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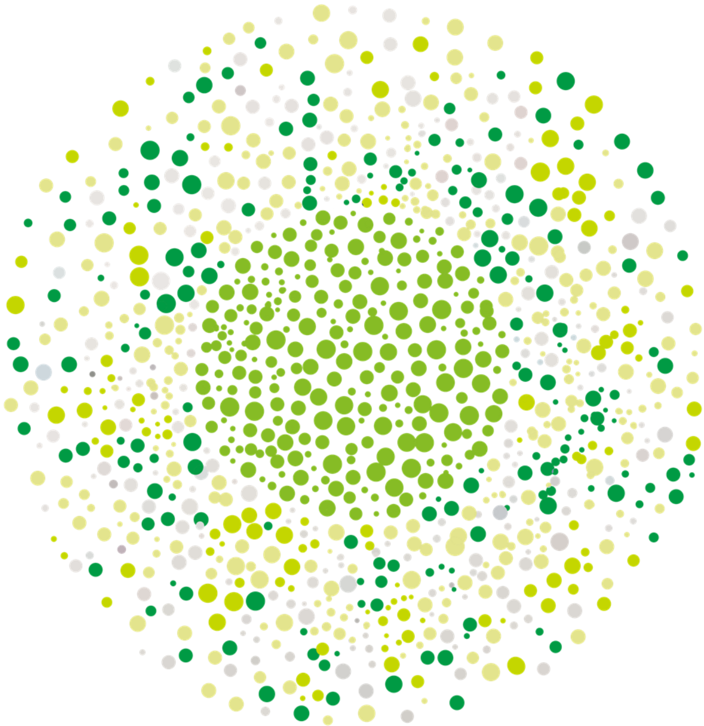

Federal Budget 2017-18

Tax Insights

Real estate tax measures

On 9 May 2017 the Treasurer handed down the 2017-18 Federal Budget which had a strong emphasis on infrastructure, promoting housing affordability and assisting first home buyers enter the property market. Some of the announced tax measures impact on the Australian real estate sector and Australian property developers.

Affordable housing measures

Two inter-related tax driven measures were announced that are intended to encourage investment into affordable housing.

Increased capital gains tax (CGT) discount

Generally, from 1 January 2018, the CGT discount will be increased from 50 per cent to 60 per cent for resident individuals investing in qualifying affordable housing, where the property has been held for a minimum of three years.

The increase to the CGT discount will only be available where the affordable housing is managed through a registered community housing provider. There is no requirement that the affordable housing be newly constructed.

The additional discount will also flow through to resident individuals investing in qualifying affordable housing through managed investment trusts (MITs) where the property has been held for a minimum of three years.

Non-residents will continue to be ineligible for the CGT discount, but could benefit from a concessional 15 per cent final withholding tax rate by investing in affordable housing MITs.

Superannuation funds will not be able to benefit from the additional 10 per cent CGT discount.

Managed investment trusts

The Government has also announced that new measures will be introduced that will enable MITs to invest in affordable housing for income years starting on or after 1 July 2017.

Under the current law, the ATO has generally taken the view that investment in residential property is primarily for the purpose of deriving a profit on disposal due to the low rental yield, and therefore not eligible for the existing MIT tax concessions, which apply to passive rental investments only.

Eligible MITs will be able to acquire, construct or redevelop residential property but must derive at least 80 per cent of its assessable income from affordable housing. Qualifying housing must be provided to low to moderate income tenants, with rent charged at a discount below the private rental market rate.

Up to 20 per cent of the income of the MIT may be derived from other eligible investment activities permitted under the existing MIT rules in the income tax law. If this threshold is breached, or less than 80 per cent of the MIT's income is from affordable housing in an income year, non-resident investors will be liable to pay withholding tax at 30 per cent on investment returns for that income year.

Should properties be held for a period of less than 10 years, non-resident investors resident for MIT purposes in a relevant exchange of information country can still receive the benefit of the concessional 15 per cent final withholding tax rate on investment returns, but will be subject to a 30 per cent final withholding rate on capital gains.

