

Accountants News

INFORMATION FOR PRACTISING ACCOUNTANTS

Refurbishments & Alterations: No Documentation = No Claim

Many taxpayers are discovering that their purchase of a renovated rental property was not the tax effective investment they expected



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A common misconception

Despite what most taxpayers believe, purchasing a house that has had a post 1985 refurbishment or alteration does not automatically guarantee them a Division 43 deduction. They must first prove the three W's: What? When? and Why?

An often impossible task.

Much of the frustration and disappointment we have observed could have been avoided if the taxpayer had simply consulted their accountant prior to purchase. Empowered with the following basic advice they could have made a fully informed investment decision.

Substantiating a Div. 43 claim

Before they claim a Division 43 deduction a taxpayer must be able to establish:

- the scope of the work done,
- the date at which the work was done,
- the cost of the work, and
- whether the work was of a type that qualifies for a Division 43 deduction.

If they are unable, or unwilling, to obtain reasonable proof of these facts (as decided by the ATO), they are not entitled to a Division 43 deduction. Claiming a deduction without the required proof could result in both rejected claims and penalties.

As quantity surveyors, we can assist the taxpayer meet requirement *c*, but only if they have the documentation necessary to satisfy the other three requirements.

What documentation is needed?

Ideally the claim should be based on formal documentation. This may take the form of architectural drawings, specifications of works, contract documents, receipts or photographic records of the works.

If formal documentation of this style is not available, it may still be possible to substantiate a claim if the basic details of the work can be obtained from the property owner at the time or the contractor.

How much documentation is required and in what form will depend on the nature of the work. Brief notes from a phone conversation with the previous owner may be appropriate for a claim on a minor item such as a security grille but may not be sufficient as sole documentation for a large, complex refurbishment claim.

Isn't it your job to provide the proof?

Some of our clients believe that simply by inspecting a building a quantity surveyor should be able to determine exactly what was done and when. We wish this was true!

Without the ability to compare the building pre and post the work being undertaken, many minor structural or aesthetic changes are impossible to detect - let alone prove to an auditor. Similarly, unless work is obviously quite new, a physical inspection is unlikely to conclusively establish a construction timeframe.

Sometimes our knowledge of the industry allows us to check potential information sources that the property owner may not have considered. However, we cannot retrieve data that has been destroyed or that was never recorded in the public domain.

One of the proofs of professionalism is being aware of when to say, and being prepared to say, "We can't substantiate this claim."

Isn't your schedule the proof I need?

TR 97/25 authorises quantity surveyors to prepare an estimate of costs where the original costs are not available. This mandate does not extend to us estimating the scope of works or time of works if documents supporting these are not available.

Putting such estimates into a quantity surveyor prepared depreciation schedule does not magically make them proven fact. No matter what the schedule says, ultimately the onus of proof remains with the taxpayer.

Residential Rental Property Assets

The ATO's review of depreciable residential rental property assets has generated considerable discussion.

The ATO has taken a reasonably strong, though consistent, line on what is or is not depreciable. We don't believe this should concern taxpayers nearly as much as some commentators have suggested. For those of us who have been operating within the scope of the existing rulings, cases and Interpretative Decisions, there are only a few changes of substance affecting the majority of taxpayers.

On the positive side, the ATO has confirmed the depreciability of standard white goods such as rangehoods and ovens (something sometimes questioned), as well as substantially reducing the effective life of many common items.

The effective life changes announced on 28 June 2004 only apply to items purchased from 1 July 2004. The change in item classification now applies to *all* items regardless of acquisition date.

Existing depreciation schedules should be reviewed and items now classified as non depreciable removed.

The ATO has announced that if it 'becomes aware of blatant cases of over claiming of deductions based on the incorrect categorisation of assets, then we may adjust a taxpayer's prior [to 1 July 2004] year returns. Such adjustments will reflect the Commissioner's current view of the law. However, it appears that the Commissioner will not intervene provided that the items being depreciated would have been deemed reasonable based on the advice available at the time of lodgement.

