Question

Grace, aged 54, has worked for the Commonwealth Department of Social Security (DSS) for 22-years as a clerk. Grace also owns a three-bedroom rental property in the Sydney suburb of Ryde. The rent charged to tenants is $2,000 per month. The Ryde property is one of two rental properties that Grace owns. The Ryde property was purchased back in June 1984 for $78,000. The property is now worth $490,000. The second rental property (Epping property) was purchased in July 1995 for $280,000 and is now worth $670,000. Rent from this property is currently $2,400 per month.

In light of the hot and humid summer days in Sydney, the tenants asked Grace (through WPM) to install an air-conditioner, or some other cooling device(s) in the Ryde property. After doing some research, Grace agreed to install a ceiling fan in each of the lounge room, the main bedroom and the kitchen. The ceiling fans are designed to become a permanent feature of the premises (i.e. they are unlikely to be removed). The cost and installation of each fan, which had to be installed by a trained electrician, was $290 (i.e. $870 in total). These were installed on 30 September 2013 and became operative immediately. According to the manufacturer, the fans have an effective life of 8-years.

For some time, Grace has been seriously considering building an upstairs storey on her single-storey Epping rental property. If she did this, the property could become a five or six-bedroom property that could be rented out for a much higher rental (e.g. to overseas executives of major companies who are on secondment in Sydney for 12-month periods). Indeed, Grace engaged an architect in July 2013 to design two alternate plans for the addition. After getting those plans, Grace lodged one of those plans with the local council. (The local council has to approve extensions to buildings before work can go ahead). In the end though, Grace decided in January 2014 not to go ahead with the second storey addition. The architects charged Grace $8,800 for the two plans, and back in November 2013, the local council charged Grace a $580 development application fee on lodgement of the plan with the council. This council fee was not refundable to Grace even if she did not go ahead with the building works.

After the current tenant’s lease terminated on 31 October 2013, Grace could not find a tenant for the Epping property for six-months. Many attempts were made to find tenants and the rate of rental advertised was a market rate rental. Eventually, Grace dropped the rental down by $200 per month (to $2,300). New tenants began to occupy the property on 1 May 2014. Expenses associated with the Epping property during the six-month period it was not rented out are as follows: (i) interest on loan used to purchase property: $12,000 (iii) land tax: $200 and (iii) council rates: $190

Advise Grace on the income tax treatment of the above transactions, events, etc. Your advice must be supported by reference to relevant legislation and principles of tax law. (Note, there is no need to calculate Grace’s taxable income or liability to the ATO because we do not know about other assessable income items or deductions). Ignore the wages Grace obtains from DSS.
Solution, Feedback, Etc

This solution is very comprehensive. In an exam, with limited time, you would not be expected to mention everything here. But, you would be expected to identify and deal with the central issues for each transaction. The following does provide you with not only an identification of issues, but also a fairly comprehensive answer and perhaps an example of approaching an expense problem(s) in a structured way. In addition, in the view of this academic, you cannot be expected to write down all the legislative sources for rules and cases in support of every point.

1. Three Ceiling Fans: $870

As an aside, the air-conditioner purchase transaction never occurred, and therefore it is not a taxable event (transaction) that requires analysis (application of the tax law).

1.1 General Deduction Provision: s 8-1

The first positive limb is satisfied but the expenditure is capital, and therefore excluded from deductibility under s 8-1. The first positive limb is satisfied because the ceiling fans are installed in a property owned by Grace, and the property is the thing or item that is made available to tenants in return for the rent received by Grace. This makes the occasion of these expenditures the production of Grace’s assessable income. The rent is income (as a return from property), and therefore included in Grace’s assessable income.

