

TR 2003/4 - Income tax: boat hire arrangements

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Taxation Ruling

Income tax: boat hire arrangements

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Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section, **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner of Taxation. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling considers the operation of sections 26-50¹ and 40-25² of the *Income Tax Assessment Act 1997* ('ITAA 1997') which prevent expenses incurred in respect of a boat used for hire from being deductible unless this activity amounts to the carrying on of a business³. Specifically, this Ruling deals with:

- when the taxpayer's activity amounts to the carrying on of a *business⁴ in relation to a boat for the purposes of subsection 26-50(5);
- the operation of the anti-avoidance rule in subsection 26-50(7);
- when deductions are not denied or reduced for a boat under subsection 26-50(5) and subsections 40-25(3) and (4); and

¹ Prior to 1 July 1997 deductions for a boat were denied under section 51AB of the *Income Tax Assessment Act 1936* ('ITAA 1936').

² Prior to 1 July 1997 deductions for depreciation of a boat that was a 'leisure facility,' were denied under subsection 54(3) of the ITAA 1936, subject to subsections 54(3A) and (4) of the ITAA 1936. From 1 July 1997 subsections 42-45(3) and 42-170(2) and (3) of the ITAA 1997 have substantially the same operation, in relation to boats acquired before 1 July 2001.

³ The Appendix to this Ruling sets out the provisions of section 26-50.

⁴ An asterisk before a term in this Ruling denotes that the term is defined in the *Income Tax Assessment Act 1997* ('ITAA 1997'). Terms that are defined in the ITAA 1997, and identified with an asterisk in the Act, are similarly identified in this Ruling.

- apportionment of expenses between *business and non-business use where a *business is being carried on in relation to the boat.

2. This Ruling applies only to boat hire activities. The Ruling deals with specific provisions of the ITAA 1997 that relate to deductions for expenses incurred in relation to the ownership or use of boats. It is not to be construed more widely. In particular, this Ruling does not deal with the application of the tax law to other 'negatively geared' activities, for example, rental properties, which do not have to satisfy the requirements of subsection 26-50(5) of the ITAA 1997.

3. Deductions in respect of negatively geared assets are usually claimed on the basis that the expenses are for the purpose of deriving assessable income, rather than for the purpose of carrying on a business. In contrast, section 26-50 of the ITAA 1997 prevents deductions being claimed in respect of boats which are let on hire unless the activity amounts to the carrying on of a business. Consequently, this Ruling first examines the characteristics of boat hire arrangements which indicate whether a business is being carried on by the boat owner.

4. Section 26-50 of the ITAA 1997 operates to deny deductions in respect of a boat, it does not prevent amounts received from being included in the assessable income under Division 6 of the ITAA 1997. Consequently, where deductions are denied in respect of a boat which is used in charter operations, the amounts received in respect of the charter of the boat will often still be included in a taxpayer's assessable income.

Class of person/arrangement

5. This Ruling applies to a taxpayer who owns a boat and:
- (a) enters into an arrangement to provide the boat to a charter operator,⁵ or another party, for the charter operator or that other party to hire, lease or charter to others; or
 - (b) directly provides the boat for hire, lease or charter including through an agent.

(Refer to diagrams below)

⁵ The terms and words used in relation to agreements between parties mentioned in the Ruling are not intended to reflect the meanings given in, or have implications under, Admiralty or Maritime Law.

(a) Boat provided to charter operator

(b) Boat Provided Directly to Hirer

6. The boat hire, lease or charter activities of the boat owner are referred to for the rest of this Ruling as the ‘boat hire activities’.

Date of effect

7. This Ruling applies to income years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

The activity must be more than the passive receipt of income from property

8. For deductions in respect of a boat used in a charter activity to not be denied under section 26-50 of the *Income Tax Assessment Act 1997*, the boat charter activity must amount to the carrying on of a business. The receipt of income from the lease of an asset does not of itself amount to the carrying on of a business (see *FC of T v. McDonald* 87 ATC 4541; (1987) 18 ATR 957), but instead would generally be the passive receipt of income from property.

9. When determining whether a boat owner is carrying on a business in respect of a boat hire activity, or is instead only passively receiving income from property, two issues need to be considered:

- where the boat is let to the public through a charter operator: what is the nature of the arrangement between the boat owner and the charter operator, that is, whether the arrangement is correctly characterised as the boat owner's business or alternatively, the provision of the boat to the charter operator for use in the charter operator's business; and
- whether letting the boat to boat hirers, either directly by the boat owner or through a charter operator, amounts to more than the passive receipt of income from property.

Arrangements with a charter operator

10. Whether an arrangement between a boat owner and a charter operator is an agreement for the lease of the boat to the charter operator to use in the charter operator's business, or an agreement for the charter operator to manage the operation of the boat owner's boat hire activity, is a question of fact which must be determined in each case. The character of the arrangement is determined by the terms and conditions of the agreement under which the boat is provided to the charter operator and the matrix of relevant events providing the context in which the agreement was executed (see *Reuter v. FC of T* 93 ATC 5030 at 5036; (1993) 27 ATR 256 at 262). The labels used by the parties will not be determinative (*Reuter*).

11. The extent to which the boat owners participate in, and the effective control they have over, the operation of the charter activity, as well as the extent to which they share in the risks and rewards of it, will assist in determining the character of the arrangement. However, where the boat owner is doing no more than providing a boat to the charter operator for use in the charter operator's business, the receipt of a percentage of the proceeds of charter fees does not by itself indicate that the boat owner is carrying on a *business. Rather, the boat owner is receiving passive income for leasing the boat to the charter operator.

Letting of a boat or carrying on a *business?

12. Where the boat owner does in fact have an agreement with a charter operator for the management of their boat hire activity, or operates the boat hire activity in their own right, the question still arises as to whether the activity involves only the passive receipt of income from letting the boat to boat hirers, or amounts to the carrying on of a *business.

13. Whether letting a boat on charter involves only the passive receipt of income or amounts to the carrying on of a *business will depend on the level of services provided in addition to the hire of the boat (see further paragraphs 50 to 57 below). These services may be provided directly by the boat owner, or through the charter operator as the manager of the boat owner's activity. Where the activity involves only the provision of the boat to the hirer, without sufficient services provided, it will not amount to more than the passive receipt of income. Where sufficient services are provided as part of the hire arrangement, the activity may amount to the carrying on of a *business, depending on how the activity is evaluated against the general indicators of a business.

The receipt of income by a company from the lease of an asset

14. In the Privy Council case of *American Leaf Blending Co Sdn Bhd v. Director of Inland Revenue* [1978] 3 All ER 1185, Lord Diplock noted that the exploitation by a company of its assets for the benefit of its shareholders prima facie amounts to the carrying on of a business. Consequently, the receipt of income from the lease of boat may amount to carrying on of a business for a company, in circumstances where it would not for an individual. This presumption however, does not mean that everything that a company does, amounts to the carrying on of a business. Where a company's boat hire activities lack a significant commercial purpose and are carried on with an intention of making losses rather than profits, it is unlikely that these activities would amount to the carrying on of a business.

General indicators of a *business as applied to boat hire arrangements

15. Determining whether a taxpayer's boat hire activities amount to the carrying on of a *business also involves considering the general indicators of when a business exists. These general indicators, and how they apply in relation to boat hire arrangements, are set out in the following paragraphs. While no single indicator is determinative and the determination is based on the 'large or general impression gained' (*Martin v. FC of T* (1953) 90 CLR 470 at 474; 5 AITR 548 at 551), the prospect of profit is highly significant when assessing if an activity

has the character of a *business (see *Stone v. FC of T* [2002] FCA 1492 at [68]).

Significant commercial purpose or character

16. This indicator generally covers aspects of all the other indicators. A business is generally carried out on such a scale and in such a way as to show it is being operated on a commercial basis and in a commercially viable manner and, with an intention of producing a significant commercial gain.

Prospect of profit

17. For the purposes of determining whether a *business is being carried on, the courts have used the term 'profit' in its legal and general sense⁶. This indicator is directed at determining whether the boat owner entered into the boat hire activity with an intention to make a significant commercial or financial gain from it. The intentions of the boat owner are ascertained from looking objectively at their actions⁷, including any arrangement entered into with a charter operator. All of the income expected to be received from, and all of the costs associated with, the boat hire activity are taken into account to determine what profit, if any, is expected. The expenses necessarily include the decline in value of the boat over the intended term of the activity and any interest incurred.

18. Where an objective analysis of the boat hire activity demonstrates that the boat owner carries it on with a bona fide expectation of making a commercially realistic profit, this indicator will be satisfied. It is not necessary that a profit actually be made in every year (particularly in earlier years) provided there is a bona fide expectation of a commercially realistic profit over the life of the activity. However, where an objective analysis of the boat charter activity indicates that the overall costs will exceed the income derived over the anticipated life of that activity, it is not credible to conclude that it is undertaken with the requisite intention of profit.

⁶ See *Re Spanish Prospecting Co Ltd* (1911) 1 Ch 92 at 98.

⁷ See *Case H11 76* ATC 59 at 64; (1976) 20 CTBR Case 65 at 607.

Activities of the kind carried on in a similar manner to those of ordinary trade

19. The boat hire activity is more likely to be a *business where it is carried on in a similar manner to other businesses in the industry.

Features indicating that the activity is similar in this sense, include:

- the boat is available for charter on an arms length basis;
- the charter operators (whether the boat owner operates the activity directly or through another party) have:
 - appropriate licences;
 - appropriate permits (e.g. for marine parks, boat surveys, etc);
 - appropriate experience;
 - appropriate insurances;
 - the owner and / or operator have appropriate indemnity cover; and
- the use of the boat is not primarily directed at private use.

20. Where the boat owner's hire activities are more correctly characterised as leasing the boat to a charter operator, who uses that boat in carrying on the *business of a charter operator, the boat owner is not carrying on a *business in respect of that boat.

Organised, systematic, business-like manner

21. Boat hire activities are more likely to amount to the carrying on of a *business where they are carried out in a systematic and organised manner. This usually involves matters such as advertising for customers in a consistent and systematic manner, maintaining operations on a consistent basis, retaining and pursuing profitable activities, discontinuing unprofitable activities, and keeping appropriate business records. These may be carried out by the boat owner, or by a manager on the boat owner's behalf.

Repetition and regularity

22. A boat hire activity is more likely to amount to the carrying on of a *business where it displays repetition and regularity in its conduct.

The size and scale of the activity

23. Generally the larger the scale upon which the boat owner conducts the boat hire activity the more likely it is that it will amount to the carrying on of a *business. However this indicator is not determinative.

Otherwise allowable deductions denied by sections 26-50 & 40-25

24. Section 26-50 and subsections 40-25(3) and (4) operate to deny or reduce deductions in relation to a boat that are otherwise available under the taxation law, unless a *business is being carried on in relation to the boat by the taxpayer claiming the deductions.

25. Section 26-50 will not, subject to the part year provisions contained in subsection 26-50(6), deny a *deduction to a taxpayer if, at all times in the income year, the taxpayer:

- holds the boat as trading stock for sale;
- uses or holds the boat mainly for letting it on hire; or
- uses or holds the boat mainly for transporting the public or goods for payment

in the ordinary course of a ***business carried on by the taxpayer**. (Refer paragraphs 26-50(5) (a), (b) and (c).)

26. Deductions are also not denied under 26-50 where the use of the boat is essential to the efficient conduct of a *business carried on by the taxpayer. (Refer paragraph 26-50(5)(d).)

