RENTAL PROPERTIES - INITIAL REPAIRS, GENERAL REPAIRS OR CAPITAL IMPROVEMENTS

Everyone wants the maximum income tax deduction for every dollar spent on a rental property, and there is often a question as to whether an amount of expenditure is classed as an initial repair, a 'general' repair, or an improvement. Following is some general information that may be of assistance in making this distinction.

Initial Repairs

Initial repairs are not necessarily the first repairs undertaken after you purchase a rental property, although they may be. If repairs need to be undertaken at the time the property was acquired, regardless of whether you undertake those repairs in the first year or a number of years down the track, the repairs are classed as 'initial repairs' and will not be deductible as an immediate, outright tax deduction. It is immaterial that you may not have been aware of the need for the repairs at the time of purchase, or if the purchase price reflected (or did not reflect) the need for repairs.

An 'initial repair' is a repair that is necessary when the asset is acquired because the asset has defects, damage or deterioration or is not in good order and suitable for use in the way intended. To be an 'initial repair' the work done to the asset must be a 'repair' in the ordinary meaning of the word (that is, the remedying or making good of defects in, damage to, or deterioration of, the asset to restore its efficiency of function without changing its character); it must not constitute an improvement, addition or alteration nor be a renewal, restoration or reconstruction of the entirety of the asset. (TD 98/19)

TD 98/D3 states that initial repair expenditure does form part of the cost base of an asset, so while it is not deductible in full at the time the expense is incurred, it will help to reduce any capital gain on the eventual sale.

In ATO ID 2003/795, internal painting repairs undertaken after purchase but prior to letting to a tenant were considered initial repairs, and deductible under the capital allowance provisions (over 40 years), not as an immediate tax deduction.

Travel and accommodation costs incurred by a taxpayer in undertaking initial repairs are also included in the cost base of the property asset (ATO ID 2007/67).

General Repairs

The ATO considers a repair as making good something, by repairing defects, damage to or deterioration of the property. Repairs restore the efficiency and function of an asset, without changing or improving it's character. Maintenance can also be to prevent deterioration of the property in the future.

Some examples from the ATO of repairs are replacing guttering or windows damaged in a storm and repairing electrical appliances or machinery. Maintenance can be regular painting, maintaining plumbing and keeping items in good working order.

It is essential for any repair to be deductible that the repair arose from the use or action (or inaction) of the person making the claim, and not a previous owner.

Where an asset was previously not used to derive income, repairs carried out after the property was wholly income producing are still able to be deducted in full, eventhough part of the deterioration may have arisen before the asset was income producing. This would occur when you move out of your home of a number of years and commence renting the property.

In ATO ID 2002/330, the cost of removing worn carpet and polishing the existing floor boards was found to be a repair and the costs were immediately deductible.

Improvements/ Capital works

Improvements generally result in a greater efficiency or function of the property. Capital works include a building or an extension, alteration or improvement to a building.

Expenditure on capital works and improvements will be deductible over the life of the asset – in the case of building extensions and renovations to residential property – 40 years or 2.5% per annum.

Use of the same materials or different materials does not determine whether an expense is classed as repair or improvement – the key is whether there is an increase in the efficiency or function of that part of the property. In saying this, the ATO have stated in TR 97/23 at para 53 that the general proposition is that where more modern materials are used, the more likely that the expense has gone beyond a repair, due to the increased efficiency of newer products.

Two examples from TR 97/23 provide further evidence of ATO views in comparing improvements with repairs:

> ***Example 7***
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> *171. Ken-the-Shopfitter runs a factory in a building in which the wooden floor needs repairing. The options are either to repair the old floor or to replace it with an entirely new one of steel and concrete. Ken decides to adopt the second option because it will save future repairs and because it has distinct advantages over the old wooden floor. By choosing the second option, Ken cannot claim a deduction as if he had simply repaired the wooden floor. His actual expenditure being capital, none of it is allowable as a repair.*
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> ***Example 8***
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> *172. Mary Fabrica owns a factory in which the bitumen floor laid on a gravel base needs repairing. She replaces it with a new floor consisting of an underlay of concrete topped with granolith (a paving stone of crushed granite and cement). The new floor, from a functional efficiency (rather than an appearance) point of view, is not superior in quality to the old floor. The new floor performs precisely the same function as the old and is no more satisfactory. In fact, the new floor is more expensive to repair than the old. Because the new floor is not a*

substantial improvement, it is a repair and its cost is deductible under section 25-10: Case T75 (1968) 18 TBRD 377; (1968) 14 CTBR (NS) Case 40 .

In ATO ID 2003/222 a taxpayer was unable to claim the replacement of kitchen cupboards as a repair, but was able to claim this expense under the capital allowance provisions (over 40 years). This is because kitchen cupboards are affixed to the walls with the intention of them being there indefinitely.

Underpinning the foundations of a rental property after the ground underneath the property subsided by adding a further foundation under the existing foundation was found to be a capital outlay in ATO ID 2001/30, because the additional foundation went beyond restoring the state of the existing foundation to its original condition.

As you can see from the discussion above, the test as to whether a repair is an 'initial repair', a general repair or a capital improvement is measured on a case by case basis. Knowing that initial repairs are not immediately deductible will encourage you to ensure that the purchase price paid for your rental property reflects any expense that must be incurred, but will not be immediately deductible. Prior to claiming an outright deduction for repair expenditure, we recommend that you measure the expense incurred by whether there is an increase in the efficiency or function of the asset.

To obtain further information from the ATO rulings and Interpretive Decisions (ID's) listed, go to www.ato.gov.au and search the number quoted, or simply search 'rental property repairs'. If search the specific reference numbers, select the Legal Database option.

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