Draft Treasury Laws Amendment Bill 2017: Official submission from BMT Tax Depreciation, 9th August 2017

This submission has been prepared by national Quantity Surveying firm BMT Tax Depreciation (BMT) who specialise in the preparation of Property Tax Depreciation Schedules with 230 staff and 12 offices across Australia.

The purpose of this submission is to provide an official response to the Draft Treasury Laws Amendment (Housing Tax Integrity) Bill 2017.

This above mentioned Draft Bill outlines proposed legislation regarding the Government's decision to deliver an integrity measure addressing concerns that some plant and equipment assets are being depreciated by successive property investors in excess of their actual value.

A key area of this Bill is the amendment of the Income Tax Assessment Act 1997 which denies income tax deductions for the decline in value of 'previously used' depreciating assets (plant and equipment) within residential properties.

From the 1st of July 2017, the Government intends to limit plant and equipment depreciation deductions to only those outlays actually incurred by investors in residential properties. The acquisition of existing plant and equipment assets will be reflected in the cost base for capital gains tax purposes for subsequent investors.

Existing investments intend to be grandfathered, plant and equipment assets forming part of residential investment properties as of 9th of May 2017 (including contracts already entered into at 7:30pm (AEST) on 9th of 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 assets for a residential investment property after the 9th of 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 assets purchased by a previous owner of that property.

This measure targets a single investment class and goes beyond fixing the integrity issue

While there are gaps in current legislation around establishing a depreciable value for second hand plant and equipment, the proposed changes go further than what is necessary to address the integrity issue identified by the Government. Plant and equipment depreciation is a fundamental element of our tax system which should not be removed or altered based on a transaction.

The proposed changes will result in residential property investors (mum and dads, police, nurses and teachers) being treated differently to investors in other asset classes by proposing that the transaction of a property between two parties extinguishes the ability to claim a deduction for depreciation on plant and equipment assets within the property.

The approach proposed in the draft legislation also treats specific plant and equipment assets in residential investment properties differently to other investment classes.

The Tax Commissioner's published list of plant and equipment assets and effective lives (Tax Ruling 2016/1) identifies 6,507 depreciable assets across all industries, of which 167 relate to residential property investors. These changes are targeting a very small group of assets found in rental properties.

Under the proposed changes, a subsequent investor who purchases a business or retail suite such as a café or shop, will have different and sufficiently improved depreciation benefits applicable, compared to a mum and dad investor who purchase a residential property.

At times, these two investors could be within the same building complex with exactly the same assets such as carpets, blinds and hot water systems. They could even share the same lift. However, if these changes were to take effect, one would be able to claim a deduction for depreciation on the lift and a subsequent residential owner would not.

It is important to note that property investors predominantly target and buy second hand properties. In the 2015-2016 financial year BMT prepared 63,285 residential depreciation schedules. Of those the vast majority purchased second hand buildings.

Our data demonstrates that the average depreciation deduction claimed for plant and equipment assets on a typical three year old residential property, purchased for $600,000, is $21,178 for the first five years. The proposed changes would result in an average loss of $4,236 (deduction) per year in this scenario. Based on a marginal tax rate of 37 percent, an increase of $47 per week in rental income would be required to counter balance this reduction.

These changes will have a major impact on investors, reducing the annual deductions claimable and therefore reducing their cash return each year. This could lead to investors being in a tighter financial position, potentially increasing rents and discouraging investors from targeting second hand residential properties, most of which provide affordable housing for renters in lower socio economic areas.

Application of 'previously used' includes assets that were used for non-taxable purposes

BMT are concerned that assets that were acquired before the 9th of May 2017 will still be affected by the proposed changes. This is not a true grandfathered approach.

Paragraph 2.28 of the draft Treasury Laws Amendment Bill outlines the following –

An entity will have 'previously used' an asset if either:

- the entity is not the first entity that used the asset or installed the asset ready for use (within the meaning of Division 40) other than as trading stock; or
- the entity had used the asset wholly for purposes that were not taxable purposes (within the meaning of Division 40) for an income year.

The second point targets (presumably unintentionally) those who acquired a property for the purpose of living in the property for a period of time and then renting the property out later. This is a popular strategy among property investors who upgrade their primary place of residence and turn their previous residence into a rental property.

Paragraph 2.72 of the Draft Treasury Laws Amendment Bill mentions that the application of transitional provisions (referring to assets that were previously used prior to the announcement for non-taxable purposes) is to avoid creating unintended incentives for individuals to move personal assets into rental properties.

BMT prepare tens of thousands of property depreciation schedules every year and very rarely come across a situation where assets are moved from a home into an investment property. If this does take place there would be no opportunity to seek any advantage, provided the correct legislation is applied. Assets depreciate from the date of ownership whether they are used for taxable purposes or not. The difference is whether the owner is eligible to claim the decline in value as a deduction. Depreciation starts from the date ownership commences, there is no opportunity for an individual to claim in excess of the value of the asset simply because it was not previously used for taxable purposes.

This section goes beyond addressing the integrity issue identified by the Government. Assets acquired before the 9th of May 2017 should be allowed to continue to deduct an amount for the decline in value when they are located within an income producing property. The written down value can be easily calculated from when the asset was acquired.