27. However, subsections 40-25(3) and (4) deny a *deduction for a decline in value of a depreciating asset that is a boat if these tests for deductions under section 26-50 are not satisfied.

'mainly' held or used for letting it on hire in the ordinary course of a business

28. Paragraph 26-50(5)(b) provides that one of the exceptions where subsection 26-50(1) will not apply, and hence will not stop the taxpayer being able to claim a *deduction for their boat, is where they:

‘ ... use the boat (or hold it) mainly for letting it on hire in the ordinary course of a *business that [they] carry on ...’ .

29. To satisfy the requirements of this paragraph, the boat owner is required not only to use or hold the boat mainly for letting it on hire, but must do so in the ordinary course of a business that they carry on. That is, the boat owner's activities in respect of the boat must amount to the carrying on of a business, and letting the boat on hire must be in the ordinary course of that business. In addition, this business must be

carried on by the boat owner. If the boat owner is merely in receipt of income for letting the boat to a charter operator, who uses that boat in their business of letting it on hire, this will not satisfy the requirements of paragraph 26-50(5)(b) for the boat owner.

30. It is not sufficient that the boat is used or held for letting it on hire in the ordinary course of a business for only a minor part of the year. It must be used or held 'mainly' for this purpose. If the boat is not used or held 'mainly' for this purpose, deductions in respect of the boat are denied by subsection 26-50(1). Deductions for the decline in value of that boat are also denied under subsection 40-25(4).

31. To establish whether a boat is used or held mainly for the purpose of letting it on hire in the ordinary course of a business, it is necessary to look at all of the factors surrounding the operation of the boat hire arrangement, including the pattern of use of the boat and the objects of the boat owner. Often, a comparison of the periods when the boat was used or available for hire against the periods when the boat was used or reserved for use for private purposes, would appropriately determine whether the boat was used or held mainly for letting it on hire. However, other factors may be present which indicate that a simple time analysis will not give a correct result. For example, if the boat were available for hire on more than half of the days in the year, but was withdrawn for private use for all or most of the peak commercial hiring periods, this may indicate that the main purpose for holding the boat throughout the year was for private use.

32. Only where the conclusion drawn from this analysis is that the boat was indeed used or held mainly for the required purpose, will the exception in paragraph 26-50(5)(b) be satisfied.

'essential to the efficient conduct of a *business'

33. Paragraph 26-50(5)(d) provides that one of the exceptions where subsection 26-50(1) will not apply, and hence not prevent the taxpayer being able to claim *deductions for their boat, is where they

'... use the boat for a purpose that is essential to the efficient conduct of a *business that [they] carry on...'

The requirement will not be satisfied if use of the boat is merely convenient, an aid or economical. The boat must be essential to the efficient conduct of the *business: *Re Sinclair v. FC of T* [2000] AATA 1168; 2001 ATC 2092; (2000) 47 ATR 1001.

Note: this paragraph is not generally relevant to boat hire activities which are specifically covered by paragraph 26-50(5)(b).

34. If the boat is not used as mentioned in paragraph 26-50(5)(d), deductions for the decline in value of that boat are also denied under subsection 40-25(4)⁸.

Schemes to avoid section 26-50

35. Even if a boat is being used, or is held, in a way that satisfies subsection 26-50(5), so that deductions are not denied under that provision, that use (or holding) may be because of a *scheme. If the Commissioner forms the opinion that this *scheme would not have been entered into or carried out if section 26-50 had not been enacted, then the boat is taken by subsection 26-50(7) not to have been used in the way that satisfies subsection 26-50(5). An example of where subsection 26-50(7) may be applied is where a boat owner and a charter operator prepare a written agreement structured to appear to satisfy the requirements subsection 26-50, but in practice their intention is to operate in a substantially different manner (see further, paragraphs 111 to 112 below).

Apportionment of expenses

36. Where a boat is held or used in a manner that satisfies subsection 26-50(5), expenses referable to the taxpayer's personal use of the boat are not allowable deductions. Therefore, many of the expenses incurred may need to be apportioned to reflect the business and non-business use of the boat.

37. Expenses which can be traced to either private or business use of the boat can be directly allocated to each use and no apportionment will be necessary, for example, fuel expenses in relation to a particular private or business trip. Other expenses however, may not be directly attributable to either business or private use of the boat. These expenses will need to be apportioned to exclude amounts referable to private use on a fair and reasonable basis, after considering the nature of the expense and the circumstances surrounding it.

38. Expenses which are strongly linked to usage of the boat, for example general maintenance, may be appropriately apportioned based on the days used for private purposes against total days the boat is actually used. That is, if the boat is let on hire for 80 days in the year and used for private purposes for 20 days, the proportion to be excluded for private use may be appropriately calculated as 20/100.

⁸ Note: In many circumstances where deductions are denied in respect of a boat under section 26-50, amounts received from letting the boat will still be assessable income in the hands of the boat owner.

39. Alternatively, for fixed expenses of holding the boat, for example interest and depreciation, the amounts relating to private use may be most appropriately calculated based on the days that the boat is used for private purposes against the total number of days that the boat is genuinely available for letting it on hire. That is, if the boat is genuinely available for charter for the whole of the income year, but is used for private purposes for 20 days in that year, the proportion to be excluded for private use may be calculated as 20/365.

40. It is important to note however, that the apportionment for private use of the boat discussed in paragraphs 37 and 38 above is a guide only. The appropriate apportionment of expenses must be determined by each taxpayer based on their individual circumstances.

Explanations

The activity must be more than the passive receipt of income from property

41. To satisfy the exception in paragraph 26-50(5)(b), the boat owner must use or hold the boat mainly for letting on hire in the ordinary course of a *business carried on by the boat owner. If the boat owner's involvement in the activity amounts to no more than the passive receipt of income for the lease or hire of the boat, then they are not carrying on a *business in respect of that boat and they do not satisfy the requirements of the exception.

Arrangements with a charter operator

42. The provision of a boat under a lease does not of itself indicate that the taxpayer is participating in the business of the person who uses the asset in the ordinary course of **their** *business. However, a taxpayer can still operate a *business even though they allow the day to day operations of the *business to be carried out by another party.

43. Payment to the taxpayer made in the form of a percentage of the charter income from the boat held and used by a charter operator or other party does not in itself result in the taxpayer carrying on a *business in common with the charter operator. In *Taxiway Pty Ltd v. Commissioner of State Revenue (Vic)* 95 ATC 4667; (1995) 31 ATR 362, the taxpayer owned a number of licensed taxis. It entered into lease agreements with taxi drivers which permitted the lessees exclusive use and possession of the taxi during the period of the lease. The court held that the fact that the rent payable to Taxiway was 50% of the gross revenue received by the lessee, did not change the nature of the business carried on by Taxiway. The court rejected arguments

that the taxi drivers were acting as agents for Taxiway or that Taxiway was carrying on a business in common with the taxi drivers.

44. The majority in *FC of T v. Murry* 98 ATC 4585; (1998) 39 ATR 129 held that the taxpayer and her husband merely exploited the economic potential of a taxi licence by leasing it to a taxi operator. While a taxi business existed, it belonged to the operator. The licence was an asset that could be sold independently of the business activity of the owner/operator of the taxi.

45. On the other hand, in *Ferguson v. FC of T* 79 ATC 4261; (1979) 9 ATR 873; (1979) 37 FLR 310 and *FC of T v. JR Walker* 85 ATC 4179; (1985) 16 ATR 331; (1985) 79 FLR 161, the courts accepted that a person can still be carrying on a business notwithstanding that they used an expert manager to handle the day to day running of the business (see also *Cooke v. FC of T*; *Jamieson v. FC of T* [2002] FCA 1315 and the authorities cited on this point at [60]).

46. Whether an arrangement between a boat owner and a charter operator is only a lease of the boat to the charter operator or a management agreement concerning the boat owner's activity, is a question of fact which needs to be determined in each case. This is based on the terms and conditions of the agreement and the relevant surrounding circumstances (*Reuter*).

47. Indicators that the arrangement between a boat owner and a charter operator is a management agreement include:

- the contract for the provision of the boat to the hirer shows that the charter operator is acting as the agent of the boat owner in the boat hire arrangement;
- the boat owner derives the income and incurs expenses relating to the charter of the boat; and
- the boat owner maintains sufficient control of the operation of the boat.

48. Indicators that the arrangement between a boat owner and a charter operator is a lease, include:

- the arrangement grants rights of exclusive use and possession to the charter operator in respect of the boat;
- the charter operator retains a right to all charter income and the owner is entitled to a fixed amount per month or a lease fee based on the usage of the boat;
- the owner does not have any right to non-refundable deposits paid to the boat charter operator by prospective hirers; and

- the charter operator acts in their own interest, sometimes to the detriment of the boat owner.

49. Thus, if the boat hire arrangement entered into by the taxpayer is more correctly characterised as a lease agreement, the taxpayer is not carrying on a *business in relation to the boat.

Letting of a boat or carrying on a business?

50. Where the arrangement between the boat owner and the charter operator does amount to a management agreement, or the boat owner operates the boat hire activity in their own right, the question still arises as to whether this activity amounts to the carrying on of a *business, or instead involves only the passive receipt of income for letting the boat to the boat hirer.

51. In *McDonald* the taxpayer purchased several income producing properties as joint tenants with his wife, which were subsequently let through letting agents. Beaumont J indicated (quoting *Wertman v. Minister of National Revenue* 64 DTC 5158) that for a business to be carried on by owners of property, one would expect that they would be involved in providing services in addition to the process of letting property (as with a boarding house), not merely receiving payments for the tenants' occupation of the property. At ATC 4552; ATR 969 he concluded that:

'In the present case, a number of indications point to the conclusion that the parties were not carrying on a business, with the consequence that their relationship was that of co-ownership rather than partnership. Their investment involved little, if any, active participation from either party. This was inevitable because the respondent was apparently in full-time employment, and Mrs McDonald was fully committed at home. On the few occasions on which the owners needed to be involved, the respondent and not Mrs McDonald attended to the matter. This was not the case of the active joint participation by the parties in a business activity. Rather, it was a case of renting out of premises without the provision of other services of the kind discussed in *Wertman, supra*. In my view, there was here a mere investment in property rather than a partnership in the properties or their profits.'

52. In *Case G10 75* ATC 33; (1974) 19 CTBR (NS) *Case 103*, the taxpayer was letting out several holiday flats for short term rental. The taxpayer was actively engaged personally from day to day in multifarious activities directed to the profitable operation of his income producing holiday flats. This included the provision of furniture, blankets, crockery, cutlery, pots and pans, laundering blankets and linen when supplied, showing visiting enquirers over the premises, taking bookings and transacting payments, cleaning, garbage removal and maintenance of the facilities.

53. At ATC 38; CTBR (NS) 705 the Board members stated that:

‘Here the elements of repetition and continuity of acts and transactions are for present purposes sufficient evidence of the existence of a business. The taxpayer was actively engaged personally from day to day in multifarious activities directed to the profitable operation of his income-producing holiday flats. His is not a case of a person who simply owns flats which bring to him income vicariously through a letting agent. This taxpayer was personally gainfully employed in his occupation of managing his holiday flats for short term lettings. His income was the reward for his combined use of his capital and his labour...’

It was essential to this decision that the taxpayer was doing more than just letting out the flats. The extent of his activity was considered sufficient for him to be considered to be carrying on a business.

