

Investment Property Deductions Disallowed

In a recent decision in *Fogarty and FCT* [2007] AATA 1822, the Administrative Appeals Tribunal (AAT) partially disallowed rental deductions for a taxpayer in relation to his rental property. The deductions were disallowed on the grounds that the property was purchased for use as a residence and not as a rental property.

The applicant owned a rental property in Sydney for which he claimed rental deductions of \$190,432 in 2001, \$164,181 in 2002 and \$48,318 in 2003. All of these deductions were offset against total gross rent of \$14,700. The applicant claimed that as the property was available for rent during this period, he was entitled to claim the full amount of the deductions.

The Commissioner only allowed a deduction for the expenses on a pro rata basis of 8.2%, as the property was only used to gain assessable income for 30 days in the 2001 and 2002 years. In 2003, the property gained rental income on 8 of the 91 days that the apartment was owned by the applicant. Therefore the applicant was entitled to 8.8% of the total deductions claimed.

Section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) sets out the general rules for deductibility. The two positive limbs of the provision are contained in section 8-1(1), which provides that a taxpayer can deduct from their assessable income any loss or outgoing to the extent that it is either incurred in gain or producing assessable income, or which is necessarily incurred in carrying on a business for the purposes of gaining or producing assessable income.

Where an expense or outgoing is incurred for both deductible and non-deductible purposes, section 8-1 requires that the expense be apportioned between those purposes.

The AAT stated that it was clear that the expenses incurred by the applicant should be apportioned based on the following:

- the applicant had admitted that he purchased the property to make a capital gain;
- based on the evidence, the property was only partially used by the applicant for the purpose of gaining assessable income by way of rental; and
- there was no evidence that the apartment was used or available for use at any relevant time by anyone other than the applicant.

In conclusion the AAT found that the applicant was not carrying on a business and noted that the applicant's income tax returns showed income from salary, interest, dividends, trust distributions and capital gains, but no income from carrying on a business.

For more information about *Fogarty and FCT* [2007] AATA 1822, visit the Australian Legal Information Institute's website at: www.austlii.edu.au/au/cases/cth/aat/2007/1822.html.

Deductions for Quarrying Joint Venture Investment Denied under Part IVA

In a recent decision in *Balestra and FCT* [2007] AATA 1845, the AAT applied the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) to disallow certain investment deductions.

Background

The taxpayer had claimed deductions of over \$100,000 in the 1998 financial year for his investment in the Rydal Hard Rock Joint Venture Project No. 1.

In the 1998 income tax year, the taxpayer wanted to diversify his investment portfolio and was attracted to 'riskier' investment opportunities to generate an income stream. After speaking with his accountant, and reading the prospectus, the taxpayer decided to invest in the joint venture project. Towards the end of June 1998, the taxpayer signed several documents, including an application form for the purchase of five units in the project, a loan indemnity agreement and a loan agreement with Horizon Lending Company (Horizon). The taxpayer also entered into a technical management agreement with Rydal Management Pty Ltd (Rydal).

When the taxpayer completed his application form, he paid the following amounts:

- \$1,000 for manager's fees payable to Jedidiah Management Limited;
- \$6,250 for licence fees payable to Rydal;
- \$90,000 for technical management fees payable to Rydal;
- \$8,665 for prepaid interest payable to Horizon; and
- \$3,750 for indemnity fees payable to Rydal.

Decision

The AAT considered whether the joint venture was entitled to a deduction under section 8-1 of ITAA 1997. It held that the expenses incurred in the 1998 tax year were incurred too early in the life of the quarrying operations to be deductible. The expenditure was preliminary to the earning of assessable income rather than incurred in the gaining of producing of that income. Accordingly, the joint venture did not incur a partnership loss, and the taxpayer was not entitled to a deduction for his share of that loss.

The taxpayer was unable to produce a copy of the loan agreement with Horizon. As a result, the AAT disallowed the deduction for prepaid interest.

