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Capital works deductions for rental property

Rental property investors can claim capital works deductions for construction costs for a rental property, however there are limits imposed in relation to the dates such works were completed. The deductions are only available on residential properties if these were built after 17 July 1985. Generally, up to 15 September 1987 the rate is 4% a year (over 25 years) and after then is 2.5% (but over 40 years).

Residential property investors seeking capital works deductions need to remember that you can only make a claim for periods when the rental property was used for income producing purposes, not when used for private purposes.

Subsequent purchasers of a property can claim for the balance of the period, because unlike a depreciating asset there is no balancing adjustment on disposal of the property, unless the building is destroyed. The balance of any claim is passed on, on the same basis, to any later owners.

The seller of a property is required by legislation to provide the buyer with the cost of construction of the original building and any structural improvements, however this does not always occur and there is no enforcement mechanism in the legislation. If it is not possible to determine the actual construction costs, it is allowable to obtain an estimate from a quantity surveyor or other independent qualified person. It is also permissible to claim a deduction for the cost of that estimate.

Capital works expenses incurred form part of the cost base of the property for capital gains tax purposes. If you claim a capital works deduction, this will need to be taken into account when working out a future capital gain or loss (more below).

Construction expenditure that can be claimed

Some costs that may be included in construction expenditure are:

- preliminary expenses such as architects' fees, engineering fees and the cost of foundation excavations
- payments to carpenters, bricklayers and other tradespeople for construction of the building, and
- payments for the construction of retaining walls, fences and in-ground swimming pools.

Construction expenditure that cannot be claimed

Some costs that are not included in construction expenditure are:

- the cost of the land on which the rental property is built
- expenditure on clearing the land prior to construction
- earthworks that are permanent, can be economically maintained and are not integral to the installation or construction of a structure, and
- expenditure on landscaping.

Required details

To make sure that you are eligible to make a capital works deduction claim, all of the following is required:

- details of the type of construction
- the date construction commenced
- the date construction was completed
- the construction cost (not the purchase price)
- details of who carried out the construction work
- details of the period during the year that the property was used for income producing purposes.

Adjustments to the CGT cost base

In calculating a capital gain or capital loss from a rental property, the cost base and reduced cost base of the property may need to be reduced to the extent that it includes construction expenditure that has been claimed or can be claimed as a capital works deduction.

However, the ATO states that it will accept that a taxpayer cannot deduct an amount for construction expenditure in respect of a rental property if the taxpayer:

- does not (as a question of fact) have sufficient information to determine the amount and nature of the expenditure, and
- does not seek to deduct an amount in relation to the expenditure.

This means that in working out a capital gain or loss arising from a CGT event happening in relation to the rental property, the taxpayer is not required to reduce the asset's cost base by the amount not deducted under the capital works deduction rules in relation to the asset.