This application will create confusion around when assets within a variety of scenarios qualify for the amendment, considering so many people adopt this strategy in a variety of ways. Some buy new and second hand properties, live in them and then rent the property out. Some move in and out of a rental property over time. Others are first home buyers forced to rent out their property due to changing circumstances often out of their control.

Treating residential property investors fairly – an alternative solution

BMT has prepared alternative methodologies for residential property investors. These options exclude corporate tax entities, large unit trusts or superannuation entities that are not self-managed.

Plant and equipment depreciation is a fundamental element of our tax system which should not be removed from any investment class. These alternative options will address the Government's integrity issue without removing a legitimate deduction available to property investors.

It is clear that there are gaps across all industries in current legislation around estimating depreciable values for second hand plant and equipment assets. A problem is created when an asset is sold, currently there is no clear costing methodology preventing an updated value being allocated to an asset each time it is purchased which can result in claims being made in excess of the assets value.

BMT would like to propose alternative methods focused around establishing a single historical value for depreciable plant and equipment assets that is carried forward and written down as it is claimed by the first and subsequent owners. When an asset is sold the written down value will become the opening value and maximum amount claimable by the subsequent owner, until there is no remaining un-deducted value left to claim. This will allocate each plant and equipment asset one value over an effective life regardless of how many owners the asset has had.

We believe some adjustments to the general depreciation legislation should be considered, these are as follows:

- Low value pooling and immediate write-off legislation for residential property investors may need to be reviewed. For an individual property investor, an asset can be claimed at an accelerated depreciation rate of 18.75% in the year of acquisition and 37.5% each year after for assets that qualify for a low value pool. These assets are qualified for the pool by costing or being valued at less than $1,000. Investors can choose not to use a low value pool. When an asset is allocated to the low value pool its identity is removed and an accelerated rate of depreciation is used. An investor can also utilise immediate write-off legislation, claiming 100% of an assets value in the first year of ownership for assets that are valued at less than $300. While ever there are alternative mechanisms which allow one owner to accelerate the rate of depreciation or completely write-off an asset, it will be difficult to administer a method which ensures the value used is in fact the true un-deducted written down value. This is because the history of claims can be difficult to substantiate on a case by case basis.
- Currently, a property investor can choose either a diminishing value method which accelerates the rate of depreciation and maximises the claim in the first five years or a flat line prime cost method which simply allows for the same yearly claim based upon the rate of depreciation. The prime cost method spreads out the deductions evenly over an assets effective life. Allowing a prime cost method only when establishing a rate of depreciation will avoid confusion by subsequent owners when an assets un-deducted written down value needs to be determined.

- A list of appropriately qualified individuals should be established to estimate an un-deducted value for plant and equipment if the actual cost is unavailable. An example of this could be the current scenario as per paragraph 28 of Tax Ruling 97/25 http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR9725/NAT/ATO/00001 which is used to identify appropriately qualified people who may be able to estimate construction costs should actual costs be unavailable.

We believe that there are alternative ways to deliver on the Government's integrity issue which are simpler. Following are alternative options for consideration.

Alternative option 1 - Establishing a historical total installed cost

A historical total installed cost can be established, this can be either the actual installed cost or the estimated historical cost of the asset at the time the asset was originally purchased and installed. This value can be easily established and runs in line with current legislated methodology used to establish a value for the structural element of a building when calculating a capital works deduction (division 43).

A rate of depreciation can be calculated using current prime cost methodology, with the annual depreciation amount calculated for the original and subsequent owners. The un-deducted or written down value can then be claimed over the remaining effective life of the asset which is set using effective lives currently outlined by the Commissioner in Tax Ruling 2017/1 (TR 2017/1).

An example of this could be when a property investor purchases a five year old property with an electric hot water system. Using the make, model and date stamp on the system it was determined that the hot water system was also five years old and installed at the same time the property was built.

In TR 2017/1 The Commissioner has determined that an electric hot water system has an effective life of twelve years, resulting in a prime cost depreciation method rate of 8.33%. The historical market value for a five year old 250 litre hot water system can be determined using product catalogues and asset cost data bases. A typical system would be around $800 when it was purchased five years ago, resulting in a deduction of $66.64 ($800 x 8.33%) per year. Based on the above, the subsequent owner would continue to claim $66.64 per year for the remaining seven years making the total un-deducted value for the subsequent owner $466.48.

Once the total value has been claimed for the hot water system there will be no depreciation deduction available for the current or subsequent owners. If the hot water system is older than twelve years there will be no deduction available. This can be applied to all plant assets in a residential property.

It should be assumed that the assets within a building are the same age as the building itself unless proven otherwise. The vast majority of plant items have serial numbers, model numbers and some have date stamps. Using this information the age of assets can be easily determined. An example of this is blinds, they have an order number sticker usually on the top rails so that install date can be determined by manufacturers. Air conditioners, hot water systems, ovens, cooktops, range hoods, garage door motors and many other items have sufficient information including date stamps and serial numbers which enable anyone to accurately determine their age.