54. In contrast, in *Cripps v. FC of T* 99 ATC 2428; (1999) 43 ATR 1202 the taxpayers were held not to be carrying on a business despite the fact that they jointly owned 14 double storey townhouses and periodically rented out two houses. The Tribunal contrasted the activities of the taxpayer with the cases of *Walker* and *Ferguson*, because those cases ‘were concerned with actual farming activities (albeit on a small scale) and are not properly to be compared with the letting out of real property’. The Tribunal noted that the activity in *Cripps* involved little, if any, active participation from the taxpayer or his wife and concluded that the taxpayers were unlikely to have been any more involved than a concerned and interested absentee landlord.

55. Whether letting of a boat on charter amounts to the carrying on of a business, rather than the passive receipt of income, will depend on the level of services provided in addition to the hire of the boat. These services may be provided directly by the boat owner, or through the charter operator as the manager of the boat owner’s activity. Where services are provided as part of the hire arrangement, the extent of those services will be a relevant matter in considering whether the activity amounts to the carrying on of a *business rather than the passive receipt of income.

56. Services which may be provided to the hirer, which could establish that a *business is being carried on by the boat owner, include:

- customer inquiry and booking services;
- issuing of accounts and processing of deposits and payments;
- reception area for charter guests;
- pre-charter briefing including training and assistance in the correct operation of the boat and safety equipment;

- access to jetties with electric power, hot and cold water, waste disposal facilities and fuelling facilities;
- support infrastructure for the hirer while the boat is on charter, including a radio and rescue service; and
- additional services connected with the boat charter, including booking services for:
 - activities and facilities in the area;
 - permits for entrance to various areas;
 - flights and other transport; and
 - hotel and dinner reservations.

57. Where the activity involves only the provision of the boat to the hirer, it is unlikely that the activity will amount to more than a lease and the passive receipt of income.

The receipt of income by a company from the lease of an asset

58. Case law both within and outside of Australia indicates that the activities of a company may be considered to be the carrying on of a business where the same activities carried on by an individual would not. Specifically, the receipt of income from rents or investments, which for an individual would be considered to be the receipt of income passively, may amount to the carrying on of a business for a company.

59. In the Privy Council case of *American Leaf Blending Co Sdn Bhd v. Director-General of Inland Revenue* [1978] 3 All ER 1185 the taxpayer was incorporated with the principle objective of carrying on a tobacco business. The company ceased trading in tobacco and commenced letting out a warehouse for rent. When deciding if the receipt of the rental income amounted to the carrying on of a business by the taxpayer, Lord Diplock observed at page 1189 that:

‘Their Lordships would not endorse the view that every isolated act of a kind that is authorised by its memorandum if done by a company necessarily constitutes the carrying on of a business.’

He later concluded however:

‘In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships’ view, **in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.** Where the gainful use to which a company’s property is put is letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which

would displace the prima facie inference that in doing so it was carrying on a business.’ (emphasis added)

Lord Diplock then stated that carrying on a business normally encompassed some form of activity, though the nature of the business may mean that the activity is intermittent with long intervals of quiescence between. He went on to observe that the taxpayer had negotiated with different tenants and that there had been three successive tenants in the five years in question. He concluded that there was nothing in the evidence of the case which was capable of rebutting the prima facie inference that the taxpayer was carrying on a business.

60. *American Leaf Blending Co* has been considered in many Australian cases, and generally the Australian courts have agreed that the presumption discussed by Lord Diplock applies in Australian cases.⁹

61. Not everything that a company does amounts to the carrying on of a business however. For a boat charter activity carried on by a company to amount to the carrying on of a business, it must still have the characteristics of a business. In *London Australia Investment Co Ltd v. FC of T 77* ATC 4398 at 4409; (1977) 7 ATR 757 at 770, Jacobs J noted that ‘...business has in it a notion of profit making rather than loss making...’. Consequently, where a company’s boat hire activities lack a significant commercial purpose and are carried on with an intention of making losses rather than profits, it is unlikely that these activities would amount to the carrying on of a business.

General indicators of a *business as applied to boat hire activities

62. Broadly, in order for a taxpayer’s activities to amount to the carrying on of a *business, it is necessary that the activity amount to a commercial enterprise and involve notions of repetition and continuity of activities (see, for example, *Hope v. The Council of the City of Bathurst* (1980) 144 CLR 1 at 8-9; 80 ATC 4386 at 4390; (1980) 12 ATR 231 at 236, and *State Superannuation Board (NSW) v. FC of T 88* ATC 4382 at 4389-4390; (1988) 19 ATR 1264 at 1273-1274).

63. In *Ferguson* at ATC 4271; ATR 884, Fisher J said:

‘It is necessary to give consideration to the essential nature of the activity, and the question whether it has the characterisation of a business is primarily a matter of general impression and degree.’

⁹ *Kwikspan Purlin System Pty Ltd. v. FC of T 84* ATC 4282; (1994) 15 ATR 531, *FC of T v. McDonald* 87 ATC 4541; (1987) 18 ATR 957, *FC of T v. Bivona Pty. Limited* 89 ATC 4183; (1989) 20 ATR 282, *Cripps v FC of T 99* ATC 2428; (1999) 43 ATR 1202, *Email v. FC of T 99* ATC 4208; (1999) 42 ATR 698, *Unisys Corp Inc v. FC of T 2002* ATC 5146; (2002) 51 ATR 386.

64. The general indicators of when a *business is being carried on are discussed in Taxation Ruling TR 97/11. That Ruling is directed to determining whether a *business of primary production is being carried on. However, the principles discussed in that Ruling also apply to determining whether other forms of activity amount to carrying on a *business.

65. The general indicators of a *business, and how they apply in relation to boat hire arrangements, are discussed in the following paragraphs. **No single indicator is determinative. The determination is to be based on the overall general impression gained.** In *Martin* at CLR 474, Webb J said:

‘The test is both subjective and objective: it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and, as counsel for the taxpayer put it, the determination is eventually based on the large or general impression gained.’

66. The indicators of a *business discussed below therefore, provide characteristics which indicate that an activity may amount to a business. However, they are only a guide. Whether a *business being carried on is still determined based on the overall impression gained after looking at the activity as a whole and the intentions of the taxpayer undertaking it. Consequently, while no single indicator is determinative, the lack of significant commercial purpose and a prospect of profit will strongly influence the large or general impression gained to being that a *business is not being carried on (see *Stone's case* (supra) at [68]).

Significant commercial purpose or character

67. This indicator often overlaps with aspects of the other indicators. The boat owner's hire activity is more likely to amount to the carrying on of a *business where it is carried out on a scale, and in such a way as to show:

- the activity is being operated for commercial reasons and in a commercially viable manner;
- the activity is capable of producing a significant overall profit over the term of the activity; and
- the activity is not attractive to the boat owner primarily for private and / or tax related reasons.

68. The phrase ‘significant commercial purpose or character’ is referred to by Walsh J in *Thomas v. FC of T* 72 ATC 4094; (1972) 3 ATR 165. In that case, Walsh J found that the taxpayer’s activities in growing macadamia nut trees and avocado pear trees amounted to the carrying on of a *business, but that his activities of growing pine trees did not. Walsh J summarised the taxpayer’s activities at ATC 4099; ATR 171 as follows:

‘In my opinion the appellant’s activities in growing the trees ought not to be found to have been carried on merely for recreation or as a hobby. I leave out of account the pine trees, the growing of which did not have, I think, a significant commercial purpose or character. But the appellant in planting the avocado pear trees and the macadamia nut trees set out to grow them on a scale that was much greater than was required to satisfy his own domestic needs and he expected upon reasonable grounds that their produce would have a ready market and would yield, if they became established, a financial return which would be of a significant amount, with a relatively small outlay of time and money and that this return would continue for a very long time.’

69. In the context of a boat hire arrangement, where the boat owner carries on the activity for commercial reasons and with an intention and prospect of producing a significant overall profit over the planned period of the arrangement, it is more likely that the activity will amount to the carrying on of a *business. Further support for this would be present where the boat owner is able to demonstrate the commercial basis for entering into the boat hire arrangement, including how a significant profit is expected to be made from it.

Prospect of profit

70. In order to demonstrate that a boat hire activity amounts to the carrying on of a *business, a taxpayer needs to show that it is carried on with the intention of making a significant commercial profit.

71. Mason J in *Hope* CLR at 8-9; ATC at 4390; ATR at 236, indicated that the carrying on of a business is usually such that the activities are:

‘... engaged in for the purpose of profit on a continuous and repetitive basis.’

72. For the purposes of this indicator, it is the intention of the operator of the business which is relevant. In *Tweddle v. FC of T*; (1942) 180 CLR 1; (1942) 7 ATD 186; 2 AITR 360, Williams J rejected the argument that the activity did not have any hope of producing a profit and was not undertaken for this purpose. Instead he argued that it was not a function of taxing Acts to dictate to taxpayers how to run their businesses profitably and concluded that it was sufficient that the taxpayer had a genuine belief that he would eventually be able to make the business pay.

73. It is not sufficient however, that the taxpayer merely asserts that they have an intention to make a profit. In *Case H11* 76 ATC 59; (1976) 20 CTBR (NS) *Case 65*, Mr CF Fairleigh QC (Member) stated at ATC 64; CTBR (NS) 607:

‘It is clear that in considering a person’s intentions to carry on a business or not to do so his acts should be viewed objectively and not subjectively. ‘The intention of a man cannot be considered as determining what it is that his acts amount to’ (per Lord *Buckmaster, J. & R. O’Kane v I.R. Commrs.* (1919-1922) 12 T.C. 303).’ ... **The taxpayer believes that he will make a profit. The evidence leads to a finding of fact that he has established a farm woodlot with the intention of making a profit from the sale of pine trees at various stages of growth...**. (Emphasis added)

74. Thus, although it is the intention to profit from undertaking the activity that is generally essential when looking at this indicator of *business, the intention is ascertained by looking at the taxpayer’s actions objectively. Consequently, where it is clear from the objective evidence that the taxpayer can not show the existence of a genuine belief that the activity can be profitable, they will not have the requisite intention of profit.

75. Where a boat owner has a genuine belief that their activity will produce a commercially realistic profit, they may still be carrying on a *business notwithstanding that the objective evidence indicates that it is unlikely that a profit will be made. However, if the objective evidence available to the boat owner at the time of entering the boat hire activity shows that it cannot turn a significant overall profit within its effective life, then this would strongly indicate that entering into that activity was not motivated by profit, and this indicator would not be satisfied.

76. Further evidence of an intention to make a significant profit occurs when the taxpayer has conducted research into their proposed activity and consulted experts or received advice on the running of the activity, and the profitability of it, before setting it up. This was the case in *JR Walker* (above).

Meaning of the term 'profit'

77. The term 'profit' as it has been used by the courts when examining whether a *business is being carried on, does not necessarily mean profit as determined by the taxation law, or accounting profit as determined by the application of accounting standards. Instead it is used in its legal and general sense. In *Re Spanish Prospecting Co Ltd* (1911) 1 Ch 92 at 98, Fletcher Moulton LJ stated:

'The word 'profits' has in my opinion a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance... 'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year.'

Later at 99 he concluded:

'We start therefore with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they shew at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.'

