Senior Tax Counsel's Report

8 June 2018

Rental property deductions – the do's and don'ts!

Some weeks ago, I canvassed issues relating to work-related deductions.

In the final weeks of the financial year, I will focus my attention on different aspects of deductions that can be claimed with a particular focus on contentious areas.

This month, I thought I would look at the question of deductions in the context of investment properties.

In Australia, there are over 2 million people who claim some $46 billion in rental property deductions in their tax returns, and this number appears to be growing. The lion's share of the available tax deductions is generally the interest portion of a mortgage connected with the property.

However, other costs can be claimed on an immediate basis provided that they have been incurred by the relevant taxpayer, and they have not been recouped from elsewhere, such as a payment from the tenant. Items that can be claimed on this basis include:

- Advertising for tenants
- Bank charges
- Body corporate fees and charges / or strata levies
- Cleaning costs
- Council rates
- Depreciation, including certain capital works
- Electricity and gas
- Gardening and lawn mowing services
- Inhouse audio/video service charges
- Insurance (including building contents and public liability)
- Land tax
- Letting fees
- Pest control services
- Property agent's fees and commission
- Quantity surveyors' fees

- Secretarial and bookkeeping fees
- Security patrol fees
- Servicing costs, such as the costs of servicing a water heater
- Stationery and postage costs
- Tax-related expenses
- Phone call and rental costs
- Water rates

Importantly, you cannot claim expenses which are:

- of a capital nature or of a private nature;
- related to the acquisition and disposal of the relevant property;
- body corporate payments to a special purpose fund to pay a particular capital expenditure;
- expenses which are not actually incurred by the taxpayer, such as water and electricity charges paid by the tenants.
- expenses that are not related to the rental of a property, such as expenses connected to a holiday home that is rented out for part of the year.

Some words of caution in relation to particular areas where errors have been made are worthy of emphasis.

First, a taxpayer who claims a deduction in relation to an investment property must be sure to have receipts to justify the deductions that are being claimed. An absence of such receipts will make life very difficult if an audit calls for proof of the expense. Normally, this will require full substantiation, which means that there needs to be a receipt that is in conformity with the requirements imposed by the Act etc. Although there may in cases be some leeway on this front, reliance should not be placed upon that possibility.

Secondly, the property must either be rented, or “genuinely available" for rental in the income year for which a deduction is claimed. If a taxpayer uses the property for private purposes, to that extent, the taxpayer cannot claim expenses.

Importantly in this context, you must demonstrate a clear intention to rent out the property. If no attempt is made to advertise the property, or the rent is set at an unrealistically high non-commercial level such that it could not on any reasonable basis be rented out, the ATO is likely to take the view that there was no intention to rent out the property, and the rental claims will accordingly be disallowed.

Thirdly, in some situations, rental expenses need to be apportioned. This arises particularly in the context of holiday homes, where either the taxpayer or the

taxpayer's family or friends, can stay in the property free of charge for part of the year. To the extent that the expenses relate to that part of the year during which the property is not rented or available for rent, the taxpayer is not entitled to a deduction for costs incurred during those relevant periods.

Fourthly, to that point, if the property is rented to family or friends for less than arms-length market rental, the ATO may well treat the arrangement as being of a private nature, and could, in all likelihood, only allow the taxpayer to claim sufficient deductions to offset the rent, but not so as to make a tax loss.

Fifthly, you can no longer claim deductions for travel expenses relating to inspecting, maintaining, or collecting rent for a residential property.

Sixthly, where residential investment properties were purchased after 9 May 2017, plant and equipment depreciation deductions will be limited only to outlays actually incurred by the investor.

All these various rules can give rise to some complex outcomes. Where investment property is involved, it can often be worthwhile obtaining the professional advice of a competent tax agent who can reliably advise on what can and cannot be claimed as a deduction.

Kind regards,

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