trusts – sometimes known as a HDT)
- company
- self-managed superannuation fund

TRUSTS

There is a lot of talk out there about trusts and the benefits of investing via a trust, however a lot of the information is either incorrect or only part of the story. This section of the book is an attempt to summarise the situation in regard to setting up one or more trusts to invest in residential property with information on some things to watch out for and some tips to make it all more efficient. However, the first thing we must look at is what a trust actually is.

What is a trust?

Firstly, I should point out the concept of 'trusts' can be very simple to understand, yet at the same time is also extremely complex. It takes many years for the concept to 'sink in' for most people. This includes lawyers who all would have taken a subject on trusts during their law studies, but who may not have any practical experience with trusts. This is similar for the accountants and financial planners.

Many people speak of trusts as a separate entity, like a company. But this is not the case; a trust is not an entity, but rather a relationship. A trust is not a 'legal person' and cannot

own anything, and therefore it cannot sue or be sued. It is the trustee who acts for the trust and owns trust property in its capacity as trustee.
The trust is the relationship between the trustee, the property and the beneficiaries.

However, for tax purposes, a trust is considered a separate entity.

Let's look at a standard legal definition of a trust:

> A trust is "when the holder of a legal or equitable interest in certain property is bound by an obligation recognisable and enforceable in equity, to hold that interest not for his own exclusive benefit but for the benefit, as to the whole or part of such interest, of another person or persons, or of himself and such other person or persons, or for some object or purpose permitted by law."[3]

[3] Jacobs, as quoted in Dal Pont, Equity and Trusts in Australia, p. 429.

Justice French in *Harmer & Ors v. FC of T* 89 ATC 5180; (1989) 20 ATR 1461 stated that a trust 'is notably a definition of a relationship by reference to obligations'. Summarised the 4 essential elements of a trust are:

1. Trustee who holds property;
2. Trust property;
3. One or more beneficiaries other than the trustee; and
4. A personal obligation on the trustee to deal with the trust property for the benefit of the beneficiaries.

What does this mean in plain English? Think of a trust this way:

A trustee holds property for a beneficiary or beneficiaries.

Simple isn't it!

Or another way to put it, even simpler: A holds property for B.

A Mother opens a bank account for a 1 year old child. Mum is the trustee, the bank account is the property and the child is the beneficiary.

Trustees have special obligations towards the beneficiaries, these obligations are also known as "fiduciary duties". The trustee has special duties because the trustee has legal ownership of the assets but hold these assets for others. There is a potential for abuse because of this and the law has evolved so as to protect the beneficiaries against potential abuse by the trustees. In the example above the mother has a duty to the child so if the mother were to spend the child's money on herself then she would be breaching her duties as trustee.

Other examples of trusts include:

- A trustee of a SMSF holding super funds for its members;
- A custodian Trustee owning property for a SMSF;
- A parent holding property for a disabled adult child;

Imagine your industry superannuation fund. This is your money, but it is held by a trustee who will invest it and hold the funds and the returns on those funds until you meet a 'condition of release' such as reaching retirement age. The trustee has special obligations to invest the money prudently and account to the beneficiaries for their money.

Why Use a Trust?

Briefly, a trust is usually set up with the aim of benefiting one or more persons. Sometimes these person(s) may not have the legal capacity to look after their own property, such as children or the disabled. A person may also want to invest in a way in which the benefits can benefit the whole family, or a group of people. More on this below.

The main reasons for using a trust are the side effects of benefiting the family as a whole and these are:

1. Asset Protection
2. Estate Planning
3. Tax minimisation

Rules about trusts

Trusts are primarily governed by the 'rules' specified in the trust deed. Since a trust is not an entity but a relationship the trustee must abide by the rules agreed to with the settlor which is evidenced by the trust deed.

These rules are augmented by the various trustee acts in each state. Trust law is State based legislation. For example trusts operating under NSW law would be regulated by the *Trustee Act* 1925. Although generally similar, there are significant differences between the trustee acts in the different states. The legislation enables the courts to appoint a new trustee for instance. This may be required where a trustee dies and there is no successor trustee nominated in the deed.

Starting a Trust

Usually a trust is started by one person, called the Settlor, handing over property to another person, the trustee, to hold for other persons, the beneficiaries. The Settlor lays down the conditions under which the trustee holds the property, this is done by a trust deed.

What happens in practice is that the person setting up the trust is usually the trustee or the person that controls the trustee. They will work out the terms of the trust in consultation with their advisor and will have a deed drafted which outlines these terms. They will then find a settlor who will hand over property to the trustee and sign the deed to this effect. The Settlor is often the advisor.

Because of the tax laws the settlor cannot benefit, or should not be able to benefit, from the trust. So the settlor is usually a next door neighbor, or an accountant or solicitor who is not related to those setting up the trust. The property that is handed over is usually $10 or $100. The reason for this is that the stamp duty laws in each state impose stamp duty in transfers involving dutiable property such as land. Cash is not classed as dutiable property and it is easy to hand over - despite this some states such as NSW and VIC have introduced stamp duty on the formation of a trust with no dutiable property – currently $500 in NSW and $200 in VIC.

The deed will almost always allow the trustee to accept further monies settled on the trust. These funds are treated differently from the initial funds settled and the givers may still benefit from the trust, unlike the original Settlor[4]. The trustee will, usually, be allowed to borrow money and can in that way increase the capital of the trust to invest and build up the assets.

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[4] However this will depend on the wording of the deed. Some deeds are apparently worded on the mistaken assumption that any Settlor should not benefit from the trust. This could mean that someone gifting money to the trust after it is established is excluded as a beneficiary.

The above describes the situation with a discretionary trust. With a testamentary trust the settlor is actually the person who dies and leaves property to a trustee - and they won't be benefitting from it anymore! With unit trusts the unit holders generally subscribe money for units of the trust. There is no settlor, or appointor in a unit trust.

SMSFs are created by deed poll (i.e. a deed with one only party, the trustee), and members transfer existing funds into the new SMSF. There is no settlor or appointor in a SMSF.

THE ROLES PLAYED IN A TRUST

To understand trusts further we need to look at all the players involved in the operation and management of a trust. This section gives a very brief outline of each of those playing roles.

Settlor

The settlor is the person who kicks off a discretionary trust. It is the person who asks the trustee to hold property for the beneficiaries. Due to tax reasons the settlor cannot (or should not) benefit from the trust at all[5], they should not even be able to benefit or there will be adverse tax consequences.

The Trustee

The trustee is one of the most important positions because it is the trustee who legally owns the property of the trust. The trustee's name is on title to property such as land, bank accounts, share certificates etc.

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[5] s 102 ITAA 1936. See http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s102ag.html

It is also the trustee that administers and runs the trust and makes the management decisions (as well as the day to day decisions).

Appointor/Guardian

The Appointor is perhaps even more important than the trustee because it is the Appointor who can appoint and remove the trustee. This power is termed a 'power of appointment'. The specific powers will vary depending on the wording and set up in the trust deed.

Not all trusts have an Appointor. Unit trusts do not, SMSFs no not and some discretionary trusts do not - especially some of the simpler testamentary trusts set up under a will.

The Appointor is sometimes called 'Guardian' in some trusts.

Protector

There is another role which is included in some discretionary trusts. The protector position is often used to stop the trustee and/or Appointor doing certain things without obtaining approval from the Protector. A lawyer or accountant could be

appointed as Protector, for example, and if the trustee wants to distribute any capital of the trust the trustee may be required to obtain the approval of the Protector. It is very important that the person be nominated at time of trust formation as its protection is from adverse events that are unforeseen.

Often this role is used by parents who worry about the children dissolving the trust and selling all the assets once the parents are dead.

Unit holders

With a unit trust and/or a fixed trust the beneficiaries are the holders of units. They are usually paid income and/or capital in proportion to the percentage of units held. Depending on the deed, there is often little discretion involved with the trustee being compelled to distribute.

Members

For SMSF the rules are regulated by the SIS Act and the beneficiaries are known as members.

Beneficiaries

A beneficiary is someone for whose benefit the trust is formed. The beneficiary can receive income and/or capital from the trust. In a unit trust the beneficiary is the unit holder and in a SMSF the beneficiary is the member of the fund.

