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Tax Insights

Housing integrity measures

On 9 May 2017 the Treasurer handed down the 2017-18 Federal Budget which had a strong emphasis on promoting housing affordability and assisting first home buyers enter the property market. Exposure Draft (ED) legislation is now starting to be released to implement and enact some of the announced measures.

Deduction of travel expenses for residential rental property

On 14 July 2017, the Australian government released ED legislation, together with accompanying explanatory material, on denying deductions for travel expenses related to residential premises used as residential accommodation.

This is an integrity measure to address concerns that many taxpayers have been claiming travel deductions without correctly apportioning costs, or have claimed travel costs that were for private purposes. As part of the Government's strategy to improve housing outcomes, this measure is intended to provide confidence in the tax system by ensuring eligibility for tax deductions is better targeted.

Subject to the exclusions discussed below, the ED legislation proposes to insert new section 26-31 into the *Income Tax Assessment Act 1997* (ITAA 1997), which will, from 1 July 2017, deny the deduction of a loss or expenditure attributable to travel where it is incurred in gaining or producing assessable income from the use of residential premises as residential accommodation, which is not being carried on as a business.

Amendments to the capital gains tax (CGT) cost base provisions in ITAA 1997 also are proposed, to ensure that disallowed deductions cannot form part of the cost base or reduced cost base of residential properties for CGT purposes.

Applying the provisions

The ordinary meaning of travel applies and is expected to include motor vehicle expenses, taxis or hire cars, airfares, public transport costs and any meals or accommodation related to the travel. The travel costs are not restricted to travel costs to and from the property itself, and will also include the travel costs of a third party that are paid for or reimbursed by the taxpayer.

The ED legislation adopts the definition of residential premises included in *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act), which already has been the subject of judicial scrutiny.

The legislation is also not restricted to entities that have a legal ownership interest in the property. Therefore, as drafted, any travel expenses incurred for any purpose associated with using residential premises as residential accommodation will be disallowed, unless the relevant income is being derived in the course of carrying that activity on as a business.

The Explanatory Material to the ED clarifies that the measures will not apply to the extent that the residential premises are being used for other income producing purposes, such as generating electricity from solar panels on the roof. Travel expenses incurred in respect of residential premises that are both being used as residential accommodation, and also for another income producing purpose, will need be apportioned on a just and reasonable basis.

Whilst this has been referred to as an integrity measure, the draft legislation is clear that the denial of the deduction is not targeted at only inappropriate claims; rather, expenditure of this nature will no longer be deductible in all cases that do not fall under the prescribed exceptions.

Notably travel deductions for investment in commercial real estate will remain deductible. The blanket denial of legitimate expenses appears harsh - perhaps a ceiling or cap on these types of claims would tackle the concerns in a more equitable manner?

Specific exceptions and exclusions

The ED legislation for the travel and depreciation measures specifically excludes the following entities from the operation of the travel measures:

- Corporate tax entities (that are not acting as a trustee);

- Superannuation plans that are not SMSFs; and
- Unit trusts that have at least 300 unit holders and are widely held.

The unit trust exclusion appears to require 300 direct unit holders, which could be seen as overly restrictive and misaligned with existing "widely held" tests (e.g. the "managed investment trust" widely held requirements or the "public unit trust" definition).

As noted, the measures will also not apply to taxpayers who derive assessable income from the carrying on of a business related to the use of residential premises to provide residential accommodation. Whether a taxpayer is carrying on such a business will be based on the overall impression of the activities and the relevant indicia of whether a business is carried on (for example, if the taxpayer has multiple rental properties).

Limitation of depreciation deductions to outlays actually incurred by investors

The 2017-18 Federal Budget also announced that depreciation deductions on plant and equipment would be limited to outlays actually incurred by investors providing residential property. This measure is due to questions over whether some plant and equipment items have been depreciated by successive residential investors in excess of their actual value or cost.

Whilst the announcement referred to "plant and equipment," the ED legislation which has now been released proposes to insert and amend relevant provisions in Division 40 of ITAA 1997 and, therefore, covers all "depreciating assets" in residential premises.

Properties acquired after 9 May 2017

Subject to exceptions and exclusions, the ED legislation will effectively now prevent investors who purchase residential investment premises from claiming deductions for depreciation in respect of items of plant and equipment that are purchased as an existing part of the property. However new items of plant and equipment later acquired by the investors themselves will be eligible for deductions for depreciation as normal.

Subsequent owners of existing or pre-owned plant and equipment will instead only be able to claim a capital loss in respect of the disallowed depreciation deductions when the relevant depreciating assets are either disposed of, or when they cease to be used in providing residential accommodation for residential use. In the unlikely event that the depreciating assets increase in value, a capital gain can also arise.

Effectively therefore the proposed legislation will largely serve to defer and recharacterise affected annual deductions for depreciation into capital losses, which will be quarantined to only be used against capital gains.

The implicit requirement to apportion any capital gains tax calculations between the building and the depreciating assets on disposal will be onerous and impractical. Perhaps an alternative compliance solution is needed, allowing taxpayers to elect on acquisition that any depreciating assets are included as part of the cost base of the building for CGT purposes?

Grandfathered property

In line with the original announcement, the ED legislation proposes to implement these changes with effect from 1 July 2017, with deductions relating to existing investments acquired on or before 9 May 2017 grandfathered (that is, including contracts already entered into at 7:30PM (AEST) on 9 May 2017).

Existing plant and equipment forming part of grandfathered residential investment property will therefore continue to give rise to deductions for depreciation until either the investor no longer owns the asset, or the asset reaches the end of its effective life.

