



July 2017

Happy New Financial Year!



BUSINESS, TAXATION &amp; INDUSTRY NEWS

## ATO waves a red flag on deductions for holiday rentals

Just when many Australians are considering getting away for a mid-winter break, the ATO is reminding taxpayers that it is paying close attention to rental properties located in popular holiday destinations around Australia.

The ATO recently issued a statement saying that last year it identified a large number of mistakes with deductions for rental properties, particularly with regards to holiday homes. It claims that it noticed some people claiming deductions for holiday homes even where the property is not actually being rented out, or not “genuinely available” for rent.

While of course there is no problem with people using their rental property for a holiday, the ATO is at pains to point out that holiday home owners need to remember they can only claim tax deductions for expenses made during a period when the home is rented out or genuinely available for rent.

It also emphasises that property owners need to understand that if they rent their property at a discount, or “mates rates”, they can only claim deductions equal to the amount of rent charged. The ATO cites one case where the taxpayer had to pay back more than \$45,000 in tax from deduction claims made for a holiday home they were renting out to friends and family below the market rate.

Property owners should be aware that technology enhancements and the ATO’s extensive use of data is allowing it to identify claims that can be deemed suspect, or in need of checking, now more than in past income years.

There is of course nothing untoward with rental property owners claiming a deduction on expenses for an investment property when it is rented out — this is a stalwart of the tax regime concerning investment property. But even if it isn’t rented out, it is still possible to claim a deduction if the property is “genuinely available” for rent.

To ensure claims made regarding holiday rental property are less likely to be challenged by the ATO, there are four questions to keep in mind.

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### *How do you advertise your rental property?*

Owners need to advertise in a way that maximises exposure to potential tenants, such as an online site. Advertising in ways that limits exposure to potential tenants, such as by word of mouth, can mean that the ATO has more reason to think the property may not be “genuinely available” for rent.

### *What location and condition is your rental property in?*

It is important that the rental property is in a location, and maintained in a condition, that tenants will want. If the property is poorly cared for, or in a remote and uninviting area, it is unlikely to be tenanted, and may not pass an ATO assessment as being genuinely available.

### *Are there reasonable conditions for renting the property, and is the rent charged at market rates?*

If an owner places unreasonable conditions that reduce the likelihood of the property being rented out, such as setting the rent above the market rate, the property may not be considered genuinely available for rent.

Likewise, if you, your family or your friends stay for free, your property will not meet the criteria during that time period. If the property is being tenanted at a discounted rate (“mates rates”) then the allowable deductions are limited to the amount of rent charged, not market rates.

### *Are interested tenants accepted, unless there is a good reason not to?*

If an owner refuses to rent out the property to interested potential tenants without a good reason, this indicates that they may not have a genuine intention to make income from the property and could be reserving it for private use. In this case, the property will probably not meet the ATO’s criteria for being genuinely available for rent.

### **Love & Partners Comment**

Further to the above we remind owners of Rental Properties that from 1 July, 2017 you are no longer able to claim the cost of travel to visit and inspect rental properties. This area has been identified as an area that has been rorted by tax payers particularly when the rent property is in a popular holiday area.

Other changes to take effect are in relation to the depreciation on fixtures and fittings, these will no longer be allowed unless they are actually bought by the owner. Previously, a property owner was able to claim deductions for all plant and equipment items in the property at the time of acquiring the asset, according to each item’s effective life.

The good news for property investors is that negative gearing of properties and other investments remains untouched – for now.

## **Streaming trust capital gains and franked distributions: An overview**

The ATO has stated that a trust’s capital gains and franked distributions can, if not prevented by the trust deed, be streamed to beneficiaries for tax purposes by making these beneficiaries “specifically entitled” (more below) to the amounts.

This allows beneficiaries to offset capital gains with their capital losses, apply applicable discounts and, subject to certain integrity rules, get the benefit of any franking credits attached to a franked distribution.

Capital gains and franked distributions to which no beneficiary is specifically entitled are allocated proportionately to a trust’s beneficiaries based on their present entitlements to trust income (which generally is calculated by excluding capital gains and franked distributions to which any entity is specifically entitled). The trustee is taxed in respect of any amounts to which no beneficiary is specifically or presently entitled.

**TIP.** Note that “net income of the trust” is defined in legislation (see Division 6 of Part III of the ITAA 1936). In the context of the taxation of trusts this is the equivalent legislative term to “taxable income”.

For tax purposes, a trustee can stream capital gains or franked distributions provided the trustee has the power (either express or implied, see below) under the trust deed.

- An **express** power to stream may arise where the trust deed empowers the trustee to separately account for distinct classes of income or capital, and where the entitlements of beneficiaries may then relate to those classes.
- A streaming power may be **implied** if the trust deed empowers the trustee to distribute income or capital at their absolute discretion and there is nothing further in the trust deed, or trust law in the relevant jurisdiction, which limits that power.

