



Maximise your claim: Overlooked property deductions for investors

Many investment property owners may be missing out on valuable property depreciation entitlements, simply by not being up-to-speed on what is and is not depreciable.

About this newsletter

Welcome to Watson Erskine & Co's client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. Should you require further information on any of the topics covered, please contact us via the details below.

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Generally speaking it seems that many property investors may not be claiming their full tax entitlements, most likely because the range of items that qualify can be unexpectedly diverse. Examples may surprise many taxpayers. These can even include items such as kids' cubby houses or even garden gnomes, as long as the item forms part of the investment property.

But before you go out and splash cash on an upmarket Dopey or Sneezy, remember that conditions usually apply. The ability to access the depreciation is limited to investors, and certain conditions and limitations may also have to be considered.

A gas hot water system, with 5 years still left on its 15-year effective life, can have its leftover value deducted in the financial year in which it is scrapped

HOW DO YOU MAKE A CLAIM FOR A DEDUCTION?

Broadly speaking, depreciation and amortisation allow property investors to deduct a portion of the original cost of equipment and capital works on an investment property every financial year over the item's "effective life".

This is the time over which the ATO or the legislation deems the depreciable asset will lose its value. Basically, the building and its assets are getting older and wearing out, so the ATO allows investors to claim part of their cost each year as a deduction.

Note special statutory rules apply to building works deductions (see below).

TYPICAL DEPRECIATION ITEMS THAT CAN BE DEDUCTED

Rental property investors can depreciate hundreds of household items for tax purposes, including dishwashers, dryers and even built-in coffee machines.

Other eligible but often overlooked items include:

- pumps attached to spa baths
- free-standing spas
- children's cubby houses, and
- water tanks.

DEPRECIATION AND DEDUCTION TIPS AND TRICKS

Other tax depreciation considerations include:

- **Beware of initial repairs on new purchases of investment properties:** Look at your renovations to determine if they would be an initial repair to improve the property (and therefore depreciable) or simply repairs and maintenance (and thus deductible in the current period).
The ATO has been on the look-out for initial repairs erroneously claimed fully as a deduction in the year in which the cost was incurred.
- **Keep all your records:** Keep all invoices and do not claim personal labour costs
- **Claim it all:** Ensure the full and correct effective life of all depreciable items is claimed (speak to us if necessary)

- **Building works deductions:** Some investment buildings are eligible for a 40 year depreciation based on actual or historical construction cost. This is typically referred to as a capital works deduction.

This applies to buildings built after 1985, however extensions and alterations to older buildings may also be eligible to be claimed over 40 years. Note that:

- new kitchens, bathrooms, carports, garages, patios and barbecue areas built after September 1985 in older properties may be eligible for a capital works deduction
- swimming pools built after February 1992 may be eligible for depreciation as structural improvements

- **Get a depreciation schedule:** Provided no changes occur to the assets of an investor on an investment property, a tax depreciation schedule is only required once during the life of an investor's ownership of the investment property — a qualified quantity surveyor can provide this schedule.

- **Scrapped assets:** There is also the option to claim a deduction for the "residual value" of depreciable assets that are scrapped and replaced.

A gas hot water service for example, with 5 years still left on its 15-year effective life, can have its leftover value deducted in the financial year in which it is scrapped.

For any assistance with the above, please contact this office. ■



Novated leases explained

Wrapping a car into a salary package is a popular choice. Doing so by salary sacrifice often raises the topic of novated leases. Is it worth it?

WHAT IS A NOVATED LEASE?

Simply put, a novated lease is a way for an employee to buy a new or used car and have their employer assist in the organised repayment for that car to an agreed financial supplier.

The way this is done is by the employer agreeing to make the repayments out of the employee's pre-tax salary in a salary sacrifice arrangement which, like any such arrangement, reduces the employee's taxable income. The terms of the lease repayments are calculated according to the employee's earnings and the amount salary sacrificed.

A novated lease is therefore a three-way deal – between an employee, a financier, and the employer. The employee leases the car, and the employer agrees to make the lease repayments to the financier for that car as a condition of employment.

For these arrangements, one obvious such condition is to remain an employee. In the event that employment ceases, the obligations and rights under the lease revert to the (former) employee.

This can suit the person involved, as they keep the vehicle (and there are no tax consequences), but can also suit the employer as they are not saddled with an extra vehicle or a financial commitment to keep paying for the car.

During the period of the novated lease, the employer is entitled to a deduction for lease expenses where the car is provided as part of a salary sacrifice arrangement. But it does give rise to a car benefit under fringe benefits tax (FBT) rules.

FRINGE BENEFITS TAX

Fringe benefits that fall under the FBT regime can be provided directly by the employer, by an "associate" of the employer, or by a third party who has an arrangement with the employer (in this case, the finance supplier). A car provided by novated lease is considered a fringe benefit to an employee, and gives rise to an FBT liability for the employer.

