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Depreciation and Travel Expenses Deductibility Exposure Draft Legislation

Thank you for the opportunity to provide our comments on the *Limiting deductions for plant and equipment in residential premises and travel expenditure for residential rental property* exposure draft (ED).

The Property Council is the peak body for owners and investors in Australia's $670 billion property investment industry. We represent, owners, fund managers, superannuation trusts, developers and investors across all four quadrants of property investments: debt, equity, public and private.

The Property Council understands that the proposed amendments are integrity measures which are not intended to affect deductions for institutional investors in residential premises. As such, the enacted legislation should provide clear exclusions for institutional investors without imposing onerous additional compliance burdens on those investors.

We are also keen to ensure that the measures do not inadvertently place some developers at a competitive disadvantage in the market, or inadvertently capture retirement villages, aged care, hotels and student accommodation.

Each of these issues are discussed further below.

1. Institutional Investor Exception

We understand that the proposed amendments seek to improve the integrity of the tax system by addressing concerns that some taxpayers have been inappropriately claiming deductions relating to the decline in value of plant and equipment and travel expenses for residential rental property. These integrity concerns do not arise for institutional investors. As such, the amendments are intended to have no impact on deductions presently available to institutional investors with companies, superannuation funds and unit trusts with more than 300 investors specifically carved out of the rules set out in the ED.

Unfortunately, as presently drafted, the relevant operative provisions could inadvertently deny deductions to certain institutional investors who acquire "used" plant and equipment in residential property.

This is because a common investment structure for institutional investors (including superannuation funds) involves holding a property investment in a unit trust, which may hold single or multiple assets (including through sub-trusts). A unit trust may be wholly owned, or partly owned, in the case of a joint venture. We attach illustrative examples of common institutional investment structures in Attachment 1.

The "kind of entity" exception in proposed subsections 26-31(2) and 40-27(3) does not provide an exclusion from the relevant operative provisions for the investment structures in Attachment 1 because the entity claiming the deduction (i.e. the unit trust which is the owner of the plant and equipment) is not:

- A corporate tax entity
- A superannuation plan that is not a self managed superannuation fund
- A unit trust that has at least 300 unit holders and is not a trust covered by section 116-35

To achieve the desired policy outcome, the "kind of entity" exception should be drafted to recognise indirect ownership (whether wholly owned or in joint venture) by a range of institutional investors including superannuation funds, pooled superannuation trusts, life companies, pension funds, widely held trusts (including managed investment trusts), sovereign funds, as well as the overseas equivalents of these institutional investors.

Indirect institutional ownership of unit trusts is currently accommodated by a number of provisions of the income tax legislation. For example, the managed investment trust definition in section 275-10 of the Income Tax Assessment Act 1997 (ITAA 1997) provides such a framework with established widely held and closely held definitions.

Whilst residential premises are not presently commonly held by managed investment trusts, the Multi-Family asset class (being long-term holders of residential premises) is a developing area. Managed investment trusts are likely to be one of the investment vehicles of choice for the Multi-Family asset class.

Institutional investments are also likely to be made via unit trusts that do not qualify as managed investment trusts. Additional tests (such as the public unit trust test in section 102P ITAA 1936) would need to be referenced to ensure that these investments are also excluded.

We propose the following drafting for the "kind of entity" exception to accommodate the various forms of institutional investment in unit trusts:

(3) Subsection (2) does not apply to you if, at any time during the income year, you are:

(a) a *corporate tax entity; or

(b) a *superannuation plan that is not a *self managed superannuation fund; or

(c) a *managed investment trust; or

(d) a *public unit trust for the purposes of section 102P; or

(e) ~~(c)~~ a unit trust that has, directly or indirectly (through one or more interposed entities)[1] at least 300 unit holders and is not a trust that is covered by section 116-35 (about trusts that are not widely held)~~.~~; or

(f) a unit trust, all the membership interests in which are owned by any of the following:

(i) entities mentioned in the preceding paragraphs of this subsection;

(ii) entities that are wholly-owned by entities mentioned in the preceding paragraphs of this subsection;

[1] Proposed amendments to (3)(e) are based on existing section 116-35.

(iii) entities that are covered under this subsection because of a previous operation of this paragraph[2].