PRACTICAL ASPECTS OF RUNNING A TRUST

Usually books on trusts focus on theoretical aspects and the reader is often left wondering how to apply the concepts. Below are some of the practical aspects of running a trust.

Read the Deed!

The first thing the trustee should do is to read the deed. It is rare to come across a trustee who has actually read the deed in full (or sometimes not even at all). Yet if the trustee does something that is not permitted by the deed they may have inadvertently breached their duties as trustee. They would then be liable to reimburse the trust and could be sued by the beneficiaries.

Make sure the people distributed to are actually beneficiaries

Sometimes assumptions are made and these can be wrong. Check to make sure that each person being distributed to is actually a beneficiary. This is especially important if there has been marriages or divorces in the family. There may also be different beneficiaries for income and capital so don't assume

a person is a beneficiary for both income and capital distributions as capital beneficiaries are often more restricted. As always read the deed.

One simple example is distributing income to a relative who may not actually be a beneficiary at all. Not all family will be beneficiaries so please check and don't assume. There is a recent case, where during a family law case, it was discovered that over a 10 period income had been distributed to a family member who wasn't actually a beneficiary. This mean that the trustee (spouse A) had to reimburse the trust for all distributions paid out and the trust was now controlled by spouse B.

Put decisions in writing

The trustee is only in temporary control of the trust so it is essential that everything be written down. There should be minutes of meetings where important decisions are made and these should be recorded in writing. A sole trustee should record their decisions in a resolution, dated and signed. These records should be stored with the trust deed.

The trustee should also consider that they may be challenged to produce documents and/or justify decisions and that this could occur years down the track.

Some of the important decisions to record are:

- who to distribute to and how much;
- what to invest in;
- to give a beneficiary a loan;
- to open a bank account

There are also requirements under the Corporations Act where a company is trustee. It would be an offence for a director of a company not to keep proper records.

Also make sure you don't write down anything which could be used against you at a later date. An example is "The trustee has decided not to distribute any money to John because he is a member of 'X' religion".

Word distribution minutes carefully

This should be done with your accountant. Consider that income of the trust could change if the ATO denies a deduction for example.

If your minutes say, the trustee resolves to distribute 10% to A and 90% to B with an income of $1,000. If the ATO denies the interest deduction of $10,000 then the trusts actual income may no longer be $1000 but it could be $11,000 and A may be entitled to 90% of the $11,000. This has the consequences of money potentially falling into the wrong hands, but potentially adverse tax results, especially where children are involved.

Terms of the trust

Don't assume the trust will allow a particular activity. Speak to your adviser about what you want the trust to do before it is set up. Make sure the deed specifically allows it.

Changing the Trust terms

Terms of Trusts can be changed, sometimes. Check to make sure that the trust deed allows the terms to be modified. See who has this power and how this power is exercised. Don't assume that the appointor can change the trust, as it maybe the trustee that has the power - or vice versa.

But changing terms of a trust deed can have serious consequences. The changes may result in a resettlement occurring. A resettlement is where it is considered that one trust is closed down with a new trust being formed.

Entering contracts

The trust is not a legal entity and therefore cannot enter into a contract rather it is the trustee that must enter into the contract in their capacity as trustee. However there is no legal requirement for a trustee to stipulate that they are acting as trustee. So if the 'trust' buys a house for example, it will be the trustee's name that goes on the contract. Often the trustee will write "as trustee for the X family trust" after their name. This shows they intended to enter into the contract as trustee.

It is also common for the trust's ABN to be inserted into the contract as well.

Trustees of SMSFs should seek specific legal advice about what name should go on contracts as there are custodian trust issues where borrowings will occur and stamp duty consequences as a result of this.

Where to set the trust up?

Since stamp duty is payable in some states you need to be careful when setting up trusts, especially if there are parties in different states. For example, there is no stamp duty on a trust set up in QLD, but if one party is in NSW then the NSW duty of $500 may apply. Stamp duty will also vary depending on what the initial property transferred into the trust. This is why usually a trust is commenced with the Settlor handing over $10 or $20 to the trustee as the initial property of the trust. If real property, i.e. land (including houses) is handed over then full stamp duty on the value of the property will apply.

TRUST CHECKLIST

Before setting up a trust or other structure consider the following issues[6]:

1. Land tax consequences;
2. Income tax;
3. CGT;
4. Tax position of property - negative cash flow etc.;
5. Ability to obtain finance;
6. Control of trust now;
7. Control of trust on your incapacity;
8. Control of trust on your death;
9. Ease of relinquishing control;
10. Stamp duty consequences of passing on control;
11. Control of trustee;
12. Ownership of shares of trustee;
13. Control of trustee company upon your incapacity;
14. Control of trustee company on your death;
15. Asset protection;
16. Bankruptcy;
17. Death;

[6] A non exhaustive list.

18. Divorce;
19. Incapacity;
20. Other assets in the trust;
21. Beneficiary attack;
22. Reducing personal guarantees;
23. Effect on pensions;
24. Stamp duty on issue;
25. Place of settlement of trust;
26. Terms of the deed;
27. Ability to mortgage property;
28. Ability to borrow money;
29. Ability to make interest free loans to beneficiaries;
30. Capital beneficiaries;
31. Income beneficiaries;
32. Who should you name as a beneficiary;
33. Effects on borrowings;
34. Any default beneficiaries;
35. Effect on asset protection;
36. Effect on distributions;
37. Ability to renounce interest in the trust;
38. Potential failed distributions;
39. Ability to segregate assets;
40. Future companies as beneficiaries;

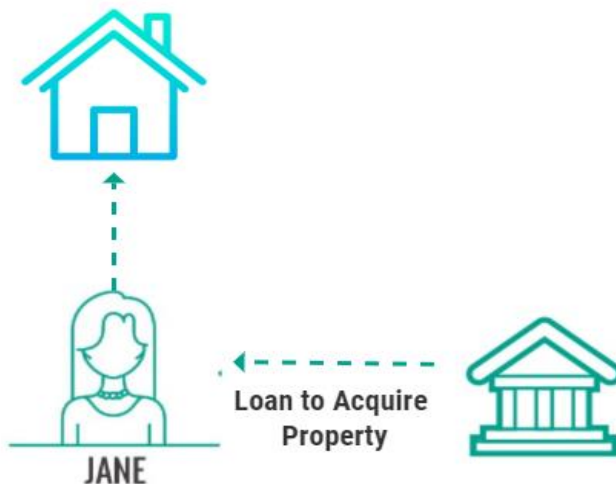
41. Future trusts as beneficiaries;

42. Is the trustee (i.e. the position of trustee) a beneficiary?;

Investing On Your Own or With a Partner

The simplest and sometimes most appropriate structure for holding an investment property is simply 100% in the name of the individual earning the highest income.

Individual Name



Advantages

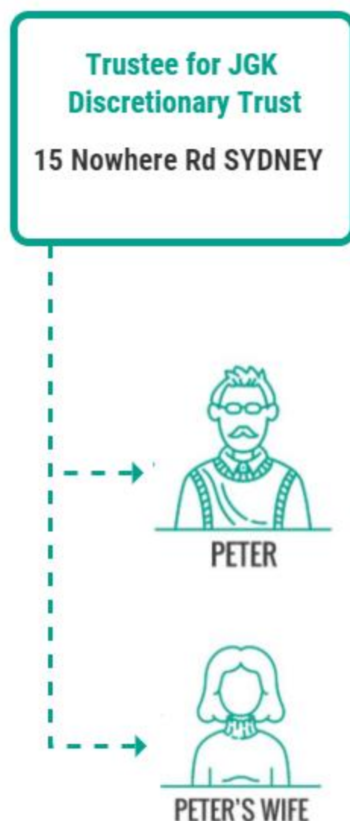
- The individual can claim the net loss on the property against their other taxable income
- Easy for financing purposes.
- Very simple to administer and accounting fees are generally low

Disadvantages

- Cannot move the property to a Self-Managed Superannuation Fund at a later stage.
- Changing interests in the property e.g. moving 50% to a partner will result in full stamp duty in most States.
- The individual or individuals holding the properties will receive the net distribution when the property is positively geared and will receive the capital gains when the property is sold.

Discretionary Trust

A discretionary trust could be used to hold a negatively geared property. The main disadvantage of this structure is that any net losses are trapped in the trust. However these can be carried forward indefinitely to be offset against any future net income of the trust.



