10 Myth Busters for Renovators

After 3 days on a stand at the Cherie Barber Boot Camp I realised there are a lot of fundamental issues that are misunderstood by renovators so here are the basics. If you would like more we have a renovator's booklet on our web site https://www.bantacs.com.au/booklets/Renovators.pdf

1) **Borrowings – It is all about the link between the loan and the expense, not where the loan is secured.**

What the money is used to buy determines whether the interest on the loan is tax deductible, it does not matter where the loan is secured. For example if you make extra payments on a loan then you are permanently reducing the debt on the asset that loan was used to buy. If you ever withdraw those funds then that is a new loan for whatever purpose you spend the redraw on. If you are thinking of renting out your home and buying a new one there is no consideration for the fact that borrowing for your new one meant that you did not have to sell the old one. The interest on borrowings to buy the new one will not be tax deductible if you live there.

Even if you do not live there, after 30th June 2019 there will still be no immediate deduction for the interest until the property is available for rent. Any costs associated with holding a property that you are renovating to eventually rent increases its cost base for CGT purposes, it is not immediately tax deduction.

A common trap for renovators and their loans is drawing money out of the loan and mixing it with private money before using it in relation to the property. There must be a clear nexus between the borrowings and the use of the funds in relation to the property. According

to Domjan's case, if there is a detour via your personal bank account the nexus is lost. If you must draw a lump sum out of the loan to slowly disburse on various costs relating to the house open a bank account just for that purpose only, do not deposit any of your own funds into that account. If that account is an offset account then you can also avoid paying interest on that money until it is used.

An offset account is a separate bank account from the loan but the bank only charges you interest on your loan balance less the amount you are holding in the offset account.

If you have spare money you would like to use to reduce the loan best put it into an offset account instead just in case you need it for private purposes.

2) **Capital Gains Tax – If the property was not your home from settlement it will always have a pro rata CGT obligation, there is no line in the sand or reset.**

The only time you get to reset the cost base of the property to market value is if it has always been your home and covered by your main residence exemption up until the time when you use it to produce income. It does not work the other way around. Unless the property is covered by your main residence exemption right from the start there will always be some CGT exposure no matter how long you end up living there. To cover it with your main residence exemption right from the start you need to either move in straight after settlement or immediately start to renovate and then move in straight after the renovation is completed and not cover another property with your main residence exemption from the date you purchased the renovated property. Now there is a small window of opportunity in the 6 months overlap rule, if you have another house at the time of purchase but this rule has many traps so get advice.

Capital gains tax and the associated main residence exemption or 50% CGT discount do not apply to business ventures such as renovating to sell at a profit, these are taxed as normal business income. This is important to consider when you are deciding whose name to buy the property in.

You cannot qualify for the main residence exemption unless the property is held in the personal name of you or your spouse.

3) **Flips – This is a business no CGT discount or main residence exemption**

You will not qualify for the 50% CGT discount or the main residence exemption if you buy the property with the intention of renovating and selling it for a profit. This is a business activity you will pay tax at your marginal rate on any profit you make on the property.

Additional factors that suggest you are in business include having a logo, business cards, letterhead, signage, not being able to afford to hold the property long term and your history of selling your renovated properties. Unfortunately, the ATO has the benefit of hindsight. No flying under the radar. The ATO data match all property sales. Reference TR 92/135

4) **Scrapping – The little you can claim is probably not worth the cost of the Quantity Surveyors report.**

This is when you attempt to claim a tax deduction for any unclaimed building depreciation. Buildings or improvements built after 16th September, 1987 can be written off over 40 years if in the relevant year the property is being used to produce rent. This means if the wall that you are about to rip down is less than 40 years old it may have some depreciation left on it. If it is destroyed then you get to write that off, but before you organise a quantity surveyor report get advice from your Accountant on just how much you really will be able to claim. Refer ID 2010/35, if you are living there when or before you scrap, no deduction at all. This concession only applies to properties that have been held as a rental. ID 2010/36 points out that you look back over the whole life of the area you are going to

scrap and apportion your claim to only the percentage of the time that the property was used as a rental. If you do not know how the previous owners used the property then you cannot assume it was a rental. Then of course you are only going to get back the amount of unclaimed depreciation multiplied by your tax rate, so it is unlikely that the expense of the quantity surveyors report could be justified.

