client alert | explanatory memorandum

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Investment Property Deductions

In the recent case of *Ormiston and Commissioner of Taxation*, the Administrative Appeals Tribunal (AAT) held that interest payments on a loan to purchase an investment property were allowable deductions, even though the property was never used to derive assessable rental income in five years of ownership.

The taxpayer, Mr Ormiston, purchased a residential investment property in July 1998 with the intention of deriving long-term rental income. A house jointly owned by the taxpayer and his de facto partner was used as collateral on the investment property loan. After discussing the possible levels of rent the property could generate, the taxpayer decided to make some capital improvements to the property to increase its potential rental yield.

The taxpayer was skilled in renovating and initially planned that the capital improvements and repairs and maintenance would take approximately 12 months. However, due to inefficient planning, time delays and cost overruns, the capital works continued throughout 1999 to 2002.

During these income years, the taxpayer claimed deductions related to the investment property, including interest, rates, depreciation, and repairs and maintenance. The taxpayer stated that he was unable to contract out the renovation work due to insufficient financial resources and was unable to take out further borrowings. Due to the scale of the works, the investment property was unable to be rented until the works were complete. In the 2001 income year, the taxpayer's de facto relationship broke down, and the property was sold in August 2003 to rationalise their joint affairs. The investment property was never rented while the taxpayer owned it.

Intention of the taxpayer

The taxpayer argued that it was always his intention to bring the investment property to a condition where it could be let and generate income for the future. The taxpayer sought to rely on the decision in *Steele v. Deputy Commissioner of Taxation* (1999), arguing that the deductions should be allowed, as he would have earned assessable income from the property had his personal circumstances allowed.

The Tax Office argued that the deductions should not be allowed on the basis that the taxpayer's dominant intention in incurring the interest and other expenses was to protect the capital value of the investment property and to allow him to engage in home renovations. It stated that any intention to produce rental income was a secondary intention, as none was derived in over five years of ownership. The period between the incurring of the expenditure and possible production of future rental income was too long for there to be a sufficient connection.

AAT decision

The AAT accepted the taxpayer's evidence that at the time of purchase it was his intention to use the investment property to generate assessable income, and allowed the interest payments on the loan and the rates paid to be allowable deductions under section 8–1 of the *Income Tax Assessment Act 1997* on the authority of the *Steele* case. Conversely, the AAT declared that amounts for repairs and maintenance could only be deductible where the need for repairs and maintenance resulted from the use of the investment property for the production of assessable income. As no assessable income had been produced, the deductions were denied.

For further information, please review *Ormiston and Commissioner of Taxation* [2005] AATA 978 at:

www.austlii.edu.au/au/cases/cth/aat/2005/978.html

No Revenue Loss on Sale of Land

In a recent private hearing, *The Taxpayer and Commissioner of Taxation*, the Administrative Appeals Tribunal (AAT) confirmed that a company was unable to claim a revenue loss on the sale of an asset, as it was held to be a capital asset and not an item of trading stock. In addition, even if the asset had been an item of trading stock, the loss would have been denied on the basis that the company would not have satisfied the requisite continuity of ownership or same business tests for the years in question.

Purchase of property

The background of the case is very complex, with multiple entities and transactions occurring over a number of years. The taxpayer was a company, beneficially owned by a non-resident businessman. In December 1989, the businessman purchased 10 hectares of land in Queensland in his own name for the purpose of building student rental accommodation adjacent to a university.

The land was subsequently transferred from the businessman to the taxpayer company in the 1992 income year. Soon after, in the 1993 income year, the land was sold at a significant loss to an external company, with the proceeds being paid directly to the businessman. It is unclear on what basis this payment was made.

Request for amended assessment

The taxpayer's original 1993 return, lodged in August 1993, disclosed a $4,422 capital loss resulting from the sale of the land. However in July 1994, the taxpayer's new accountants requested an amendment to the return to decrease the capital loss to nil and increase the taxable losses from $4,422 to $755,377. The reason for the amendment was that the previous accountants had made an error, being regarding 'the incorrect treatment of the sale of trading stock, which was inadvertently classified as a capital loss'. The taxpayer wished to carry forward this resultant loss to later years of income.

The Tax Office denied the amendments and the issue was brought before the AAT by the taxpayer. Under section 144ZK of the *Taxation Administration Act 1953*, it is the taxpayer's responsibility to convince the AAT that the Tax Office's decisions should have been made differently.

AAT decision

At first instance, the AAT needed to determine if the loss from the sale of land was to be carried forward as a capital loss or as a revenue loss resulting from the disposal of trading stock. For the asset to be trading stock, it needed to be shown that it was bought and sold (or bought, developed, subdivided and sold) as part of a business dealing in and developing land, in line with the decision in *FCT v. Whitford's Beach Pty Ltd* (1982) 150 CLR 355.

The taxpayer argued that it was in a profit-making venture that acquired the land with a view to developing it or on-selling the property. The taxpayer investigated a number of property development options before completing the sale of the land.