Trustee for JGK Discretionary Trust

Rental Income	$ 20,000
Agents Fees	$ 2,000
Capital Allowances	$ 2,000
Depreciation	$ 2,000
Insurance	$ 1,000
Interest	$ 15,000
Rates	$ 1,500
Other	$ 1,000
Net Loss	**$ 4,500**

If the property had been held in the name of an individual, then the $4,500 loss could be offset against the individual's other taxable income and used to reduce the overall tax payable at the individual's level. If the individual had made tax payments during the year e.g. from their PAYG employment income, then in most instances they would receive a refund. However, if the property is held by a discretionary trust then the $4,500 loss cannot be offset against the individual's other taxable income and must be carried forward. This can have a significant impact on the after tax cashflow for the property

and why holding a property in a discretionary trust is generally unattractive for a lot of investors.

For properties which are negatively geared or where the investor doesn't plan on holding the property for a long period of time and instead making a reasonable capital gain then a discretionary trust may be a more appropriate vehicle to hold such an investment.

The main attraction of such an investment structure will be the ability to stream the net income i.e. future capital gains to the range of beneficiaries. The example below will demonstrate the potential tax savings from such a strategy over holding the asset in the name of one individual.

Michael's taxable income before capital gain	$100,000
Chi's taxable income before capital gain	$ 5,000
Capital Gain	$ 60,000

Scenario One

After Tax Position – 100% in Michael's Name

Taxable Income before capital gain

$ 100,000

Plus : Net Capital Gain after 50% CGT Discount	$ 30,000
Adjusted Taxable Income after capital gain	$ 130,000
Tax on Adjusted Taxable Income after capital gain	**$ 38,332**

Scenario Two

After Tax Position – Capital Gain Distributed 100% to Chi

Michael's Taxable Income	$ 100,000
Tax on Michael's Taxable Income	$ 26,447
Chi's Taxable Income before capital gain	$ 5,000
Plus : Net Capital Gain after 50% CGT Discount	$ 30,000
Chi's Adjusted Taxable Income after capital gain	$ 35,000
Tax on Chi's Adjusted Tax Income after cap gain	$ 3,447
Total tax payable by Michael and Chi	**$ 34,885**
Tax Savings of Scenario One vs Scenario Two	**$ 8,248**

It is important to compare this tax benefit to the deferral of the negative gearing benefits. Remember a discretionary trust will still receive the benefits of the net tax loss but this will be deferred until such a time as to when the trust has positive net taxable income. The time value of money (commonly used to

calculate the net present value of an investment) will erode the value of this tax loss over time.

Advantages

- A corporate trustee provides limited liability and a discretionary trust with a corporate trustee is still considered to be a good structure where asset protection is important.
- Ability to distribute the net taxable income to the beneficiaries and maximise any tax planning opportunities.
- Good for properties that are positively geared or where the net capital gain is expected to be significant and there is potential to distribute the net capital gain to individuals with a low taxable income.

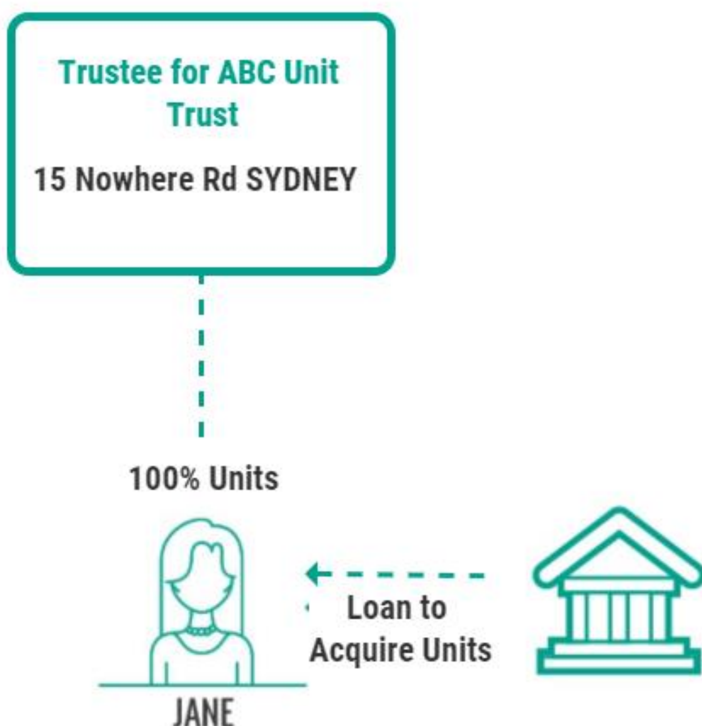
Disadvantages

- The negative gearing loss cannot be claimed in an individual's name.
- Higher land tax rates in many States. Discretionary trusts do not receive a land tax threshold in many States.
- Cannot move residential property to a Self-Managed Superannuation Fund (SMSF) at a later stage.

- More expensive to setup and administer when compared to holding the property in an individual's name.

Unit Trust

A structure which is becoming more common is for a unit trust to hold the property with an individual (usually the highest income earner) holding the units in the unit trust.



Advantages

- Ability to move the units (and indirectly the property) to a Self-Managed Superannuation Fund (SMSF) at a later stage.

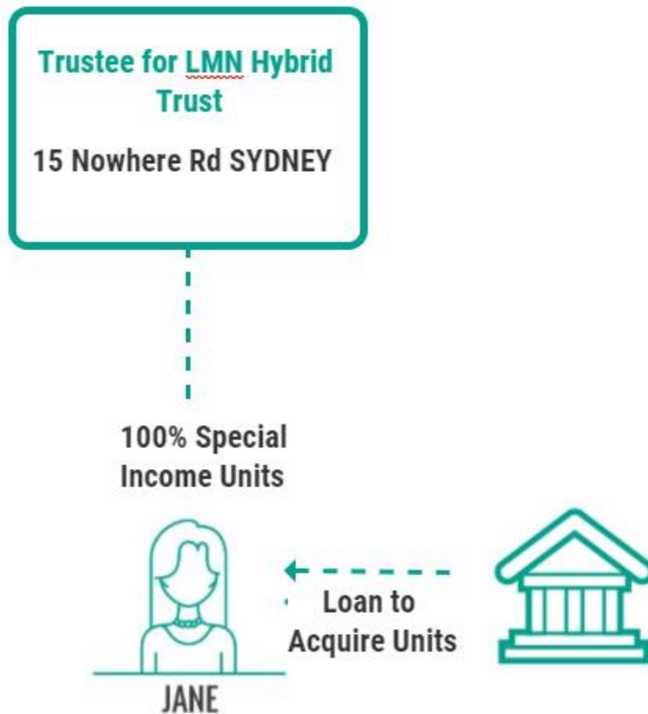
- Ability to transfer the units in the unit trust to different parties or between the family members with little or no stamp duty based on the State the property is purchased.
- Ability to take advantage of the refinancing principle.
- Ability to use the 'refinancing principle'. The decision in FC of T v Roberts & Smith would allow the Trustee of a Unit Trust a deduction for interest expenses incurred on funds borrowed and used to reduce or extinguish a Beneficiary/Unit Holder's interest in the trust or which is used to pay a liability to the Beneficiary/Unit Holder for a share of their income.

Disadvantages

- More complex to understand than having the property held in a simpler structure such as tenants in common between individuals.
- More expensive to establish and ongoing accounting and administration fees will be slightly higher under this type of structure.

Hybrid Trust

A structure which has been recommended by several advisers is a hybrid trust. Most often it is a hybrid discretionary trust otherwise known as a HDT.



