

Crunching the numbers

In the first of a two-part report, **Julia Hartman** looks at the sums you should do before buying a rental property to work out how much it's going to cost you.

ACCORDING to our recent survey, there are some readers who think tax law could be more entertaining. Well get a load of this one, it has more twists and turns than an Agatha Christie murder mystery. The suspense is just too much as you work your way through the stimulating numbers to the startling conclusion next month.

The following takes a bit of commitment but is a very worthwhile exercise. Don't leave anything to chance when you buy a rental property. Make sure you know exactly how much it's going to cost you.

While the repairs and capital growth do leave you with some uncertainty, you can still gain some valuable insight into what it will take to make your investment successful. Don't just do the exercise once, try some 'what if' analysis. For example, reduce the rent to see the effect, after allowing for tax, of a period of vacancy. Or increase the interest expenses to see the effect of a rate rise.

This is the first stage -- determining how the property affects you while you own it. Next month we'll take this one step further to consider capital gains tax on the sale and the ultimate conclusion of what it takes to make the investment worthwhile.

The following assumes the property is negatively geared (i.e. the tax deductible costs of holding the property exceed the rental income).

TAX RATES	
Up to \$6,000	No tax payable
\$6,001 to \$25,000	16.5%
\$25,001 to \$75,000	31.5%*
\$75,001 to \$150,000	41.5%
Over \$150,000	46.5%

*Note the low income rebate of \$600 shades out between \$25,000 and \$40,000 at the rate of 4 cents in the dollar so if you earn under \$40,000 but more than \$25,000 your effective tax rate is 35.5%. The above rates include Medicare levy of 1.5% but this doesn't apply if your income drops below the threshold for your family size.



EFFECT ON YOUR TAX RETURN

Total rent for the year	
Less:	
Depreciation (refer Note 1)	
Special building write-off (refer Note 2)	
Interest	
Borrowing costs (amortised over first five years)	
Estimated repairs	
Rates and insurance or body corporate fees	
Landlord's insurance	
Costs associated with inspecting the property	
Agent's fees (8 or 9 per cent of total rent)	
Net effect of property on your taxable income	

To calculate the tax refund you can expect from the property, you need to apportion, between the property owners, the net effect of the property on your taxable income that you have calculated in the box (below left). Then apply to that amount each owner's individual tax rate. The tax rate box (shown far left) shows you the brackets. Don't forget to check whether the rental property moves you into a lower tax bracket. For example, if you earn \$80,000 and the rental property is making a \$10,000 loss, your refund will be \$5000 x 41.5 per cent plus \$5000 x 31.5 per cent = \$3650. This tax refund is part of the cash flow of the property so will need to be taken into account in the next step.

Note 1

This is depreciation on the plant and equipment in the house. Any items included here are not included in Note 2 (special building write-off).

If you have a quantity surveyor's report there should be a page or two with a schedule of these items that you can use. Otherwise, the ATO will allow you to use a reasonable estimate of the value of the items when you purchased the property.

Unless the house is new, you will have to estimate the secondhand value. If you're renting out a house you previously lived in there may be nothing left to depreciate. There are two methods of depreciation that you can use.

The diminishing value method is a higher rate but each year the value of the asset that you apply the rate to decreases by the amount of depreciation claimed in the previous years.

The prime method is a consistent amount each year. The prime method is best used in this calculation. If any of the plant or equipment is valued at less than \$1000 when you purchase it, it qualifies to go into a low value pool. This is

■ Don't leave anything to chance when you buy a rental property

\$1000 per owner, so a \$1800 hot water system in a property owned by a husband and wife would be considered under \$1000. Items in a low value pool will qualify you for a diminishing value depreciation rate of 18.75 per cent in the first year, then 37.5 per cent per annum for each year after that.

Examples of the items that would be considered plant and equipment and their depreciation rates if purchased after May 2006 are listed in the box (right).

Note 2

Special building write-off is depreciation that's allowed on residential buildings constructed after July 17, 1985. It applies to future owners of the property but only on the original cost of building the house. If the original owner was a builder (i.e. a spec home) then it's the cost to the builder, so their profit margin isn't included. The amount claimed each year is the same. For residential buildings constructed between July 18, 1985 and September 16, 1987 the rate is 4 per cent per year. Buildings constructed after that date are 2.5 per cent per year.

It may seem there's an advantage in purchasing a property built between July 18, 1985 and September 16, 1987 but remember it's the original building cost so the actual amount claimed will probably be less.

Also once the property is 25 years old no more depreciation can be claimed, whereas buildings constructed after September 16, 1987 can be depreciated for up to 40 years.

When purchasing a property, make sure you ask the previous owner for the original building costs. If they've been using it as a rental property, they are required by law to give you this information.

If you can't get the actual cost from the previous owner you can have it estimated by a quantity surveyor.

Cash flow calculation

This calculation will tell you how much

PLANT AND EQUIPMENT	PRIME	DIMINISHING
Light fittings not hardwired	20%	40%
Security systems	20%	40%
Water pumps	5%	10%
Motors and fans	5%	10%
Ceiling fans	20%	40%
Air conditioners	10%	20%
Hot water systems:	Gas	8.33%
	Electric	8.33%
	Solar	6.67%
Dishwashers	10%	20%
Stoves and ovens	8.33%	16.66%
Range hoods	8.33%	16.66%
Garbage disposal units	10%	20%
Carpets and vinyl	10%	20%

you will need in after-tax dollars to prop up your investment.

Note: principal repayments haven't been included in the above because even if applicable, they're really just a form of compulsory saving. But you should take them into account when working out whether you can afford to meet the

commitments of the rental property. So the first question is, can you afford the annual net cash out flow amount as calculated in the box in the middle column on this page, plus any principal repayments if applicable? If you have non tax deductible debt, such as a loan used to buy your own home, you should concentrate on paying it off by making the rental property loan interest-only. As you can see by the annual net cash out flow amount, this property isn't going to be worth investing in unless you can offset your losses during ownership by a capital gain on its sale.

But just how much gain do you need to make it all worthwhile, and how do you factor in the tax consequences?

All will be revealed next month, together with some worked examples. ■

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■ This information is of a general nature only and does not constitute professional advice. You must seek professional advice in relation to your particular circumstances before acting. This information is also to be read subject to the disclaimer on page 6.

CASH FLOW CALCULATION

Cash in flows:

Refunded as calculated above

Total annual rent received

Less cash out flows:

Interest for the year

Estimated repairs

Rates and insurance or body corporate fees

Landlord's insurance

Costs associated with inspecting the property

Agent's fees (8 or 9 per cent of total rent)

Annual net cash out flow