Tax issues when converting your home into an investment

There are many reasons why homeowners choose to convert their current principal place of residence into an investment property – but regardless of the motivation, there are a number of taxing factors that property owners should be aware of when making the switch. *Michael Quinn*, lawyer, accountant and director of The Quinn Group, explains

Many homeowners look to upgrade their home to a larger residence – or perhaps downsize to a smaller model – and wish to retain their original property as an investment. They may have been relocated due to work obligations, or a growing family might necessitate the move. There are many reasons why people switch abodes, but there are also many tax matters to be considered first.

To start with, let's clarify the two main terms that we're dealing with.

A principal place of residence (PPOR) is defined in the *Duties Act 1997 (NSW)* sec 162A (1) as "the place of residence that is, among the one or more places of residence of the person within and outside Australia, the principal place of residence of the person". Put simply, it's the home that you primarily reside in – and you can only have one PPOR anywhere in the whole world at any one time.

An investment property is a property, whether land or a building, or part thereof, or both, which is held by an owner (or by a lessee under a finance lease) to earn rental or capital appreciation, or both.

The shifting of labels from PPOR to investment property occurs upon the homeowner's physical relocation to a newly purchased property – that is, to their new PPOR. Once this relocation has occurred and the first property is deemed to be an investment, there are several tax implications that the owner needs to be aware of.

Such tax issues include, but are not limited to, potential deductions as well as possible capital gains tax (CGT) exemptions that the owner may not have been able to claim on their PPOR.

Tax deductions

1 Mortgage interest rates

Perhaps one of the simplest tax deductions that can be claimed is mortgage interest. As soon as the property legally becomes an investment, and is no longer the taxpayer's PPOR, any interest that's paid as part of the loan repayment for that property becomes a tax deduction.

2 Uniform capital allowance

Introduced in July 2001, the uniform capital allowance applies to most depreciating assets, including investment properties.

The allowance combines a range of former capital allowances into a single structure, with a general set of rules that can be applied across various depreciating assets and certain other related expenditures, such as repair and maintenance costs.

Depending on whether the property's depreciation is measured using a 25- or 40-year structure, the uniform capital allowance is calculated annually, at either 4% or 2.5% respectively, of the property's purchase price, for every year that it's an investment property for the owner.

For example, say you purchase a two-year-old investment property for $400,000, and it's depreciated using the 40-year structure. The uniform capital allowance that can be claimed is $10,000 (2.5% of $400,000) annually for the remaining 38 years (or the proportion of that period that the taxpayer retains the property).

3 Related expenses

Other expenses related to maintaining and owning the property, such as council rates, repair costs and property management fees, will also be tax deductible.

CGT exemptions

Generally speaking, any capital gain or loss that's incurred as a result of disposing of, or selling, a PPOR is exempt from any CGT obligations.

However, there exist certain situations whereby at the time of the sale of the property, the owner may only be eligible for a partial CGT exemption. The two particular circumstances where the partial exemption is applied are:

1. When the property wasn't used as the owner's PPOR for the entire period of ownership (although some specific absences are allowed and are discussed further below)
2. When the property was used for income-producing purposes while it was the taxpayer's main residence, and if a loan was taken out to purchase the property and that the taxpayer could have deducted the interest paid on that loan

For the purposes of this particular article we're more concerned with the first instance. The example below demonstrates how the partial CGT exemption can be applied upon the disposal of an investment property that was once a PPOR.

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The six year rule

As mentioned above, there are provisions that allow for an owner's temporary absence from their PPOR, which don't affect the owner's eligibility for the full PPOR CGT exemption. This is commonly referred to as the 'six year rule'.

The six year rule provides that the property's owner can be temporarily absent from their PPOR for up to a maximum of six years at a time, without losing the exemption, provided that no other property is treated as the PPOR during that period. The owner can use the property to produce assessable income during that time, and reset the six-year period each time they move back.

As a practical example:

A property is owned and occupied by the owner for a period of three years. The owner is then posted overseas for work commitments. They remain overseas living in a rented property for four years. During this time, their Australian property is rented out.

The owner returns to Australia and occupies their PPOR for another three years, until such time that they're again posted overseas, this time for a period of two years.

Upon returning to Australia a second time, the owner then sells the property. In this case, there's no CGT payable upon the disposal of this property, as the owner was never away from the property for more than six years at a time, and no other property was treated as the PPOR during this period.

Considerations

There are some definitive factors that must be considered in order for the six year rule to apply. One of these is that you need to move from your principal place of residence for a 'good reason'.

Some examples of good reasons include: accepting a new job interstate or overseas; staying with a sick relative for a long period of time; or going on an extended holiday.

There are various other financial and tax implications to be considered when transferring a PPOR to an investment property and some of the main ones to be aware of have been explored above.

It's important to remember that each individual situation is different and has a range of influencing factors. When considering any kind of significant financial investment or transfer, it's imperative that you seek the professional advice of a lawyer and/or accountant, in order to ensure that you make the best possible choice for your situation.

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 their website: www.quinns.com.au

How CGT is calculated

A property was purchased on 1 July 2002 for $500,000. It was the owner's principal place of residence (PPOR) until 30 June 2005, when it was then rented out until it was sold for $750,000 on 1 July 2007.

The capital gain as a result of the sale was $250,000. The owner is entitled to a partial tax exemption for the period in which they occupied the property. The exempt amount is calculated using the formula:

($ capital gain x time property was owner's PPOR)/total years of ownership = amount of capital gain that is exempt

In this instance, the calculation is as follows:

($250,000 x 3 years)/5 years = $150,000

As $150,000 of the total capital gain is exempt from tax, the amount of taxable capital gain is $100,000.

Additionally, as the property was owned for more than 12 months, the owner is entitled to a further 50% discount on the assessable amount. This means that the total capital gain amount that is assessable for tax purposes upon the disposal of this property is $50,000.