



Why does it matter whether you are an Investor or in Business?

Being in business generally opens up a lot more tax advantages than just being an investor. Though on the downside it is a lot more difficult to negative gear a business unless your turnover is more than \$20,000. In this blog we consider the definition of business in regard to the following points:

- 1) It may allow you to distribute the profit or loss differently to the percentage on the title by entering into a partnership agreement. For example, if one owner is more proactive in the running of the “business” they should get a greater share of the profit.
- 2) It may allow you to claim the small business tax offset which will reduce your tax rate on the “business” income by 16% in the 2021/2022 financial year. Up to a maximum tax benefit of \$1,000. Though if the property is making a loss this is not relevant.
- 3) It may allow you to claim travel to your rental properties as it is travel for your business.
- 4) It may allow you to depreciate second-hand plant and equipment i.e. P&E when you purchase an established property

- 5) It may allow you to immediately write off the plant and equipment in a property when you purchase it. This relates to the COVID tax concessions for small businesses.
- 6) It is still very unlikely that you will be entitled to claim interest and other holding costs, while you are constructing or renovating a residential rental property.
- 7) At the top end of the scale, it may entitle you to the CGT small business active asset concessions that could mean no CGT when you sell.

There are few precedents and expect the ATO to ask questions but on the up-side great tax savings so worth looking into the detail. Each point builds on the knowledge from the previous point so don't skip.

Point 1 – Distributing Profit According to a Partnership Agreement

This is just a question of when earning income from properties can be considered in business, based on common law principles. That is precedents that have evolved over decades, no hard and fast rules. You need to tick most of the elements listed below but missing one is not a deal breaker. The business tests that apply to property owners are:

- Profit making purpose – ignoring capital gain
- Complexity and magnitude of the undertaking
- Regular trade, routine or systematic
- Business like manner, degree of sophistication
- Size of operations – number of properties
- Amount of capital involved
- Active participation – number of hours per week.

An example of being in the business of rental properties is YPFD 2014 AATA 9 <https://www.ato.gov.au/law/view/document?LocID=%22JUD%2F2014ATC1-063%22> The taxpayer had 9 rental properties and was found to be in business even though she did employ a property manager. She successfully argued that the property manager needed supervision and that she was very active in managing the properties herself. She had a significant amount of money tied up and had been operating for many years. All this despite the fact she also had a day job.

Another positive example is Case G10 <https://www.ato.gov.au/law/view/document?LocID=%22JUD%2F75ATC33%22> where a taxpayer was letting out six holiday flats in a single building but they were short term rentals so basically a 7 day a week job. The taxpayer was actively involved in maintaining the flats, showing visitors around, managing bookings and cleaning (with some help). It appears that it was also relevant that they provided furniture, linen and cutlery.

On the other hand, there are a few private rulings PBR 1051806842321, PBR 1051495691567 and PBR 1012037922051 where 3 or less properties used for short term rental were not considered to be in business even though furniture, linen and in one case even a stocked pantry was provided. The taxpayers were involved in the management and cleaning but also used a lot of external providers.

In summing up, before you will be considered in business at common law you must be very involved, in a business like fashion and have at least more than 3 short term letting properties or 9 long term rentals.

If you can meet this definition of being in business, you could use a partnership agreement to distribute income of the partnership on a different basis to the percentage of ownership. A partnership tax return would be needed. The income would then flow through to the individual partners' tax return

All the other points include consideration of the principle above but there is also legislation to consider.

Point 2 – Small Business Tax Offset.

The tax offset of 16% on business income for the 2021-2022 financial year, applies to the individual's tax return. If a partnership return was prepared the income flows through and is taxed in the individual's tax return with the offset applying. This is also the case for trust distributions providing the trust is the entity that runs the business. If you are the only owner of the property then you need to put the income and expenses in the business section of your tax return (section 328-365 ITAA 1997) and claim the tax offset.

This is covered in section 328-355 ITAA 1997, part of the small business concessions, where you need a turnover of less than \$10mil. Section 328-110 defines a small business <https://www.ato.gov.au/law/view/document?docid=PAC/19970038/328-110> probably the only part that is relevant is:

- (a) you carry on a *business in the current year

The definition of business in the Act is all about including things and not about excluding.

Business:

Includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee.

So if you can meet the common law definition of business in point 1 you will qualify here.

In short if you meet the definition of being in business as per point 1), your business is profitable and your turnover is under \$10mil then make sure you place the income and expenses in the business section of your tax return so you don't miss out on the small business tax offset. Various business tax offsets have been available since the 2020 financial year.

Points 3 – Travel to Properties

Since 1st July 2017 Mum and Dad property investors have not been able to claim a tax deduction for travel to their investment properties. But there is a carve out if you are in business. 26-31(1)

You cannot deduct under this Act a loss or outgoing you incur, insofar as it is related to travel, if:

- (a) it is incurred in gaining or producing your assessable income from the use of *residential premises as residential accommodation; and
- (b) it is not necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.

Just as above the definition of business in the Act is all about including things not excluding.

business

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LCR 2018/7 is the ATO ruling on the new legislation denying a claim for travel to investment properties.

<https://www.ato.gov.au/law/view/document?DocID=COG/LCR20187/NAT/ATO/00001>

Paragraphs 15 to 21 discuss when a property investor is in business. It relies on the common law principles discussed in point 1.

So once again if you can meet the common law definition of business you will also qualify to claim your travel in relation to your investment properties.

Point 4 - Claiming Secondhand Plant and Equipment

First make sure you understand what plant and equipment is. There is a table at the back of this guide that covers most items.

