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Rental expenses in excess of income not deductible

With many parts of Australia in the grip of a rental crisis, a significant number of tenants may be residing in the properties of friends and relatives.

A recent case that came before the Administrative Appeals Tribunal (AAT), *Rizkallah and FCT* [2022] AATA 3081, is a timely reminder that rental expenses in excess of income may not be deductible in these circumstances. Instead, the deductions may be limited to your income from the property.

The taxpayer acquired a unit in Sydney for $300,000 in September 2010, financed by way of a mortgage. After using it as her principal residence for about six months she found it difficult to keep up with the mortgage payments and commenced letting the property to a tenant after moving back in with her parents, who lived across the road.

In May 2015 the taxpayer's future husband arrived in Australia on a partner visa sponsored by her. He joined the taxpayer, living with her in her parents' house. The couple married in August 2015 and moved into the taxpayer's property for about one month, after which time they split up due to the husband's gambling addiction.

Keen to keep her estranged husband nearby in the hope of a reconciliation, the taxpayer then came to an informal tenancy agreement with her husband for $1,016 per month, to be paid in cash. She claimed this reflected the going rate for comparable housing in the area, although it subsequently emerged at the hearing that the market rate was at least double the rate she struck with her husband.

In her 2016 and 2017 income tax returns, the taxpayer disclosed the rent received as assessable income, but claimed net losses of $24,200 and $23,500 respectively, due to significant claims for interest, capital allowance deductions (that is, depreciation on the building) and other expenses, including repairs and maintenance.

In relation to the capital allowances claim (totaling $22,100 over the two income years), on being notified of an audit the taxpayer produced invoices totaling almost $200,000 from a company associated with her family which turned out to have been deregistered at the relevant time. She subsequently withdrew her capital allowances claim, saying the work was never undertaken nor the expenditure incurred, without offering any explanation as to her basis for making the claim in the first place.

The ATO disallowed the net losses claimed in both years and imposed a 50% shortfall penalty on the basis of recklessness. The taxpayer sought a review in relation to both he disallowance of her claims and the penalties imposed.

The main question addressed by the AAT was whether the expenditure claimed (other than the withdrawn capital allowance claim) was deductible – was it necessarily incurred in gaining or producing assessable income, or was it incurred for some other purpose?

The AAT agreed with the Commissioner that the arrangement was non-commercial because: (a) the property was rented to the taxpayer's former partner in an attempt to facilitate the reconciliation of the relationship (b) the rent was well below market rates (c) no tenancy agreement was lodged with authorities. All told, the rent payable was below market rates and based on non-commercial considerations.

The tribunal therefore held that deductions were only allowable up to the extent of the rental income disclosed.

If you have any questions around the taxation of your rental property and the deductions available, please reach out to us.