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LOSS CARRY BACK TAX OFFSET ("LCB") – TO CARRY BACK OR NOT TO CARRY BACK, THAT IS THE QUESTION!

The temporary loss carry back rules allows corporate tax entities to carry back losses to earlier profitable income years as far back as the 2018-19 income year to generate a refundable tax offset.

The rules are limited to corporate tax entities that:

- Are a small business entity in the loss year or would have been a small business entity if the aggregated turnover threshold was $5 billion;
- incur a tax loss in the 2019-20, 2020-21 or 2021-22 income years; and
- have a profit in a relevant previous year as far back as the 2018-19 income year.

Eligible entities may obtain an offset by choosing to carry back losses to earlier years in which there were income tax liabilities. The choice to claim a loss carry back tax offset means that rather than carry forward tax losses for recoupment in future years, it chooses to carry back the loss and obtain a refundable tax offset in either the 2020-21 or 2021-22 income year.

As it is a refundable tax offset, it may result in a cash refund, a reduced tax liability or a reduction of a debt owing to the ATO.

*The Government announced the extension of the temporary loss carry-back rules for another year to **30 June 2023**. The rules were initially announced in the 2020 Federal Budget – we note at the time of writing this, the extension has not been legislated.*

Avoid Mistakes When Claiming Loss Carry Back

The ATO has provided some guidance in common errors with recent claims for LCB. They are as follows:

- Calculation of the tax offset – To calculate the tax offset you need to use your tax rate in the income year in which you made the loss (for the 2021 year that rate is 25% for Base Rate Entities).
- Use the correct income tax liability amount – The amount of your tax offset cannot exceed their income tax liability for the income year you are carrying the loss back to.
- Franking account balance – The amount of your tax offset cannot exceed your franking account closing balance at the end of the claim year.
- Complete all mandatory labels within tax return – If you choose to claim the LCB, it's important that we complete all of the required LCB labels within the tax return.

The "Forgotten" Integrity Rule

Where companies wish to recoup prior year losses, they are subject to integrity rules, these being either the Continuity of Ownership Test or the Business Continuity Tests. You need to be mindful the same integrity rules apply to companies that choose to carry their losses back to obtain a tax offset.

Key Takeaway

To carry back or not to carry back. As LCB is optional, careful consideration should be given prior to simply choosing to carry back losses. Like many areas of tax, does going down a particular path result in an inadvertent tax impact down the track. One example being, utilising LCB may result in the inability to pay franked dividends in the future.

That being said, the Government's goal in providing temporary tax incentives can be achieved via the use of LCB. Navigating through the LCB rules and choosing to access the LCB provides the ability for businesses to increase business cash flow by generating a tax refund.

If you would like to discuss any of the above further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Business of Letting Rental Properties

In recent years, the Government has introduced rules to restrict certain deductions for landlords owning rental residential properties. The following rental-related expenses (among others) are no longer deductible:

- travel expenses incurred in relation to inspecting, maintaining or collecting rent for a rental property;
- depreciation on second-hand depreciating assets used in rental properties; and
- holding costs of vacant land (e.g. interest expenses, council rates and land tax).

One of the exceptions to the new rules above are that they do not apply where the expenses are incurred in the course of carrying on a business. As a general rule, investors earning rental income are not classified as carrying on a business. However, there is a rare exception where a landlord can be classified as carrying on a business of letting rental properties. This classification is particularly useful to landlords who have a portfolio of rental properties that they manage themselves.

Further, landlords that qualify as a Small Business Entity (e.g. carrying on a business and aggregated turnover of less than $10 million) can also access a raft of small business tax concessions including the Temporary Full Expensing of eligible assets.

However, the Australian Taxation Office (**ATO**) has set a high bar for taxpayers to satisfy the requirements of carrying on a business of letting rental properties. In the ATO's publication *Rental Property 2021*, the ATO provides an example where a taxpayer who owned a total of 26 properties and spent an average of 25 hours per week qualified as carrying on a business of letting properties. Further, there are a limited number of court cases that can provide guidance in this area.

