Renovations vs repairs

***Michael Quinn*, lawyer, accountant and director of The Quinn Group, explains the difference between repairs and renovation, and shows what you can legally claim as a tax deduction**

Generally speaking, a deduction can usually be claimed for certain expenses that are incurred in relation to the period that your property is being rented or is available for rent.

The various types of rental expenses can be categorised into one of the following three groups:

- Expenses that cannot be claimed
- Expenses that can be claimed as an immediate deduction in the year that they are incurred
- Expenses that can be deducted over a number of years

Be aware that these form only a portion of the total expenses that can be claimed in relation to rental properties.

What cannot be claimed

There are a number of property-related expenses that cannot be claimed as a deduction. Expenses that are capital or private in nature cannot be claimed.

However, you may be able to lodge a claim for decline in your property's value or capital works deductions. Also, for capital gains tax purposes, you may be able to include certain costs in the 'cost base' of the property.

The terms 'capital' and 'of a capital nature' refer to expenses such as:

- The replacement of an entire structure or unit of property, eg, a kitchen cupboard or a fence
- Improvements, renovations, extensions and alterations
- Initial repairs, eg, correcting any defect or damage that was present from the day the property was purchased by you

While the difference between a repair and an improvement or renovation is dependent on each individual situation, if the answer to the following questions is 'yes' then the work is more likely to be considered an improvement.

Does the work:

- Result in a reduced 'likelihood of future repairs'?
- Increase the life of an asset?
- Improve the asset's efficiency?
- Cost more than if you were to use the original materials?

Examples of works that have been found to be considered improvements include replacing a wooden floor with a concrete floor, replacing an electrical system and rectifying a pre-existing drainage fault.

Conversely, if assessment of the asset answers 'yes' to the following questions, then it is less likely to be considered an improvement.

Does the work:

- Result in disadvantages as well as advantages, for example, is it a longer-wearing floor that may be harder to walk on?
- Use materials that are cheaper than the original materials?

Some works that have been considered not to be improvements include replacing timber and sawdust insulation with foam insulation or using part-steel and part-timber uprights to replace timber uprights.

Important note

If the work is a repair, to aid in making claims it is good practice to have the person carrying out the work provide you with a letter that states as such.

While repair work and improvements can take place at the same time, for the purposes of your deduction it is necessary to separate the costs. If this cannot be done, the entire work may be considered an improvement.

Other expenses that cannot be claimed include costs that are incurred in relation to the acquisition and disposal of the property, expenses that are not actually incurred by you but perhaps by your tenants, such as water and electricity, and other expenses that are not directly related to the renting of your property.

What can be claimed immediately

Expenses that are incurred in relation to the repair and maintenance of a rental property can usually be deducted in the financial year in which they are incurred.

A repair is considered to be directly related to the wear and tear of a property that occurs as a result of the property being rented. It usually involves the replacement or renewal of a part that is worn out or broken, such as replacing a broken window or part of a fence that was damaged in a storm.

Repair costs can usually be deducted as long as the property is rented or available to rent for a continual period. Short stretches of vacancy do not impact on the deductibility of repairs.

If during any particular financial year the property becomes no longer available for rent, it may still be possible to claim a deduction. There is no minimum time that the property needs to be rented for, as long as it generates some income in the financial year.

If the repairs are deemed necessary, have arisen as a result of the property being rented and the associated costs are incurred within the same financial year that the property was rented, you are likely to be eligible for a deduction.

In addition to the actual costs incurred in repairing and maintaining your rental property, you may also be eligible to claim a deduction for any interest that is paid on loans that are taken out to purchase depreciating assets or to finance the repair or renovation of the property.

This is provided that the property is being rented, or is available for rent, in the year that the deduction is claimed. If the property is used for private purposes for part of the year, it is necessary to apportion the amount of interest that is claimed.

If you travel during the period that your property is being rented for the purposes of inspection, maintenance or to carry out repairs, you can claim the associated costs of the trip, provided that is the sole purpose of the journey. If the rental property visit only forms part of your trip, for example, you went for a holiday and called in to inspect the property as well, the claim amount

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needs to be apportioned. In this case, you cannot claim for the cost of the entire trip.

Provided that the purchase meets the following guidelines, you may also be able to claim an immediate deduction for any non-business depreciating assets (that is, purchases that are utilised in producing non-business income, in this case rental income) that have a cost of $300 or less.

You can claim an immediate deduction if the asset:

- Costs $300 or less
- Is used predominantly for producing non-business income
- Is not part of a set or one of a number of identical, or substantially identical, assets that together costs more than $300
- Was purchased in the current financial year

What can be claimed over a number of years

There are a number of rental property-related expenses that you may be able to claim over a number of income years. These include borrowing expenses, decline in value of depreciating assets and capital works deductions.

You can claim for low-cost and low-value assets over a number of years by using a low-value pooling system or a general diminishing value method or prime cost method.

You can allocate both the low-cost assets and low-value assets into a low-value pool. Low-cost assets are all assets that cost less than $1,000 not inclusive of GST; low-value assets are assets that have declined in value under the diminishing value method to less than $1,000.

You can work out the deduction for the decline in value of depreciating assets in a low-value pool using a diminishing value rate of 37.5%. Low-cost assets that are added to the pool are depreciated at half the rate, 18.75%, for the year in which they enter the pool.

If you jointly hold any assets with others and the opening adjustable value of your interest in the asset is less than $1,000, then you can allocate your interest to your low-value pool.

Most importantly, once an asset is allocated to a low-value pool it is not necessary to work out each asset's adjustable value or decline in value individually. This is done using the total value of the asset pool as a whole. Calculation for the decline in value for all of the depreciating assets in the pool is only required to be done once annually, usually at the beginning of the financial year.

However, for other depreciating assets that cost more than $1,000 or have opening adjustable values of more than $1,000, the deduction for the decline in value of that depreciating asset is calculated using either the prime cost or diminishing value method. Both methods are based on the effective life of the asset.

As mentioned previously, you cannot claim deductions for expenses of a capital nature; however, you may be eligible to claim a deduction for the construction expenditure that is related to these expenses, known as a capital works deduction. These deductions are usually spread over either a 25- or 40-year period.

It is necessary to point out that total capital works deductions must not be greater than the total construction expenditure and no deduction can be claimed until the construction is complete. Also, the deductions can only be claimed for as long as the property is being rented or is available for rent.

Deductions for capital expenditure can be applied to a variety of works, for example, a building or extension (adding a pergola, a garage or an extra room to the property), alterations (adding or removing an internal wall), or structural improvements (adding a new fence or a retaining wall).

Costs that can be included in the expenditure total can include engineer and architect fees, and payments to tradespeople such as bricklayers or carpenters. You cannot claim for expenses such as land clearing prior to the construction, landscaping or the cost of the land that the rental property is built on.

There is a detailed table of dates and conditions that determines which specific construction expenses can and cannot be deducted, and the rates at which the deductions are calculated. These amounts vary depending on the date upon which the work was commenced.

In order to claim these deductions, you must engage a quantity surveyor and obtain a depreciation schedule for your property.

As there are many contributing factors when determining your eligibility for claiming rental property deductions, it is important that you seek the advice of a professional. This will ensure that you are getting the maximum Australian Taxation Office (ATO) refund legally due to you. ■

Michael Quinn, director of The Quinn Group, is an experienced lawyer, accountant and educator. For further information or assistance, contact Michael and the team of legal and accounting professionals at The Quinn Group on 1300 QUINNS or visit www.quinns.com.au

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