The expenditure is capital because the each ceiling fan is a long-lasting asset (or advantage) or structural advantage, and each one is designed to provide a long-lasting advantage. Indeed, the manufacturer said they will last around 8-years. The first guideline of Dixon J’s three guides in *Sun Newspapers* (character of advantage sought) is the most important, but the second and third guidelines also support the capital conclusion here because: (i) the fans are used and enjoyed by Grace by remaining in place, and there is no need to keep obtaining new ones (there is no recurrence associated with the fans) and (ii) they are paid for in a lump sum which secures the use of the fans for a long period, which means there is no need to keep paying to secure the use of them.

1.2 Capital Allowance Regime(s)

The ceiling fans meet all the requirements for being a depreciating asset under s 40-30(1) (e.g. they are an asset, they have a limited effective life, they will decline in value over the time they are used). Perhaps importantly, even if the fans are an improvement to, or a fixture on, land, they will be regarded as an asset separate from the land.

The fans are also used for a taxable purpose (i.e. producing assessable income, confirmed from analysis above about the first positive limb of s 8-1(1)), a necessary requirement for deductibility under s 40-25. And, Grace holds the asset. At first glance, s 40-25(1) may apply to provide a depreciation deduction (strictly called a decline in value deduction).

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1 *FCT v Western Suburbs Cinemas Ltd* (1952) 9 ATD 452 at 455 can serve as an authority on this.
2 Section 6-5 of the *Income Tax Assessment Act* 1997. All section references are to this Act unless stated otherwise.
3 Note that an asset is not defined for the purpose of s 40-30(1). The CGT definition in s 108-5 is not relevant to s 40-30(1). All this means is that the accounting definition is the relevant definition, namely, something that embodies future economic benefits. The fans do embody future economic benefits.
4 Subsection 40-30(3).
5 Subsections 40-25(2) and 40-25(7).
6 Item 10 in Table in s 40-40.
However, the potential application of s 43-10 could or should be briefly mentioned; after all, the fans are attached to the building premises and they were attached with the intention of remaining there indefinitely. The question is whether the fans can be said to be an extension, alteration or improvement to the building (premises)? It is arguable that they are not because these three concepts suggest that the item becomes a “part” of the building and it loses its separate identity. The fans are unlikely to meet this as they do retain their own identity, even though they are attached to the ceiling (therefore building). Accordingly, Division 43 will not apply, and therefore s 40-25 will operate to confer deductions.

But, even if the fans meet one of the above requirements (e.g. alteration to building), the fans will still be taken out of Division 43 because the fans are “plant”, and plant is excluded from Division 43 through the definition of “construction expenditure area”. The fans are plant because they are machinery. They are machinery because the ceiling fans utilise or depend for their operation on using energy in the form of electricity. This holds even though the fans have been attached to the building with the intent of remaining there for a considerable time and they are part of the setting of Grace’s operations.

Given this, the fans will be treated as a separate CGT asset from the rest of the Ryde property.

1.3 Amount of Deduction

Putting aside the low-value pool regime, one’s initial thinking might be to “depreciate” the fans using one of the formulas (formulae) in ss 40-72 and 40-75. However, the potential application of the special rule in s 40-80(2) should be considered. Broadly stated, this rule provides immediate deductibility for low-cost depreciating assets. In Grace’s case however, she does not satisfy the conditions for accessing this rule. It is true that she satisfies some of them (e.g. cost of depreciating asset (one fan) does not exceed $300, use of fan is not from a business). But, all four conditions need to be satisfied. Given that the three fans are “identical” or at least “substantially identical”, the cost of all three fans are aggregated, and when aggregated, they do exceed the $300 threshold for exclusion from the immediate deductibility rule.

In the end, s 40-80(2) is not available to Grace. Therefore, the normal rules will apply. Grace can choose between the diminishing value method and the prime cost method. Grace can also choose to use the ATO’s effective life for the fans, or make her own assessment of their effective life, assuming these two differ. In this case, they do; the ATO’s is 5-years and the self-assessed one by Grace is 8-years. We will use the ATO one as it gives faster deductions.

