New depreciation rules exposure

Dear Ms Travis

I would like to outline some difficulties with the exposure draft Housing Tax Integrity Bill and EM in relation to limiting deductions for plant and equipment in residential premises. The amendments proposed and explained in the draft Bill and EM do not target the problem under the current law accurately, and operate against a range of situations which present no problem under the current law. Accordingly the amendments are likely to hinder substantially the provision of housing compared to other investment, where what was intended appears to have been to create neutrality between housing and other investment.

Depreciation and building capital cost deduction:

Apart from any special features of housing and tax administration, the depreciation principles are straightforward.

Depreciating assets decline in value over their effective lives. Their cost, to the particular holder of the assets, is subject to that decline; and so much of the decline in a year of tax as is attributable to use for a taxable purpose, or to holding ready for that use, is deductible.

If such assets are disposed of or lost, the consideration to the holder (or deemed consideration) is assessable income to the same extent that decline was deductible (even if the consideration exceeds the cost to the holder).

So where depreciating assets change hands any step-up in cost to the acquirer should correspond to a step-up in income to the disponor.

For depreciating assets included with residential premises, there can be practical difficulty. Where depreciating assets are included in the assets acquired for an undifferentiated sum, the total sum must be attributed between the assets acquired on a reasonable basis: but as the acquirer and the disponor have not agreed on that basis their tax attributions may not match. Variance need not be so great as to show that either party's attribution is incorrect for tax purposes. This is a possible source of difficulty in relation to residential housing.

Buildings and structural improvements used for qualifying purposes are subject to deduction of the original capital cost of the building or structural work. This does not step up or restart when a building changes hands - the deduction is straight line and once only. If buildings change hands for less than the original capital cost of the work, or more, the remaining deduction is unchanged. And if buildings have had the original capital cost fully covered by the time since the work was done, no more such deductions can be had.

Because there were originally no provisions requiring vendors to pass on information about original capital costs, the Commissioner of Taxation has long accepted that qualified professionals can provide an estimate of what those original capital costs were (if the current owner and user of the building does not know them). Quantity surveyors are among those able to estimate original capital costs of building work at a particular time or period.

Quantity surveyors have no expertise or competence in apportioning undissected lump sums between different assets and particularly between structures and depreciating assets. Their views on how much of the cost of a building relates to included depreciating assets, and how much to the structure, are irrelevant for tax purposes. No ATO view allows or adopts the views of quantity surveyors on this question. However many quantity surveyors purport to offer schedules of depreciable costs of included depreciating assets when residential property is acquired, and several promoters of residential property investment endorse the use of such schedules. This is another possible source of difficulty in relation to residential housing.

There is a residual deduction for costs in relation to income producing activity that are neither deductible elsewhere nor part of CGT cost base. This residual deduction has no application to residential housing before the proposed Bill and EM.

Budget announcement:

As from Budget 2017, 'the Government will limit plant and equipment depreciation deductions 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. Acquisitions of existing plant and equipment items will be reflected in the cost base for capital gains tax purposes for subsequent investors.'

'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.'

The announcement clearly means that depreciating assets included when residential property changes hands cannot be depreciated by the new holder. However it is equally clear that depreciating assets acquired by the owner of a residential property and installed in it will be depreciable in the usual way. This is so regardless of whether the depreciating assets so acquired and installed were then new or had previously been used by someone for some purpose. Nothing in the announcement has a 'new' versus 'second hand' depreciating asset content.

The announcement does not address cases where depreciating assets have not been included with a residential property, for an undifferentiated price, but rather have been separately acquired at a specific price along with the acquisition of the residential property. It is not clear that this was intended to be included in the scope of the budget announcement. As the announcement described the measure as 'an integrity measure to address concerns that some plant and equipment items are being depreciated by successive investors in excess of their actual value', it could reasonably be thought that separate acquisition at a specific price would exclude depreciating assets from the measure. Such assets have their value included in the vendor's assessable income, with anti-avoidance rules available for those cases where this effect is evaded.

Bill and EM:

- New assets:

The approach in the exposure draft denies depreciation - that is, decline in value deductions - for depreciating assets acquired by the holder of a residential property and installed in the property, if the depreciating assets are not new. It proceeds by denying depreciation for all second hand assets to which the draft applies. This is substantially wider than the budget announcement, yet unsupported by any identified concern.

