Salary sacrificing your rental expenses

Salary sacrificing work-related expenses has long been utilised as an effective way to reduce taxable income – but did you know you can also apply it to property expenses? The higher earning half of a partnership can even salary sacrifice the lion's share of deductions, as *Michael Quinn* from The Quinn Group explains

In most cases, having your employer deduct payments for your expenses from your pre-tax salary can provide an increased tax refund amount. The most commonly salary-sacrificed expenses are for motor vehicles and laptops but it's also possible to use this method for the payment of some rental expenses.

Any rental expenses that are 'otherwise deductible', meaning they are actually paid or due to be paid and have the potential to be claimed as part of the owners' rental return, are able to be salary sacrificed as well.

Depreciation is not considered a 'paid' expense and as such cannot be salary sacrificed. Additionally, as the 'otherwise deductible' rule applies to the payment of these expenses, no fringe benefits tax is payable on these transactions.

Taxpayers have been able to have employers pay their rental expenses for some time now. However, following a recent court judgment, *National Australia Bank Ltd v Federal Commissioner of Taxation* 93 ATC 4919 (the NAB decision), there has momentarily developed a unique opportunity for couples who own investment properties as joint tenants to further reduce the higher income earner's tax liability.

Higher income earners

Previously, in any situation where a rental property was owned by joint tenants, the only option was for all of the related income and expenses to be divided evenly between the couple, 50:50. This meant that each partner received 50% of the income from the property, was responsible for paying 50% of the expenses and as a result, was eligible to claim 50% of the deductions.

The recent court ruling has produced a 'loop-hole' situation in the current fringe benefits tax legislation that allows the highest income earning partner in the joint tenancy arrangement to salary sacrifice 100% of the rental expenses, thereby significantly reducing the higher income earner's tax liability and producing significant tax benefits.

By shifting the ownership percentages in the property, the lower income earner still receives 50% of the rental income and pays a reduced tax rate on that amount, while the higher income earner pays all of the expenses and reduces their tax liability.

How does it work?

Under a conventional 50:50 joint tenancy, for rental property ownership in 2008/09 Sam and Mary's tax returns would look something like in the table below.

Without salary sacrifice	Sam	Mary
Salary (per annum)	$200,000	$0
Tax payable	$67,000	$0
Rental income	$25,000	$25,000
Rental expenses	$40,000	$40,000
Net loss	-$15,000	-$15,000
Taxable income	$185,000	-$15,000
Total tax payable (per owner)	$60,250	$0
Combined total tax payable		$60,250

However, if Sam was to elect to salary sacrifice 100% of the rental property expenses, the refund they would be eligible to receive would look a little more like this:

With salary sacrifice	Sam	Mary
Salary	$200,000	$0
Salary sacrificed expenses	$80,000	$0
Taxable income	$120,000	$0
Tax payable	$34,000	$0
Rental income	$25,000	$25,000
Taxable income	$145,000	$25,000
Tax payable	$44,000	$2,850
Remaining tax payable	$10,000	$1,650
Total tax payable (per owner)	$44,000	$1,650
Combined total tax payable		$45,650

This shows that by having the higher income earner salary sacrifice 100% of the rental expenses, Sam and Mary have a considerable tax benefit of $14,600.

In the second situation, Mary is also eligible for the low-income tax offset, which further aids the reduction of the tax payable amount.

It should be noted that, in this instance, we have produced the calculations without considering the Medicare levy and Medicare levy surcharge, as well as omitting other possible deductions such as depreciation, to provide a simplified view of how the process is applied.

> The recent court ruling has produced a 'loop-hole' situation in the current fringe benefits tax legislation that may bring significant tax benefits

New changes to the law

Obviously, the government and the Australian Taxation Office do not want to create such situations where taxpayers can make such a dramatic improvement on their returns.

The federal government is more than aware of the situation that has developed as a result of the ruling and has consequently announced in the 2008/09 Federal Budget that immediate action will be taken to rectify the anomaly. It was stated that the main purpose of the correction is to restore the original intent of the fringe benefit tax law and to restore equality in the way in which employee remuneration is treated.

Effective 7.30pm (AEST) 13 May 2008, when the 2008/09 Federal Budget was handed down, the fringe benefit tax law will be amended such that the 'otherwise deductible' rule now will be applied appropriately in relation to jointly held assets.

This means that income and deductions for jointly held properties are only able to be allocated according to the owner's legal interests in the property. Expressly, no more arrangements for an owner to salary sacrifice 100% of the property expenses are allowed to be entered into where the entire amount is considered 'otherwise deductible'.

It may still be possible to salary sacrifice 100% of the expenses but only the proportion relative to the owner's legal interest in the property is considered 'otherwise deductible'. The remaining proportion of the payment will be seen as a fringe benefit, and as such the employer will be liable for fringe benefits tax on this payment.

Employees currently utilising this type of agreement with their employer will be able to continue to do so until the end of the current fringe benefits tax year – 31 March 2009. It's expected that this will allow adequate time for employers and employees to renegotiate existing salary packages.

If you are currently salary sacrificing more than your legal interest of rental property expenses, it's important that you plan for the change following 31 March 2009. Discuss the terms of the new arrangement with your employer as they may need to adjust your PAYG withholding amount.

A change in salary sacrificing will see your taxable income increase and, if your PAYG amount is not adjusted accordingly, you may be hit with a considerable tax bill come the end of the next financial year.

You should also seek professional, independent taxation and accounting advice in order to devise a strategy that will see a smooth transition to the new agreement, minimising any monetary disruption and continuing to maximise your eligible tax refunds. ■

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