

Accountants News

INFORMATION FOR PRACTISING ACCOUNTANTS

Property Deductions: Basics and Beyond



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It is seventeen years since Leary & Partners introduced its depreciation scheduling service. Back then our challenge was to convince property owners that the law permitted building write-off and depreciation deductions for their property. It was a concept that people associated with large commercial buildings but not their standard investment house or unit. Making strata lot owners comfortable with the concept of depreciating shared building structures and communal equipment was a particularly noteworthy challenge.

Times have certainly changed. Many taxpayers now assume that owning an interest in a building automatically equates to the right to a Div. 42 and Div. 40 deduction. The challenge today is to explain to a small percentage of taxpayers why we cannot (legally and ethically) provide a depreciation schedule to substantiate the claim they anticipate.

Using our experience we have compiled the following list of issues that you may wish to keep in mind when discussing potential property deductions with your clients.

It's too old for Div. 43

This is the most frequent reason for disappointment.

- Eligibility for Div. 43 is based on the date construction commenced. Knowing when the building was finished will often provide a reasonable guide but if the building was completed within a few years of the qualification date (18 July 1985 for standard residential and 20 July 1982 for commercial) it may be wise to investigate further. Large building complexes often take two – four years to construct. 'Owner-built' properties are also prone to extended construction periods.

- You can't always judge a building's age from its appearance. Many houses have been refurbished to remove their 'dated' features. There is a higher than average risk that high-rise residential and office units in capital city CBD

areas and buildings in old wharf or warehouse districts could also be aged structures that have been refurbished. While the renovation work may qualify for Div. 43, the associated expense will typically be much lower than if the building had been built from scratch.

- The deduction for structural improvements to the land (such as roadways, paving, fencing, retaining walls, tennis courts, swimming pools and boardwalks) only applies to items started after 21 February 1992. For large community / townhouse complexes this may have a noticeable impact on the deduction available.

- Be cautious about relying on verbal estimates of age provided by sales agents or vendors. If eligibility for a Div. 43 deduction is an important consideration, establish the building's age prior to entering the contract. This can normally be done by requesting a search of the local council's building archives. (The authorisation of the property owner may be required.)

Div. 43 is about to run out

The 25-year claim period is almost over for commercial buildings commenced between 22 August 1984 and 15 September 1987 and residential buildings commenced between 18 July 1985 and 15 September 1987. It may end as early as 2009 for the earliest built commercial buildings. (The end date will be 25 years from when each building commenced being used.)

Div. 40 has run out

Owners who first used their property as private residences often assume that the decline in value of their furniture and fittings does not commence until the date they make their property income producing. As the decline actually starts on the date they first privately used the items, there may be little if any deduction left to claim.

The asset / expense isn't deductible

Property owners are often upset to discover that some of the assets they bought or expenses they have incurred

do not qualify for Div. 43, Div. 40, or an outright deduction.

- Many external items fall into the category of ineligible earthworks or soft landscaping (including dirt roads and drives, turfing, garden beds and irrigation pipework). If you paid a premium to buy into one of the new golf course complexes, finding out that few of the costs associated with constructing the course are depreciable can be a shock!

Some homeowners undertake expensive yard makeovers and discover that only a small proportion of the cost (typically for paving) qualifies for a deduction. The rest, at best, becomes part of the cost base of the property. The landscape architect's fee to design the landscaping work is also ineligible. This is likely to remain true even if the landscaping contains some component of eligible construction expenditure (ATO ID 2006/2365).

- People commissioning and constructing a building often incur costs that do not form part of the 'eligible construction expenditure' as defined by the legislation and TR 97/25. For example, preparatory works such as demolition, site clearance and bulk cut or fill to create the basic site platform are ineligible. As are the cost of initial surveys to establish the site boundary, council fees to obtain copies of existing building plans, rezoning applications, legal fees for lodging or changing title documents and any form of marketing or finance charges.

- If the building does not have a typical construction history, there is an increased chance that an anomaly in the system may reduce the Div. 43 deduction. For example, on an 'owner built' property the Div. 43 expenditure cannot include an estimated value for unpaid labour contributed by the owner or savings if work is done at 'mates rates'. We have prepared several schedules where the expense documentation associated with tradesmen was in the form of barbecue meat and beer receipts.