The Government will consult further on the implementation of this policy, including on the precise definition of affordable housing and tenant eligibility, and what qualifies as rent charged below the market rate.

It seems that the measures are designed to address some of the shortcomings of the National Rental Affordability Scheme (NRAS). One of the issues in connection with the NRAS was that income thresholds were fixed nationally and therefore did not appropriately target "key and essential service workers" in the higher wage cities. It is hoped that the tenant eligibility criteria may be more flexible under these proposals.

There are also a number of other barriers to institutional investment in residential properties which have previously been identified, including the impact of aggregation of properties on land tax costs.

There is obviously a lot more detail needed in order to assess this measure, and the announcement leaves a number of questions unanswered, including:

- Whether there will be a strict minimum holding period requirement in order to qualify for "flow through" treatment
- Whether a MIT can "control" an affordable housing MIT without failing the MIT requirements
- Whether affordable housing MIT capital gain distributions can "flow through" another trust without losing the benefit of the 60 per cent discount

From the limited information available, it does not seem like the rules will cater for the holding of market rental residential properties without potentially causing the MIT to lose "flow through" benefits. This might limit the appeal of the affordable housing MIT given that developers may look to integrate affordable housing within a broader housing development and investors may wish to hold a mix of residential properties to improve rental yield and capital growth.

CGT changes for foreign investors

As part of a wider effort to reduce pressure on housing affordability for Australians, the proposed Budget measures will significantly tighten the foreign resident CGT rules in relation to residential real estate by:

- Denying foreign and temporary tax residents access to the CGT main residence exemption from 7:30PM (AEST) on 9 May 2017. Existing properties held prior to this date will be grandfathered until 30 June 2019
- Increasing the CGT withholding rate for foreign tax residents from 10 per cent to 12.5 per cent, from 1 July 2017
- Reducing the CGT withholding threshold for foreign tax residents from $2 million to $750,000, from 1 July 2017.

The announced measures will also improve the integrity of the foreign resident CGT regime by applying the principal asset test on an associate-inclusive basis from 7:30PM (AEST) on 9 May 2017 to foreign tax residents with indirect interests in Australian real property.

This integrity measure is intended to ensure that foreign tax residents cannot avoid an Australian CGT liability by disaggregating indirect interests in Australian real property.

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 would move from no tax on disposal to suffering tax at top marginal rates (on the basis that the CGT discount is 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 will bring 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.

Tax Integrity Package — improving the integrity of GST on property transactions

With effect from 1 July 2018, the Government is aiming to strengthen the compliance of property developers with the GST laws by requiring purchasers of newly constructed residential properties or new subdivisions to remit the GST directly to the Australian Taxation Office (ATO) as part of the settlement process.

The context for this measure is that, in accordance with the current law, some property vendors have failed to remit the GST to the ATO as they are required to.

In these cases, it can be uneconomic for the ATO to pursue debt recovery action. This is typically because the vendor entities are 'special purpose vehicles' which may not have substantial assets remaining to satisfy the GST debt. Also, the opportunity for the ATO to have recourse to connected parties, such as directors, may be limited and can be complex and costly to pursue.

At this stage, detail on the mechanics of the proposed measure are scant, and so it remains unclear whether the purchasers will have a liability for the GST (in place of the vendor), or the purchasers will simply be participants in a 'withholding' arrangement (effectively paying over the amount on behalf of the vendor). Although superficially similar, the two mechanisms give rise to different considerations.

Depending on the mechanics ultimately adopted, some issues that might arise could include the following:

1. A key question is what would happen if the purchaser did not pay the GST to the ATO, or did not pay the correct amount. Would the vendor still be liable for any amount underpaid? What contractual protections should be put in place between the parties to deal with this possibility?

2. Would the purchaser simply pay GST to the ATO at 10% in every case? If so, and the margin scheme was applicable to the land transaction (which usually results in an effective GST rate of less than 10%), would the vendor be entitled to a credit or refund of the amount of GST overpaid by the purchaser?