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7 Subsection 43-20(1).
8 Even though there may be some room to debate the binding effect of ATO rulings, the fact that the ATO mentions fans in residential rental premises in its effective life tables for Division 40 depreciating assets (Entry for ceiling fans under Residential property operators (67110) in Effective Life Table A, in Taxation Ruling 2014/4) is not a sufficient reason for not discussing the possible application of Division 43.
9 Subsection 43-10(2) and s 43-70(2)(e).
10 Subsection 45-40(1)(a).
12 *Carpentaria Transport Pty Ltd v FCT* 90 ATC 4590 at 4593.
13 Section 108-60. This may have implications when the Ryde property is sold.
14 Note that there can be no depreciation deduction under Division 40, unless the cost of the fans is capital (s 40-220), hence emphasising the importance of the revenue-capital issue generally (and under s 8-1).
15 The “and” after each of the first three conditions, is the basis for this interpretation.
16 Subsection 40-80(2)(d).
17 Subsection 40-65(1).
18 Subsection 40-95(1).
The calculations for each fan are:

Prime Cost: $43 ($290 x 9-months/12-months x 100%/5-years)\(^{20}\)

Diminishing Value Method (DVM): $86 ($290 x 9-months/12-months x 200%/5-years)

A different method can be used for each fan.\(^{21}\) If the same method was used for each fan, multiply the relevant amount by three for the total deduction from the three fans (e.g. $258 on use of DVM).

The calculations for each fan for the following income year (2014-15), up to the date of the sale of the fans (Ryde property) is:\(^{22}\)

Prime Cost: $9 ($290 x 2-months/12-months x 100%/5-years)

Diminishing Value Method (DVM): $6 ($204 [$290 - $86] x 2-months/12-months x 200%/5-years)

### 1.4 “Sale” of Ceiling Fans

When Grace sells her Ryde property, a balancing adjustment event occurs to the fans on the date of settlement (31 August 2014) because Grace ceases to hold the asset on that date.\(^{23}\) A comparison needs to be made between the termination value and the adjustable value (WDV) to determine whether there is an assessable income inclusion\(^{24}\) or a further deduction\(^{25}\) on sale. There is no mention of an amount for the fans in the sale contract, and therefore part of the sale proceeds that is reasonably attributable to the fans becomes their termination value.\(^{26}\)

Any capital gain or capital loss arising under the CGT on sale of the fans is disregarded: s 118-24(1).

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\(^{19}\) Entry for ceiling fans under Residential property operators (67110) in Effective Life Table A, in Taxation Ruling 2014/4.

\(^{20}\) The formulas in ss 40-72 and 40-75 use days, but as advised in lectures, I am not concerned if you use months.

\(^{21}\) Subsection 40-65(1). In this regard, it is worth noting that s 40-30(4) should not make the three fans one depreciating asset.

\(^{22}\) Grace continues to be the “holder” of the fans right up to the date of settlement of the contract of sale of the Ryde property because she is the legal owner up to the date of settlement, even if the purchaser has an equitable interest in the fans between date of exchange and date of settlement: Item 10 in Table in s 40-40.

\(^{23}\) Subsection 40-295(1)(a) and s 40-40.

\(^{24}\) Subsection 40-285(1).

\(^{25}\) Subsection 40-285(2).

\(^{26}\) Section 40-310.
2. Architects Fee ($8,800) and Council Development Application Fee ($580)

This is a fairly hard issue(s). The two expenditures are dealt with together because it is the same circumstance (context) in which they are incurred, and that they are both “necessary” costs in attaining the ultimate goal of extending the Epping property.

2.1 General Deduction Provision: s 8-1

Like all expenditures, these must be viewed from the taxpayer’s perspective; that is, the taxpayer incurring the expenditure. Accordingly, the fact that the fees are on revenue account (and income) to the architect (recipient) under s 6-5 is completely irrelevant to Grace’s tax position.