Advantages

- Ability to use the 'refinancing principle'. The decision in FC of T v Roberts & Smith[7] would allow the Trustee of a Hybrid Discretionary Unit Trust a deduction for interest

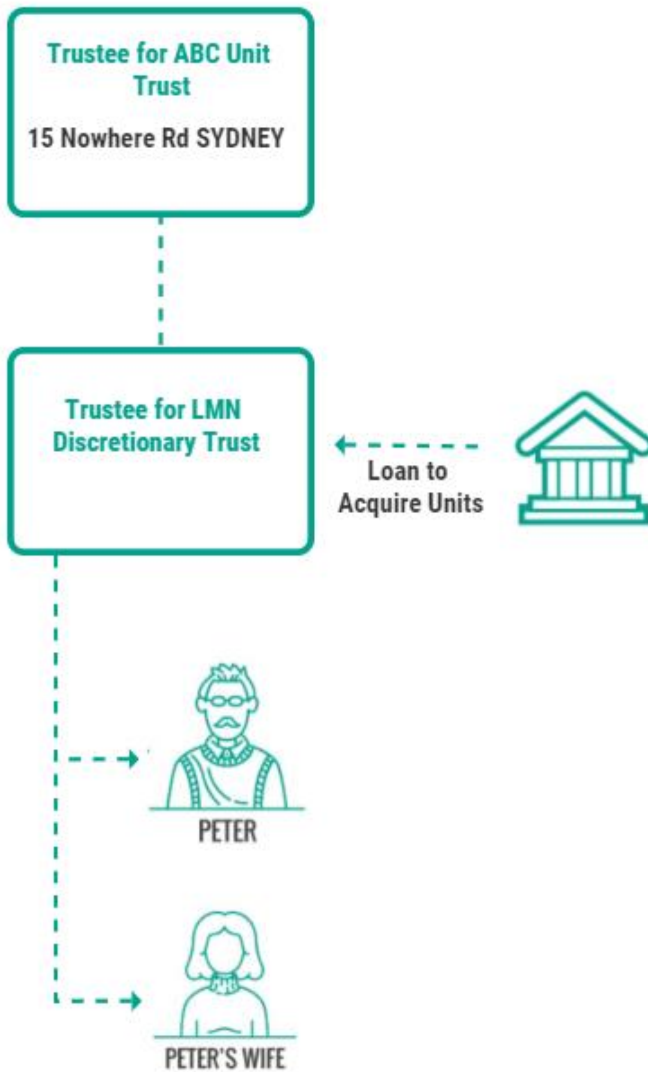
[7] *FC of T v. Roberts; FC of T v. Smith* 92 ATC 4380; (1992) 23 ATR 494

expenses incurred on funds borrowed and used to reduce or extinguish a Beneficiary/Unit Holder's interest in the trust or which is used to pay a liability to the Beneficiary/Unit Holder for a share of their income.

Disadvantages

- Some of the claims being made that you can stream capital gains to a lower income earner and for the higher income earned to obtain the negative gearing benefits are not correct. The ATO has confirmed that individuals with a properly structured hybrid discretionary trust deed with special income units will obtain the negative gearing benefits but that same individual must also receive the capital gain and any future income. Refer to ATO TD 2009/17.
- More expensive to establish and ongoing accounting and administration fees will be slightly higher under this type of structure.
- Very difficult to obtain finance under this structure.
- In many states (particularly NSW) a HDT does not obtain the land tax threshold. This can be close to $6k per annum in lost benefits over something like a land tax unit trust with the units held by a high-income earner.

Unit Trust with Units Held by Discretionary Trust



Advantages

- Corporate trustee provides limited liability.

- Provides good asset protection. If an individual family member was sued in their individual capacity or was made bankrupt, then it could be argued that as the property is held by the unit trust then this is not an asset available to any creditor (someone who you owe money to). Similarly, as the units in the unit trust which holds the property are owed by each families discretionary trusts then again a similar argument would be put forward that the asset is not owned by the individual but rather by the trustee of each discretionary trust.
- Provides flexibility for "streaming" of the positive profit. What this means is that both Peter and John can decide who to distribute the profits to. If his wife is on a lower income or his children (over age 18 and at university where he is supporting them) are also on low incomes, then it may be more tax effective for them to receive the profits.
- Ability to transfer the units in the unit trust to different parties or between the family members with little or no stamp duty based on the State the property is purchased.

- Clear distinction of ownership interests between the two respective families.
- Ability to transfer the units to a Self-Managed Superannuation Fund (SMSF) at a later stage. This would not be possible if the property was held by the individuals as tenants in common.

Disadvantages

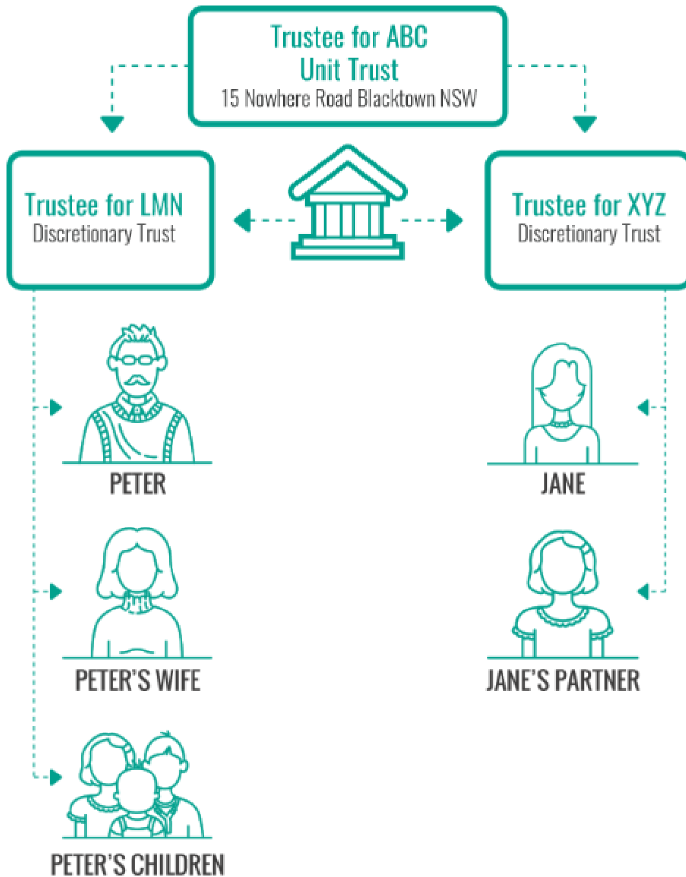
- If units are held by a discretionary trust, then in some States the unitholder is assessed for land tax purposes. In NSW for example if the units are held by a discretionary trust then there is no threshold.
- Units held by the unitholders are exposed to potential creditors but with the units being held by a discretionary trust this provides good asset protection for the units.
- More complex to understand than having the property held in a simpler structure such as tenants in common between individuals.
- More expensive to establish and ongoing accounting and administration fees will be slightly higher under this type of structure.

Investing with Other People

John and his family are looking at investing in a residential property with Peter and his family. The two families will respectively have a 50% interest in the investment property.

It is anticipated that the property to be acquired will have a market value of approximately $400,000. Each family has savings available and will contribute $100,000 each towards the property. The remainder of the balance being $200,000 will be financed through a lending institution. They have obtained a variable interest rate of 6% per annum.

Unit Trust and Two Discretionary Trusts as Unit Holders



Advantages

- Corporate trustee provides limited liability.
- Provides good asset protection. If an individual family member was sued in their individual capacity or was made bankrupt, then it could be argued that as the property is held by the unit trust then this is not an asset available to any creditor (someone who

you owe money to). Similarly, as the units in the unit trust which holds the property are owed by each families discretionary trusts then again a similar argument would be put forward that the asset is not owned by the individual but rather by the trustee of each discretionary trust.

- Provides flexibility for "streaming" of the positive profit. What this means is that both Peter and John can decide who to distribute the profits to. If his wife is on a lower income or his children (over age 18 and at university where he is supporting them) are also on low incomes, then it may be more tax effective for them to receive the profits.
- Ability to transfer the units in the unit trust to different parties or between the family members with little or no stamp duty based on the State the property is purchased.
- Clear distinction of ownership interests between the two respective families.
- Ability to transfer the units to a Self-Managed Superannuation Fund (SMSF) at a later stage. This would not be possible if the property was held by the individuals as tenants in common.

Disadvantages

- If units are held by a discretionary trust, then in some States the unitholder is assessed for land tax purposes. In NSW for example if the units are held by a discretionary trust then there is no threshold.
- Units held by the unitholders are exposed to potential creditors but with the units being held by a discretionary trust this provides good asset protection for the units.
- More complex to understand than having the property held in a simpler structure such as tenants in common between individuals.
- More expensive to establish and ongoing accounting and administration fees will be slightly higher under this type of structure.

To provide an example of how the taxable income flows through this type of structure we will assume that the loan in this example has been taken out by each of the Trustees for the Discretionary Trusts to acquire units in the ABC Unit Trust.

