

THE REPORT

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Tax News, Views & Clues

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Investment Property Deductions

In a recent case, the Administrative Appeals Tribunal (AAT) held that interest payments on an investment loan were deductible even though the property was never rented in five years of ownership.

The taxpayer purchased a residential investment property in July 1998 with the intention of deriving long-term rental income. After researching possible rental income for the house, the taxpayer decided to undertake some capital improvements in order to increase its potential rental yield.

The taxpayer planned to complete the capital improvements within a 12-month period. However, due to inefficient planning, time delays and cost overruns, the capital works continued throughout 1999 to 2002. During this time the house remained vacant and the taxpayer claimed deductions including interest, rates, depreciation, and repairs and maintenance.

Due to changes in the taxpayer's personal affairs, the property was sold in August 2003.

The Tax Office argued that the interest and other property-related deductions should be disallowed on the basis that no rental income was derived over five years of ownership. The period of time between expenditure and future assessable income was too long for there to be sufficient connection.

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 a deduction for interest payments on the loan.

However, the deductions for repairs and maintenance were disallowed on the grounds that the property never produced assessable income.

No Revenue Loss on Sale of Land

In a recent hearing, the AAT confirmed that a company was unable to claim a revenue loss on the sale of land as it was held to be a capital asset and not an item of trading stock.

In the case under review, the taxpayer was a company, which was beneficially owned by a non-resident. In December 1989, the non-resident purchased 10 hectares of land in Queensland in his own name for the purpose of building student rental accommodation adjacent to a university.

The student accommodation was built and the land was subsequently transferred to the taxpayer company in the 1992 income year. Soon after, in the 1993 income year, the land and buildings were sold at a significant loss to a third party.

The taxpayer's original 1993 income tax return disclosed a 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 recognise a significantly increased revenue loss.

The stated reason for the amendment was '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.

Based on previous cases, for the land to be trading stock, it must have been bought and sold (or bought, developed, subdivided and sold) as part of a business dealing in and/or developing land.

The taxpayer argued that it acquired the land with a view to developing it or on-selling the property. The AAT held that the taxpayer's evidence was insufficient to prove that the sale of land was anything other than a sale of a capital asset. Therefore the loss from the sale was considered to be a capital loss.

The AAT went further in its deliberations, declaring that even if the asset were an item of trading stock, the resulting loss would not have been available to carry forward, on the basis that the company would not have satisfied the continuity of ownership or same business tests for the years in question.

Tax Office Audit Program — Service Trusts

Taxpayers should be aware that the Tax Office has been under-taking a significant review of service trust arrangements. As part of the review the Tax Office is undertaking a retrospective audit of service trust arrangements. The Tax Office has modifications to the audit for 2006.

A service trust arrangement exists where a trust provides services (e.g. staff, premises, other services and facilities) to related entities at a mark-up. The Tax Office focuses on the commerciality of the mark-up charged, having regard to the nature of services rendered.

For the first six months of 2006, the Tax Office will concentrate its audit efforts on service trust arrangements that meet the following criteria:

- service fees in excess of \$1 million;
- service fees representing in excess of 50% of the gross fees derived by the firm; and
- situations where 50% of combined profits have been directed into the service entity.

In addition, the Tax Office announced that it is reviewing the 'safe harbours' currently published in both its draft ruling (TR 2005/D5) and service entity booklet. It intends that the review will result in the information being simpler and more accessible for small businesses when released in the final ruling and booklet.

- **TIP:** Service trust arrangements are an area of significant Tax Office focus and care should be taken in structuring arrangements of this type. It is anticipated that the Tax Office will continue its reviews for some time, potentially including smaller taxpayers. Those with service trusts should consider a review of their current arrangements against existing guidelines.

Hire Purchase Depreciation

The Tax Office has recently released Taxation Ruling 2005/20, which considers when a taxpayer will be able to depreciate an asset owned under a hire purchase agreement.

For income tax purposes, a hire purchase agreement results in a sale of goods, combined with a loan.

The capital allowance (depreciation) rules provide for a tax deduction for the decline in value of a depreciating asset.

The ruling states that a taxpayer with an asset acquired under a hire purchase agreement will generally be able to claim depreciation. This applies where it is reasonable to expect that at the end of the hire purchase agreement the taxpayer will acquire the asset.

The Tax Office states that, while the two areas of law do use different terms, it is the objective of the law to entitle the economic owner to deductions for the decline in value of the asset.

Death of Family Trust Member

Complex election rules apply to discretionary trusts. Specifically, in many cases taxpayers make family trust elections and interposed entity elections to protect discretionary trusts from losing access to tax losses and franking credits. Each of these elections requires the nomination of a test individual, which then limits distributions to a defined family group.

The Tax Office has recently released Interpretative Decision 2005/313, stating that in the situation where a sibling of the test individual dies, the sibling's spouse will remain in the family group until 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.

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