New residential premises

The proposed amendments will not apply to depreciating assets installed in new residential premises (within the meaning of the GST Act) if no entity has previously been entitled to a depreciation deduction. This exclusion ensures that investors that purchase new residential premises from a developer are not precluded from claiming depreciation deductions due to the fact that the developer may have been the entity that actually purchased an item of plant and equipment.

Building allowance deductions

No amendments are proposed for "building allowance" deductions, which are addressed under Division 43 of ITAA 1997, and which already are limited to the expenditure incurred to construct the building (rather than the purchase price).

The government has also clarified that these changes will not prevent investors from claiming a deduction for the expense of engaging third parties, such as real estate agents, to provide property management services for investment properties.

Specific exceptions and exclusions

The same specific exceptions and exclusions that apply to the travel measures discussed above also apply to these depreciation measures. As such the following entities are excluded:

- Corporate tax entities (that are not acting as a trustee);
- Superannuation plans that are not SMSFs; and
- Unit trusts that have at least 300 unit holders and are widely held.

Similarly, the measures will not apply to taxpayers deriving assessable income from the carrying on of a business related to the use of residential premises to provide residential accommodation.

CGT changes for foreign investors

As part of the wider effort to reduce pressure on housing affordability, a number of changes to the foreign resident CGT rules were also announced.

To date, legislation has already been enacted which has increased the CGT withholding rate for foreign tax residents from 10 per cent to 12.5 per cent, and reduced the CGT withholding threshold for foreign tax residents from AUD 2 million to AUD 750,000, both with effect from 1 July 2017.

On 21 July 2017, ED legislation was also released in respect of two further CGT changes for foreign residents to take effect from 9 May 2017, being:

- the removal of the main residence exemption, and
- the strengthening of the principal asset test.

Removal of main residence exemption

To implement this announcement, the ED legislation proposes to amend the eligibility provisions for the main residence CGT exemption with effect for CGT events occurring after 9 May 2017.

Where a taxpayer is a foreign resident at the time of the relevant CGT event, the amendment will disallow any entitlement to full or partial CGT main residence exemptions in respect of dwellings that would otherwise have qualified as their main residence.

Notably this measure is an 'all or nothing' exclusion – unlike the application of the main residence CGT exemption when dwellings have also been used to derive assessable income. There is no proposed scope to time apportion the CGT main residence exemption between periods of residence and non-residence during the ownership period. The Explanatory Material to the ED makes it clear that previously occupying the dwelling as a main residence during any period of Australian residence does not affect the outcome.

Conversely where an individual had become a foreign resident, but re-establishes Australian residency for taxation purposes before the relevant CGT event occurs, the main residence exemption can apply (subject to the existing rules for a full or partial exemption).

Although the initial announcement contemplated the inclusion of temporary residents (including many New Zealand citizens residing in Australia on temporary visas), the ED legislation encompasses only foreign residents. Temporary residence status is broadly based on the holding of a temporary visa, so a temporary resident can be either a resident or a non-resident of Australia at a specific time. The actual tax residence status of a temporary resident at the time of the contract will therefore be critical.

The proposed amendments also ensure that the removal of the exemption extends to situations where dwellings are acquired from the deceased estates of foreign residents, and the rules affecting special disability trusts.

Transitional provisions have been included as section 118-110 of the Income Tax (Transitional Provisions) Act 1997 to grandfather the exemption for dwellings acquired before 9 May 2017, and sold before 30 June 2019. To obtain the exemption, the CGT event must occur before 30 June 2019, so it will be critical that for disposals the contract is entered into on or before 30 June 2019.

After 30 June 2019, all capital gains or losses arising upon disposal of a foreign resident's main residence will need to be recognised for tax purposes.

Principal asset test strengthened

With effect from 9 May 2017, the foreign resident CGT regime will also be modified. Generally under the foreign resident CGT regime, a capital gain or capital loss made by a foreign resident in respect of a membership interest is disregarded unless both a non-portfolio test and a principal asset test are satisfied in relation to the interest.

The principal asset test will be amended to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from taxable Australian real property, the test will apply on an associate-inclusive basis. This will ensure that foreign tax residents cannot avoid a CGT liability by disaggregating indirect interests in Australian real property.

We expect there will be pressure on the government to soften the impact of this main residence exemption proposal, perhaps allowing a partial exemption for Australian citizens and permanent residents for the period they were actually residing in their main residence.

It will be interesting to observe whether the expiration of the main residency exemption grandfathering will impact on the market in the period leading up to 30 June 2019, given that non-residents will move from no tax on disposal to suffering tax at top marginal rates (on the basis that the CGT discount is also not available).

The principal asset test integrity provision appears to be aimed at structures designed to take advantage of a lack of tracing through less than 10 per cent interests for the purposes of identifying whether an investment by a foreign resident is "taxable Australian real property", and therefore not eligible for the foreign resident CGT exemption.

The reduction in the CGT withholding threshold has now brought a significantly higher number of residential properties within the scope of these rules and will require many more vendors to approach the ATO for a residency "clearance certificate" to avoid the purchaser applying the withholding.

Housing-related superannuation changes

On 21 July 2017, ED legislation was also introduced to enact the two superannuation housing-related announcements in the 2017-18 Budget.

The proposed legislation for a First Home Super Saver Scheme (FHSSS) will allow individuals to save deposits for their first homes inside existing superannuation schemes from 1 July 2017. Under the scheme, first home savers who make voluntary contributions into the superannuation system will be able to withdraw those contributions, and an amount of associated earnings, for the purposes of purchasing first homes from 1 July 2018. Concessional tax treatment would apply to amounts withdrawn.

With effect from 1 July 2018, the ED legislation for a downsizing measure will also allow individuals aged 65 years or over to make additional non-concessional superannuation contributions of up to AUD 300,000 from the proceeds of selling their main residence that they have owned for 10 years or more.

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