### **Specifically entitled**

A beneficiary who is specifically entitled to a capital gain or franked distribution that has been received by a trust is generally assessed for tax on the gain or distribution. They also get the benefit of any franking credits attached to a franked distribution (subject to integrity rules).

A trustee of a resident trust can choose to be specifically entitled to a capital gain of their trust (making such a choice in the trust tax return), in which case the trustee is taken to be specifically entitled to all of the capital gain. This choice can only be made if no part of the capital gain is paid or applied for the benefit of a beneficiary.

Note however that a trustee cannot choose to be specifically entitled to a franked distribution in the same manner.

### **Capital gains**

If not prevented by the trust deed, a trust's capital gain can be streamed to beneficiaries for tax purposes (even if they don't have a present entitlement to trust income) by making them specifically entitled to the capital gain. A trustee has until two months after the end of the income year to make a beneficiary specifically entitled to a capital gain (ordinarily, this is August 31).

The trustee of a resident trust may also choose to be assessed on a capital gain if no beneficiary has received or benefited from any amount relating to the gain during, or within two months of the end of, the income year. This allows a trustee to choose to pay tax on behalf of a beneficiary who is unable to immediately benefit from the gain.

Where no beneficiary has a specific entitlement to all or part of a capital gain, and the trustee has not chosen to be assessed on it, the capital gain is allocated to beneficiaries according to their present entitlements to trust income. Any part of a capital gain that isn't allocated to a beneficiary in this way is allocated to the trustee.

A beneficiary who has a capital gain streamed to them is treated as having an extra capital gain that they will then take into account in working out their own net capital gain for the income year.

### **Franked distributions**

Franked distributions of a trust are taxed to the beneficiaries and the trustee in accordance with the rules contained in the relevant legislation (ask us for more). The rules specify how to:

- calculate the portion/share of a franked distribution that the trustee or a particular beneficiary will be assessed on
- allocate the franking credit attached to the distribution.

Note that to avoid double taxation of trust capital gains and franked distributions, there are specific rules that may be required to apply. Again, ask for our guidance should this match your circumstances.

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## **Be prepared: What you need to bring to your tax return appointment**

If you're coming in soon to discuss your tax return for yourself or your business, try not to turn up completely empty handed, or at least to turn up prepared with some records or electronic access to them.

To "be prepared" is not just a great scouting motto, but a wise approach for everyone, especially at Tax Time. It will also save a lot of time and effort for both yourself and for us.

If you are a new client, it is always smart to arm yourself with last year's tax return or access to it if online. This should have your personal details, tax file number, income streams, tax offsets, deductions, and other relevant information previously claimed. Also have your bank account details in the event that you're entitled to a refund.

If you use an online accounting solution, all or most your data should be available online for us to access. Most packages capture business transactions, and allow you to record data in real-time and in a format that we understand (as well as giving us access to it 24/7 so we can keep working on your return if we need to after the appointment is over).

### **What to bring?**

Here is a brief general checklist of things to prepare for your tax return appointment. Not all of the following will be relevant for everyone, but will depend on your own circumstances. But as a checklist it should help you tick off what you do or don't have in preparation for your next visit.

#### **Income**

- PAYG summaries from employers
- Bank statements for any interest received during the financial year
- Distributions from trusts, partnerships, managed super funds
- Allowances (car, travel, entertainment, meals etc)
- Government pensions and allowances
- Foreign income
- Capital gains – for example, sale of shares or property
- Dividends
- Personal services income
- Net income/loss from business
- Rental income – for example, from an investment property
- Lump sum termination payments
- Superannuation lump sum payments

#### **Expenses for tax deductions**

- Motor vehicle expenses based on business use percentage and kilometres travelled (include your log book if applicable)
- Travel and accommodation information – domestic and overseas
- Work uniforms and other clothing expenses
- Courses, education and seminars
- Home office expenses
- Computer, software and repairs
- Tools and equipment

- Employee costs
- Superannuation contributions
- Rent/lease payments
- Interest paid – say on an investment property loan
- Dividend deductions
- Bank fees
- Low value pool deductions/depreciation
- Telephone and internet costs
- Freight and transport costs
- Utilities – electricity, gas, water
- Legal and accounting fees
- Donations
- Income protection insurance
- Details of any asset purchases

It is highly recommended that you keep receipts for all expenses and possible tax deductions you are considering claiming for you or your business. It is also a good idea to scan and file them electronically so that they are accessible should you need them for audit purposes.