While not that important in the scheme of things, the expenditures are very likely to satisfy the first positive limb of s 8-1 because these expenses are directed at increasing assessable income through having a more attractive rental property. These expenses should not be denied satisfying the first positive limb because of a lack of contemporaneity on the basis of the principles in Steele v DFCT.27 It is submitted that Softwood Pulp and Paper v FCT is distinguishable from Grace’s facts.28

The expenditures are both capital though. The reasoning is that the first guideline of the three in Sun Newspapers, requires a focus on the advantage sought. Grace incurred these expenses with the aim of getting an extension to her Epping property (i.e. bigger). Extending or adding to a structural asset is a capital outgoing. Expenses directed at achieving this, even though preliminary to the extension, take on the same character as the purpose for their incurrence as they are an essential step in adding to the structure.

2.2 Capital Allowance Regimes, Etc

2.2.1 Depreciating Asset (Division 40) and Capital Works (Division 43)

The short answer is that there is no depreciating asset to which the expenditure relates. And, there is no capital works.

2.2.2 “Blackhole” Expenditure Provisions: ss 40-832 and 40-880

Neither of these provisions can operate to confer a deduction. Section 40-832 cannot apply because there is no “project amount”.29 And, s 40-880 cannot apply because Grace is not carrying on, or intending to carry on a business in regard to her two properties.30

2.2.3 Cost Base of Epping Property

The Epping property is a post-CGT asset to Grace, and therefore, a gain or loss on disposal is not disregarded. Cost base inclusion is therefore important to Grace.

The fourth element of the cost base31 is the only possible avenue for inclusion. The expenditure is capital, as noted above in the s 8-1 discussion, and which is imported into the fourth element.

27 Steele v DFCT 99 ATC 4242. The two key considerations are, the time gap between incurring expenses and expected production of assessable income and the degree of commitment taxpayer has to assessable income project.
28 Softwood Pulp and Paper Ltd v FCT 76 ATC 4439.
29 See in particular, s 40-840(2).
30 Subsection 40-880(2). It will be seen in 5.2.3 that the other reason why s 40-880 cannot apply is due to the fact the expenses are included in the cost base of the Epping property: s 40-880(5)(f).
It is clear that the fact that the expenditures did not lead to the extension being made to the property is not a reason for excluding the application of the fourth limb.32

Even though these two expenses were not directly going to be reflected in the extension to the Epping property (direct expected effect), the purpose of these expenses was to lead to the extension of the property, and therefore increase its value. It is submitted that the purpose limb, at the very least, is broad enough to cover these types of expenses.33

3. Interest, Land Tax and Council Rates

A number of you queried the accuracy of the rent figure of $2,300. The reasoning of these people was that $2,400 less $200 does not make $2,300. My short answer was: “Read the facts carefully.” The $2,400 actual rent previously received from a tenant is not related to the later attempt by Grace to rent out the property at $2,500 per month ($2,300 + $200).

In regard to this issue, I am hoping students did not just rely on an ATO document on their website as an authority for addressing this issue. Documents on the ATO website, aside from binding rulings, are not an authority. I am hoping students used the cases in support of their analysis.

3.1 Rent

As noted earlier, rent received is income on ordinary concepts because it is a return from putting Grace’s property to work to obtain receipts. Therefore, it is included in Grace’s assessable income.

3.2 Interest on Loan, Land Tax34 and Council Rates35

3.2.1 Does Absence of Rent put Deductions under s 8-1 in Jeopardy?

The fact that Grace did not obtain rental income from the Epping property for a six-month period (November to April) does not preclude Grace from obtaining a deduction under s 8-1 for related expenditure. The principle is that a deduction is not precluded under s 8-1 - and I suggest for most other deduction conferral provisions36 - just because the taxpayer is currently not successful in producing [actual] income from their operation/activity. Ronpibon,37 Fletcher38 and Steele39 are the best authorities for this proposition.

