TECHNICAL UPDATE

RESIDENTIAL RENTAL PROPERTIES – CHANGES TO DEDUCTIONS FOR TRAVEL COSTS AND DEPRECIATION

In the May 2017 Federal Budget, the Government announced a raft of proposals it hoped would relieve the pressure on residential property prices. Two of these measures are targeted at reducing the income tax deductions passive investors in rental residential properties can claim on travel expenses and depreciation of assets used in those properties.

Legislation has now been introduced into Parliament in relation to these changes.

WHO IS AFFECTED?

The amendments refer to taxpayers who are not subject to the new rules:

- Companies (other than companies acting as trustees)
- Super funds (other than SMSFs)
- Managed investment trusts
- Public unit trusts
- Unit trusts and partnerships comprised exclusively of these excluded entities.

In addition, any entity that is carrying on a business is excluded from these new provisions.

It therefore follows that individuals, SMSFs and smaller trusts (including family trusts) who are not carrying on a business will be impacted by these amendments.

WHAT TYPES OF REAL PROPERTY ARE AFFECTED?

The amendments apply to residential premises that are used for residential accommodation. 'Residential premises' takes its meaning from the GST legislation to mean '*land or buildings that are occupied as a residence or for residential accommodation or intended to be occupied, and are capable of being occupied, as a residence of for residential accommodation*'.

This is described broadly as land or buildings that provide minimum shelter and basic living facilities which is occupied or designed to be occupied by a person. This includes houses, flats and apartments. It also includes commercial residential premises such as hotels and boarding houses.

Importantly, the property must also be used for residential accommodation. Where residential premises are being used to derive income other than residential rent (for example, a partnership of dentists leases a house fitted out as a dental practice), these provisions do not apply.

DENIAL OF TRAVEL DEDUCTIONS

Where the provisions apply, any travel expenditure incurred by the taxpayer in relation to the property will no longer be deductible. The amendments apply to expenditure incurred on or after 1 July 2017.

SECTOR
Tax

STEPHEN NISBET
Director, Adelaide
+61 8 7324 6129
stephen.nisbet@bdo.com.au

MARK MOLESWORTH
Partner, Brisbane
+61 7 3237 5999
mark.molesworth@bdo.com.au

ERIC OLUFSON
Partner, Cairns
+61 7 4046 0000
eric.olufson@bdo.com.au

MAL SCIACCA
Partner, Darwin
+61 8 8981 7066
mal.sciacca@bdo.com.au

BRETT SKIRVING
Partner, Hobart
+61 3 6234 2499
brett.skirving@bdo.com.au

JASON DE BOER
Partner, Melbourne
+61 3 9603 1781
jason.deboer@bdo.com.au

KUMAR KRISHNASAMY
Partner, Melbourne
+61 3 9603 1773
kumar.krishnasamy@bdo.com.au

MARK POLLOCK
Partner, Perth
+61 8 6382 4794
mark.pollock@bdo.com.au

MARCUS LEONARD
Partner, Sydney
+61 2 9240 9771
marcus.leonard@bdo.com.au

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It is intended that the term 'travel' takes its ordinary meaning. It includes motor vehicle expenses, taxis, airfares, and any meals and accommodation costs associated with the travel.

The types of travel that the amendments are designed to catch include costs incurred when the property was first acquired or when the property is in the process of being sold, costs incurred in visiting or inspecting the property or visiting the property manager, and costs incurred in collecting rents. It covers all costs, from flying to the Gold Coast to inspect your rental apartment, to driving to the next suburb to mow the lawns at a house you rent out. Travel expenses incurred on residential premises that are being used both as residential accommodation and for another income producing purpose (for example, you lease a shop and the residential premises upstairs above the shop), the travel costs can be apportioned on a reasonable basis.

Consequential amendments also ensure travel expenses that are made non-deductible through these amendments cannot be deducted as blackhole expenditure under section 40-880 ITAA 1997.

DENIAL OF COST BASE ADJUSTMENTS

To ensure there is no indirect tax benefit from these amendments for affected taxpayers, the CGT provisions are also being amended. Under this consequential amendment, travel expenses that have been made non-deductible under these amendments will also be excluded from the cost base of the rental property for CGT purposes.

DEPRECIATION DEDUCTION LIMITATIONS

The same taxpayers affected by the amendments denying deductions for travel expenses on residential rental properties may also be impacted by the amendments to the depreciation rules.

The deduction for depreciation on assets used or installed ready for use in residential premises (i.e. the premises impacted by the travel deduction amendments) will be reduced where the relevant depreciable assets have been previously used.

