Rental properties: Traps and pitfalls

Following the ATO's claims that nine out of ten residential rental property investors who have been audited have been getting their returns wrong, it might be worth touching on some of the tax traps and pitfalls to be wary of. In no particular order, these include:

Apportionment of rental income and deductions

Where a rental property is jointly owned by two or more people, the income and deductions are split according to the owners' respective shares of the legal ownership of the property. Joint tenancy between spouses is the most common situation, meaning a 50:50 split. In those situations there is no legal basis for the spouse with the higher marginal tax rate claiming a disproportionate share of the deductions for mortgage interest, rates, land tax, insurances, repairs and maintenance in their own return – even where they fund the payments from their own bank account.

Private use

Interest and other outgoings are not deductible to the extent the property was used for private purposes – eg, while you or a relative or friend lived in it for no or nominal consideration.

Interest deductions

Where the acquisition of a rental property has been funded by way of debt, the associated interest costs will be deductible. However, where a loan (or part of a loan) that is secured over a rental property is used for private purposes, such as buying a car or renovating the house you live in, interest can only be claimed on a pro rata basis.

Care needs to be taken when refinancing debt to ensure the tax deductibility of interest attributable to the rental property is not jeopardised.

Repairs vs improvements

The cost of genuine repairs to fix something that is broken or worn down due to wear and tear that happened while the property was tenanted is immediately deductible. Work that involves replacing the entirety of an asset would be a capital improvement and is deductible at 2½ %.

For example, your rental property might have an original 1960s bathroom, with leaky pipes and tiles that are broken or coming away. Fixing the leaks and replacing the tiles (even with something a little more modern) would fall on the repairs side of the line and be deductible outright. On the other hand, gutting the whole bathroom and replacing all the fittings with something out of Home Beautiful would be a capital upgrade and deductible at 2½ % per annum.

Initial repairs

Any deductions for repairs to your rental property have to be attributable to the time you were earning rental income from the property. If you buy a property that requires initial repairs before you can put tenants in, the cost of those repairs will not be deductible. You should still keep track of the amount you've spent on initial repairs as it will trigger off a capital loss when you sell the property down the track.

Certain initial repair works may be unavoidable, but defer non-urgent work if possible. So if your newly acquired rental property is in need of a coat of paint, maybe wait two or three years before contacting a painter.

Travel costs

The cost of traveling to visit your rental property to attend to things is no longer deductible. This matters especially to investors who have bought property interstate. There is an exception where an investor is in the business of letting rental properties – but very few are.

Depreciation

Second-hand depreciating assets acquired as part of the rental property can't be written off against rental income, again unless you are in the business of letting rental properties. But the unclaimed depreciation can trigger off a capital loss on the eventual sale of the property. It's important to keep track of these amounts in the meantime.

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Succession planning cont

Consider each strategy and identify (and keep records of) significant transactions.

For example, say, as the owner of a successful family business, you prepared a basic succession plan many years ago, but since then your business has expanded and your children have grown up. One of them may work with you in the business and you would like to see them take over when you retire. The discussion you could have with this office would be how best to transfer the business and make the transition to retirement.

One option could be to restructure your business as a family trust, so you can still have some control of the business while reducing your involvement in the day-to-day operations. We can explain the tax consequences of this strategy, while also alerting you to other options and tax considerations. Once you decide on your strategy, you update your succession plan, which now includes a section detailing the tax treatment and tax payable on transfer.

Whatever strategies you use to transfer your business onto the next generation, make sure your plans are documented and you seek advice from professional advisers where needed. This will reduce the risk of incorrect tax treatment and outcomes, and possibly consequent penalties.

Rental properties cont

Cash jobs

It's not unheard of for the tradesperson offering the best quote for a repair or maintenance job on your rental property to ask for payment in cash. Before rushing in to accept such a quote, just make sure they're not keeping the job completely off the books and that you'll still be getting an invoice that satisfies the substantiation rules. Otherwise you could end up blowing your cost savings (and maybe more) because you won't be entitled to a tax deduction for the cash you've handed over.

What your tradie does in relation to his tax affairs is a matter between them and the Commissioner, but it shouldn't cost you a tax deduction. Always insist on getting an invoice.

Holiday homes

Own a holiday home? Great for family holidays, but if the property is also offered for short-term rentals there are a few wrinkles you need to be aware of.

The main one is that the property needs to be genuinely available for rent, and not just at times when demand is seasonally low. So if you book the place out for yourself or family and friends for all or most of the school holidays and other peak times, the ATO will take the view that you're not seriously trying to make a profit from any rental income you receive and will limit your deductions for mortgage interest, rates and land taxes, repairs and maintenance, insurance etc to the amount of your rental income. Likewise if you only charge mates' rates when family and friends come to stay.

Some holiday house owners have even pretended to market their property by demanding excessive rents or imposing unrealistic conditions for short-term stays (eg, references, no pets, no kids). That is not likely to pass muster either.

Some limited personal use of the property is acceptable to the ATO, as long as you're genuinely trying to turn a profit. Where this is the case, the deductions claimed need to be pro-rated to reflect the time the property was let or was genuinely available for rent.

Any disallowed deductions won't be wasted entirely as they will create a capital loss on the sale of the property.

Please contact us if any of these issues raise concerns for you.