The AAT held that the taxpayer had not proved that the sale of land was anything other than a sale of a capital asset and that the loss from the sale was a capital loss. The AAT declared that the stated intention of the taxpayer was to construct student accommodation on the land. While the AAT acknowledged that the taxpayer had investigated property development possibilities (including subdividing), the taxpayer failed to develop the land in any fashion comparable to the situation in *Whitford's Beach*.

Even though the asset was held to be capital, the AAT held that the change in ownership in the company that occurred in 1994 would have acted to prevent any prior year losses from being carried forward. It also found that the same business test had not been satisfied.

For further information, please review *The Taxpayer and Commissioner of Taxation* [2005] AATA 1156 at:

www.austlii.edu.au/au/cases/cth/aat/2005/1156.html

Tax Office audit program — service entities

For further information, please refer to the ATO's updated compliance program 2005/06, which can be found at:

www.ato.gov.au/corporate/content.asp?doc=/content/61826.htm

For details of the ATO's view on service entities please refer to TR 2005/D5: Deductibility of service fees paid to associated entities.

Hire Purchase Depreciation

The Tax Office has recently released Taxation Ruling TR 2005/20, which considers when a taxpayer, who is taken to own an asset under a hire purchase agreement, will be able to claim depreciation on the asset under the uniform capital allowance (UCA) provisions.

The hire purchase provisions are found in Division 240 of the *Income Tax Assessment Act 1997* (ITAA 1997). For income tax purposes, these provisions define a hire purchase agreement as a sale of goods, combined with a loan. The UCA provisions are found in Division 40 of ITAA 1997 and provide for a deduction for the decline in value of a depreciating asset that the taxpayer holds.

Notional buyer

Under the ruling, if a taxpayer (who is defined as 'the notional buyer') is taken to be the owner of goods under a hire purchase agreement (section 240–20(2)), the taxpayer **will not be the holder** of the goods for the purposes of the UCA provisions (Division 40), unless it is reasonable to conclude that the taxpayer will acquire the asset, or that the asset will be disposed of at the direction of, and for the benefit of, the taxpayer.

Under section 240–20, the notional seller is taken to have disposed of the asset to the notional buyer and the notional buyer is taken to have acquired the asset at the start of the arrangement. Subject to section 240–115, the notional buyer is taken to own the asset until either the arrangement ends or the asset is on-sold.

Circumstances where taxpayer is taken to hold the asset

Section 40–40 sets out a list of ten depreciating assets and whether a taxpayer is taken to hold them. The default rule, where the taxpayer owns the asset, is found in Item 10. Consequently, a notional buyer who is taken to own the asset under section 240–20 will be the owner of the asset for the purposes of Item 10 and so be the holder of the asset under section 40–40.

If it is reasonable to conclude that the taxpayer will acquire the asset, the taxpayer will be the holder of the asset under section 40–40 under Item 6. Broadly, Item 6 applies where:

- a taxpayer (notional buyer) has possession, or an immediate right to possession, of the depreciating asset combined with a right, the exercise of which would make it the holder (for example, an option to acquire); and
- it is 'reasonable to expect' that the taxpayer will become the asset's holder by exercising that right or that the asset will be disposed of at their direction and for their benefit.

If Item 6 applies, the entity in possession of the asset will be taken to be the holder of the asset for Division 40 purposes and the legal owner (notional seller) of the asset is not.

The ruling states that the requirements to 'hold' under Item 6 and to 'own' under Division 240 were intended to achieve the same result, namely, to entitle the economic owner to any deductions for the decline in value of the asset.

Accordingly, the application of the tests in Division 240 and Item 6 will, in most cases, produce the same outcome so far as whether or not the hirer is the holder of the asset under Division 40. In the rare instances where Division 240 is satisfied and Division 40 is not (or vice versa) the ruling states that it is highly likely that the Tax Office will allow decline in value deductions in such circumstances.

For further information, please review TR 2005/20 — Income tax: the interaction of deemed ownership under Division 240 of the Income Tax Assessment Act 1997 with the 'holding' rules in Division 40, at:

http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~tr~basic~exact:::AND~2005%2F20~basic~exact&target=EA&style=java&sdocid=TXR/TR200520/NAT/ATO/00001&recStart=1&recnum=2&tot=5&pn=ALL:::ALL

Death of Family Trust Member

The Tax Office has recently released ATO ID 2005/313, declaring that in the situation where a sibling of the test individual dies, the spouse of that sibling will remain a member of the test individual's family as defined by Schedule 2F of the *Income Tax Assessment Act 1936* (ITAA 1936).

Under section 272–95 of Schedule 2F, the family of a test individual consists of all of the following:

a) any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:

    i) the test individual; or

    ii) the test individual's spouse; and

b) the spouse of the test individual or of anyone who is a member of the test individual's family because of the first point.

Under subsection 6(1) of ITAA 1936, a spouse is defined as including 'another person who, although not legally married to the person, lives with the person on a bona fide domestic basis as the husband or wife of the person'.

The Tax Office has determined that the spouse of the deceased sibling will remain in the family group until such time that the spouse remarries or enters into a de facto relationship. At this time, the spouse will no longer be regarded as a family member of the test individual's family group.

For further information, please review ATO ID 2005/313 — Income Tax: Family trust election: family — death of a family member, at:

http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID2005313/00001

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