<https://www.ato.gov.au/uploadedFiles/Content/IND/Downloads/Rental-properties-2021.pdf>

Here is the legislation prohibiting a deduction for secondhand plant and equipment:
40-27(2)

Reduce your deduction by any part of the asset 's decline in value that is attributable to your use of it, or you have it *installed ready for use, for the *purpose of producing assessable income:

(a) from the use of *residential premises to provide residential accommodation; but

(b) not in the course of carrying on a *business; if:

(c) you did not *hold the asset when it was first used, or first installed ready for use, (other than as trading stock) by any entity; or

(d) at any time during the income year or an earlier income year, the asset was used, or installed ready for use, either:

(i) in residential premises that were one of your residences at that time; or

(ii) for a purpose that was not a *taxable purpose, and in a way that was not occasional.

Note:

Your deduction could be reduced to nil if the purpose to which paragraphs (a) and (b) relate is your only taxable purpose for using the asset or having the asset installed ready for use.

It is the same definition of business in the act as above, about including things not excluding.

business

includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee.

So really comes back to the common law definition.

By meeting the definition of being in business you are not prevented from depreciating secondhand plant and equipment including all the plant and equipment when you buy an established house.

Point 5 – The Immediate Write Off Concessions for Small Businesses

It follows from the points above that if you are in business, then you qualify to immediately write off your plant and equipment.

The catch is that the small business simplified depreciation rules (accelerated depreciation to the extent of immediate write off) do not apply to assets used for rental activities even if the owner is carrying on a rental property business for common law purposes as stated above. Having said that, the temporary full expensing rules do allow assets used in a rental business to be immediately written off. Get in quick as this is expected to finish on 30th June 2023.

The strategy of buying new plant and equipment and immediately writing it off, might be very useful in a year you have a large capital gain. But give this deduction some thought, you may want to opt out if your income is going to end up under \$23,226 i.e. not taxable.

In the extremely unlikely case that a rental property is owned by a company TR 2019/1 says that a company is considered to be in business with just one rental property. Accordingly, a company may be able to immediately write off the value of all plant and equipment acquired for the property being rented in the company's business under the temporary full expensing measures. However, it is not generally possible for the small business simplified depreciation rules to apply to assets used for rental activities, even if owner is carrying on a business.

Point 6 – Holding Costs During Construction

Recent legislation removes a tax deduction for holding costs on vacant land during construction or renovation of residential premises for Mum and Dad investors. There is a carve out for vacant land used in a business but it must actually be being used in the business at that time. There is also an overriding clause that, unless you are a company or public entity you are not allowed to claim holding costs on vacant land during the construction of residential property. Note this is in regard to vacant land, you are still entitled to claim interest on the construction loan whether you are in business or not, just as long as you are constructing a rental. The full legislation is here

<https://www.ato.gov.au/law/view/document?docid=PAC/19970038/26-102>

Being in business with your other properties will not help you to claim expenses for vacant land, while you are constructing a residential property. Owning the property in a company will but this is not advisable because a company does not qualify for the 50% CGT discount.

Point 7 – Reducing the CGT by the Small Business Concessions

Small businesses are generally entitled to reduce their capital gain on active assets by the small business CGT concessions. This allows a second 50% CGT discount so you are only left with 25% of the capital gain which can be rolled into another active asset or you can utilise the retirement concessions. An individual is only allowed to exempt from CGT up to \$500,000 in their life time under the retirement concessions. If they are over 55 they can just take the money in cash, tax free. If they are under 55 they have to put it into superannuation but it will not be

taxed going into the super fund or in their hands in the first place. Further, you may be able to take the sale proceeds and contribute them into your superannuation fund, tax free without affecting your other contribution caps.

There is a catch though. The definition of active asset specifically excludes assets used to produce predominantly rent income. So the bar here for being in business is much higher. But all is not lost, section 118-152(4) gives as an example:

A company uses a house purely as an investment property and rents it out. The house is not an *active asset* because the company is not using the house in the course of carrying on a business. If, on the other hand, the company ran the house as a guest house the house would be an *active asset* because the company would be using it to carry on a business and not to derive rent.

So you can see there is potential for short term accommodation, if your operations are business like enough, to qualify for the small business CGT concessions but long term rentals do not appear to stand a chance even if you have 100s of them.

Warning – There are consequences of being in business. From a CGT 50% discount point of view you are still entitled to that if the property is just considered an asset you are using in your business. This would change if it was considered that you built the property to sell.

GST is the dangerous one. The first sale of a new home is subject to GST even if it is several years later. There are just three ways to avoid this.

- a) Hold the property as a rental for a continuous period of at least 5 years, or
- b) Not build it as part of an enterprise i.e. your own home, or
- c) Be able to show that you did not build it for resale **and** not be registered for GST. If the ATO decides that you did build with the intention of selling then you are required to register for GST because your turnover (i.e. sale of the house) is over \$75,000 (section 23-5). If you can show that you did not build it for resale you still have to charge GST on the first sale of a residential property if you are already registered for GST. The trick is, if you didn't build for resale then the value of the property does not contribute to the \$75,000 turnover test (section 185-25) so won't force you to register for GST. Nevertheless, if you are already registered for GST you even have to charge it on the sale of a capital asset that would be subject to GST i.e. a new residential property. Fortunately, residential rents do not count towards the \$75,000 turnover test because they are input taxed (section 118-15). So you may be ok but as you can see the push towards being more business like combined with building new homes needs detailed examination.

Note if you own your properties in a company the bar, to be considered in business, is much lower but I have not gone into that here because it would be unusual for a company to hold investment properties as companies do not qualify for the 50% CGT discount.

This is just a heads up with references, please consult your Accountant, do not rely on this information alone, there is a lot to consider.