Trustee for ABC Unit Trust

Rental Income	$ 25,000
Agents Fees	$ 2,000
Capital Allowances	$ 2,000
Depreciation	$ 2,000
Insurance	$ 1,000
Rates	$ 1,500
Other	$ 1,000

Trustee for LMN Discretionary Trust

Interest Expense	$6,000

Trustee for XYZ Discretionary Trust

Interest Expense	$6,000

At the end of the financial year the Trustee for ABC Unit Trust will have net income of $15,500 to distribute to the unit holders based on their percentage unit holdings which in this example is 50% respectively.

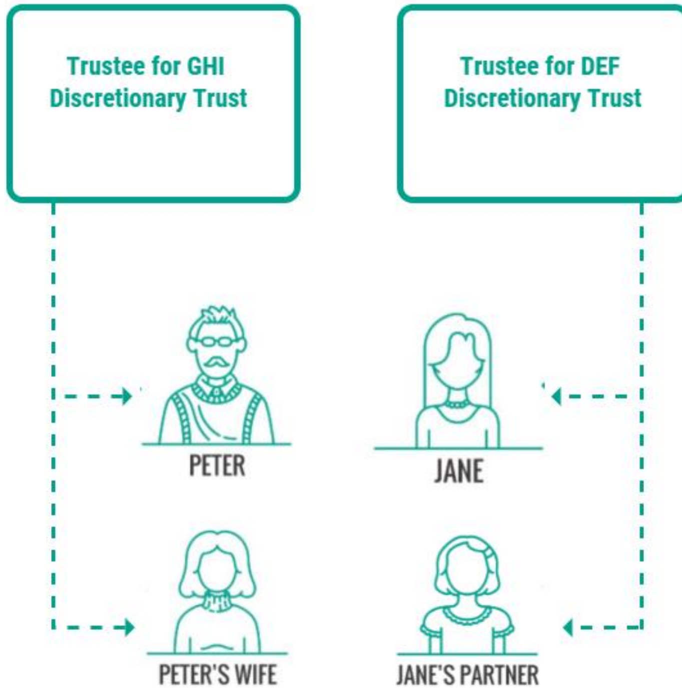
Therefore, the Trustee for the LMN Discretionary Trust will receive a distribution of $7,750 and the Trustee for the XYZ Discretionary Trust will also receive a distribution of $7,750.

Each of the trustees of the discretionary trusts will then claim an interest deduction for the cost of borrowing to acquire units in the ABC Unit Trust.

The net income of each of the trusts will therefore be $ 7,750 (trust distribution from the ABC Unit Trust) less $6,000 interest expense being $1,750.

The trustees of the LMN Discretionary Trust and the XYZ Discretionary Trust can then distribute this positive net income to the beneficiaries of their trusts.

Partnership of Discretionary Trusts



Advantages

- Corporate trustee provides limited liability.
- Provides good asset protection. If an individual family member was sued in their individual capacity or was made bankrupt, then it could be argued that as the property is held by the discretionary trust then this is not an asset available to any creditor (someone who you owe money to.

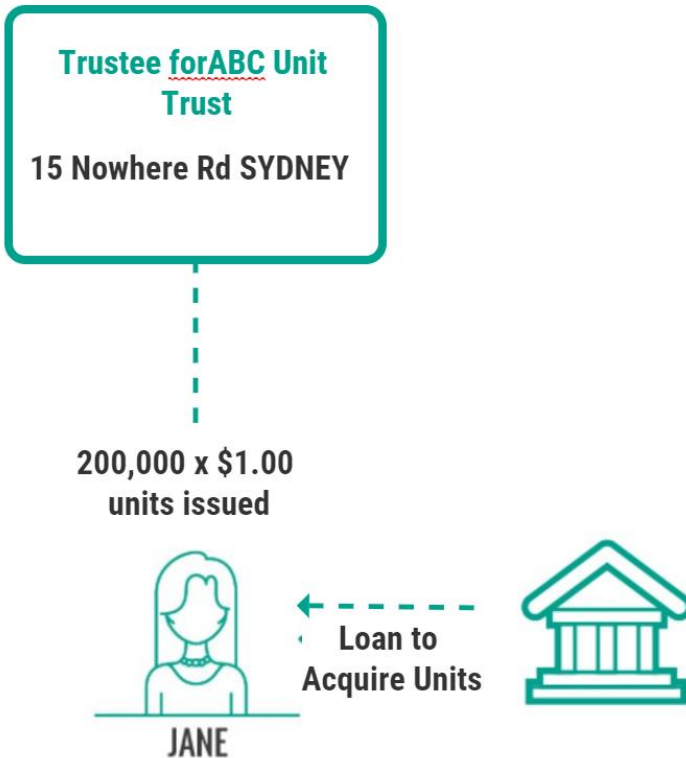
- Provides flexibility for “streaming” of the positive profit. It will be important for Peter and John to ensure that all members of the family are included in the class of beneficiaries.
- Each family has a clear interest in the property.

Disadvantages

- No land tax threshold in some States in Australia particularly in NSW.
- More complex to understand than having the property held in a simpler structure such as tenants in common between individuals.
- More expensive to establish and ongoing accounting and administration fees will be slightly higher under this type of structure.

What is the refinancing principle and how does it work?

One of the advantages of a unit trust is the ability to use the refinancing principle. Let's assume the following



Jane originally borrowed $200,000 to acquire 200,000 $1.00 units in the ABC Unit Trust. The ABC Unit Trust then acquired a property for $200,000. Jane has now repaid her entire

borrowing of $200,000. The property currently has a value of $400,000.

She is willing to lend to the unit trust 75% of the valuation and therefore the unit trust has the capacity to borrow $300,000. Jane applies to redeem 100,000 of her units which now have a market value of $2.00 per unit. The unit trust borrows $200,000 against the value of the property in the unit trust and uses those funds to pay Jane for her redemption of her units.

The borrowing of $100,000 which was originally in Jane's name has now been shifted from her name into the trust.

Jane will pay CGT on the redemption of her units. Her cost base would have been 100,000 x $1.00 = $100,000 and the redemption of her units at market value of 100,000 x $2.00 = $200,000 will produce a capital gain to Jane of $100,000. The gain made by Jane is first reduced by any capital losses carried forward she may have and any current year capital losses and then discounted by 50%. Her net taxable capital gain will then be $50,000. Assuming her income before the capital gain was $100,000 then the tax payable on the capital gain will be $ 19,250 for the 2014 financial year. Jane will therefore have disposable funds of $ 180,750.

The $180,750 Jane receives can be used for whatever purpose she likes. She may decide to upgrade her family home and use the funds plus the sale of her existing home to do so.   By using the refinancing principle, she has shifted $200,000 worth of ordinarily non deductible debt i.e. if she borrowed $200,000 to upgrade her PPOR the interest on those borrowings would ordinarily be non deductible. However, as the borrowing has occurred at the unit trust level to borrow to redeem her units then the interest is deductible to the unit trust.

It is important to weigh up any potential capital gains payable on the redemption of units against the tax benefits obtained from the interest deductions from the refinanced debt.

An alternative to this strategy is to provide the unitholders with a return of capital rather than redeeming the units. With this strategy Jane would receive a return of capital of $200,000. There would be no capital gains tax implications on the return of capital to Jane but instead her remaining units would have a reduced cost base. i.e. the value of her units would be reduced by the amount of the return of capital.

PURCHASING PROPERTY IN YOUR SMSF

What is a Self-Managed Super Fund (SMSF)?

Superannuation is a savings arrangement where employers, employees, people who are self-employed and others contribute to a trust fund which holds and invests the contributions made throughout a member's working life to provide benefits upon their retirement.

Self-managed superannuation funds perform this function in a similar way to publicly available retirement savings vehicles, with the main difference being that the members of the fund are also required to be the trustees of the fund. The effect of this requirement is that the members control the way in which their contributions are invested.

More specifically, for a fund to satisfy the requirements of being a self-managed superannuation fund, the fund must:

- have a deed that conforms with superannuation legislation;
- have four members or less;
- comply with the requirements in relation to members being trustees;

- no members of the fund are employees of another member of the fund, unless those members are related; and,
- no member of the fund receives remuneration for his or her services as trustee.

