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Dear Sir/Madam,

Submission on Limiting Deductions for Plant and Equipment in Residential Premises Exposure Draft

Grant Thornton Australia Limited (Grant Thornton) thanks Treasury for the opportunity to make a submission on the 14 July 2017 Exposure Draft (ED) for the proposed measures regarding housing affordability and tax integrity.

Grant Thornton acknowledges the intention of Treasury to reduce pressure on housing affordability and to improve the integrity of the tax system for deductions relating to investment properties.

This submission will only address the depreciation aspects of the ED. We believe the approach to removing deductions available to property investors for the decline in value of plant and equipment for previously occupied properties (as proposed in the ED) will place undue pressure on both property developers and property investors, and as such would not necessarily achieve the objective of housing supply and affordability.

Insertion of Section 40-27 Income Tax Assessment Act 1997

Section 40-27 implements the Federal Government's 2017-18 Budget announcements and limits deductions available for the depreciation of second-hand assets in residential properties. We wish to highlight the negative impact that this proposed legislation would have on both property developers and property investors – both integral to the supply of affordable housing in Australia.

Developers of residential premises carry on the business of developing and selling residential premises (generally apartments and townhouses) as trading stock. Under s 40-27(2)(c), purchasers of this trading stock will be exempt from the depreciation reductions detailed in s 40-27(2). However, it is common practice for developers in the industry to enter into short term rental

arrangements for unsold properties to mitigate the financial burden of holding a vacant property. In particular, this occurs while selling in a challenging market. From our discussions with Treasury and per the proposed wording of the ED, it appears that s40-27(4)(b) has been included to deny investors the opportunity to deduct depreciation on plant acquired from a developer (as a first sale), if the property has been occupied prior to the sale - regardless of the fact that the developer has not claimed any depreciation on the plant.

We believe there is an unintended consequence here - or if it was intended then the commercial implications need to be carefully considered. Where the property asset is purchased by an investor while it is trading stock of a developer, this would fall within the exclusion of s 40-27(2)(c). However, where the developer has allowed anyone to occupy the property (for example a short term tenant) for whatever duration, the legislation denies the acquiring investor the ability to claim depreciation on the assets acquired.

Where a property is being occupied by a tenant but is still held by the developer for resale, it should retain the nature of trading stock. This interpretation is consistent with the understanding that the depreciation benefits continue to apply for the “first sale” of a property and the wording of s40-27(2)(c).

The inclusion of s40-27(4)(b) will mean that despite the status of a property as trading stock and the absence of any depreciation claims by the developer, investors purchasing a previously occupied premise will be disadvantaged. Both the EM and the ED state that if the premise has been previously occupied by any entity, it will not be eligible for depreciation to be claimed, notwithstanding the treatment of the premise as trading stock throughout its life to date.

In order to claim depreciation, investors will generally pay for the services of a Quantity Surveyor (QS) to support any depreciation and capital allowance claims, particularly for new apartments. A QS will take into consideration the age of the assets in determining the depreciation claim available to the investor in any period. Given that there will be a period of time between installation and ownership for the investor (generally the period of occupancy prior to sale), the investor will not be eligible to claim depreciation for the period they did not own the property. The depreciation claim will start from the date of purchase and as such, we do not believe that it is fair to deny depreciation for the remaining life of these assets to investors who are the first acquirers of the property.

The depreciation applicable for the period between completion and the sale – potentially the period of rental by the developer, will not be claimed by anyone as the property has the nature of trading stock while held by the developer. Therefore we cannot see the mischief that inclusion of s40-27(4)(b) is intending to rectify.

Market Impact

We would suggest that the following commercial consequences of denying depreciation deductions for properties acquired from the developer that have been previously occupied will require further consideration by Treasury given its impact on the stated objectives around housing affordability.

Developer Concerns

At the forefront of commercial considerations is the potential impact that s 40-27 will have on the cash flow of property developers. The ability to rent out properties proving difficult to sell provides developers with relief to their cash-flow in this period and alleviates the burden of interest and other holding charges incurred.