On the occasion that age cannot be proven using serial, make and model numbers then generational features can be matched with product catalogues. These can then be cross referenced with construction of renovation dates identified as per normal practice when determining capital works deductions. It is important that current practices of inspecting a property when needed and obtaining photographic evidence of all plant assets continue.

This information should be stored along with serial, make model numbers so that the age and value of an asset can be substantiated.

Under the current system, when calculating and qualifying capital works deductions, (division 43) the age of the building and additional works to the building need to be established. This is achieved in a number of ways. For example, by reviewing local council records and records of other relevant authorities such as water board connection, construction certification dates and planning registration dates. This information can be substantiated during an onsite inspection. Plant and equipment assets installed at construction will likely be the same age as the building. Adequate proof of age will need to be determined for assets installed during a renovation or replaced after construction by previous owners. This can be achieved using serial, make and model numbers, asset categories, generation differences or receipt of purchase and installation. The vast majority of properties applicable will be less than twelve years old making it easy to determine the building age and assets age.

Assets depreciate in value regardless of whether they have been used to produce income or used privately. Therefore assets that have been previously used in a non-tax deductible capacity will share the same methodology when calculating a written down value.

Option 2 - Total install cost provided with every contract of sale.

Legislation could define a method for passing on an un-deducted value to subsequent owners within the contract of sale. A vendor will be required to provide an un-deducted or written down value in every contract of sale regardless of the previous or future use of the building and its assets.

An option could be that in order for a subsequent owner to be eligible to claim depreciation deductions there must be an un-deducted or written down value provided in the contract of sale.

An asset will carry a single value with it from its first use through to the point where the total depreciable value has been claimed. If the asset is older than its effective life it would be allocated a zero value in the contract of sale and there would be no deduction available for subsequent owners.

Consideration will need to be given to this option as it may add a cost to the process of selling a property.

The same depreciation method and asset valuation methodology can be adopted as outlined in Option 1.

Final note

As our submission states, there are simple solutions which will address the Government's intention to fix the integrity issue identified. The proposed changes go well beyond this intent causing a financial disadvantage for property investors. The measure will result in residential property investors (mum and dads, police, nurses and teachers) being treated differently to investors in other asset classes by proposing that the transaction of a property between two parties extinguishes the ability to claim a deduction for depreciation on plant and equipment assets within the property.

For more details on BMT Tax Depreciation please refer to Attachment A.

If you would like further information please contact Bradley Beer (Chief Executive Officer, BMT Tax Depreciation) on 0413 271 777.

Attachment A

About BMT Tax Depreciation

Founded in 1997, BMT Tax Depreciation (BMT) are Quantity Surveyors who specialise in property depreciation. They currently employ 230 staff in 12 offices across Australia.

BMT operates in line with Tax Ruling 97/25, which addresses the entitlements that income producing property owners have in relation to claiming capital allowance deductions. TR97/25 specifically identifies Quantity Surveyors as being appropriately qualified to estimate construction costs and calculate depreciation allowances.

BMT have a proven record of preparing comprehensive and accurate tax depreciation reporting, with more than 420,000 residential depreciation schedules completed for 265,574 property investors across Australia. As can be seen in the table below, the majority of our investor clients, (83.04 per cent) ordered one depreciation schedule for their investment property. 95 per cent ordered one or two residential depreciation schedules for properties owned. The remaining 5 per cent of investors ordered three or more residential depreciation schedules for properties they owned. Only 1.21 per cent of BMT's property investor clients ordered schedules for 5 or more properties they own. It is important to note that this data was collected over a period of twenty years and some of these investors may have sold an investment property relating to their original depreciation schedule. This would indicate that the vast majority of Australian property investors own a single investment property.

Number of residential properties owned by property investors

Properties	Investment property owners	Percentage of total investment property owners	Schedules ordered (properties)
1	265,574	83.04%	265,574
2	37,619	11.76%	75,238
3 to 4	12,777	3.99%	42,135
5 to 9	3,176	0.99%	19,034
10 or more	681	0.21%	18,535
Total	**319,827**	**100%**	**420,516**

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Over recent years, BMT has been associated with a wide range of projects, diverse in scale and type. Our scope of service is predominately residential and also encompasses a broad spectrum of property types including commercial, government, engineering and industrial. BMT offer a nation-wide service with twelve offices located across Australia.

The BMT executive management team is led by Chief Executive Officer, Bradley Beer (B.Con Mgt, AAIQS, MRICS, AVAA.)

Bradley began his career at BMT as a Quantity Surveyor in 1998, working with two of the founding Directors to build the company organically from the ground up. After six years of successful performance and supporting year on year growth, he became a Director in 2002 and a Managing Director in 2012.

Since then, Bradley's leadership and specialist experience in property tax depreciation and construction cost consulting has led to the exceptional performance and strong yearly growth across the organisation. In 2015, Bradley was appointed to Chief Executive Officer.

Bradley's wealth of depreciation knowledge is often drawn upon as a keynote speaker at local and national conferences. He also regularly appears on television, radio and in various media publications as an expert in property, tax and depreciation.

If you would like further information please contact Bradley Beer on 0413 271 777.