78. To establish whether a boat owner has a bona fide intention to make a profit from entering into a boat hire activity, it is necessary to take into account all of the expected income and expenses. This will necessarily include any interest incurred and the decline in value of the boat while used in the boat hire activity. For example, in *Thomas* interest was clearly considered to be part of the relevant expenses considered. Further, in *Daff v. FC of T* 98 ATC 2129; (1998) 39 ATR 1042 and *Case H11* (supra), the major items of expenditure were noted to include interest and depreciation. In no case is it evident that the courts or the Boards of Review have deliberately removed allowances for interest or depreciation when considering if the taxpayer had an intention to profit from an activity.

79. Making losses in the short term does not preclude an activity from being a business. In *Tweddle, Ferguson and Thomas*, the courts held that the taxpayers were carrying on businesses, notwithstanding that they made losses over several years. In each of these cases, the courts found that the taxpayers had an intention and expectation that their activities would eventually become profitable. In all of these cases the taxpayers intended to carry on the businesses for an indefinite period.

80. In *Case H11* the taxpayer was conducting an afforestation activity and was incurring losses in the years in question. In that case the Board of Review established that the taxpayer had an objective expectation that he would recoup the substantial costs in the early years of the activity when the trees were harvested on maturity.

81. For this indicator to be satisfied, it is not sufficient that the taxpayer only expects a token profit. In the Administrative Appeals Tribunal case of *Cecil Crees v. Commissioner of Taxation* 2001 ATC 2021; (2001) 46 ATR 1091 Mr DW Muller, Senior Member, noted at ATC 2024; ATR 1095:

‘It would be a most unusual business operator who would expend large amounts of money and labour, for more than ten years, on a business which was unlikely to ever cover the expenditure and even if it did, was not likely to give a reasonable return for effort. Under the circumstances I find that the orchid growing enterprise of Mr. Crees does not have a significant commercial character and that, therefore, it does not amount to a business of primary production.’

82. Similarly, boat owners entering into a boat hire activity may make losses in the initial years, but must be able to demonstrate that they intend to make a significant commercial profit from the boat hire activity. That is, that they genuinely believe that total income will significantly exceed the total expenses over the anticipated life of the activity. The expenses will necessarily include any interest on borrowings and the decline in the value of the boat or boats used in the activity.

83. The tax savings made by offsetting the losses from the charter activity against other income are not part of the profits from the boat hire activity, as there is no indication in any of the cases that the term ‘profit’ is used in any after tax sense.

Activities of the kind carried on in a similar manner to those of ordinary trade

84. A boat hire activity is more likely to be a *business where it is conducted by, or on behalf of, the boat owner based around business methods and procedures of a type ordinarily used in boat hire activities that would commonly be said to be businesses. Factors which may indicate that the boat hire activity is a *business include:

- the boat is available for charter to the general public;
- the boat owner owns or leases the appropriate licences and permits required to carry on the charter activity;
- the charter operator (whether the boat owner operates the activity directly or through another party) has the appropriate experience;

- the owner and / or operator have appropriate indemnity cover; and
- the use of the boat is not primarily directed at private use.

85. For an activity in relation to a boat to be accepted as carried out by a manager or agent on behalf of the taxpayer, it must be demonstrated that the *business is that of the taxpayer, not that of the manager or agent. However, this indicator will not be satisfied, and the boat owner will not be carrying on a *business, if the arrangement is more correctly characterised as the boat owner leasing their boat to a charter operator for the carrying on of the *business of the charter operator.

Organised, systematic, business-like manner

86. Boat hire activities are more likely to amount to the carrying on of a *business where they are carried out in a systematic and organised manner.

87. In the New Zealand case of *Case M36* (1990) 12 NZTC 2224 Bathgate DJ considered whether a yacht charter business was being carried on by the taxpayer. Bathgate DJ, when determining that the taxpayer did not carry the activity on in a business-like manner, considered the following:

- the taxpayer's actions in purchasing the yacht and committing himself to fairly significant loan expenditure and interest payments prior to making definite arrangements for chartering the yacht;
- the taxpayer's haphazard approach to the venture as reflected in a small amount of income received from the activity; and
- the taxpayer's concern that the yacht be available to him for personal use during the peak charter season.

88. Factors that would indicate that a boat hire activity is conducted in a business-like manner by the boat owner, or by a manager on behalf of the boat owner, include:

- the keeping of appropriate business records;
- operations are carried on a consistent basis and are not haphazard in their nature;
- advertising for customers is carried on in a consistent and systematic manner;
- profitable activities are pursued and unprofitable activities are discontinued; and

- personal availability or use of the boat by the taxpayer does not take priority over the availability of the boat and use of the boat for charter purposes.

Repetition and regularity

89. A boat hire activity is more likely to amount to the carrying on of a *business where it displays repetition and regularity in its conduct. This indicator will be present in many boat hire activities. However this will not of itself lead to the conclusion that the activity amounts to a *business.

The size and scale of the activity

90. This indicator examines whether the taxpayer's activities are of a sufficient scale to be commercially viable. In *Ferguson* however, at ATC 4265; ATR 877, Bowen CJ and Franki J commented on this indicator in the following manner:

‘The volume of his operations and the amount of capital employed by him may be significant. However, if what he is doing is more properly described as the pursuit of a hobby or recreation or an addiction to a sport, he will not be held to be carrying on a business even though his operations are fairly substantial.’

91. The number of boats that the boat owner has in a boat hire arrangement, is not of itself determinative of whether a *business is being carried on. The greater the number of boats in the boat hire activity, the more likely that a taxpayer will be considered to be carrying on a *business.

92. Where the scale of the activity is small other indicators take on greater weight when deciding whether a *business is being carried on by the taxpayer. For example, in *Thomas* the court was influenced by the fact that even though the activity was small, the scale of the activity was sufficient to provide the taxpayer with an expectation of a financial return which would be of a significant amount, with a relatively small outlay of time and money, and that this return would continue for a very long time.

Otherwise allowable deductions denied by sections 26-50 & 40-25

93. Section 8-1 provides that losses and outgoings are deductible to the extent to which they are incurred in earning *assessable income or in carrying on a *business for that purpose.

94. Deductions in relation to boats are denied under subsection 26-50(1) for losses or outgoings incurred in:

- acquiring and retaining ownership of or rights to use a boat; or
- using, maintaining or repairing a boat; or
- relation to an obligation associated with ownership or rights to use the boat.

95. Subsection 26-50(5) provides exceptions to the denial of deductions under subsection (1) where you:

- hold the boat as trading stock for sale in the ordinary course of a business that you carry on; or
- use the boat (or hold it) mainly for letting it on hire in the ordinary course of a business that you carry on; or
- use the boat (or hold it) mainly for transporting for payment in the ordinary course of a business that you carry on, the public or goods; or
- use the boat for a purpose that is essential to the efficient conduct of a business that you carry on.

96. Subsections 40-25(3) and (4) also deny deductions for a decline in value of a depreciating asset that is a boat if the tests for deductions under section 26-50 are not satisfied.

‘mainly’ held or used for letting it on hire in the ordinary course of a business

97. Paragraph 26-50(5)(b) provides that one of the exceptions where subsection 26-50(1) will not apply, and hence will not stop the taxpayer being able to claim a *deduction for their boat, is where they:

‘ ... use the boat (or hold it) mainly for letting it on hire in the ordinary course of a *business that [they] carry on ... ’.

It is this exception that a boat owner’s boat hire activity would normally need to satisfy, if any expenses in respect of the boat are to be deductible.

98. To satisfy the requirements of this paragraph, the boat owner not only has to use or hold the boat mainly for letting it on hire, but must do so in the ordinary course of a business that they carry on. That is, the boat owner’s activities in respect of the boat must amount to the carrying on of a business, and letting the boat on hire must be in the ordinary course of that business. In addition, this business must be carried on by the boat owner. If the boat owner is merely in receipt of income for letting the boat to a charter operator, who uses that boat in

their business of letting it on hire, this is will not satisfy the requirements of paragraph 26-50(5)(b) for the boat owner.

99. Paragraph 26-50(5)(b) requires not only that the boat is used or held for letting it on hire in the ordinary course of a business that you carry on, but also that it is ‘mainly’ used or held for such purposes. Therefore, where the boat is used or held for more than one purpose, it is necessary to establish what is meant by the term ‘mainly’.

100. In the case of *FC of T v. FH Faulding & Co Ltd* (1950) 83 CLR 594, the High Court examined whether two cordials produced by the taxpayer were ‘essences, concentrates and cordials, consisting wholly or principally of juices of Australian fruits’. In doing so the Court noted that ‘principally’ had the same meaning as ‘mainly’ and further that whether this was referring to a quantitative or other measure was determined by the context in which it was used. At page 602 Fullager J. concluded that:

‘The natural meaning of the words ‘consist . . . principally’ is emphasized in item 36(3) by the presence of the words ‘wholly or’. The reference must be to quantity’

As the cordials in question consisted of well under 50% juices of Australian fruit, the court held that, on a quantitative analysis, they did not consist wholly or principally of such juices.

101. Later, in the case of *Universal Press Pty Ltd v. FC of T* 89 ATC 5234; (1989) 20 ATR 1758, the Federal Court considered whether street directories published by the appellant were books consisting wholly or principally of maps. Gummow J referred extensively to the decision in *Faulding* before stating at ATC 5240 and 5241; ATR 1765:

‘On the other hand, counsel for the Commissioner said that the High Court decision had to be understood in the setting in which there appeared the words ‘consisting wholly or principally of ...’ The question was the identification of that which the cordial consisted. That directed attention to identification of ingredients. Here, one is concerned with the characterisation of the finished product, namely a book, and of the contents of the book. The task might be a simple one because one might be able to say that the book contained nothing but maps and so consisted wholly of maps. If that were so, the exemption would be lost. But, counsel submitted, the exemption would be lost also if the book comprised varied contents, but one could characterise it in the qualitative sense as consisting principally of maps; it would be the maps which provided the essential character of any street directory.

In my view, there is much to be said for the submissions by counsel for the Commissioner. If it had been necessary for me to do so, I would have accepted those submissions.’

102. The above cases demonstrate that the word ‘mainly’ can have a quantitative or qualitative meaning attached to it, depending on the context in which it appears. Where a quantitative meaning is attached, a simple comparison of a measure is used. For example, a percentage of total volume as was used in *Faulding* above. Alternatively, where a qualitative meaning is attached, an analysis of all of the facts is required to ascertain the character of arrangement in question.

103. Likewise, whether a qualitative or quantitative approach is taken for determining whether a boat owner uses or holds a boat ‘mainly’ for letting it on hire in the ordinary course of a business, must be ascertained by the context in which ‘mainly’ is used. If paragraph 26-50(5)(b) had merely referred to the boat being used mainly for the required purpose, this may have indicated that a quantitative approach is appropriate because how it is actually used is readily quantifiable based on time. However, the paragraph refers to whether you ‘use the boat (or hold it) mainly’ for the required purpose. As you can hold a boat for more than one purpose, the word ‘mainly’ in this context requires a qualitative analysis to establish the purpose for which that boat is being held.

104. Often, a comparison of the periods when the boat was used or available for hire against the periods when the boat was used or reserved for private use, would appropriately determine whether the boat was used or held mainly for letting it on hire. However, other factors may be present which indicate that a simple time analysis will not give a correct result. For example, if a boat were available for hire on more than half of the days in the year, but was withdrawn for private use for all or most of the peak commercial hiring periods, this may indicate that the main purpose for holding the boat throughout the year was for private use.

105. Only where the conclusion drawn from an analysis of all of the circumstances of the arrangement is that the boat was indeed used or held mainly for letting it on hire in the ordinary course of a business carried on by the taxpayer, will the exception in paragraph 26-50(5)(b) be satisfied.