The main advantages that are attributed to self-managed funds over public offer funds are increased investment freedom and greater control over superannuation savings.

The Trust Deed

The fund's trust deed outlines a few important aspects about its operation. Some of these aspects include:

- details of who the trustees are;
- the process of appointing and removing trustees;
- the powers of the trustees;
- eligibility for membership of the fund;
- conditions relating to the fund's acceptance of contributions;
- conditions relating to the fund's payment of benefits to members and their beneficiaries in the event of the death of a member; and,

- the procedures for varying the provisions of, or winding up, the fund.

The superannuation legislation imposes certain covenants which are deemed to be included in the deeds of all regulated funds and which reflect fiduciary duties implicit in trust law. These duties require trustees to:

- act honestly, and prudently in all matters;
- exercise the same degree of skill, care and diligence as an ordinary person;
- act in the best interests of fund members;
- quarantine the assets of the fund from non-fund assets;
- retain control over the fund;
- implement and adhere to an investment strategy; and,
- allow members access to relevant fund information.

Many of the clauses within the trust deed will mirror those in legislation such as the Superannuation Industry (Supervision) Act and Regulations, but to the extent of any inconsistency between the legislation and the deed, the statutory requirements will prevail.

Membership and Trustee Structure

There is a broadly stated requirement, that all members be trustees, or a director of a corporate trustee, which ensures that each member is fully involved and can participate and make decisions about the fund.

Specifically, the fund is required under the SIS Act:

- to have four members or less;
- each member is a trustee, or director of a corporate trustee;
- no members of the fund are employees of another member of the fund, unless those members are related; and,
- no trustee, or director of the corporate trustee, receives remuneration for his or her services as trustee.

Where a fund has only one member, there is a requirement for a corporate trustee with the member being the either the sole director or have a second director who is a relative or not employed by the member. Alternatively, if a sole member fund did not wish to appoint a corporate trustee, two individual trustees could be appointed where the second trustee was

either a relative of the member trustee or not employed by the member.

It is important to note that certain persons are disqualified from acting as trustees, these will include:

- persons who have ever been convicted of an offence involving dishonesty;
- persons who have ever been convicted of a civil penalty offence under the SIS Act;
- persons who are insolvent or under administration, or in the case of a corporate trustee, a receiver, official manager, or provisional liquidator has been appointed; and,
- persons who are undischarged bankrupts, or in the case of a corporate trustee, action has been commenced to wind up the company

Minors, those persons under the age of 18, are under a legal disability and accordingly, are unable to be appointed as trustees of a self-managed fund. Where contributions are made on behalf of minors, a parent, guardian or legal personal representative would ordinarily be required to act as trustee on their behalf.

Trustee Requirements

Whilst often an accountant, lawyer or financial adviser will assist with the establishment and operation of a self-managed superannuation fund, it is the trustee’s responsibility to ensure that all of the fund's legal requirements have been satisfied, there are significant penalties that may be imposed on trustees who fail to properly perform their duties.

The main legal requirements are:

- to comply with the sole purpose test;
- to only accept contributions from members in accordance with the SIS Act;
- to manage the funds’ investments;
- to only pay benefits in accordance with the rules;
- to comply with administrative obligations; and,
- to comply with the investment restrictions.

A broad overview of the first five of these requirements follows, with a more in-depth overview of the investment restrictions in the next section.

Sole Purpose Test

Requires that the fund is maintained for providing benefits to members upon their retirement, or their dependents if a member dies before retirement.

The Contribution Standards

Are designed to ensure that contributions are made for retirement purposes only and require trustees to allocate contributions to member accounts within 28 days after the end of the month in which they are received.

Managing the Funds' Investments

The trustees are required to formulate and adhere to an investment strategy which considers the risk, return, diversification and the liquidity of investments that the fund intends to hold. The investment strategy is required to outline the investment objectives of the fund together with the methods that the trustees will adopt to achieve those objectives and should reflect the purpose and circumstances of the fund. Trustees should be able to demonstrate that these matters have been formally considered by way of minutes or similar fund documentation.

Benefit Payment Standards

The payment standards and preservation requirements ensure that fund monies are only paid to members in appropriate circumstances.

Administrative requirements in maintaining a fund

These include:

- the preparation and retention of accurate accounting and administrative records for the fund; appointing an auditor and ensuring that the fund has an audit completed each year;
- lodging a fund income tax and regulatory return and payment of the supervisory levy to the ATO annually
- lodging Superannuation Contribution Statements outlining the contributions made to the fund each year; and, complying with benefit payment reporting obligations.

If the trustees fail to comply with any of the requirements of the SIS Act, the trustees are at risk of disqualification from being a trustee, prosecution, penalties and the fund being made non-complying, which could result in the loss of the cumulative tax concessions

Investment Restrictions

Trustees are required to make investment decisions about the fund for the benefit of all members. It is important to note

that there are severe penalties for trustees who misuse the fund's superannuation benefits and who do not comply with the relevant legislation.

Whilst superannuation laws don't prescribe the types of investments that trustees can invest in, there are investment restrictions which aim to protect the members from being exposed to undue risks, such as the failure of a business operated by a member and ensure that investment decisions of the trustees are consistent with the sole purpose of generating retirement benefits for members.

Some of the main investment restrictions include:

- a prohibition on lending to or providing financial assistance to members;
- a prohibition on acquiring certain assets from related parties.

WARNING

An SMSF cannot purchase a residential property from a member or a related party of a member. This means that your SMSF cannot purchase a property owned by either you or your wife if you are members of the fund

or your mother's house or Aunty Mary's investment property.

An SMSF can however acquire units in a unit trust that owns a residential property if the residential property was acquired from a third party. The unit trust can't borrow, and its assets cannot be subject to a charge.

Borrowing in Super

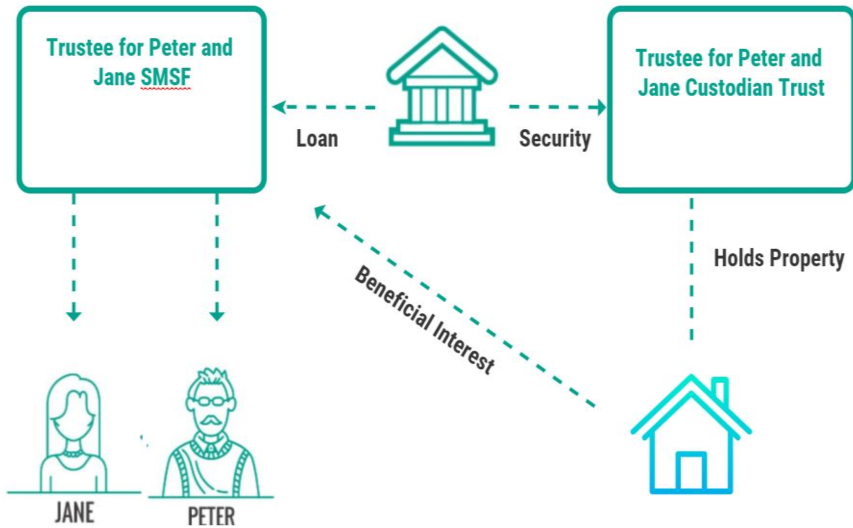
Many people will have heard about the ability to borrow within your SMSF and this has become quite attractive for many people who are looking at building their property portfolio further, acquiring another residential property when they otherwise might not have been able to or simply for preparing for a tax-free income stream when they retire.

Legislation now allows self-managed superfunds to borrow to invest in residential, commercial or industrial property. This is a breakthrough for investors as it gives them the chance to leverage into property and apply the rents and their contributions to paying off the loan.

It also allows people to do some strategic tax planning and using their employer mandatory contributions (currently 9.5% for 2020) and salary sacrificing up to their 'contribution limits' we can help reduce their overall tax position and help pay off a property within super. We will run through this as an example later.

One of the main attractions of super is that any earnings are taxed at 15% while in what is called the 'accumulation phase' and are tax free when in the 'pension phase'

The diagram below shows how the arrangement works in practice.



EXAMPLE

Chris's taxable income (excl. super)	$ 100,000
Chris's employer superannuation contribution	$ 9,250
Current superannuation balance	$ 150,000

Chris is looking at a residential property in South Australia with the following rental income and expenses.