### **If you're in business**

Further to the above information, we may also require the following information for review, so it is recommended you scan or photocopy these:

- Bank and credit card statements
- Lease, hire purchase, chattel mortgage or other loan agreements to your business
- Business Activity Statements and Instalment Activity Statements and working papers
- Stock valuation figure after performing your June 30 stock take.

We will work through every allowable tax deduction available for you and/or your business. Don't forget to ask us what tax incentives are available to you which may work to increase your tax deductions.

**Tip!** If you have sold the family home over the last income year, although it is CGT-free we will still need to note in your individual tax return that this property has been sold. Rest assured that capital gains will not be calculated for this asset sale, although we will of course explain this to you before lodging on your behalf.

### **Accelerated depreciation for small business**

In the 2015-16 federal budget, the government increased the small business immediate deductibility threshold from \$1,000 to \$20,000, which was originally due to end at June 30, 2017. But a law amendment bill has recently been passed by Parliament that extends that measure by 12 months until June 30, 2018, after which the deductibility threshold will revert to \$1,000.

At the time of the original announcement, small businesses were defined as having an aggregate annual turnover of less than \$2 million. Announcements from the most recent federal budget however, and the new legislation, make it clear that the depreciation measure will not only be extended for a year but also extend to businesses with an aggregated annual turnover of less than \$10 million.

Small businesses can therefore continue to immediately deduct purchases of eligible assets costing less than \$20,000 first used or installed ready for use by June 30, 2018. Only a few assets are not eligible (such as horticultural plants and in-house software).

Assets valued at \$20,000 or more (which cannot be immediately deducted) can continue to be placed into a small business simplified depreciation pool and depreciated at 15% in the first income year and 30% each income year thereafter. The pool can also be immediately deducted if the balance is less than \$20,000 over this period (including existing pools).

The current “lock out” laws for the simplified depreciation rules (these prevent small businesses from re-entering the simplified depreciation regime for five years if they opt out) will continue to be suspended until June 30, 2018.

## **Deduction tip: Can you claim the cost of travelling to this office?**

Tax time has arrived, and if you haven't had us lodge your return yet, here is another deduction tip — should your circumstances allow. (If your return has already been lodged, then this could be a handy tip to file away for next income year.)

The ATO recently issued what it calls a “tax determination” which more clearly spells out the circumstances of what may be an allowable claim (under the general heading of “managing tax affairs”). The fact that you can deduct the fee that we charge you is the most widely known of these allowable deductions, but not everyone is aware that you can also make a claim for the costs of travel you incur where the purpose of the journey is to have your tax return prepared.

The Taxation Commissioner's view, as stated in the tax determination, is that such costs should be deductible. But, as with deducting the fee charged for such professional services, a non-negotiable stipulation is that the task must be carried out by a “recognised tax adviser”.

The costs included in allowable claims (that are involved with managing tax affairs) include accommodation, meals, public transport fares and even travel insurance.

Importantly, to the extent that some of the travel costs relate to another non-related purpose, such expenditure is expected to be apportioned. The Commissioner states that this is required to be done in a “reasonable” way, although whether or not a method of apportionment is reasonable or not will depend on the facts of each case. Only the costs that reasonably relate to managing tax affairs are deductible.

According to the determination, taxpayers should be able to demonstrate the reasonableness of the apportionment methodology used, including keeping any relevant evidence, to support the deduction claimed. Evidence could include calendar entries, car odometer records, taxi fare receipts, journals showing time spent at meetings with the tax agent and time spent on private activities.

The tax determination includes three examples, which work to explain the different circumstances where either the total cost of travel is deductible, or a portion of that expenditure.

### **Sole purpose of travel**

Maisie and John are partners who carry on a business of sheep farming on a station near Broken Hill. Every year they travel to Adelaide for the sole purpose of meeting with their tax agent to finalise preparation of their partnership return. They stay overnight at a hotel, meet with their tax agent the next day, and fly back to Broken Hill that night. The full cost of their trip, including taxi fares, meals, accommodation and travel insurance, is deductible.

### **Apportionment when travel is equally for managing tax affairs and private purposes**

Julian is a sole trader who carries on an art gallery business in Oatlands. He travels to Hobart for two days to attend a friend's birthday party and to meet his tax agent to prepare his tax return. He stays one night at a hotel.

Because the travel was undertaken equally for the preparation of his tax return and a private purpose, Julian must reasonably apportion these costs. In the circumstances, it is reasonable that half of the total costs of travelling to Hobart, accommodation, meals, and any other incidental costs are deductible.

### **Apportionment when travel is incidental to main private purpose**

Erin is an employee working in Warragul. She has her tax return prepared by a tax agent in Melbourne. When travelling to Melbourne for a week long football training camp, she decides to stay an extra night in a hotel to visit her tax agent the following day. She travels back to Warragul after the meeting.