As for claiming scrap on any plant and equipment, their effective life is shorter so less likely to have any undepreciated value left. Further, if you purchased the property after 9th May 2017 or it wasn't used to produce income before 1st July 2017, or you have lived in the property after that date you are not entitled to claim depreciation on plant and equipment or scrap anyway.

5) **Depreciation – Not on second hand equipment anymore, which includes if you have lived there or if the builder bought it.**

This is only of interest to renovators that are considering renting the property out after they have finished the renovation. There is a trap with new plant and equipment such as a stove that you may buy while you are renovating a property. If you live in a property while renovating, even if you do not use the plant and equipment while there, it will still be considered second hand when you move out, so if you rent it out you cannot claim depreciation. Even if you are not living in the property, if the builder buys the plant and equipment going into the renovation it will be considered second hand when you pay the builder for it. The only exception to this is if you undertake a substantial renovation; refer GSTR 2003/3.

6) **Claiming Travel – Only if you are flipping**

Investors are no longer entitled to claim the cost of travel to and from their investment property or in relation to it for that matter, such as visiting real estate agents and body corporate meetings.

On the other hand if you are caught being in the business of renovating for profit then your travel costs are a business expense, not the cost of earning passive rental income. As a result, you will be able to claim your travel expenses so make sure you keep records.

7) **Claiming Holding Costs – No longer claimable unless it is ready to rent out**

From 1st July, 2019 investors will no longer be entitled to claim a tax deduction for expenses during the renovation phase if the property is not listed as available immediately for rent. These expenses will now just increase the cost base if you are renovating to hold as a rental or your home. The treatment of holding costs is all about your intended use of the property after the renovation. If it is as a rental then they merely increase the cost base. If it is as your home, no deduction, they can still increase the cost base but probably will never useful as your main residence is exempt from CGT. If it is a flip, then holding costs will be deductible either against the sale proceeds or during the renovation.

8) **Repairs – If it needed doing when you purchased it then it is an improvement not a repair**

If you are renovating to sell at a profit, that is flip the property, then these sort of costs are going to be deducted against the sale proceeds promptly after being incurred.

Alternatively, if you are going to keep the property as an investment after the renovation, then the repairs are only tax deductible if they are done in a year that the property earns income and they did not need doing when you purchased the property. Note that if you lived there while the repairs are undertaken then they are a private expense.

Consider carefully the concept of initial repairs, these are repairs that were necessary when you purchased the property, even if you didn't know they needed doing. Even repairs that come about because of a fault that was present at the time you purchased the property are initial repairs. This is another advantage of a building inspection report. At least it allows you to independently prove the condition of the property when you purchased it. Though this works both ways, anything mentioned in the building report is an initial repair, beyond doubt.

Basically, initial repairs are an improvement to the property so not deductible in the way normal repairs are.

If you intend to keep the property as a rental, initial repairs that do not qualify for an immediate tax deduction, can be depreciated at 2.5% a year, once the property begins to earn income. This 2.5% write off is available under division 43 ITAA 1997, commonly referred to as building depreciation but the reality is the expenses do not have to be structural for division 43 to apply, even painting qualifies.

9) GST – Can apply to second hand houses if they are substantially renovated

If you are undertaking a substantial renovation (refer GSTR 2003/3) with the intention of selling at a profit then you could be caught for GST. The important heads up here is the GST will be a lot less if you use the margin scheme in the sell contract. Make sure you are sure whether GST applies, maybe even get an ATO ruling, before you put the property on the market.

With data matching you are unlikely to slip under the radar and if the ATO decide it is a substantial renovation it could be too late to get the buyer to agree to the margin scheme and claim GST input credits back on the renovation costs. If the margin scheme is not used the GST is $1/11^{th}$ of the selling price which could mean the loss of your whole profit!

10) Accountant's Workflow – We love all our clients, don't take delays personally

I also heard a few complaints about how long it had taken for their Accountant to get around to doing their tax return when they had all the stuff ready for them in July.

The trouble is most of our clients do the same thing. Unlike any other occupation all our clients want their work done at the same time of the year. We could employ temporary, low skill staff to deal with this workload like a production line but we prefer to provide full time employment developing our employees' skills over the year to provide the best service.

Please don't ever think you are not important to us, all our clients big and small are. To provide the best quality Accountants at a reasonable price this work needs to be spread to keep them employed all year. In recognition of this the ATO grants tax agents a lodgement program that allows us to lodge without penalty up to June the following year.