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IN THIS ISSUE

SECTION 1 – PROFESSIONAL DEVELOPMENTS	1
REPAIRS OR IMPROVEMENTS?	1
¶4.1 Cases on repairs.....	1
¶4.2 Conclusions.....	4
SECTION 2 – PROFESSIONAL CURRENCY	5
BILLS AND LEGISLATION	5
¶4.3 Promoter penalty laws update.....	5
¶4.4 Draft legislation to clarify tax practitioner code of conduct	6
¶4.5 The end of deductions for GIC and SIC	7
¶4.6 Mandatory climate reporting.....	7
¶4.7 Doing financial services business in Australia.....	8
¶4.8 Delivering Better Financial Outcomes.....	9
¶4.9 Luxury Car Tax	9
¶4.10 The new Administrative Review Tribunal.....	10
¶4.11 Super for Commonwealth funded Paid Parental Leave.....	11
¶4.12 First Home Super Saver amendments.....	11
¶4.13 Aged care and social security rates and thresholds.....	12
CASES AND DECISIONS	13
¶4.14 Imputation credits disallowed	13
¶4.15 Employer/employee relationship again in the spotlight	17
¶4.16 Work-related claims.....	18
¶4.17 Profit on sale of lots not increased by GST liability	18
¶4.18 No film producer offset allowed	20
¶4.19 Jail time for fraudulent early release of super applications	22
¶4.20 Penalty for misleading ESG claims.....	22
¶4.21 Settlement payment assessable.....	22
¶4.22 Carrying forward unused concessional contributions.....	24
¶4.23 Termination of tax agent’s registration confirmed.....	24
¶4.24 TPB case studies	25

Continued



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IN THIS ISSUE

RULINGS AND GUIDELINES.....	27
¶4.25 Donations to school and college building funds	27
¶4.26 Flow-through tax treatment Corporate collective investment vehicles.....	28
¶4.27 How the ATO deals with ‘invalid tax law claim’ correspondence.....	29
¶4.28 Class and product rulings.....	29
¶4.29 Financial advice fees not always deductible.....	29
¶4.30 Scrip for scrip roll-over	30
¶4.31 ATO website updates	30
SECTION 3 – QUESTIONS AND ANSWERS	33
¶4.32 Vacancy fee as cost base or expense	33
¶4.33 GST treatment of Australian fee or charge.....	34
¶4.34 Transfer of shares to a trust	35
¶4.35 Premises as going concern	38
¶4.36 PSB separate business premises	39
¶4.37 Fringe benefits tax – travel to work.....	40
¶4.38 Death benefit.....	40
¶4.39 Superannuation obligations – contractors	41
¶4.40 Super contributions.....	42
¶4.41 SMSF related party acquisitions	43
¶4.42 Real estate incorrectly in names of directors of trustee of a SMSF.....	44

SECTION 1 – PROFESSIONAL DEVELOPMENTS

REPAIRS OR IMPROVEMENTS?

The ATO has warned that rental properties are again in the crosshairs. In June this year, the ATO warned that most rental property owners are making mistakes in their tax returns (even though an estimated 86% are using the services of registered tax agents). The distinction between deductible repairs and capital expenditure (such as repairs or improvements) remains the most common problem according to the Commissioner.

Readers will be aware that disallowed repairs expenditure¹ generally falls into three main categories:

- expenditure that **improves** the asset;
- expenditure on **additions** to the asset; and
- expenditure that repairs a **pre-existing** defect (in other words, a defect that was present when the item was acquired).

The focus of this article is on expenditure that was incurred to repair a defect that was present in the asset when it was first acquired. It is irrelevant whether either (or both) parties were aware of the defect – the only relevant inquiry is whether those defects were in existence prior to the sale.

¶4.1 Cases on repairs

Law Shipping Co case

The leading case on disallowed expenditure on initial repairs is the *Law Shipping Co* case² that involved repairs made to a vessel after it was purchased. The issue was whether the repair (including the repair of defects already in existence when the vessel was purchased) were deductible. The Court decided that the repair of pre-acquisition defects were not deductible. The Court's view was informed by the proposition that had the vessel been in good order when it was purchased, the purchase price would have been higher.

So, in essence, the cost of repairing those pre-existing defects were, in essence part of the cost of acquiring the vessel in the first place. Accordingly, those repair costs should be treated as part of the cost of acquisition.

Conclusion

In the context of modern Australia, the issue often arises in relation to purchases of rental properties. The natural instinct of most buyers of existing rental properties is to rush out to the hardware store and attend to perceived defects before putting the property on the market. The cost of these repairs is frequently claimed by the new owners as 'repairs and maintenance'.

¹ Subsection 25-10(3) of the ITAA97.

² *Law Shipping Co v Inland Revenue Commissioners* (1923) 12 TC 621.