The AAT then considered the application of the anti-avoidance provisions in Part IVA of ITAA 1936. In order for the anti-avoidance provisions to apply, the taxpayer must have obtained a tax benefit in connection with a scheme to which Part IVA applies. The AAT held that while there was a scheme, the taxpayer did not obtain a tax benefit as the deductions were not available to the taxpayer.

However, the AAT then went on to consider if there had been a benefit, whether the scheme was carried on for a tax avoidance purpose. It held that a reasonable person could conclude that the dominant purpose was to obtain a tax benefit. In doing so, the AAT considered the manner in which the scheme was entered into, in particular the fact that the taxpayer entered into the arrangement close to 30 June, while preliminary matters were still being resolved, and that funding took place by way of a 'round robin' of cheques. The AAT also considered the form of the scheme, and formed the view that the initial contribution of the taxpayer was actually capital in nature, but that the investment was structured so that the capital contribution became deductible. On this basis, the AAT concluded that the anti-avoidance provisions would apply to the taxpayer in relation to the joint venture.

For more information about *Balestra and FCT* [2007] AATA 1845, visit the Australian Legal Information Institute's website at: <www.austlii.edu.au/au/cases/cth/aat/2007/1845.html>.

Apportionment of 'Home Office' Expenses Affirmed

In a recent decision in *'The Taxpayer' and Commissioner of Taxation* [2007] AATA 1830, the AAT affirmed the Commissioner's decision that the deduction for home office expenses should be apportioned on a floor area basis.

Background

The taxpayer was a private Australian resident company of which both Mr. and Mrs. A were the directors and shareholders. The taxpayer carried on businesses as an authorized representative of an Australian financial services licensee and a provider of musical and related services.

The taxpayer operated its business activities in an office in one of the front rooms of the directors' main residence, and used this room exclusively for business purposes. The office had an area of roughly 20 square meters which represented approximately 10% of the total floor area of the property. The taxpayer held a 50% interest in the property and the remaining 50% was held by both directors as tenants in common. The directors, along with their children, used the property as their main residence.

For the years ended 30 June 2003, 2004 and 2005 the taxpayer claimed 50% of the property-related expenses as a deduction in its tax return. The taxpayer applied for a private ruling in relation to property related expenses for the 2004/05 to 2006/07 income tax years. The Commissioner advised that the expenses should be apportioned on a floor area basis and that the taxpayer was only entitled to claim 10% of the occupancy expenses.

The taxpayer argued that since it had a 50% ownership interest in the property, it was entitled to 50% of the deductions and that its use of the property did not amount to a 'home office' case as referred to in Taxation Ruling TR 93/30.

TR 93/30 outlines the circumstances in which a deduction is allowed in relation to 'home office' expenses. In particular it explains where an area of a home is considered to be a private study and where an area is considered to be a place of business. An area will be considered to have the character of a place of business where:

- the area is clearly identifiable as a place of business;
- the area is not readily suitable or adaptable for use for private or domestic purposes in association with the home generally;
- the area is used exclusively or almost exclusively for carrying on a business; or
- the area is used regularly for visits of clients or customers.

Decision

The AAT rejected the taxpayer's arguments, and agreed with the Commissioner's decision that in most cases the apportionment of expenses should be made on a floor area basis entitling the taxpayer to claim 10% of occupancy expenses.

The AAT went on further to say that it was clear from section 8-1 that irrespective of the ownership of the property, deductions are only allowable to the extent that they are not private or domestic in nature. The AAT found that the expenses relating to the common access areas were of a private and domestic nature. Any business usage relating to these areas was merely incidental to their primary function as a home.

For more information about *'The Taxpayer' and Commissioner of Taxation* [2007] AATA 1830, visit the Australian Legal Information Institute's website at: <www.austlii.edu.au/au/cases/cth/aat/2007/1830.html>.