3. If the purchaser is responsible for paying the actual margin scheme GST amount (where applicable), there is a practical question of how the purchaser would satisfy themselves that the GST amount is correct (noting that the margin scheme calculation is variable, and often involves complex computations and potentially contentious valuations in arriving at the amount of GST due). Some elements of the margin scheme calculation may be commercially sensitive for the vendor, which they may not want to disclose to actual or prospective purchasers.

4. Would there be an exemption for 'low risk' vendors, such as government organisations or entities with a historical record of compliance with their tax affairs?

5. Would there be an impact on how the purchase price of properties is displayed in marketing, in contracts etc.? Currently, vendors to individuals are often required to display prices on a GST-inclusive basis.

6. It would likely be important for pre-existing sale contracts or other arrangements (such as option agreements or 'Project Development Agreements') to be grandfathered so that the treatment under the current law is preserved. These arrangements might have been struck on the presumption that the vendor will have the responsibility for paying the GST, and so if that was not to ultimately transpire, it could affect the economics of the arrangements.

7. In circumstances where the purchaser is liable for the GST instead of the vendor, it may have the (likely unintended) result of reducing the stamp duty payable on the transaction. It remains to be seen how the States and Territories might respond to this proposed measure, given the potential impact on stamp duty revenues.

8. Some developers have already expressed the concern that not being paid the GST inclusive purchase price on settlement might reduce their capacity to borrow for development projects.

This change will fundamentally alter the way GST is accounted for on certain property transactions in a way that pre-existing contractual and other arrangements are unlikely to have foreseen. The changes may well be particularly pronounced (and potentially problematic) for transactions occurring under the margin scheme.

The precise mechanism to be adopted in implementing the measure, as well as any grandfathering made available, will be key to understanding the impact and managing any detrimental consequences.

Limit plant and equipment depreciation deductions to outlays actually incurred by investors

With effect from 1 July 2017, depreciation deductions on plant and equipment will be limited to outlays actually incurred by investors in residential real estate properties.

This is an integrity measure to address concerns that some plant and equipment items are being depreciated by successive investors in excess of their actual value or cost. The acquisition of existing plant and equipment items will need to be claimed as part of the cost base of the property for CGT purposes by subsequent investors.

These changes will apply on a prospective basis, with existing investments grandfathered. Plant and equipment forming part of residential investment properties as of 9 May 2017 (including contracts already entered into at 7:30PM (AEST) on 9 May 2017) will 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.

Investors who purchase plant and equipment for their residential investment property after 9 May 2017 will be able to claim a deduction over the effective life of the asset. However, subsequent owners of a property will be unable to claim deductions for plant and equipment purchased by a previous owner of that property.

While the announcement refers to "plant and equipment", it potentially covers all "depreciating assets", which can include large items which are not "easily removed" such as air conditioning and elevators. It does not seem to include "building allowance" deductions, which are in any event limited to the expenditure incurred to construct the building rather than the purchase price.

It is not clear whether the plant and equipment acquired by an investor on the purchase of a new dwelling would be considered to be expenditure incurred by the investor. As the purpose of the measures is stated to be the avoidance of "double dipping", it would be hoped that depreciation would be available to the investor in this case, as the plant and equipment has never been previously depreciated.

It is also unclear whether these measures will equally apply to affordable housing MITs or investors in larger scale residential properties, such as apartment buildings, retirement villages, tourism parks, student accommodation or manufactured housing estates.

If these limitations apply to these sectors, this will potentially limit the attractiveness of institutional investment in residential property compared to other real estate asset classes where tax depreciation is available for acquisitions of existing plant and equipment.

Given that there are also incentives for Affordable Housing MITs to hold residential properties for 10 years or more, the benefit of an increase in cost base for CGT purposes would be further diminished.

Deduction of travel expenses for residential rental property

From 1 July 2017, the Government will disallow deductions for travel expenses related to inspecting, maintaining or collecting rent for a residential rental property.

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 travel purposes. As part of the Government's strategy to improve housing outcomes, this measure will provide confidence in the tax system by ensuring tax concessions are better targeted.

While this is referred to as an integrity measure, there is no suggestion that the denial of the deduction will be targeted at inappropriate claims, and it appears that expenditure of this nature will no longer be deductible in all cases.

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