As Erin's trip is mainly for private purposes, and visiting the tax agent is incidental to that main purpose, she must reasonably apportion the costs.

In the circumstances, it is reasonable that only the direct costs of her accommodation for the extra night, incidental costs associated with this time, and the taxi fares from the hotel to her tax agent's premises and back to the hotel are deductible.

## **Substantiation for mobile, home phone and internet costs**

The ATO has issued guidance on making claims for mobile phone use as well as home phone and internet expenses, and says that if you use any of these for work purposes you should be able to claim a deduction if there are records to support claims.

But the ATO points out that use for both work and private matters will require you to work out the percentage that "reasonably relates" to work use.

### **Substantiating claims**

In this area of deductions, it is a general ATO requirement that records are kept for a four-week representative period in each income year to claim a deduction of more than \$50. These records can include diary entries, including electronic records, and bills. "Evidence that your employer expects you to work at home or make some work-related calls will also help you demonstrate that you are entitled to a deduction," its guidance says.

### **When you can't claim a deduction for your phone**

Of course if your employer provides you with a phone for work use and also pays for usage (phone calls, text messages, data) then plainly you will not be able to claim a deduction. It would be the same if you pay for usage but are subsequently reimbursed by your employer.

### **How to apportion work use of a mobile phone**

As there are many different types of plans available, you will need to determine the work use using a reasonable basis.

#### ***Incidental use***

If your work use is incidental and you are not claiming a deduction of more than \$50 in total, you can make a claim based on the following (without having to analyse the relevant invoices):

- \$0.25 for work calls made from a landline
- \$0.75 for work calls made from a mobile
- \$0.10 for text messages sent from a mobile.

#### ***Usage is itemised on bills***

If you have a phone plan where you receive an itemised bill, you need to determine the percentage of work use over a four-week representative period, which can then be applied to the full year.

This percentage needs to be worked out using a reasonable basis. This could include:

- the number of work calls made as a percentage of total calls
- the amount of time spent on work calls as a percentage of total calls
- the amount of data downloaded for work purposes as a percentage of total downloads.

### **Usage is not itemised on bills**

If however you have a phone plan where you don't receive an itemised bill, you can determine work use by keeping a record of all calls over a four-week representative period and then calculate the claim using a reasonable basis.

The ATO uses an example to further explain this.

*Ahmed has a prepaid mobile phone plan that costs him \$50 a month. He does not receive a monthly bill so he keeps a record of his calls for a four-week representative period. During this four-week period Ahmed makes 25 work calls and 75 private calls. He worked for 11 months during the income year, having had one month of leave. He therefore calculates his work use as 25% (25 work calls out of 100 total calls). He claims a deduction of \$138 in his tax return (25% x \$50 x 11 months).*

### **Bundled phone and internet plans**

Nowadays phone and internet services are often bundled together. The ATO says that when you are claiming deductions for work-related use of one or more services, you will need to apportion costs based on your work use for each service. "If other members in your household also use the services, you need to take into account their use in your calculation," it says.

If you have a bundled plan, you need to identify work use for each service over a four-week representative period during the income year. This will allow you to determine your pattern of work use, which can then be applied to the full year.

A reasonable basis to work out work-related use could include:

Internet:

- the amount of data downloaded for work as a percentage of the total data downloaded by all members of the household
- any additional costs incurred as a result of work-related use – for example, if work-related use results in you exceeding your monthly cap.

Phone:

- the number of work calls made as a percentage of total calls
- the amount of time spent on work calls as a percentage of total calls
- any additional costs incurred as a result of work-related calls – for example, if work-related use results in exceeding the monthly cap.

Again, the ATO uses a worked example to illustrate.

*Des has a \$90 per month home phone and internet bundle, and unlimited internet use as part of his plan. There is no clear breakdown for the cost of each service. By keeping a record of the calls he makes over a four-week representative period, Des determines that 25% of his calls are for work purposes. Des also keeps a record for four weeks of the data downloaded and determines that 30% of the total amount used was for work.*

*He worked for 11 months during the income year, having had one month of leave. As there is no clear breakdown of the cost of each service, it is reasonable for Des to allocate 50% of the total cost to each service.*

**Step 1** – work out the value of each bundled component.

*Internet: \$45 per month (\$90/2 services).*

*Home phone: \$45 per month (\$90/2 services).*

**Step 2** – apportion work related use.

*Home phone: 25% work related use x \$45 per month x 11 months = \$124.*

*Internet: 30% work related use x \$45 per month x 11 months = \$149.*

*In his tax return Des claims a deduction of \$273 (\$124 + \$149) for the year.*

Please ask for our help and guidance should you wish to make a claim for mobile and home phone and internet costs.