ASSETS PREVIOUSLY USED

The intention is that second hand assets will not be depreciable where the premises are used for residential premises. These assets, defined as 'assets previously used' are assets that:

- The taxpayer did not own (referred to as 'hold' in the legislation) when they were first used or installed ready for use (other than assets that were the trading stock of someone else)
- Were used or installed ready for use in residential premises that the taxpayer used as a residence (either main residence or otherwise, such as a holiday house), or
- Were used or installed ready for use for a purpose that was not a taxable purpose, where that use was not incidental or occasional.

The trading stock exclusion is interesting. In many cases, a property owner is not the first owner of a depreciable asset. They either acquire the asset from a developer or builder as an asset installed in a construction, or alternatively, they purchase the asset from a retailer (for example, you buy a new dishwasher for a rental property from Harvey Norman).

In all of these instances, the depreciable asset will have been trading stock of all of the entities who previously owned it. These types of assets will be excluded from the new provisions.

According to the accompanying material, staying at the property for one evening while carrying out maintenance would generally be incidental use, while allowing a relative to spend a weekend in a holiday home free of charge would generally be occasional use.

EXCLUDED ASSETS

In addition to the trading stock exclusion, assets are specifically excluded from these provisions if they:

- Are installed in premises supplied as new residential premises/premises that have been substantially renovated, and
- Have previously been depreciated by any entity, and either
- They were acquired as new by the taxpayer for premises not previously resided in, or they were used or installed within six months of the premises being completed and were not previously installed in any residence.

This exclusion is intended to cover new purchases from builders or developers, including off-the-plan purchases. The exclusion will also apply where a taxpayer purchases new premises from the developer within six months of construction being completed where the property is tenanted.

The exclusion also applies to assets installed in premises associated with the residential premises. This applies to assets such as those installed in the common property of a residential apartment block i.e. elevators and lighting and fire systems. These assets can be depreciated by the purchaser of the new property unless a previous owner of the apartment claimed a deduction for depreciation of the assets or the premises were previously used as a residence.

IMPACT OF THE AMENDMENTS

Where the amendments apply, the taxpayer's deduction for depreciation of the asset will be reduced. The reduction in the depreciation claim is based on the extent the assets are used to derive residential rent from the premises. In most cases, the deduction would be reduced to nil, as the premises would ordinarily be used for residential rental purposes.

There are also implications where the assets are subsequently sold by the taxpayer. Ordinarily, when depreciable assets are sold, a balancing adjustment gain or loss arises, calculated as the difference between the sale price of the asset and its tax written down value. Under these amendments, the balancing adjustment is reduced to the extent these provisions reduce the allowable depreciation deduction. In the ordinary case where the asset is used wholly for residential purposes, the balancing charge amount would be reduced to nil.

Where the assets are disposed of, there may also be CGT implications (CGT Event K7). This provision applies to assets used for income producing purposes (depreciable assets), where there is some non-deductible use of the asset (such as assets now covered by these provisions).

Where CGT Event K7 applies, a capital gain or loss arises, adjusted to the extent some of the gain or loss has been assessed as a balancing charge. In the ordinary case where the asset is used wholly for residential purposes, the gain or loss on the disposal of the asset will be wholly subject to CGT.

Consider an asset acquired by a taxpayer for $3,000 which is subject to these provisions. As a result of the amendments, the taxpayer is not entitled to claim a deduction for depreciation on the asset. The taxpayer subsequently sells the asset for $2,000. The $1,000 loss on the disposal of the asset will be a capital loss. There is no balancing charge loss on the disposal.

WHAT ASSETS ARE IMPACTED?

The amendments apply to income years starting on or after 1 July 2017. They apply to assets acquired on or after 7.30pm on 9 May 2017 (Budget night) unless the asset was acquired under a contract entered into before that time.

The amendments also apply to assets acquired before 9 May 2017 where the assets were first used or installed ready for use by an entity during or prior to the income year in which 9 May 2017 falls (expected to be the year ended 30 June 2017) where the asset was not used at all for a taxable purpose in that year. These measures are designed to prevent taxpayers moving personal assets into rental properties.

BDO COMMENT

It is interesting to consider the Government's reasons for introducing these amendments. The provisions are contained in a package designed to reduce pressure on residential property prices. However, the explanatory materials accompanying the legislation refer to the provisions being integrity measures designed to prevent inappropriate deductions for travel expenses and depreciation claims on second hand assets.

Whilst removing some income tax deductions may take some heat off the property market, it is clear these are integrity measures designed to target 'inappropriate' deductions, more so than as an aid to first home buyers.

However, it is clear from experience and disputes argued before Courts and Tribunals that individuals have been claiming excessive deductions for travel and depreciation on residential rental properties.

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