Putting aside the relevance aspect of the first positive limb for the moment (see below), the fact that Grace has genuinely attempted to obtain assessable income from renting out the property means that the lack of actual income and the contemporaneity principle does not preclude the amounts from satisfying the first positive limb. On the basis of Steele, the key thing is

31 Subsection 110-25(5).
32 The old version of the fourth element did require this.
33 The expected effect limb would probably also be satisfied.
34 Land tax is a state government tax that is levied on the unimproved value of a property (land value). It does not apply to the family home (residence). Land tax is levied yearly.
35 Council rates are a local government tax on properties including the family home (residence). This is levied yearly.
36 Note that there are comments in Ormiston v FCT 2005 ATC 2340 at 2344 that cast real doubt over this in regard to depreciation deductions.
37 Ronpibon Tin NL v FCT (1949) 8 ATD 431 at 436.
38 Fletcher & Ors v FCT 91 ATC 4950 at 4957.
39 Steele v DFCT 99 ATC 4242.
commitment to the income-producing project. That is clearly present in Grace’s situation as she owns the property and she is attempting to rent it out at a realistic market rate ($2,500 per month). The decision in *Ormiston v FCT* is also a good factual precedent (taxpayer ended up selling the rental property without it ever producing rental income and yet deductions were allowed under s 8-1). Indeed, Grace’s situation is much stronger than that in *Ormiston* and *Steele* because in those cases, the situation dealt with activities that never produced assessable income, whereas Grace’s situation is dealing with an established income-producing investment with a track record of producing income.

Two Administrative Appeals Tribunal cases, namely, *Fogarty v FCT* and *Bonaccordo v FCT* emphasise the importance of the taxpayer making genuine attempts to find tenants before holding and maintenance costs associated with a “rental” property can satisfy the positive limbs.

### 3.2.2 Expenditures Themselves: s 8-1

All three expenses satisfy the first positive limb of s 8-1. The basis for this for the interest is that it is incurred on loan funds used to purchase an income-producing item (asset). In regard to the land tax and council rates, the occasion of (context of, or the sole explanation for) these expenses is Grace’s ownership of an income-producing property.

None of the expenditures are capital. Interest only secures a very short-term advantage, namely, use of the borrowed funds for the period to which the interest relates. Interest is the cost of hiring someone else’s money for a period. In this sense, it is analogous to rent and on application of the three guides in *Sun Newspapers*, it is on revenue account. (Hopefully, no one applied s 25-25 to the interest, as that section does not deal with interest; interest is not a “borrowing expense”).

The land tax and council rates are on revenue account as well. The reason is that both these expenses accrue periodically and they are recurrent. Put another way. They are part of the range of expenses that are a continuous demand on Grace as owner of the Epping property, and that no structural advantage accrues to Grace from their incurrence.

### 3.2.3 Section 25-75 (Mutual Receipts)

In short, this deduction conferral section is not available to Grace in regard to the council rates and land tax. The reason is that Grace’s use of the Epping property does not satisfy any of the conditions in ss 25-75(1)(c)-(f). In particular, Grace is not producing mutual receipts from the Epping property. Broadly, stated, mutual receipts involve the situation where the taxpayer is the source of its own receipts (e.g. member of a club purchases an item from the club in which she is a member), and therefore in effect, the member is partly paying herself. On this basis, they are not income or assessable income to the association.

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40 *Ormiston v FCT* 2005 ATC 2340.
41 *Fogarty v FCT* 2007 ATC 2654.
42 *Bonaccordo v FCT* 2009 ATC 10-092.
43 *Fletcher & Ors v FCT* 91 ATC 4950 at 4958.
44 *Sun Newspapers v FCT* (1938) 5 ATD 87 at 96.
45 *FCT v Morgan* (1961) 12 ATD 370 at 372.
46 *FCT v Australian Music Traders Association* 90 ATC 4536 contains a good discussion of the mutuality (mutual receipts) principle.