WHY IS THIS IMPORTANT?

A basic principle of salary sacrifice arrangements is that an employer is no better or worse off from having offered an employee a form of remuneration other than straight cash salary.

However as the leased car potentially gives rise to an FBT liability, and as FBT is an employer's obligation, it is generally the case that any FBT amount arising as a result of the novated lease is charged to the employee's salary package post-tax. The employer then remits the FBT to the ATO as required under the FBT rules.

WORKING OUT THE FBT

The value of the car benefit (on which the amount of FBT is based) is taken on the actual purchase price of the car. Working out its “taxable value” for FBT can be done using two available methods – the “statutory formula” method (the default and most commonly used), or the “operating cost” method.

The latter requires working out the total operating costs of the car (fuel, oil, servicing, etc) and reducing that total amount by the portion of private kilometres travelled (which attracts FBT) as compared to the total kilometres. It is most often used where business kilometres travelled are high, but is more complicated and requires more records (logbooks) to be kept and calculations to be made.

With the “statutory formula” method, the taxable value is very broadly calculated at a flat rate of 20% of the purchase price of the car.

HOW YOU MIGHT SAVE TAX:

POST-TAX CONTRIBUTIONS TO REDUCE FBT

The employer’s FBT liability that arises from salary packaging a car through a novated lease can be reduced by the employee making contributions towards, say, the running costs of the car from after-tax dollars. It is important that these contributions come from after-tax salary, as every dollar so contributed reduces the taxable value dollar-for-dollar up to the total.

By doing this, rather than the employer paying the FBT tax rate (which is 49% for the 2016-17 FBT year) and passing it on, the employee typically pays tax at their marginal rate, which for many will be much less than that.

Working out whether novated leasing is right for your circumstances can be a tricky exercise – contact us if you need assistance. ■

Novated lease implications in a nutshell

Employer outcomes

- An employer will need to agree to the salary sacrifice arrangement that allows a staff member to obtain a vehicle through a novated lease
- The employer makes lease repayments to the finance supplier on behalf of the employee from their pre-tax salary
- Being a fringe benefit, the arrangement gives rise to an FBT liability, which the employer pays
- The amount of the FBT liability should have a nil dollar consequence for the employer where post-tax contributions are made by the employee for the “taxable value” of the benefit
- Expenses incurred in arranging and maintaining the lease (not the lease repayments) are tax deductible for the employer for the period the lease is active
- The end of the employment relationship also ends the repayment commitment, as lease obligations revert to the (former) employee
- When you lease the vehicle from the finance company, you can claim a GST credit for the GST included in the lease charges. However you generally can’t claim GST credits if you make input taxed supplies.

Employee outcomes

- Salary sacrificing reduces one’s taxable income, as the amount is assigned from pre-tax salary (you may even find yourself in the next lower tax bracket)
- The vehicle is of the employee’s choice, and the employee has exclusive use and ownership
- As the car is a fringe benefit, FBT must be paid, although the employer is liable for this payment. Any FBT is typically also salary sacrificed so that the employer is no worse off
- Generally, FBT is based on the purchase price of the vehicle, as the statutory formula is the most commonly utilised method. The operating cost method applies to running costs with a percentage determined by logbook
- Making post-tax contributions to the costs of owning the vehicle can reduce the FBT liability by the same amount contributed
- Usually the vehicle is obtained more cost effectively, as there is:
 - no GST on purchase (claimed by employer)
 - leasing companies usually get fleet discounts
 - the employer may also get a corporate discount.





Real estate: Buyers turned into tax collectors

New withholding rules on the sale of property by foreign residents have been introduced. This essentially turns property buyers into potential tax collectors.

The government says this change of rules has been necessary as foreign investment in Australia, including in residential real estate, has increased, and is continuing to increase, at an unprecedented rate.

The rules will apply where real property contracts are entered into on or after July 1, 2016, but only apply to sales of residential property where that property has a market value of \$2 million or more.

Withholding will not apply to sales by Australian resident sellers, but these sellers will need to obtain a clearance certificate that they can provide to the purchaser. Otherwise, 10% of the purchase price will need to be remitted to the ATO.

The changes were announced in 2013, but only became law earlier this year. The ATO says it has already communicated to real estate agents, conveyancers and legal practitioners to ensure the industry is prepared to help their clients meet their withholding obligations.

Withholding arrangements to make sure foreign residents pay capital gains tax on the sale of residential property exist in many countries, including in Canada, France, Spain, Japan and the USA.

Information for sellers and buyers

The ATO's assistant commissioner Malcolm Allen says the new rules will only apply to a limited number of sales of residential property under contracts entered into from July 1, 2016.