- Be careful with investment houses purchased in the current rural and outback

boom areas. If what is acquired is a relocated house of pre 1985 construction, the relocated structure will remain ineligible for Div. 43. No deduction will be available for the cost of acquiring and relocating the house to site. Div. 43 will only apply to new construction work such as footings, plumbing connections and alterations or improvements to the original house structure (ATO ID 2004/137 & 2004/138).

I can't get the documentation

- In a previous newsletter we reviewed the problems associated with substantiating the scope, timing and cost of refurbishment works undertaken by previous property owners. If the vendor does not provide (at minimum) a written description of the scope and timing of the works they have undertaken, it is often impossible to meet the necessary ATO standard of proof for non-structural works such as bathroom and kitchen refurbishments.

Contrary to common expectation, TR 97/25 only authorises a quantity surveyor to provide an estimate of cost. We have no authority to go beyond this and create 'substitute' construction / installation dates or scope of work. The request to the vendor for information should be made prior to settlement while the purchaser still has bargaining power.

- In a minority of Council archive searches, bad filing, Council amalgamation, fire or flood prevent the Council from locating a property's building records. Unless it is a new or strata title complex, there is rarely any other documentation source available and the loss makes a Div. 43 claim impossible. The only way to avoid this risk is to do the search prior to settlement.

I don't have the receipts any more

There appears to be a widespread misconception that you can avoid

the need to have or use actual cost documentation by commissioning a quantity surveyor's schedule instead.

Taxation Ruling TR 97/25 (in paragraphs 23 and 24) says that the purchaser of a building may use a cost estimate if they are unable to obtain the original construction costs from the builder and / or a previous owner. Nothing in the ruling suggests that the taxpayer can use it as a means of circumventing the standard requirement to retain receipts or equivalent records documenting their own property related expenditure. Further, TR 97/25 only applies to Div. 43 deductions. It does not apply to items depreciable under Div. 40.

Where there are special extenuating circumstances it is possible that the ATO will accept a quantity surveyor's estimate to replace the owner's own documentation. We are aware of cases where the ATO has agreed (at a case management level) to permit an estimate because the original documents were destroyed by fire or flood, or became inaccessible due to an acrimonious divorce.

Based on our experience, the ATO is less easily persuaded if the documentation was not retained merely because at the time of the expenditure the taxpayer was unaware they were entitled to a deduction or could become entitled to a deduction at some time in the future. We are often asked to prepare schedules for people who did not retain documentation because their property at the time was a private residence. We normally suggest that they confirm with the ATO that this solution is acceptable before they expend the money commissioning a Div. 43 estimate. Using an estimate without approval in these circumstances could potentially result in a rejected claim, a large repayment bill and possibly additional penalties.

Even if a Div. 43 cost estimate is accepted, the need to reliably establish a purchase date (both to calculate an initial value and the current undeducted value) often prevents estimates being used for furniture added during an owner's occupancy. If you advise your clients to retain cost records for major property expenses 'just in case' you may make a friend for life.

We are confident the ATO will not accept an estimate because a taxpayer is reluctant to take the time to find and compile their records, has stored the records in a form or location that is inconvenient for them to access or is unwilling to pay the extra cost that may be associated with reconciling their various documents into a schedule.

Someone else is entitled to the claim instead

Just because someone has a right to use an asset and a responsibility to contribute toward its maintenance, does not automatically mean they are entitled to any applicable Div. 43 or Div. 40 deduction. You need to check the legal ownership structure for the item carefully.

- In some large complexes the major communal areas and facilities are held by a separate private company and are not depreciable by the lot owners.

- In leasehold title arrangements (where the developer has a long term lease on the land and subleases the individual units) it is the head leaseholder that is entitled to the deduction. Developers currently use leasehold titles for buildings in national parks or other areas where the government will not grant them full title to the land. Many owners appear unaware that what they have bought is not a standard strata title lot. Few understand the tax consequence. Be warned, these developments are regularly marketed with depreciation schedules. We know of several instances where this has been the case and the ATO has subsequently rejected the claims.

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