Residential Rental Property Advice and Tax Return Preparation Services to Non-residents not GST-free

The Tax Office recently released Draft Goods and Services Tax (GST) Determination GSTD 2007/D2, which is mainly relevant for Australian accountants providing services to non-residents.

Specifically, in this draft determination, the Tax Office details what is the correct GST treatment of the supply of advice and tax return preparation services that an Australian accountant makes to a non-resident individual in respect of a residential rental property that the individual owns in Australia. In the Tax Office's view that supply, if made on or after 1 April 2005, is not wholly or partly GST-free.

Background

The GST is a broad-based tax on consumption in Australia, and accordingly, the export of things is generally GST-free. Section 38–190 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) deals with the export of things other than goods or real property (i.e. services). There are five types of supplies listed as being GST-free under section 38–190(1). However, these supplies are not GST-free if section 38–190(2), (2A) or (3) applies.

Section 38–190(2A) is of particular relevance as it negates the GST-free status of a supply by providing that any acquisition that relates (whether directly or indirectly, or wholly or partly) to the making of a supply of real property situated in Australia is **not** GST-free.

Prior to 1 April 2005, a supply of such services was considered to be GST-free. However, it was realised that the GST-free treatment of these services was an 'anomaly', and consequently the Government introduced an amendment to section 38–190 of the GST Act (i.e. section 38–190(2A)). The purpose of this amendment was to remove the anomaly that allowed supplies of certain services made to owners of residential property to be GST-free if the owner is not in Australia at the time of the supply. This amendment resulted in the same treatment applying to both non-resident and resident entities, regardless of whether or not they are in Australia at the time of the supply.

The Explanatory Memorandum accompanying the amendment Bill contained an example of a non-resident landlord of a rental property situated in Australia who acquired tax advice (including advice in relation to the rental property) as part of the preparation of a tax return from an Australian accountant. There was some confusion amongst accountants in Australia surrounding whether GST was to apply to the supply of the tax return preparation or only to the tax advice component, and, if the latter applied, how the tax advice component should be determined for GST purposes. This is because in practice, where an accountant provides advice to a client (including a non-resident property owner) in the course of preparing a client's tax return, the accountant would normally charge the client a single fee for preparation of the return rather than splitting the total fee into separate components.

Tax Office confirmation and explanation

In this draft determination, the Tax Office confirms that the acquisition of a supply of tax advice in the course of tax return preparation is not GST-free even though the acquisition of the advice only relates in part to the making of a supply of a rental property and the advice on the rental property only indirectly relates to the making of that supply.

Furthermore, the Tax Office view is that if that supply includes services that do not relate to the making of a supply of real property that would be input taxed, such as income from other sources, the supply of services to the non-resident is not even partly GST-free, as section 38–190(2A) does not include a 'to the extent' test that allows for the apportionment of the supply. Therefore, if the requirements for a 'taxable supply' under the GST Act are met, the supply by the Australian accountant to the non-resident individual is a taxable supply.

The draft determination also contains a number of examples, including the example of a non-resident that owns a two-storey rental property in Australia and engages an Australian accountant to prepare his tax return. The ground floor of this property is leased as a shop (commercial premises) and the top floor is leased as residential premises. Even though the acquisition of the tax return preparation services relates to the making of a supply of real property that is partly input taxed (the leasing of commercial premises is not input taxed), the draft determination emphasises that the GST-free status of the entire supply is negated.

A broad range of accountants are likely to be affected by the change in the legislation that the Tax Office is seeking to explain in this draft determination, given that it affects all accountants who prepare tax returns for non-resident residential landlords.

For more information about GSTD 2007/D2, visit the ATO website at: <<http://law.ato.gov.au/pdf/gsd2007-d002.pdf>>.

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Thomson Legal & Regulatory Limited ABN 64 058 914 668
35 Cotham Road, Kew Vic 3101

Tel: 1300 304 197

Fax: 1300 304 198

Email: LRA.Service@thomson.com

Website: www.thomson.com.au