‘essential to the efficient conduct of a *business’

106. Paragraph 26-50(5)(d) provides that one of the exceptions where subsection 26-50(1) will not apply, and hence not prevent the taxpayer being able to claim *deductions for their boat, is where they:

‘ ... use the boat for a purpose that is essential to the efficient conduct of a *business that [they] carry on ...’.

The taxpayer must be able to satisfy the requirement that the boat be more than an ‘aid’ or ‘advantage’ to the conduct of the business.

107. In *Re Sinclair* ATR at 1005; ATC at 2096 the taxpayer used his boat to demonstrate navigational aids. After examining the evidence provided, KL Beddoe (Senior Member) concluded that the boat was an aid and provided advantages but it was not considered 'essential to the efficient conduct of the business'.

108. In *Case 6/2001* AATA 965; 2001 ATC 142 at 148; (2001) 48 ATR 1176 at 1185 the taxpayer owned a catamaran. The taxpayer's husband carried on an accounting business and leased part of the boat as an office. The taxpayer provided secretarial services from the boat. In disallowing deductions claimed for expenses associated with the maintenance of a boat, and interest and loan expenses, Mr KL Beddoe (Senior Member) said 'convenience and economy may suggest efficiency but they do not suggest essentiality.'

109. In *Case R63 84* ATC 457; (1984) 27 CTBR (NS) *Case 117* 934 the taxpayer was a company carrying on the *business of an advertising agency. The taxpayer claimed deductions for costs associated with a motor cruiser. The taxpayer claimed it used the boat for entertaining clients and potential clients. The deductions were disallowed by the Commissioner. When agreeing that the claims were not allowable Mr PM Roach (Member) indicated that the requirement in question meant that the conduct of the taxpayer's *business required for its efficient conduct using a boat of the type in question. The use of the boat was not essential to the efficient conduct of the *business if the *business could be conducted efficiently without the use of such a boat.

110. The requirement will not be satisfied if use of the boat is merely convenient, an aid or economical. The boat must be essential to the efficient conduct of the *business.

111. If the boat is not held for use as mentioned in paragraph 26-50(5)(d), deductions for the decline in value of that boat are also reduced under subsection 40-25(4)¹⁰.

Schemes to avoid section 26-50

112. Subsection 26-50(7) is an anti-avoidance provision which states:

'(7) A *leisure facility or boat is taken not to be used (or held) as described in subsection (3) or (5) if:

- (a) apart from this subsection, the leisure facility or boat would be used (or held) in that way because of a *scheme; and

¹⁰ Note: In many circumstances where deductions are denied in respect of a boat under section 26-50, amounts received from letting the boat will still be assessable income in the hands of the boat owner.

- (b) in the Commissioner's opinion, the scheme would not have been entered into or carried out if this section had not been enacted.'

113. Where it appears that the main reason a boat hire arrangement was entered into in a particular manner was to avoid the operation of section 26-50, consideration will be given to the application of the anti-avoidance provision contained in subsection 26-50(7). In forming this opinion, the Commissioner will take into account any evidence of:

- non-arm's length dealing;
- collusion;
- collateral advantages; or
- other elements of artificiality that point to a contrivance directed towards a particular tax outcome.

that might be obtained from arrangements that are entered into.

Apportionment of expenses

114. Losses and outgoings are not deductible under section 8-1 to the extent they are capital or private in nature, or are incurred in relation to earning exempt income. Accordingly, in appropriate circumstances, the section allows for an apportionment between the deductible and non-deductible components of a loss or outgoing: *Ronpibon Tin NL v. FC of T* (1949) 4 AITR 236; 78 CLR 47; *Ure v. FC of T* (1981) 11 ATR 484; 81 ATC 4100.

115. Where a boat is held or used in a manner that satisfies subsection 26-50(5), expenses referable to the taxpayer's personal use of the boat are not allowable deductions. Therefore, many of the expenses incurred may need to be apportioned to reflect the business and non-business use of the boat.

116. Not all expenses incurred in relation to a boat charter activity will necessarily need to be apportioned between business and private purposes however, and the most appropriate basis of apportioning different expenses will not necessarily be the same. For the purpose of identifying the amounts which relate to the private use of a boat, 3 categories of expenses can be identified:

- Category 1: expenses which can traced directly to either private or business use of the boat (e.g. fuel or catering expenses);
- Category 2: variable expenses which are directly related to using the boat but can not be directly traced to either use (e.g. general maintenance); and

Category 3: fixed expenses which are unrelated to the use of the boat (e.g. interest and depreciation).

117. Clearly, as category 1 expenses can be directly traced to particular use of the boat, they do not need to be apportioned. Instead they can be allocated directly to private or business objects. Category 2 and 3 expenses however have dual purposes, but this does not mean that they will necessarily all be properly apportionable on the same basis. In *Ronpibon Tin* at 78 CLR 59 the court stated that:

‘The question what expenditure is incurred in gaining or producing assessable income is reduced to a question of fact when once the legal standard or criterion is ascertained and understood. This is particularly true when the problem is to apportion outgoings which have a double aspect, outgoings that are in part attributable to the gaining of assessable income and in part to some other end or activity. It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently... With the latter kind, there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects.’

Further, at page 60 the court stated that:

‘The Court must make an apportionment which the facts of the particular case may seem to make just, and the facts of the present cases are rather special. In making the apportionment the peculiarities of the cases cannot be disregarded ... The question of fact is therefore to make a fair appointment to each object of the companies’ actual expenditure where items are not in themselves referable to one object or the other.’

118. Category 2 expenses are mainly dependant on the actual usage of the boat, for example general repairs and maintenance. Given the direct relationship between the usage of the boat and the expense being incurred, the most appropriate apportionment of these expenses may be based on the use of the boat. That is, if the boat is chartered for 80 days during the year and used privately for 20 days, an appropriate apportionment for these expenses may be 20/100.

119. Category 3 expenses on the other hand are incurred whether the boat is actually used or not, for example interest and depreciation. For these expenses, an appropriate amount to be excluded for private use of the boat may be based on the period of time that the boat is held and available for letting it on hire. Where the boat is genuinely available for letting on hire for the whole year therefore, an appropriate apportionment may be calculated by dividing the number of days the boat is used for private purposes by 365.

120. It is important to note however, that the apportionment for private use of the boat discussed in paragraphs 116 and 117 above are guides only. The appropriate apportionment of expenses must be determined by each taxpayer based on their individual circumstances.

Examples

121. The following examples illustrate the principles outlined in the Ruling. It is not possible in these examples to identify all possible arrangements a taxpayer may enter into with respect to a boat. The examples have been designed to highlight the factors that indicate when a *business of leasing a boat or boats is being carried on. Although a particular type of boat is used in each example, the principles illustrated apply equally to all types of boat (for example, house boats, cruisers, yachts, motor boats, catamarans and other water vessels). In the interests of readability, the amount of information contained in the examples is also necessarily less than the amount of information that the Commissioner would ordinarily seek to consider fully the question at issue.

122. Note that the calculations of profit and loss as shown in the examples have been prepared on the basis of profit and loss for accounting purposes, not for taxation purposes. The reason for this is that in each example the object of the profit and loss calculation is to determine whether the activity has a prospect of a significant and commercially realistic profit. In addition, in all of the examples, the business plans are assumed to have been prepared on a bona fide basis, using information available from other experienced people within the industry.

Example 1(a): single boat arrangement that amounts to carrying on a *business

123. Lionel purchased a yacht for \$300,000 which he funded by a loan over a 5 year term with a final balloon payment of \$120,000. Lionel believes that at the end of 5 years, based on his research, his boat will have a market value of \$210,000. Lionel entered into a 5 year management agreement with an experienced charter operator,

Barry's Boat Hire, who added Lionel's yacht to their fleet of boats available for charter.

124. At the end of 5 years Lionel intends to re-finance his boat over another 4 years with no balloon payment. He also intends to enter into another agreement for a further 5 years, either with Barry's Boat Hire or another charter operator. Lionel expects his yacht to have a market value of approximately \$180,000 at the end of the 10 year plan based on his market research.

125. Barry's Boat Hire enters into contracts with the general public to provide clients with a boat from the Barry's Boat Hire fleet, and collects the proceeds from this on behalf of Lionel. Barry's Boat Hire has the right to allocate any boat from the fleet to any particular charter contract. Lionel has the right to 4 weeks per year private use of his yacht subject to its availability. The charter operations take precedence over Lionel's private use.

126. The agreement between Lionel and Barry's Boat Hire is written as a management agreement in respect of the yacht. The day to day operations of the yacht are managed by Barry's Boat Hire, who also ensures that the boat is surveyed and kept in a suitable condition for charter throughout the year. Barry's Boat Hire also has the appropriate indemnity cover to protect themselves and the boat owners. Lionel maintains regular contact with Barry's Boat Hire to discuss:

- the condition of the yacht and its maintenance;
- promotion and marketing of the yacht; and
- market conditions and potential growth in the earnings from the yacht.

127. In addition to providing the yacht for hire, as a part of the agreement with Lionel for the management of his yacht activity, Barry's Boat Hire also provides the following services for the hirer:

- customer inquiry and booking services;
- issuing of accounts and processing of deposits and payments;
- reception area for charter guests;
- pre-charter briefing including training and assistance in the correct operation of the boat and safety equipment;
- access to jetties with electric power, hot and cold water, waste disposal facilities and fuelling facilities;
- support infrastructure for the hirer while the boat is on charter, including a radio and rescue service; and

- additional services connected with the boat charter, including booking services for:
 - activities and facilities in the area;
 - permits for entrance to various areas;
 - flights and other transport; and
 - hotel and dinner reservations.

128. Under the management agreement, Barry's Boat Hire is entitled to 25% of the gross charter income generated by Lionel's boat. This fee covers the provision of all of the above services including mooring of the boat.

129. Boats in the Barry's Boat Hire fleet are normally expected to be let out for an average of 185 days each year and Lionel expects that he will normally use it himself on approximately 14 days each year. Barring any unforeseen events, the boat is expected to be available to the public for charter throughout the year.

130. On the 14th day of each month Lionel receives a statement from Barry's Boat Hire setting out the gross charter income received for his yacht and a report notifying him when the yacht had been chartered and any repairs that had been organised for his boat for the previous month. Lionel adds these to his own business records in respect of the yacht.

131. Lionel calculated his depreciation expense on the boat as \$18,000 per year for the first 5 years and \$6,000 for the next 5 years based on his estimated market values at years 5 and 10.