The ATO says that most property sales are for less than \$2 million and will therefore be completely outside the new rules. The withholding also does not apply to sales by Australian residents where a clearance certificate is provided to the buyer.

For purchases of property with a market value of \$2 million or more from a foreign resident seller, a 10% withholding will be incurred on these transactions at settlement, with the withheld amount being credited

against any capital gains or income tax payable by the seller on the sale. "This means Australian residents who are selling a taxable Australian property with a market value of \$2 million or more need to obtain a clearance certificate from the ATO," Allen says.

"The clearance certificate will confirm that the 10% withholding amount does not apply to the transaction. If a seller doesn't provide a clearance certificate to the buyer by settlement, the buyer will be required to withhold 10% of the sales price and pay this to the ATO."

The ATO says where a buyer fails to withhold when they should, a penalty may be incurred which will be equal to the amount that was required to be withheld and paid. Interest will also be payable.

Sellers can claim the credit for the withheld amount paid to the ATO by lodging a tax return for the relevant year.

How to apply for a clearance certificate

The ATO says clearance certificate application forms are already available to download through its website (or ask us for a copy). There is no ATO fee for clearance certificate applications.

The ATO has promised an online version of the form, and says this should be available early in the 2016-17 income year. Where an application is submitted online, it says most certificates will be issued electronically within a few days. Paper applications are expected to take between two to four weeks to process.

"There may be some delays in cases where applicants have incomplete tax records, for example where tax returns have not been lodged for the last two years," Allen says. "We will follow up where we see evidence of poor tax behaviour, just as the Australian community would rightly expect of us."

A clearance certificate is valid for 12 months from issue, and must be valid at the time it is made available to the buyer. Contact us if you need further information. ■

What to bring to your tax return appointment

If you're coming in soon to discuss your tax return for yourself or your business, come prepared with some records or access to them to help us with the preparation.

Being prepared is not only wise, but saves a lot of time and effort for both yourself and for us.

If you are a new client, it is always smart to arm yourself with last year's tax return. This should have your personal details, Tax File Number, income streams, tax offsets, deductions, and other relevant information previously claimed. Also bring your latest bank account details in the event that you're entitled to a refund.

If you use an online accounting solution, all or most of your data should be available online for us to access. Most packages capture business transactions, and allow you to record data in real-time and in a format that we understand (as well as giving us access to it 24/7 so we can work on your return after the appointment is over).

Here is a brief general checklist of things to prepare for your tax return appointment. Not all of the following will be relevant for everyone, and will depend on your circumstances. But as a checklist it should help you tick off what you do or don't have in preparation for your return.

We will work through every allowable tax deduction available for you and/or your business. Don't forget to ask us what tax incentives are available to you which may work to increase your tax deductions.



INCOME

- PAYG summaries from employers
- Bank statements for any interest received during the financial year
- Distributions from trusts, partnerships, managed super funds
- Allowances (car, travel, entertainment, meals etc.)
- Government pensions and allowances
- Foreign income
- Capital gains – eg sale of shares or property
- Dividends
- Personal services income
- Net income/loss from business
- Rental income – eg from an investment property
- Lump sum termination payments
- Superannuation lump sum payments
- Any shares/options received under an employee share plan



EXPENSES FOR TAX DEDUCTIONS

- Motor vehicle expenses based on business use percentage and kilometres travelled (include your log book if applicable)
- Travel and accommodation information – domestic and overseas
- Work uniforms and other clothing expenses
- Courses, education and seminars
- Home office expenses
- Computer, software and repairs
- Tools and equipment
- Employee costs
- Superannuation contributions
- Rent/lease payments
- Interest paid – say on an investment property
- Dividend deductions
- Bank fees
- Low value pool deductions/depreciation
- Telephone and internet costs
- Freight and transport costs
- Utilities – electricity, gas, water
- Legal and accounting fees
- Donations
- Income protection insurance
- Details of any asset purchases
- Childcare expenses



IF YOU'RE IN BUSINESS

- Bank and credit card statements
- Lease, hire purchase, chattel mortgage or other loan agreements to your business
- Business Activity Statements and Instalment Activity Statements and working papers
- Post-June 30 stocktake valuation figure.



Keep receipts for all expenses and tax deductions you are claiming for your business. Scan and file them electronically so they're accessible should you need them for audit purposes. Also bring your health insurance statement and receipts for any medical expenses as an offset may be available.



Tips to spot a scam ... and what to do

The ATO has recently warned that it is continuing to see instances of scam emails, SMS messages or telephone calls where criminals try to steal money or information from taxpayers. These can be very convincing and many individuals fall victim to these each year.

It is important that you know common characteristics of a scam so that you can watch out for potential fraudsters.