The EM illustrates the argument for this wider scope with the example of a property being substantially renovated while occupied as a residence, and then being let as a residential property (at 2.30). The illustration fails entirely to make any case for the application of the rule. In the illustrated case, the renovation differs from that by a non-resident in no way relevant to ascertaining the cost of the depreciating assets. The justification (at 2.31) refers to scope to adopt a 'refreshed' valuation.

There is no such scope under the law; and if there were the scope is the same as if the renovation depreciating assets were installed during an extended period while the property was out of use for earning income as a residential property. The EM appears to hint at a real concern, the one which arises when an undifferentiated cost is used to create a cost by such unacceptable - and legally ineffective - means as an opinion from a quantity surveyor.

But a renovator who goes on to use the depreciating assets with the property as an income producing residential property does not acquire the depreciating assets as part of an undifferentiated bundle of things for an undifferentiated overall cost. Such a renovator acquires, and installs, depreciating assets individually at actual individual costs. And it is only the reduced actual cost, as at the time that the building is used as an income producing residential building, that can be deducted. The EM is free, therefore, of any effective illustration or justification of the change from the announcement. The provisions specifically acknowledging depreciating assets installed when no-one can claim any depreciation for them, in new and unoccupied residential premises, is unreasonably limited; nor is it clear that depreciation is unavailable for depreciating assets installed ready in premises offered to the market but as yet unoccupied.

Similarly, a renovator who does not occupy or use the property during renovation might make use of second hand depreciating assets. For example, genuine period assets are often used in restoring older houses. The EM is free of any illustration or justification of the suggestion that such assets, often sourced from specialist dealers in this kind of material, involve 'refreshed' valuation by the renovator.

The approach in the budget announcement supports excluding depreciation of depreciating assets acquired as part of the acquisition of a residential property. There is good reason to consider confining the budget approach only to depreciating assets acquired as part of the assets for which an undifferentiated purchase price is paid: where depreciating assets are acquired individually, for individual prices, any refreshing of their cost falls on the disponor to the same extent that it increases the cost for which the acquirer may claim deductions. But nothing in the budget announcement or in the underlying issues supports the 'new assets' drafting of the Bill and EM.

The 'new assets' approach denies neutrality in the renovation of property as between new and used assets. There are many situations in which this is contrary to good practice. If the intention is to depress the market in reuse of original depreciating assets and to restrict restoration, the EM should outline this intention and justify it.

- Excluded holders of property:

The exposure draft does not apply to residential property holders who are corporate tax entities (that is, who are taxed as companies); who are superannuation plans other than SMSFs; or who are (in essence) widely held unit trusts. This is narrower than the budget announcement, which suggested no such limit on application of the measure. The EM includes no indication of any justification for the narrowing of the application of the measure, and on its face there is none - the concern referred to in the budget announcement is equally applicable whether residential property is held by a corporate, a widely held unit trust, or a superannuation plan that is not an SMSF.

- Residential property used in carrying on a business:

The exposure draft does not apply to residential property used in carrying on a business. There may be only limited circumstances, if any, in which a residential property is so used. (Strong appellate authority continues to assert that holding residential property to produce income can never amount to the carrying on of a business.) This is narrower than the budget announcement, which suggested no such limit on the application of the measure. If there are reasons to regard residential property used in carrying on a business as free from the concerns addressed in these measures, those reasons should be given in the EM, along with some indication of what situations amount to the use of residential property in carrying on a business.

- Low value pool:

Depreciating assets allocated to a low value pool are excluded from the Bill and EM. The EM suggests no justification for this. If there is a problem of 'refreshed' valuation, there is no suggested way in which it might be inapplicable to pooled items. Perhaps the view of the drafter was that pooled items do not refresh. But the terms of s40-430 do not have the effect that disposal of low value pool items cannot occur, or that no refreshing of value can then arise. Balancing adjustment events occur in much the usual way, under s40-445.

If there is a justification for the low value pool exclusion, it should be given in the EM. I do not believe that any such justification is available.

- 40-880:

I agree that the draft Bill and EM do not open up deductibility under the residual s40-880. However I would suggest that this might be discussed expressly in the EM.

I omit comments on other machinery aspects, for which I have not identified any problems in terms of the budget announcement or the underlying intent.

Regards
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