132. Lionel developed the following schedule of his anticipated income and expenses from the activity to determine its prospect of profit for the 10 years he intends use the yacht in the charter activity:

| Year | 1 | 2 | 3 | 4 | 5 |
|-------------------|-----------|-----------|----------|----------|----------|
| Charter Income | \$96,000 | \$96,000 | \$96,000 | \$96,000 | \$96,000 |
| | | | | | |
| Management Fees | \$24,000 | \$24,000 | \$24,000 | \$24,000 | \$24,000 |
| Less: Private 4%* | -\$960 | -\$960 | -\$960 | -\$960 | -\$960 |
| Running Costs | \$48,000 | \$48,000 | \$48,000 | \$48,000 | \$48,000 |
| Less: Private 7%* | -\$3,360 | -\$3,360 | -\$3,360 | -\$3,360 | -\$3,360 |
| Interest | \$18,250 | \$16,250 | \$14,000 | \$11,500 | \$9,000 |
| Less: Private 4%* | -\$730 | -\$650 | -\$560 | -\$460 | -\$360 |
| Decline in Value | \$18,000 | \$18,000 | \$18,000 | \$18,000 | \$18,000 |
| Less: Private 4%* | -\$720 | -\$720 | -\$720 | -\$720 | -\$720 |
| Net Expenses | \$102,480 | \$100,560 | \$98,400 | \$96,000 | \$93,600 |
| | | | | | |
| Income / Loss | -\$6,480 | -\$4,560 | -\$2,400 | \$0 | \$2,400 |

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| Year | 6 | 7 | 8 | 9 | 10 | Total |
|-------------------|----------|----------|----------|----------|----------|------------------|
| Charter Income | \$96,000 | \$96,000 | \$96,000 | \$96,000 | \$96,000 | \$960,000 |
| Management Fees | \$24,000 | \$24,000 | \$24,000 | \$24,000 | \$24,000 | \$240,000 |
| Less: Private 4%* | -\$960 | -\$960 | -\$960 | -\$960 | -\$960 | -\$9,600 |
| Running Costs | \$50,000 | \$50,000 | \$50,500 | \$50,500 | \$51,000 | \$492,000 |
| Less: Private 7%* | -\$3,500 | -\$3,500 | -\$3,535 | -\$3,535 | -\$3,570 | -\$34,440 |
| Interest | \$7,000 | \$5,000 | \$3,250 | \$1,000 | \$0 | \$85,250 |
| Less: Private 4%* | -\$280 | -\$200 | -\$130 | -\$40 | \$0 | -\$3,410 |
| Decline in Value | \$6,000 | \$6,000 | \$6,000 | \$6,000 | \$6,000 | \$120,000 |
| Less: Private 4%* | -\$240 | -\$240 | -\$240 | -\$240 | -\$240 | -\$4,800 |
| Net Expenses | \$82,020 | \$80,100 | \$78,885 | \$76,725 | \$76,230 | \$885,000 |
| Income / Loss | \$13,980 | \$15,900 | \$17,115 | \$19,275 | \$19,770 | \$75,000 |

*Note: Lionel considers that a proportion of the expenses incurred in respect of the boat are referable to his private use. The management fees, interest and decline in value are most closely referable to holding the boat. Consequently, the private proportion has been calculated based on the number of days that the boat is held against the days that it is used for private purposes ($14/365 = 4\%$). The running expenses are most closely referable to the actual use of the boat. Therefore, the private proportion has been calculated based on the total days that the boat is actually used against the days that it is used for private purposes ($14/199 = 7\%$).

133. Lionel expects to make a significant profit from the hire activity of \$75,000 over the 10 years he intends to carry out the arrangement. The activity has a significant commercial purpose and also displays most of the other characteristics of a business as discussed in paragraphs 62 to 92. The written documentation and the actual conduct of the activity indicate that the agreement is for the management of Lionel's yacht activity, rather than the lease of his yacht to Barry's Boat Hire. Lionel, through Barry's Boat Hire, provides more than just the use of the yacht to the hirer, but a range of services related to that hire. The overall impression gained is that of a business being carried on by Lionel in respect of the yacht hire activity.

134. The income received is assessable in his hands and the expenses incurred are allowable subject to the normal deduction provisions of the ITAA 1997.

Example 1(b): single boat arrangement that does not amount to carrying on a *business

135. Lenny purchases an identical yacht on the same terms as Lionel in example 1(a). Lenny intends to enter into a 5 year arrangement with a different charter operator in a different location, Coldwater Sailing Experiences. The terms of the agreement and the services offered by Coldwater Sailing are similar to Barry's Boat Hire in example 1(a), however with Coldwater Sailing, he expects his yacht will only be hired out on about 60 days per year, though it will be available for hire throughout the year. Therefore Lenny believes that his income and running costs will be commensurately lower than Lionel's in example 1(a). In addition, Lenny intends to take the boat out of charter at the end of the 5 year arrangement.

136. Due to the less intense business usage of his yacht, he expects that his boat will have a market value of \$240,000 after the 5 year arrangement. Also, due to the more convenient location of the yacht to his home, Lenny believes that he will use the boat privately on about 20 days of the year. Lenny's expected income and expenses are as follows:

| Year | 1 | 2 | 3 | 4 | 5 | Total |
|---------------------|-----------|-----------|-----------|-----------|-----------|------------------|
| Charter Income | \$30,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 | \$150,000 |
| Management Fees | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$37,500 |
| Less Private: 5.5%* | -\$413 | -\$413 | -\$413 | -\$413 | -\$413 | -\$2,065 |
| Running Costs | \$19,500 | \$19,500 | \$19,500 | \$19,500 | \$19,500 | \$97,500 |
| Less Private: 25%* | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 | -\$24,375 |
| Interest | \$18,250 | \$16,250 | \$14,000 | \$11,500 | \$9,000 | \$69,000 |
| Less Private: 5.5%* | -\$1,004 | -\$894 | -\$770 | -\$633 | -\$495 | -\$3,796 |
| Decline in Value | \$12,000 | \$12,000 | \$12,000 | \$12,000 | \$12,000 | \$60,000 |
| Less Private: 5.5%* | -\$660 | -\$660 | -\$660 | -\$660 | -\$660 | -\$3,300 |
| Net Expenses | \$50,298 | \$48,408 | \$46,282 | \$43,919 | \$41,557 | \$230,464 |
| Income / Loss | -\$20,298 | -\$18,408 | -\$16,282 | -\$13,919 | -\$11,557 | -\$80,464 |

*Note: Lenny considers that a proportion of the expenses incurred in respect of the boat are referable to his private use. The management fees, interest and decline in value are most closely referable to holding the boat. Consequently, the private proportion has been calculated based on the number of days that the boat is held against the days that it is used for private purposes ($20/365 = 5.5\%$). The running expenses are most closely referable to the actual use of the boat. Therefore, the private proportion has been calculated based on the total days that the boat is actually used against the days that it is used for private purposes ($20/80 = 25\%$).

137. In this case, Lenny clearly cannot make an overall profit from the yacht hire activity because the expected expenses far outweigh the expected income over the planned operation of the activity. In this example, the activity is expected to result in an overall loss of \$80,464. Consequently, the activity does not have a significant commercial purpose or a prospect of profit. Although many of the other indicators of a business are satisfied, the overall impression gained is still not that of a business. Consequently, Lenny is not carrying a business in respect of the yacht hire activity.

138. The income derived in respect of the yacht each month is assessable income in Lenny's hands but any expenses are not allowable deductions by virtue of section 26-50 and subsections 40-25(3) and (4) of the ITAA 1997.

Example 2(a): multiple boat arrangement that amounts to carrying on a *business

139. Chester purchased a yacht for \$300,000, which he funded by a deposit of \$120,000 and a finance agreement for the remaining \$180,000. The finance agreement is for a 5 year term, with a final balloon payment of \$72,000. Chester entered into a 5 year management agreement with an experienced charter operator, Tiggersail, who added Chester's yacht to their fleet of boats available for charter.

140. At the end of 5 years Chester intends to trade in the yacht for a new one. He expects to receive approximately \$240,000 for the original yacht and plans to purchase a new yacht for approximately \$330,000. Chester intends to enter into a further 5 year agreement in respect of the new yacht with a charter company, after evaluating the performance of the first yacht and the historical performance of yachts in other fleets. He will finance the new yacht through another finance agreement. This time he will only need to finance \$162,000, due to the equity he expects to have left over from the sale of the original yacht. He intends to enter into a 5 year finance agreement with a final balloon payment of \$64,800. He believes that his second yacht will have market value of \$264,000 at this time.

141. Chester intends to enter into a further management agreement with a charter operator for another 5 years. He also intends to finance the remaining \$64,800 owing on the second yacht for a further 4 years, by which time it will be paid off in full. Based on historic resale values, Chester expects the second yacht will have a retained value of \$231,000 after 10 years in charter, being his 15th year of operation.

142. Tiggersail enters into contracts with the general public to provide clients with a boat from the Tiggersail Fleet and collects the proceeds on behalf of Chester. Tiggersail has the right to allocate any boat from the fleet to any particular charter contract. Chester has the right to 4 weeks per year private use of his yacht subject to its availability. The charter operations take precedence over Chester's private use.

143. The agreement between Chester and Tiggersail is written as a management agreement in respect of the yacht. The day to day operations of the yacht are managed by Tiggersail, which also ensures that the boat is surveyed and kept in a suitable condition for charter throughout the year. Tiggersail also has the appropriate indemnity cover to protect themselves and the boat owners. Chester maintains regular contact with Tiggersail to discuss:

- the condition of the yacht and its maintenance;
- promotion and marketing of the yacht; and
- market conditions and potential growth in the earnings from the yacht.

144. In addition to providing the yacht for hire, Tiggersail also provides the following services for the hirer:

- customer inquiry and booking services;
- issuing of accounts and processing of deposits and payments;
- reception area for charter guests;
- pre-charter briefing including training and assistance in the correct operation of the boat and safety equipment;
- access to jetties with electric power, hot and cold water, waste disposal facilities and fuelling facilities;
- support infrastructure for the hirer while the boat is on charter, including a radio and rescue service; and
- additional services connected with the boat charter, including booking services for:
 - activities and facilities in the area;
 - permits for entrance to various areas;
 - flights and other transport; and
 - hotel and dinner reservations.

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145. Under the management agreement, Tiggersail is entitled to 25% of the gross charter income generated by Chester's boat. This fee covers the provision of all of the above services including mooring of the boat.

146. Boats in Tiggersail's fleet are normally expected to be let out on average for 60 days each year and Chester expects that he will normally use it himself on approximately 20 days each year. Barring any unforeseen events, the boat is expected to be available to the public for charter throughout the year.

147. On the 7th day of each month Chester receives a statement from Tiggersail setting out the gross charter income received for his yacht and a report notifying him when the yacht had been chartered and any repairs that had been organised for his boat for the previous month. Chester adds these to his own business records in respect of the yacht.

148. Chester calculated an annual depreciation amount of \$12,000 per year for the first 5 years usage of the first yacht, \$13,200 per year for the first 5 years of the second yacht and \$6,600 for years 6 to 10 of the second yacht.