We note that a unit trust which holds residential property may satisfy the exclusions in paragraphs 26-31(1)(b) and 40-27(2)(b) on the basis that the trustee is carrying on a business. Although the unit trust may be ultimately owned by institutional investors, the activities of the unit trust itself would need to satisfy the " business" requirement. This test is factually dependent (as noted in paragraph 1.32 of the draft Explanatory Memorandum). To obtain the required level of certainty to claim relevant deductions, an institutional investor may need to obtain tax advice or an ATO ruling. This would seem unnecessarily burdensome given the clear policy intention is that institutional investors should be excluded from the rules. As such, the Property Council strongly advocates that institutional investors be excluded via the "kind of entity" exception.

2. Residential Use Prior to First Sale by Developer

A developer may construct or substantially renovate new residential premises, but rent out those premises prior to the first sale to a customer. For example, as a last resort, premises may be rented for an interim period if after an extensive effort the developer is unable to sell all apartments in a development at an acceptable price due to an oversupply in the market. During the period the premises are rented out, these premises would continue to be held by the developer as trading stock and hence no Division 40 claim would be allowable.

Despite the exclusion of assets held as trading stock in proposed paragraph 40-27(2)(c), it appears that proposed paragraph 40-27(4)(b) contemplates denying Division 40 depreciation on plant and equipment to the purchasing customer merely because an entity had previously resided in the premises.

This outcome would place the developer at a competitive disadvantage when marketing the apartment for sale. The developer would either:

- Forgo the rental income in order to preserve deductibility for the customer;
- Rent the apartment and potentially receive a reduced price to reflect the loss of depreciation deductions by the customer.

The application of proposed section 40-27 in these circumstances is inconsistent with its professed policy intent, as there is minimal scope for any entity to adopt a "refreshed" valuation which increases the amounts deductible, as the interim rental period will generally be:

- Extremely limited (i.e. as the developer will attempt to sell the premises as soon as market conditions allow); and
- No longer than the time which would elapse before sale if the premises were not leased (i.e. and thus provide no greater scope for refreshed valuations).

Accordingly, we request the following amendment to proposed subsection 40-27(4):

(4) Subsection (2) does not apply to you if:

(a) when you first *hold the asset:

(i) the asset is used, or *installed ready for use, in the *residential premises; and

(ii) the residential premises are new residential premises (within the meaning of the *GST Act); and

~~(b) at all earlier times when the asset was used, or installed ready for use, in residential premises, no entity was residing in those premises; and~~

[2] Proposed (3)(f) is based on existing paragraph 275-20(4)(k) ITAA 1997.

(b) at all earlier times, no entity had used the asset, or had it installed ready for use, wholly for purposes that were not *taxable purposes.

(c) no amount can be deducted under this Division, or under Subdivision 328-D, for the asset for any income year by any previous holder of the asset."

Alternatively, if it is considered necessary to further limited the scope for "refreshed" valuations, the exception could be limited to arrangements where the premises were only resided in by an entity for a short period (i.e. for no more than 24 months).

3. Commercial residential premises and retirement villages

The proposed definition of residential premises is drafted broadly and could capture retirement living, aged care, hotels and student accommodation.

The draft Explanatory Memorandum makes specific reference to retirement living, aged care, hotels and student accommodation as types of investments that are likely to be undertaken in carrying on a business and are therefore not intended to be caught by the rules.

However due to the uncertainties associated with a factually dependent test (as noted above) and given the low integrity risks associated with such assets, we recommend a specific exclusion to address these asset classes.

This can be easily implemented by excluding "commercial residential premises" and "retirement villages", as those terms are defined in A New Tax System (Goods and Services Tax) Act 1999, on the basis that these types of residential premises should be outside the scope of an integrity measure designed to reduce pressure on housing affordability. This could be achieved with minimal drafting, for example in subsection 40-27(2):

> (2) Reduce your deduction by any part of the asset's decline in value that is attributable to your use of it, or your having it *installed ready for use, for the *purpose of producing assessable income:
>
> > (a) from the use of *residential premises (other than *commercial residential premises or a *retirement village) to provide residential accommodation;

We would be happy to meet with you to discuss any of the above issues further.

Please contact Maureen Smith (02 9033 1944), Glenn Byres (02 9033 1952) or me if you have any queries.

Yours sincerely

Belinda Ngo
Executive Director – International & Capital Markets

Attachment 1 - Examples of widely held structures