A user friendly version of the new depreciation advice can be found in the ATO brochure Rental Properties 2003-2004. This contains both a summarised version of TR 2004/D3 (explaining the logic behind the ATO's classification system) and a comprehensive table of items showing their classification and where applicable, effective life. These pages are a very effective aid when explaining the depreciation system to rental property owners.

What happens if there are undocumented works?

Undocumented building additions

Properties we inspect often have a balcony, pergola, carport or shed that are not shown on the Council approved drawings. We can prove the existence and scope of these works, but not when they were done. If we take a conservative approach and base the cost estimate on the earliest (and hence cheapest) possible construction date, we are advised the claim is unlikely to be challenged.

Undocumented refurbishments

We constantly find ourselves dealing with undocumented refurbishments such as kitchen and bathroom makeovers undertaken by previous owners. Even when our inspection supports the fitout of these areas being newer than the original building, it is extremely difficult for us to translate this into a substantiated claim.

Unless the refurbishment included major structural alterations, there will be no council record of the work. Consequently, even if the taxpayer is certain in their own mind of the approximate age and scope of the work, they can rarely obtain hard evidence to substantiate their opinion. For example, they can't prove whether the room was completely refurbished as a one-off project, whether it was partially refurbished or whether individual items were progressively repaired and replaced.

Further, the expenditure must have qualified as s 43-70 'construction expenditure' when it was incurred by the property owner. This will not be the case if the property owner was entitled to claim the cost as a repair deduction. This makes claims for painting, tiling, roofing, etc., virtually impossible to substantiate unless we can prove the work's background history.

Lack of appropriate documentation regularly prevents a claim on most, if not all, of the work.

A typical example

The taxpayer bought a pre-1985 house. The vendor's real estate agent told them that the vendor had recently rewired the house and completely replaced the metal roof sheeting. The taxpayer subsequently asked us to prepare a taxation depreciation schedule that included the costs of the re-wiring and re-roofing.

No council building approval had been granted for the work. No documentation had been, or could now be, obtained from the vendor. The real estate agent had changed company and could not be located. The electrical wiring was not by nature something that could be reliably dated by visual inspection and the roof sheeting did not appear obviously new. Further, these items could potentially have been a tax deductible repair for the previous owner.

Despite the client's strong representations that they were entitled to a deduction, we could not include the re-wiring or re-roofing in our schedule.

Tips for older residential properties

These tips may assist your clients to maximise their claim if they purchase an older rental property.

1. Arrange with the local council to carry out a building approval and approved drawings search. Most councils will allow you to search their archives once you have a signed contract of sale. It's worth doing this search before settlement, as unauthorised building additions may also give rise to safety and liability issues.
2. Treat with scepticism any sales advice about the scope or cost of works done by the vendor. It may contain a large degree of "marketing spin".
3. Ask the vendor to advise in writing if they have made any alterations or improvements to the property.
4. If they have, ask them for copies of the architectural drawings and building

approval documents (for large projects). Also ask them to supply proof of the cost of the work done. (If it was a rental property, they should have retained expense documentation to substantiate their own claims).

5. Even if they no longer have any physical documentation, the vendor should be able to provide you with a signed written statement containing:
 - i) a detail description of the work done,
 - ii) a simple explanation about why they did the work (e.g. to fix damaged items, to update or improve existing items or to add new items to the property),
 - iii) the approximate date the work was done, and
 - iv) possibly, the approximate cost of the works.
6. Ask the vendor if they have photographs of the property taken before any works were carried out. These will be invaluable as supporting evidence and in some cases may be sufficient by themselves.
7. Ask the vendor to advise in writing whether they used the house as their residence or for rental purposes. This may affect the tax treatment of their expenditure.
8. A print out from an accounting package showing the deduction being claimed by the previous owner is useful, but is unlikely to contain sufficient detail by itself to substantiate a major claim. (Just as it would not have been proof in its own right for the previous owner).
9. Make sure you ask for and receive all documentation before the contract is settled. If this is not possible, make supplying the documentation a condition of the contract. Vendors are often far less obliging once they have your money in their hands.

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