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# AUSTRALIAN TAX ADVISER

2504 : OCTOBER 2024

The IFX Legal Tax Team

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## 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 expenditure<sup>1</sup> 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* case<sup>2</sup> 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'.

<sup>1</sup> Subsection 25-10(3) of the ITAA97.

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