Rental Income	$ 15,000
Expenses (other than interest)	$ 6,000

Chris will use the $150,000 as a deposit on the property which is selling for $370,000. He will therefore need to borrow $270,000 using his SMSF and the bank is offering a rate of 8% per annum. His yearly interest expense will be $ 17,600. He has opted for an interest only loan for 15 years. At the end of the financial year the superannuation fund will have a total income of $9,250 (employer superannuation contributions from his salary) plus the rental income of $15,000 which is a total of $24,250. The total expenses for the property are the interest of $17,600 plus the other expenses of $6,000 which is a total of $23,600.

Using this strategy Chris has been able to afford a residential rental property using his SMSF without an impact on his current cashflow. He is using his employer superannuation contributions plus the rental income stream to help purchase an investment asset for his retirement.

PROPERTY DEVELOPMENT – CAPITAL OR REVENUE

This is a difficult area of tax and I will try to explain it as simply as possible but even the simple explanation is sometimes complex.

As a tax barrister once said to me “facts matter” and when you start to undertake any type of development on your property or land the facts really do matter.

The most common question I get asked when someone has a block of land or has a house that they have held for a while is “so tell me how much capital gains tax I will pay”

It’s a fair question for those who don’t spend their days analysing tax legislation and cases but for those of us who do the first question always is “so tell me what your original intention was”

The intention and changes in that intention over time can lead to very different tax outcomes.

Now the reason this is important for many people is that if the profits on sale are taxed on what is know as capital account then they can be discounted by 50% and that 50% taxed.

However once the profits on sale are treated as being on what is know as revenue account then the 50% capital gains tax discount is no longer available. That can hurt particularly if the property is held in individual names and they are earning other income.

The difference in outcomes can be illustrated below

EXAMPLE

Johan purchased some land in 2017 for $100,000. He subdivided the land and sold the 2 lots for $250,000 in 2020. He incurred subdivision costs of $50,000

	Capital	**Revenue**
Gross Gain	$100,000	$100,000
CGT Discount	($50,000)	NIL
Net Gain	$50,000	$100,000
GST Liability		
(no margin scheme)	NIL	$22,727
Income Tax @ 47%	$24,500	$36,318
After Tax Profit	**$75,000**	**$40,955**

So, you can see why the question is important.

There are basically three ways that the profit could be treated

1. Profit making undertaking or profit from an isolated transaction
2. Mere realisation of a capital asset
3. Profit from a business in undertaking property development.

Things that you will need to consider when making which of those potential three categories include

1. Intention when the property was acquired
2. Reason for doing the works
3. Location of the property
4. Previous use of the property
5. Any previous attempts to sell and why they might have failed to sell
6. Any steps taken to initiate rezoning or development activities and who initiated those steps
7. The level of development works and activities
8. The amount of risk the owner has taken
9. The cost of the development vs the value of the property

10. Previous history of other activities the person has undertaken
11. The extent of involvement in the activities
12. The level of borrowed funds and where those funds have come from.

As you can its quite an extensive list of things to consider !!

EXAMPLE

Peter owns an industrial property on a large block of land. When Peter purchased the property he did so as part of a strategy of holding the asset long term to generate rental income.

The council has recently rezoned the area in which the industrial property is located to allow for high rise residential housing.

Peter is also undertaking a significant development as an investor with another business partner and funds are needed to fund that particular development.

Peter operates a number of cafes in the Melbourne area. A developer has approach Peter to purchase his industrial property.

If we look at this example a few things arise

1. The sale of the industrial property is outside the course of the Peter's business.
2. Peter's intention was to hold the property for the purpose of long-term leasing and not profit making by sale.
3. Peter did not approach council for rezoning but was part of a wider council strategy for the area.
4. Peter will be doing no works to the property prior to sale.

Based on these it would be reasonable to assume that the sale of the industrial property by Peter would be a mere realisation of his asset and it would be treated on capital account and if held in his own name or a trust then eligible for the 50% CGT Discount.

Just because it is your first time doing a development doesn't mean it will be treated on capital account. A single transaction can still be treated as being on revenue account.

EXAMPLE

Terry purchases a block of land in Hawthorn. It is a large residential block which currently has an old house on it.

Terry intends to demolish the house, subdivide the property and build 2 townhouses on the block.

Terry has never done any developments prior to this one and will be funding it through some of his own funds plus from an external financier.

In this case Terry has a clear intention from the beginning to realise a profit from sale in a commercial manner.

This transaction would be on revenue account and Terry would not be entitled to a capital gains tax discount.

DEVELOPING THE MAIN RESIDENCE

There can be a number of traps for the unwary when they undertake development works on a property that has been their main residence.

A situation that can cause a considerable amount of pain is where a person has lived in a property for many years, demolished the house, subdivided the block and then sold the two blocks.

A common misconception is that because they lived in the property prior to it being demolished they will be entitled to the main residence exemption and pay no tax on sale.

Even though a dwelling was on the land and it was occupied as their main residence they would get no main residence exemption for any of the ownership period. That hurts. But why is that ?

The reason is that the tax act provides an exemption where the capital gains tax event happens to the dwelling. In this case there is no longer a dwelling so the capital gains tax event is happening to the land. A technicality I agree but none the less it is how it works.

It is pretty bad as you would pay CGT for the entire ownership period with the cost base being the acquisition cost of the original property apportioned between the two blocks.

There are some strategies available however to mitigate that pain and worth discussing with your adviser if you plan on undertaking this type of activity.

GST AND PROPERTY

When it comes to GST and Property it is probably one of the most complex areas of the GST Act.

The first thing that you need to determine when analysing your property transaction is whether

(a) the sale of the property is in the course or furtherance of an enterprise that you are carrying on ; and
(b) if so, whether you are registered for GST or required to be registered for GST

The term 'enterprise' includes, among other things, an activity or series of activities done in the form of a business or in the form of an adventure or concern in the nature of trade. The phrase 'carry on' in the context of an enterprise includes doing anything in the course of the commencement or termination of the enterprise.

Miscellaneous Taxation Ruling MT 2006/1 *The* New *Tax System: the meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number* provides guidance on what activities will amount to an enterprise.

Paragraph 234 of MT 2006/1 distinguishes between activities done in the form of a 'business' and those done in the form of 'an adventure or concern in the nature of trade'. In particular:

- A business encompasses trade engaged in on a regular or continuous basis.
- An adventure or concern in the nature of trade may be an isolated or one-off transaction that does not amount to a business, but which has the characteristics of a business deal.

Paragraph 178 of MT 2006/1 lists a number of indicators considered when attempting to determine whether an activity or series of activities amount to a business:

- a significant commercial activity
- a purpose and intention of the taxpayer to engage in commercial activity
- an intention to make a profit from the activity
- the activity is or will be profitable
- the recurrent or regular nature of the activity
- the activity is carried on in a similar manner to that of other businesses in the same or similar trade
- activity is systematic, organised and carried on in a businesslike manner and records are kept

- the activities are of a reasonable size and scale
- a business plan exists
- commercial sales of product, and
- the entity has relevant knowledge or skill.

Further the cases of *Statham & Anor v. Federal Commissioner of Taxation (Statham) and Casimaty v. FC of T (Casimaty)* established a number of factors in determining whether activities are a business or an adventure or concern in the nature of trade with reference to real property transactions including:

- there is a change of purpose for which the land is held
- additional land is acquired to be added to the original parcel of land
- the parcel of land is brought into account as a business asset
- there is a coherent plan for the subdivision of the land
- there is a business organisation – for example a manager, office and letterhead
- borrowed funds financed the acquisition or subdivision
- interest on money borrowed to defray subdivisional costs was claimed as a business expense there is a level

of development of the land beyond that necessary to secure council approval for the subdivision

- buildings have been erected on the land.

No single factor will be determinative of whether the activity or activities will constitute either a business or an adventure or concern in the nature of trade.

This is extremely important and the facts of every situation means that if you are carrying on enterprise then you will need to consider GST.

GST and Residential Premises

If the residential premises are an input taxed supply then you will not be liable for GST on the sale of those premises.

The GST Act says "*a sale of real property is input taxed but only to the extent that the property is residential premises to be used predominantly for residential accommodation.*

However the sale is not input taxed to the extent that the residential premises are:

(a) commercial residential premises ; or

(b) new residential premises

Now that is a lot of information to absorb but let's slowly work through it.