That is why the recent Tribunal case (*Allen and FCT [2021] AATA 2768*) will be particularly important for landlords owning several rental properties.

Allen v Commissioner of Taxation

The taxpayer in this case owned 9 properties, including 7 units in a block in Essendon. The taxpayer managed the properties himself. His duties included engaging the services of electricians, plumbers and building professionals as required, paying for repairs and maintenance, paying council rates, water rates and land tax, communicating with tenants, preparing lease agreements, undertaking property inspections, keeping records, preparing financial statements, gardening and painting. He only used real estate agents to help him find tenants. In other words, the taxpayer spent a significant amount of capital and time in managing the rental properties.

The Tribunal held that the taxpayer was more than a "passive investor" and was carrying on a business of letting rental properties. In particular, the Tribunal found the following decisive factors in the taxpayer's favour:

- the capital invested was a sizeable sum of $6 million including debts;
- the fact that the properties were only geared (debt to market value) to 37.5% was consistent with a profit-making intention;
- the time spent in managing the properties was significant; and
- the record-keeping was consistent with being in a business-like manner, including the preparation of an "income and expense account".

The Takeaway

There is no bright-line rule in relation to carrying on a business of letting rental properties. However, some of the more important factors that may tip the scale in the taxpayer's favour include:

- *The number of properties owned by the taxpayer*. While the ATO's preferred number is closer to 26 properties in the example provided in its guidance, the recent Tribunal case demonstrated that it was possible to qualify with a much lower number of properties (e.g. 9 properties).

- *The degree of involvement of the taxpayer in managing the properties*. The more hours spent by the taxpayer in a week, the more likely it is that the activities qualify as a business.
- *The capital invested by the taxpayer*. This factor is closely related to the number of properties owned by the taxpayer as well as the level of gearing of the properties.
- *The record-keeping of the taxpayer*. The record-keeping must be "business-like" (e.g. organised and systemised).

If you have any queries about the requirements to be carrying on a business of letting rental properties, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

EXPENSES ASSOCIATED WITH VACANT LAND – ITR 2021/D5

Effective from 1 July 2019, deductions are limited for losses or outgoings that relate to holding vacant land for individuals, trusts and partnerships. Some exclusions apply, such as when the land is used in carrying on a business.

While the relevant rules refer to 'vacant land', the rules require testing of the following:

1. Whether there is a substantial and permanent structure on the land;
2. If there is a structure, if it is in use or available for use; and
3. If the structure is available for use, whether it is independent of and not incidental to the purpose of any other structure, or proposed structure on the land.

The ATO released TR 2021/D5 on 4 August 2021 which sets out the Commissioner's view on the application of the vacant land expenses limitation. A significant part of the ruling is dedicated to the three questions listed above.

The ruling states that a substantial structure is *"significant in size, value or some other criterion of importance in the context of the property. To be permanent, a structure needs to be fixed and enduring."*

To consider whether a structure is in use or available for use will firstly need to be determined based on the purpose of the structure. In the context of residential premises, it must be capable of being occupied. Residential premises constructed or substantially renovated are considered to be available for use when they are 'lawfully able to be occupied', which would typically occur when a certificate of occupancy is issued.

Once it has been determined that the permanent structure is in use or available for use, it is necessary to consider whether the structure has an independent purpose in the context of the land on which it is located. Structures that have the purpose of 'increasing the utility' of another structure are not considered independent. For example, in the context of residential land, fencing or a garage, although substantial and permanent structures, do not have any purpose independent of the main residence. The purpose of such structures is to increase the utility of any existing or proposed residence on the land. Therefore, in this example, simply erecting fencing or building a garage will not suffice in order to claim deductions associated with holding the land.

For individuals, trusts and partnerships owning land, it is necessary to analyse any structure that is on the land in order to determine whether any costs associated with the land are deductible. While there may be a permanent structure on the land, unless it is used or available for use and has a purpose independent of any other structure, expenses incurred will not be tax deductible.

If you have any queries in relation to the above, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.