Generally, scam communications:

- are unsolicited
- are pushy and can be intimidating, threatening arrests or penalties if payment for an unknown tax debt is not made immediately
- demand payment in full and in some instances via unconventional means such as iTunes cards, cash transfers or gift vouchers
- ask you for your personal or financial information or to confirm information they pretend they have
- can often be poorly worded, and (for written scams) could contain spelling and grammatical mistakes

- may promise you a tax refund in exchange for a payment or personal information
- may contain an attachment or fake links requesting you to lodge a form – opening these attachments or links can cause you to download spyware or a virus.

If a scammer or someone claiming to be from the ATO has contacted you and you are unsure of their legitimacy, let us know.

For phone scams you should:

- hang up immediately
- call the ATO's dedicated scam reporting line 1800 008 540 between 8am to 6pm EST, Monday to Friday.

For email scams you should:

- refrain from clicking on links or opening attachments
- forward the email to ReportEmailFraud@ato.gov.au

And of course, please feel free to check with us should you have any doubts or concerns. ■

SMSF TRUSTEES: NON-ARM'S LENGTH LRBA GRACE PERIOD EXTENDED

The ATO had previously held that limited recourse borrowing arrangements (LRBAs) which are not maintained on arm's length terms need to be fixed before June 30, 2016. However additional time has been granted and now trustees have until January 31, 2017 to rearrange their LRBAs and either meet the safe harbour definition or otherwise demonstrate that the arrangement was entered into and is maintained as an arm's length dealing. LRBAs established not on commercial terms give rise to non-arm's length income (NALI), which is taxed at the top marginal individual tax rate. This can negate all the benefits of holding investments in a superannuation environment.

The ATO also acknowledged that there is scope for further practical guidance clarifying the circumstances in which an SMSF will be taken to receive a greater amount of ordinary or statutory income under a particular non-arm's length arrangement, compared to the amount that it would have received under an arm's length arrangement.

The ATO says it will not select an SMSF for an income tax review purely because it has an LRBA for the 2014-15 income years and prior, provided that:

- the SMSF trustee ensures that any LRBAs that their fund has is on terms consistent with an arm's length dealing, or is alternatively brought to an end by January 31, 2017, and
- payments of principal and interest for the year ended June 30, 2016 must be made under LRBA terms consistent with an arm's length dealing by January 31, 2017. ■



Work deductions: What's on the taxman's radar?

The ATO says that this year it will pay extra attention to people whose deduction claims are higher than expected, in particular those claiming car expenses.

The expenses the ATO says it will be scrutinising can include claims by those transporting bulky tools, and deductions for travel, internet and mobile phone as well as claims for self-education expenses.

We can help you work out whether you are entitled to a deduction for such expenses and the necessary record keeping requirements – please let us know when you come in to see us.

Here are some examples of relevant cases that have been provided by the ATO:

Car expenses: Transporting bulky tools

A car mechanic claimed \$3,850 in car expenses for carrying his large toolbox to and from work each day. The employer told the ATO that they supply all of the necessary tools at the workshop for the mechanic to do his job but that he preferred to use his own tools.

The car expenses were disallowed because the mechanic chose to use his own tools, rather than the tools provided by the employer. Travel from home to work is private and not tax deductible. The mechanic was required to pay over \$2,000 in tax and penalties.

Travel expenses

For each day a boilermaker worked away from home, he received a travel allowance from his employer. The boilermaker's payment summary showed he was paid a travel allowance of \$8,000 during the year, the same amount that the boilermaker claimed as a deduction.

The employer paid the travel costs to get the boilermaker to and from work and provided accommodation and

all meals. The claim for travel expenses was disallowed because the boilermaker did not spend any money. As the travel allowance was shown on the boilermaker's payment summary, it needed to be included as income on the tax return. After penalties were applied, the boilermaker received a bill for almost \$4,000.

Car and uniform expenses

A real estate agent claimed work-related motor vehicle, work-related clothing, laundry and dry-cleaning expenses. During the audit process she provided allegedly false tax invoices from a commercial car wash and dry cleaner to support her claims. The real estate agent was prosecuted, pleaded guilty and fined \$4,000.

Mobile phone expenses

A labourer claimed \$1,200 in other work-related expenses for use of her mobile phone. The labourer told the ATO she used her phone at work to keep in touch with co-workers but did not have records to show this usage.

When the ATO spoke to the labourer's employer, it was told the labourer was not required to use their mobile phone as part of their duties. However the ATO accepted that the labourer may have occasionally used her mobile phone for work purposes and allowed a claim of \$50 for the year.

Self-education expenses

A retail sales assistant claimed a deduction for self-education expenses of \$5,165 for course fees relating to a bachelor of arts degree. As the degree did not directly relate to the assistant's current job, and there was no requirement to undertake further education, the claim was disallowed. ■

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