Once the market becomes aware of the limitations to depreciation claims if a "new" property has been previously occupied for any length of time, this will impact investor behaviour and encourage them to seek similar properties that have remained vacant. This will make it more difficult for developers to sell the occupied premise and potentially place them under financial stress and at risk of GST adjustments under Division 129.

The longer a premise is held by the developer and used for residential rental purposes, the higher the impact of denied GST credits under Division 129. Developers may seek to compensate for the additional out of pocket position through higher prices, therefore impacting the Government's efforts to facilitate housing affordability.

Limiting the ability of developers to receive rental income during the sale process may see more developers run into financial difficulties, resulting in liquidity and business continuity issues if lending commitments can't be met. By inhibiting the amount of stock that can be brought to the market, this will impact both prices and rental costs.

In the current market, renting out newly constructed properties awaiting sale is an effective way for developers to assist short-term cash flow. Whilst the legislation does not prohibit developers from entering into short term leases prior to first sale, developers would be deterred from doing so as the market awareness of the impact of s40-27(4)(b) makes it unattractive for investors to purchase previously leased premises, thus making it more difficult to sell these properties.

Investor Concerns

The inclusion of s40-27(4)(b) will mean that investors who buy a previously tenanted property direct from the developer are at a disadvantage over an investor who might purchase an apartment in the same block that has not been occupied before the sale.

Furthermore, under the ED, both the developer and the investor would be ineligible to claim depreciation on the new assets for rented properties. Thus, no party will be entitled to claim depreciation and investors will take this into consideration. An investor's access to deductions is an important aspect of purchasing an investment property. The ability to claim depreciation attracts a wider pool of equity, and from a broader economic perspective, increases investment in Australia's property market and therefore the supply of housing. The proposed ED will make new properties that have been occupied for any period unappealing to purchasers. Therefore, developers will be forced to keep the properties vacant at their cost.

We foresee significant confusion for property investors around this issue and claims for depreciation inadvertently being made where the investor is not eligible to do so. In many

instances the purchaser may not be aware that the property has been occupied prior to the sale and therefore not eligible for depreciation deductions. Is it reasonable for Treasury to expect the average residential property investor to understand the difference in available depreciation deductions between a property acquired from a developer that has been previously occupied versus not?

Effect on Housing Affordability

Amongst the repercussions, developers may be forced to reduce the prices of property below market to secure sales if they are presented with additional barriers to selling previously leased properties. While this may seem a positive outcome for affordability, this would place financial strain on developers and require them to recover profits through alternative means - generally through increasing the price of properties which have not been leased out. We urge Treasury to consider the commercial impact that the proposed ED will have on the market place and the flow-on ramifications it will have on housing affordability.

Recommendations

It is our opinion that the legislative changes as proposed, specifically s 40-27(4)(b), will have a negative impact on developers and investors and therefore the housing market generally for the reasons discussed above. If the intention of Government is to improve the integrity of the tax system for deductions relating to investment properties, a more effective mechanism would be to require a QS report for taxpayers seeking to claim depreciation claims for new properties.

As outlined above, we believe that s 40-27 should be constructed such that it does not exclude premises purchased from developers as a “first sale” of a previously occupied property, with no depreciation claimed. Any claims in the intervening period would be appropriately limited by the period of ownership rather than when the asset is first used. This information could be captured through the QS report.

To ensure integrity we would suggest a timeframe in relation to the period of occupancy similar to that of the GST rules when establishing whether it is a sale of new residential property. We encourage Treasury to remove s40-27(4)(b) from the legislation and that appropriate examples are built into the EM to clarify what depreciation claims would be available to investors in this scenario.

We would be happy to meet further with Treasury to discuss any of the matters raised in this correspondence at your convenience.

Yours faithfully,
GRANT THORNTON AUSTRALIA LIMITED

Sian Sinclair, Partner – Tax