149. Chester developed the following schedule of his anticipated income and expenses from the activity to determine its prospect of profit for the 15 years he intends use the boats in the charter activity.

| Year | 1 | 2 | 3 | 4 | 5 |
|---------------------|----------|----------|----------|----------|----------|
| Charter Income | \$50,000 | \$52,000 | \$54,000 | \$54,000 | \$54,000 |
| | | | | | |
| Management Fees | \$12,500 | \$13,000 | \$13,500 | \$13,500 | \$13,500 |
| Less Private: 5.5%* | -\$688 | -\$715 | -\$743 | -\$743 | -\$743 |
| Running Costs | \$27,500 | \$28,000 | \$28,500 | \$28,500 | \$28,500 |
| Less Private: 25%* | -\$6,875 | -\$7,000 | -\$7,125 | -\$7,125 | -\$7,125 |
| Interest | \$12,250 | \$10,750 | \$9,250 | \$7,750 | \$6,000 |
| Less Private: 5.5%* | -\$674 | -\$591 | -\$509 | -\$426 | -\$330 |
| Decline in Value | \$12,000 | \$12,000 | \$12,000 | \$12,000 | \$12,000 |
| Less Private: 5.5%* | -\$660 | -\$660 | -\$660 | -\$660 | -\$660 |
| Net Expenses | \$55,353 | \$54,784 | \$54,213 | \$52,796 | \$51,142 |
| | | | | | |
| Income / Loss | -\$5,353 | -\$2,784 | -\$213 | \$1,204 | \$2,858 |

| Year | 6 | 7 | 8 | 9 | 10 |
|---------------------|----------|----------|----------|----------|----------|
| Charter Income | \$60,000 | \$62,000 | \$64,000 | \$64,000 | \$64,000 |
| Management Fees | \$15,000 | \$15,500 | \$16,000 | \$16,000 | \$16,000 |
| Less Private: 5.5%* | -\$825 | -\$853 | -\$880 | -\$880 | -\$880 |
| Running Costs | \$30,000 | \$30,500 | \$31,000 | \$31,000 | \$31,000 |
| Less Private: 25%* | -\$7,500 | -\$7,625 | -\$7,750 | -\$7,750 | -\$7,750 |
| Interest | \$8,500 | \$7,500 | \$6,500 | \$5,500 | \$4,250 |
| Less Private: 5.5%* | -\$468 | -\$413 | -\$358 | -\$303 | -\$234 |
| Decline in Value | \$13,200 | \$13,200 | \$13,200 | \$13,200 | \$13,200 |
| Less Private: 5.5%* | -\$726 | -\$726 | -\$726 | -\$726 | -\$726 |
| Net Expenses | \$57,181 | \$57,083 | \$56,986 | \$56,041 | \$54,860 |
| Income / Loss | \$2,819 | \$4,917 | \$7,014 | \$7,959 | \$9,140 |

| Year | 11 | 12 | 13 | 14 | 15 | Total |
|---------------------|----------|----------|----------|----------|----------|-------------------|
| Charter Income | \$62,000 | \$60,000 | \$58,000 | \$56,000 | \$56,000 | \$870,000 |
| Management Fees | \$15,500 | \$15,000 | \$14,500 | \$14,000 | \$14,000 | \$217,500 |
| Less Private: 5.5%* | -\$853 | -\$825 | -\$798 | -\$770 | -\$770 | -\$11,966 |
| Running Costs | \$32,500 | \$32,200 | \$31,920 | \$31,662 | \$31,928 | \$454,710 |
| Less Private: 25%* | -\$8,125 | -\$8,050 | -\$7,980 | -\$7,916 | -\$7,982 | -\$113,678 |
| Interest | \$3,250 | \$2,250 | \$1,500 | \$500 | \$0 | \$85,750 |
| Less Private: 5.5%* | -\$179 | -\$124 | -\$83 | -\$28 | \$0 | -\$4,720 |
| Decline in Value | \$6,600 | \$6,600 | \$6,600 | \$6,600 | \$6,600 | \$159,000 |
| Less Private: 5.5%* | -\$363 | -\$363 | -\$363 | -\$363 | -\$363 | -\$8,745 |
| Net Expenses | \$48,330 | \$46,688 | \$45,296 | \$43,685 | \$43,413 | \$777,851 |
| Income / Loss | \$13,670 | \$13,312 | \$12,704 | \$12,315 | \$12,587 | \$92,149 |

*Note: Chester considers that a proportion of the expenses incurred in respect of the boat are referable to his private use. The management fees, interest and decline in value are most closely referable to holding the boat. Consequently, the private proportion has been calculated based on the number of days that the boat is held against the days that it is used for private purposes ($20/365 = 5.5\%$). The running expenses are most closely referable to the actual use of the boat. Therefore, the private proportion has been calculated based on the total days that the boat is actually used against the days that it is used for private purposes ($20/80 = 25\%$).

150. Chester expects to make a significant profit of \$92,149 over the 15 years of the yacht hire activity. The activity has a significant commercial purpose and also displays most of the other characteristics of a business as discussed in paragraphs 62 to 92. The written documentation and the actual conduct of the activity indicates that the agreement is for the management of Chester's yacht activity, rather than the lease of his yacht to Tiggersail. Chester, through Tiggersail, provides more than just use of the yacht to the hirer, but a range of services related to that hire. The overall impression gained is that of a business being carried on by Chester in respect of the yacht hire activity.

151. The income received is assessable in his hands and the expenses incurred are allowable subject to the normal deduction provisions of the ITAA 1997.

Example 2(b): multiple boat arrangement that does not amount to carrying on a *business

152. Charlie purchased a yacht for \$300,000 which he funded by a finance agreement over a 5 year term with a final balloon payment of \$120,000. At this time Charlie believes that his yacht will have a market value of \$240,000. Charlie enters into an arrangement with Highwinds Southerly Sailing Adventures. The agreement with Highwinds and the services they offer are similar to Tiggersail in example 2(a), but Charlie expects that his yacht will not attract the same level charter income but his running costs will be lower.

153. At the end of year 5 Charlie intends to sell his first yacht and to purchase another. He expects that a replacement yacht will cost \$330,000 due to inflation. He does not intend to use the equity built up in the first yacht to reduce the amount borrowed for the second yacht. He expects therefore to finance the second yacht for 5 years with a final balloon payment of \$132,000. Charlie believes that his second yacht will have a market value of \$264,000 after 5 years in charter. As with his first yacht, he intends to enter into a management agreement with Highwinds or a with another charter operator on similar terms. He does not expect his income and expenses in respect of the second yacht to vary significantly from those in respect of the first.

154. Yachts in the Highwinds' fleet are generally expected to be used for charter on 60 days per year and Charlie expects that he will use the boat privately on about 20 days per year. Barring any unforeseen events, the boat is expected to be available to the public for charter throughout the year.

155. Charlie calculates that an appropriate amount for annual depreciation will be \$12,000 per annum for the first yacht and \$13,200 per annum for the second yacht. Consequently, Charlie's expected income and expenses for the 10 years are as follows:

| Year | 1 | 2 | 3 | 4 | 5 |
|---------------------|-----------|-----------|-----------|-----------|-----------|
| Charter Income | \$30,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 |
| Management Fees | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$7,500 |
| Less Private: 5.5%* | -\$413 | -\$413 | -\$413 | -\$413 | -\$413 |
| Running Costs | \$19,500 | \$19,500 | \$19,500 | \$19,500 | \$19,500 |
| Less Private: 25%* | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 |
| Interest | \$18,250 | \$16,250 | \$14,000 | \$11,500 | \$9,000 |
| Less Private: 5.5%* | -\$1,004 | -\$894 | -\$770 | -\$633 | -\$495 |
| Decline in Value | \$12,000 | \$12,000 | \$12,000 | \$12,000 | \$12,000 |
| Less Private: 5.5%* | -\$660 | -\$660 | -\$660 | -\$660 | -\$660 |
| Net Expenses | \$50,298 | \$48,408 | \$46,282 | \$43,919 | \$41,557 |
| Income / Loss | -\$20,298 | -\$18,408 | -\$16,282 | -\$13,919 | -\$11,557 |

| Year | 6 | 7 | 8 | 9 | 10 | Total |
|---------------------|-----------|-----------|-----------|-----------|-----------|-------------------|
| Charter Income | \$30,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 | \$300,000 |
| Management Fees | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$75,000 |
| Less Private: 5.5%* | -\$413 | -\$413 | -\$413 | -\$413 | -\$413 | -\$4,130 |
| Running Costs | \$19,500 | \$19,500 | \$19,500 | \$19,500 | \$19,500 | \$195,000 |
| Less Private: 25%* | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 | -\$4,875 | -\$48,750 |
| Interest | \$20,250 | \$17,750 | \$15,250 | \$12,750 | \$9,750 | \$144,750 |
| Less Private: 5.5%* | -\$1,114 | -\$976 | -\$839 | -\$701 | -\$536 | -\$7,962 |
| Decline in Value | \$13,200 | \$13,200 | \$13,200 | \$13,200 | \$13,200 | \$126,000 |
| Less Private: 5.5%* | -\$726 | -\$726 | -\$726 | -\$726 | -\$726 | -\$6,930 |
| Total Expenses | \$53,322 | \$50,960 | \$48,597 | \$46,235 | \$43,400 | \$472,978 |
| Income / Loss | -\$23,322 | -\$20,960 | -\$18,597 | -\$16,235 | -\$13,400 | -\$172,978 |

*Note: Charlie considers that a proportion of the expenses incurred in respect of the boat are referable to his private use. The management fees, interest and decline in value are most closely referable to holding the boat. Consequently, the private proportion has been calculated based on the number of days that the boat is held against the days that it is used for private purposes ($20/365 = 5.5\%$). The running expenses are most closely referable to the actual use of the boat. Therefore, the private proportion has been calculated based on the total days that the

boat is actually used against the days that it is used for private purposes ($20/80 = 25\%$).

156. Over the 10 years of operation, Charlie expects to make a loss from the yacht hire activity of \$172,978. If Charlie decides to continue with the yacht hire activity, there is little evidence of the activity becoming profitable over a longer term. Consequently, the activity does not have a significant commercial purpose or a prospect of profit. Although many of the other indicators of a business are satisfied, the overall impression gained is still not that of a business. Charlie is not carrying a business in respect of the yacht hire activity.

157. The income derived in respect of the yachts each month is assessable income in Charlie's hands but any expenses are not allowable deductions by virtue of section 26-50 and subsections 40-25(3) and (4) of the ITAA 1997.

Example 3: independent operator whose activity amounts to carrying on a *business

158. Chloe and Roma purchased a boat for \$300,000 with which they intend to operate a skippered tour activity. They purchased the boat via a finance agreement over a 5 year term with a final balloon payment of \$120,000. At the end of this term, Chloe and Roma intend to re-finance the remainder of the debt on the boat with a loan to be paid off in full over 4 years.

159. Their business plan demonstrates an intention to establish a skippered sightseeing charter business. The boat activity is advertised weekly in a number of national tourist magazines, newspapers, on a tourist website and various radio stations as guided tours including picnic lunches at scenic locations and sunset tours with a light supper.

160. Chloe and Roma have a business independent of the boats which provides them with an average yearly income in excess of \$60,000 each. Their freelance work enables them to be available at all times to operate tours. As their charter activity develops they intend to spend less time on the freelance work and more time on the boat charter activity.

161. Chloe and Roma have done considerable research into the industry in the area in which they intend to operate. Their research has indicated that they can expect their boat to have a market value of approximately \$210,000 at the end of 10 years and they have calculated their annual depreciation as \$9,000 on this basis.

162. Chloe and Roma expect that the boat will be used for charter on an average of 4 days in each week and they plan to use it privately on average for 1 day a week. The boat will be available for charter throughout the year.