The one that interests most people is the sale of new residential premises. Many people who are undertaking their first development and purchase a property, knock down the old structure and build two new duplexes for example want to know the GST impact on that potential development.

The GST Act says that residential premises will be 'new' if

(a) *they have not previously been sold as residential premises and have not previously been the subject of a long term lease; or*

(b) *they have been created through substantial renovations of a building ; or*

(c) *have been built, or contain a building that has been built, to replace demolished premises on the same land.*

EXAMPLE

Igor owns a vacant block of land located in the Mornington Peninsula. The land was purchased in 2009 as an investment property.

Igor is considering the development of the property by constructing residential premises.

Igor has not done any property developments in the past and the majority of his assets are passive investments.

He plans to sell the units when completed as he is expected to make a decent return on that investment

In this case an isolated transaction such as this, even though it is not the normal activity of Igor, would be considered to be an ‘adventure in the nature of trade’ as the development and eventual sale of the residential premises is of a commercial character.

Igor would therefore be carrying on an enterprise and would be required to be registered for GST and pay GST on the sale of the new residential premises.

Now this doesn’t automatically mean that all new residential premises will be subject to GST

Residential premises are not considered to be new if they have been rented out for five or more years.

WARNING

The ATO has issued a Goods and Services Tax Ruling GSTR 2003/3. In this ruling the ATO states that they consider the 5 years must be a continuous period. A continuous period is not broken by short periods between tenancies where the premises are actively marketed for rent following the departure of the previous tenant.

It will not include periods where the premises are used for private purposes or left vacant with no attempt to rent the property.

As discussed previously the intentions are very important in determining whether GST will apply to the sale.

GST and Sale of Vacant Land

Many people assume that if they sell vacant land it will be GST Free.

There is no provision within the GST Act that makes the sale of vacant land GST free or input taxed. So, it becomes important to look at the basic principles of whether GST applies.

Going back to what we previously discussed the sale of vacant land by someone who is registered for GST OR required to be registered for GST will be a taxable supply unless the supply is GST Free.

Vacant land can be GST free if

- A supply of land is part of a going concern;
- A supply of subdivided farming land
- A supply of farm land for farming purposes

When analysing the sale of vacant land the concept of 'carrying on an enterprise' becomes extremely important.

The best way to illustrate the complexity is probably best through some examples.

EXAMPLE

Scenario One

Peter purchased a vacant block of land in Sussex Inlet in 2008. He purchased it so the family could spend weekends there camping and using their trail bikes.

In 2020 a developer comes along and takes an interest in the block of land. Peter is approached by the developer to acquire his vacant parcel of land.

Peter is currently not registered for GST and has never been registered for GST.   During the time he has held the land they have made no improvements to the land, have never sought to improve the land or undertake any type of building or development on the land.

So the question remains **does GST apply to the sale of this vacant land ?**

The term 'taxable supply' is defined in Section 9-5 of the *New Tax System (Goods and Services Tax) Act 1999*. Peter will make a taxable supply if he

- Makes a supply for consideration; and
- The supply is made in the course or furtherance of an enterprise that he carries on; and
- The supply is connected with Australia ; and
- He is registered OR required to be registered

So lets work through those questions

1. **The supply is made for consideration ?** Obviously if the developer is willing to pay Peter for purchasing the property then yes it will be made for consideration. In this case the consideration will be cash.
2. We will skip 2 and come back to that as it is critical
3. **The supply is connected with Australia ?** The answer here is obviously yes
4. **Peter is registered for GST OR required to be registered for GST ?** Peter isn't registered for GST however he might be required to be registered for GST and this will depend on the answer to Question 2.

So the big question then is Peter doing something in the course of furtherance of an enterprise ?

As discussed previously it wouldn't appear that the initial reason for purchasing the property and the works done to date (in this case nothing) would amount to carrying on an enterprise. It also wouldn't appear that Peter has done anything to treat this as an 'adventure or concern in the nature of trade' or a profit from an isolated transaction.

It would appear that the sale of the property by Peter will be a 'mere realisation of his capital asset' and therefore as he is not carrying on an enterprise he would not be required to be registered for GST and the sale of the vacant land would not be subject to GST.

GST and Margin Scheme

The margin scheme may assist in reducing the GST payable on the sale of real property. The rules provide an alternative method of calculating the GST on sale of property.

Step One

Will you be making a taxable supply of real property ?

You need to consider the GST implications of the sale of real property including

- The sale of a freehold interest in land (this can include residential, commercial, retail, industrial and vacant land)
- The sale of a stratum unit
- The grant or sale of a long term lease (50 years or more)

We discussed this earlier and is a critical first step in determining whether GST will apply to the sale.

Step Two

Are you eligible to use the margin scheme ?

This is critical and the rules can be extremely complex particularly where the property has been sold GST free.

The table below will help in determining whether you might be able to apply the margin scheme on sale. It depends on

the GST treatment when you purchase the property from the vendor.

Vendor Treatment	Eligible	Comments
Input Taxed	✓	Example : Second Hand Investment Property
Taxable Supply (Margin Scheme not Used)	⊘	
Taxable Supply (Margin Scheme Used)	✓	
GST Free prior to 9 Dec 2008	✓	Example : Sale of a Going Concern
GST Free after 9 Dec 2008	?	Need to know how vendor purchased the property
Unregistered Vendor	✓	Example : Main Residence

Step Three

Did you and the purchaser agree in writing before settlement that the margin scheme would be applied to the transaction ?

This doesn't necessarily have to be in the sale contract but it is extremely important that the agreement to use the margin scheme is in writing.

CAUTION

The vendor is responsible to the ATO for any potential GST liability. If the ATO determines that GST is payable

> during audit it is the vendor who will be responsible for this payment.
>
> This is one of the reasons for ensuring that advice on GST is sought.
>
> Many legal advisers will include a clause within the contract to recover GST from the purchaser if it is discovered that GST is payable. Legal advice is imperative when preparing contracts for sale to ensure that any GST risks are addressed and mitigate prior to the completion of sale.

Many people confuse the 'margin' for GST purposes with the 'profit on sale'. The margin for GST purposes does not include other costs that are included in calculating the profit such as subdivision costs, construction costs, etc.

How Do I Calculate The Margin ?

Like many things in tax calculating the margin is not always as simple as you think. It depends on several factors and the flowchart below tries to assist with helping you determine what your margin might be.

The diagram below assumes that you can in fact apply the margin scheme to the sale. This we have discussed above.

Once you have determined the 'margin' the GST is calculated as 1/11th of the margin.

For example, let us assume you have calculated the margin to be $500,000 the GST payable on sale if the margin scheme is used will be 500,000/11 = $ 45,454

For property acquired after 1 July 2000 the 'margin' is generally calculated by the consideration for the sale of the property less the consideration for the acquisition of the property.

Was the property purchased before 1 July 2000 ?

YES

NO

Were you registered or required to be registered for GST on 1 July 2000 ?

Was the property purchased after 9 Dec 2008 as a GST Free going concern or GST Free farm land ?

YES

NO

YES

NO

Margin = Sale Price - Market Value on 1 Jul 2000

Margin = Sale Price - Market Value at GST Registration Date

Did the vendor purchase the property before 1 July 2000

Margin = Sale Price - Acquisition Price

YES

NO

Was the vendor registered or required to be registered for GST on 1 July 2000

Was the vendor registered or required to be registered at time of acquisition

YES

NO

YES

NO

Margin = Sale Price - Approved Valuation or GST incl. Market Value as at 1 Jul 2000

Margin = Sale Price - Approved Valuation or GST Incl. market value on GST Registration Date for previous owner

Margin = Sale Price - Acquisition Price Paid by the Vendor or Approved Valuation

Margin = Sale Price - Approved Valuation or GST Incl. market value on GST Registration Date for previous owner

Does the consideration for acquisition include settlement adjustments ?

GSTD 2006/3 states that settlement adjustments in favour of either the supplier or the recipient of real property are taken into account in determining the consideration for the supply or acquisition.

CAUTION

The acquisition cost DOES NOT include stamp duty or legal fees paid on acquisition. This is stated in GSTR 2006/8 at paragraph 49. *"The consideration for the acquisition **does not include** costs that the supplier had incurred that were associated with their purchase of the real property, such as their legal expenses and stamp duty."*