163. Based on their research, Chloe and Roma project the following income and expenses over the first 10 years of their activity:

| Year | 1 | 2 | 3 | 4 | 5 |
|--------------------|----------|----------|----------|----------|----------|
| Charter Income | \$50,000 | \$50,000 | \$50,000 | \$50,000 | \$50,000 |
| Business Only Exp. | \$5,000 | \$5,000 | \$5,000 | \$5,000 | \$5,000 |
| Fixed Exp. | \$10,000 | \$10,000 | \$10,000 | \$10,000 | \$10,000 |
| Less Private: 14%* | -\$1,400 | -\$1,400 | -\$1,400 | -\$1,400 | -\$1,400 |
| Running Costs | \$15,000 | \$15,000 | \$15,000 | \$15,000 | \$15,000 |
| Less Private: 20%* | -\$3,000 | -\$3,000 | -\$3,000 | -\$3,000 | -\$3,000 |
| Interest | \$18,250 | \$16,250 | \$14,000 | \$11,500 | \$9,000 |
| Less Private: 14%* | -\$2,555 | -\$2,275 | -\$1,960 | -\$1,610 | -\$1,260 |
| Decline in Value | \$9,000 | \$9,000 | \$9,000 | \$9,000 | \$9,000 |
| Less Private: 14%* | -\$1,260 | -\$1,260 | -\$1,260 | -\$1,260 | -\$1,260 |
| Total Expenses | \$49,035 | \$47,315 | \$45,380 | \$43,230 | \$41,080 |
| Income / Loss | \$965 | \$2,685 | \$4,620 | \$6,770 | \$8,920 |

| Year | 6 | 7 | 8 | 9 | 10 | Total |
|--------------------|----------|----------|----------|----------|----------|------------------|
| Charter Income | \$50,000 | \$50,000 | \$50,000 | \$50,000 | \$50,000 | \$500,000 |
| Business Only Exp. | \$5,000 | \$5,000 | \$5,000 | \$5,000 | \$5,000 | \$50,000 |
| Fixed Exp. | \$10,000 | \$10,000 | \$10,000 | \$10,000 | \$10,000 | \$100,000 |
| Less Private: 14%* | -\$1,400 | -\$1,400 | -\$1,400 | -\$1,400 | -\$1,400 | -\$14,000 |
| Running Costs | \$17,000 | \$17,000 | \$17,500 | \$17,500 | \$18,000 | \$162,000 |
| Less Private: 20%* | -\$3,400 | -\$3,400 | -\$3,500 | -\$3,500 | -\$3,600 | -\$32,400 |
| Interest | \$7,000 | \$5,000 | \$3,250 | \$1,000 | \$0 | \$85,250 |
| Less Private: 14%* | -\$980 | -\$700 | -\$455 | -\$140 | \$0 | -\$11,935 |
| Decline in Value | \$9,000 | \$9,000 | \$9,000 | \$9,000 | \$9,000 | \$90,000 |
| Less Private: 14%* | -\$1,260 | -\$1,260 | -\$1,260 | -\$1,260 | -\$1,260 | -\$12,600 |
| Total Expenses | \$40,960 | \$39,240 | \$38,135 | \$36,200 | \$35,740 | \$416,315 |
| Income / Loss | \$9,040 | \$10,760 | \$11,865 | \$13,800 | \$14,260 | \$83,685 |

*Note: The expenses shown as 'Business Only Exp.' do not need to be apportioned for the private use of the boat. They relate solely to the business operations. Expenses in this category include, for example, advertising expenses and office expenses. Chloe and Roma consider that a proportion of the remainder of the expenses incurred in respect of the boat are referable to their private use. The fixed expenses (which include, for example, mooring fees), interest and decline in value are most closely referable to holding the boat. Consequently, the private proportion has been calculated based on the number of days

that the boat is held against the days that it is used for private purposes ($52/365 = 14\%$). The running expenses are most closely referable to the actual use of the boat. Therefore, the private proportion has been calculated based on the total days that the boat is actually used against the days that it is used for private purposes ($52/260 = 20\%$).

164. Chloe's and Roma's activity amounts to the carrying on of a *business. The factors that indicate that a business is being carried on are:

- the activity has a significant commercial purpose and in particular, they are able to demonstrate a strong prospect of obtaining a significant profit;
- the business plan demonstrates a clear intention to make a significant profit as well as a prospect of profit from the activity;
- the repetition and regularity of the activity; and
- the activity is conducted in a business-like manner.

165. The income from this activity is assessable under section 6-5. Deductions related to the yacht are not denied or reduced under section 26-50 and subsections 40-25(3) and (4), as Chloe and Roma are carrying on a *business in relation to the boat.

Example 4: provision of boat under a lease agreement does not amount to carrying on a *business

166. Susan purchased a houseboat for \$300,000 via a finance agreement over a 5 year term with a final balloon payment of \$120,000. She immediately entered into a 5 year lease agreement with Downstream Houseboat Hire in which she granted exclusive use and possession to Downstream Houseboat Hire to use the houseboat in their hire activities. In return Susan received a fixed monthly lease payment of \$24,000 and the right to use the houseboat for up to 4 weeks per year. Susan played no active role in the hire activities in relation to her houseboat.

167. Susan is not carrying on a *business in respect of her houseboat. Susan is in receipt of income passively under a lease agreement with Downstream Houseboat Hire. As a consequence, the income that Susan receives under the lease agreement will be assessable, but none of the expenses in relation to the houseboat will be allowable deductions by virtue of section 26-50 and subsections 40-25(3) and (4) of the ITAA 1997.

Corresponding provisions of the ITAA 1936 and the ITAA 1997

168. The following table cross references the provisions of the ITAA 1997 referred to in this Ruling to the corresponding provisions of the ITAA 1997 and the ITAA 1936.

| Current Provisions | Old 1997 provisions | 1936 provisions |
|---------------------------|-----------------------------------|------------------------|
| 6-5(1),(2),(3) | | 25(1) |
| 8-1 | | 51(1) |
| 26-50(1) | | 51AB(3)(b), (4) |
| 26-50(2), (3) | | 51AB(1) (in part) |
| 26-50(4), (6) | | 51AB(5), (6) |
| 26-50(5) | | 51AB(1) (in part) |
| 26-50(7) | | 51AB(2) |
| 40-25(3) and(4) | 42-45(3) and 42-170(2) and (3) | 54(3) |

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Commissioner of Taxation

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Previous draft:

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*Related Rulings/Determinations:*TR 92/1; TR 92/20; TR 97/11;
TR 97/16; MT 2000/1*Subject references:*

- allowable deductions
- anti-avoidance measures
- assessable income
- boat
- boat charter
- carrying on a business
- catamaran
- charter activity
- cruiser
- houseboat
- lease
- leisure craft
- leisure facilities
- negatively geared investment
- passive income
- rental
- tax avoidance
- water craft
- yacht
- yacht charter

Legislative references:

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- ITAA 1936 51(1)
- ITAA 1936 51AB
- ITAA 1936 51AB(1)
- ITAA 1936 51AB(2)
- ITAA 1936 51AB(3)(b)
- ITAA 1936 51AB(4)
- ITAA 1936 51AB(5)
- ITAA 1936 51AB(6)
- ITAA 1936 54(3)
- ITAA 1936 54(3A)
- ITAA 1936 54(4)
- ITAA 1997 Div 6
- ITAA 1997 6-5
- ITAA 1997 6-5(1)
- ITAA 1997 6-5(2)
- ITAA 1997 6-5(3)
- ITAA 1997 8-1
- ITAA 1997 26-50
- ITAA 1997 26-50(1)
- ITAA 1997 26-50(2)
- ITAA 1997 26-50(3)
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- ITAA 1997 26-50(5)
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- ITAA 1997 40-25
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- Kwikspan Purlin System Pty Ltd. v. FC of T 84 ATC 4282; (1994) 15 ATR 531
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Case references:

- American Leaf Blending Co Sdn Bhd v. Director-General of Inland Revenue [1978] 3 All ER 1185
- Case G10 (1974) 75 ATC 33; 19 CTBR (NS) Case 103
- Case H11 76 ATC 59; (1976) 20 CTBR Case 65
- Case M36 (1990) 12 NZTC 2,224
- Case R63 84 ATC 457; (1984) 27 CTBR (NS) Case 117 934
- Case 6/2001 AATA 965; 2001 ATC 142, (2001) 48 ATR 1176
- Cecil Crees v. Commissioner of Taxation 2001 ATC 2021; (2001) 46 ATR 1091
- Cooke v. FC of T; Jamieson v. FC of T [2002] FCA 1315
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- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47; (1949) 4 AITR 236
- State Superannuation Board (NSW) v. FC of T 88 ATC 4382; (1988) 19 ATR 1264; 82 ALR 63
- Stone v. FC of T [2002] FCA 1492
- Taxiway Pty Ltd v. Commissioner of State Revenue (Vic) 95 ATC 4667; (1995) 31 ATR 362
- Thomas v. FC of T 72 ATC 4094; (1972) 3 ATR 165
- Tweddle v. FC of T (1942) 180 CLR 1; (1942) 7 ATD 186; 2 AITR 360
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- Universal Press Pty. Ltd. v. FC of T 89 ATC 5234; (1989) 20 ATR 1758
- Unisys Corp Inc v. FC of T 2002 ATC 5146; (2002) 51 ATR 386
- Wertman v. Minister of National Revenue 64 DTC 5158

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Appendix

SECTION 26-50 Expenses for a leisure facility or boat

26-50(1) You cannot deduct under this Act a loss or outgoing to the extent you incur it:

- (a) to acquire ownership of a *leisure facility or boat;
- (b) to retain ownership of a *leisure facility or boat;
- (c) to acquire rights to use a *leisure facility or boat;
- (d) to retain rights to use a *leisure facility or boat;
- (e) to use, operate, maintain or repair a *leisure facility or boat;
- (f) in relation to any obligation associated with your ownership of a *leisure facility or boat; or
- (g) in relation to any obligation associated with your rights to use a *leisure facility or boat.

However, there are exceptions (see subsections (3), (4), (5), (6) and (8)).

What is a leisure facility?

26-50(2) A *leisure facility* is land, a building, or part of a building or other structure, that is used (or held for use) for holidays or *recreation.

Exception - leisure facilities

26-50(3) Subsection (1) does not stop you deducting a loss or outgoing for a *leisure facility if at all times in the income year:

- (a) you hold the leisure facility for sale in the ordinary course of your business of selling leisure facilities; or
- (b) you use the leisure facility (or hold it for use) mainly to provide it:
 - (i) in the ordinary course of your *business of providing leisure facilities for payment;

- (ii) to produce your assessable income in the nature of rents, lease premiums, licence fees or similar charges;
- (iii) for your employees to use; or
- (iv) for the care of your employees' children.

In the case of a company, subparagraphs (b)(iii) and (iv) do not apply to employees who are *members or directors of the company.

Exception - part year use of leisure facilities

26-50(4) If you use a *leisure facility (or hold it) as described in subsection (3) at all times during *part* of the income year, then subsection (1) does not stop you deducting so much of the loss or outgoing as is reasonable in the circumstances.

Exception - boats

26-50(5) Subsection (1) does not stop you deducting a loss or outgoing for a boat if at all times in the income year you:

- (a) hold the boat as *trading stock for sale in the ordinary course of a *business that you carry on;
- (b) use the boat (or hold it) mainly for letting it on hire in the ordinary course of a *business that you carry on;
- (c) use the boat (or hold it) mainly for transporting for payment in the ordinary course of a *business that you carry on, the public or goods; or
- (d) use the boat for a purpose that is essential to the efficient conduct of a *business that you carry on.

Exception - part year use of boats

26-50(6) If you use a boat (or hold it) as described in subsection (5) at all times during *part* of the income year, then subsection (1) does not stop you deducting so much of the loss or outgoing as is reasonable in the circumstances.

Anti-avoidance - when exceptions do not apply

- 26-50(7) A *leisure facility or boat is taken not to be used (or held) as described in subsection (3) or (5) if:
- (a) apart from this subsection, the leisure facility or boat would be used (or held) in that way because of a *scheme; and
 - (b) in the Commissioner's opinion, the scheme would not have been entered into or carried out if this section had not been enacted.

Exception when you provide a fringe benefit

- 26-50(8) Subsection (1) does not stop you deducting expenditure you incur in *providing a *fringe benefit.