Housing Tax Integrity – Limiting Depreciation Deductions - Submission

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Dear Sir/Madam,

Housing Tax Integrity – Limiting Depreciation Deductions

Thank you for the opportunity to make a submission on the exposure draft and explanatory materials of the *Treasury Laws Amendment (Housing Tax Integrity) Bill 2017*.

I make this submission in my capacity as a private individual and investor who has followed with keen interest the proposals in the May budget regarding the changes to the depreciation allowances for previously owned residential investment properties.

1. Background

Depreciation allowances recognise that certain assets diminish and wear out over time and will therefore need to be replaced at some time in the future. A prudent asset owner will set an amount aside every year so that when replacement of those assets is necessary there is a "pot" of money available to do so. This amount set aside is therefore an expense incurred in holding an asset and is therefore should be a deduction against the asset holder's income.

As such, depreciation deductions have been a settled feature of the Australian tax system for a long time.

Plant and equipment contained within a residential investment property, such as dishwashers, air conditioners and carpets, is no different to any other asset that wears out over time. The owner of a residential investment property, whether new or previously owned or used, will need to set aside an annual amount to replace those assets once they reach the end of their lives. Therefore, the policy that existed prior to the May budget of allowing all residential investment property owners to claim a depreciation deduction appropriately reflects the annual economic cost incurred by those owners to replace deteriorating assets when they have reached the end of their useful lives.

2. Overall policy objective

The overall policy objective of improving the integrity of the tax system by preventing the overstating of deductions via the "refreshing" of values of previously used depreciating assets is appropriate. An outcome where the total depreciation deductions claimed for any given asset across successive owners can exceed its original cost is a perverse result. However, the proposed change which denies all depreciation deductions for plant and

equipment that is not newly installed by the current owner goes too far in the opposite direction.

As an example, a new residential investment property is purchased by Owner A. Amongst other plant and equipment assets, the property contains an oven with an original cost of $1,000 and a useful life of five years. Owner A claims a depreciation deduction of $200 per year and sells the property to Owner B after two years, meaning that the oven has a residual (unclaimed) value of $600.

$600 of the purchase price paid by Owner B can be allocated to the (now second-hand) oven, which will need to be replaced in three years. Under the previous rules, Owner B could continue to claim a depreciation deduction to reflect the cost of replacing the oven at the end of its useful life, however under the new proposed rules, none of this value can be claimed. This treatment is unfair to the second and subsequent owners of the property who will need to bear the cost of replacing the oven when it reaches the end of its useful life.

3. Inconsistencies

The proposed policy contains a number of inconsistencies:

- Purchasers of new residential investment properties will be able to claim a full depreciation deduction to reflect the cost of replacing worn out assets whilst purchasers of existing residential investment properties will not, even though the economic cost of replacing those assets is essentially the same for both new and existing properties;
- Purchasers of existing commercial properties will be able to claim depreciation deductions for the plant and equipment in those properties whilst purchasers of existing residential investment properties cannot;
- Purchasers of existing residential investment properties who are engaged in carrying on a business (for example, owners of serviced apartments) will continue to be able to claim a depreciation deduction for plant and equipment whilst purchasers of existing residential investment properties intended for the longer-term rental market cannot;
- Purchasers of companies can allocate the purchase price paid to various asset classes (depreciating and non-depreciating) and claim a depreciation deduction in respect of the depreciating assets, whilst purchasers of existing residential investment properties cannot; and
- The proposed legislation would not deny deductions to companies, large superannuation funds or large unit trusts purchasing residential investment properties whilst other entities such as individuals and self-managed super funds would have these deductions denied.

4. Potential solution

Allowing purchasers of existing residential investment properties to claim the *unclaimed* written down value of plant and equipment contained within those properties would both address the policy objective of preventing assets being depreciated by more than the original cost of the asset whilst ensuring a fair treatment for investors purchasing existing residential investment property.

Whilst it may be difficult to determine how much depreciation allowance has been claimed by previous owner(s), a simple solution would be to allow a deduction for plant and equipment within an existing residential investment property that is within its useful life.

To continue the example in section 2 above, Owner B could continue to claim a depreciation deduction for the oven of $600 over three years because it still has three years' useful life and $600 of remaining value. Once the oven is fully depreciated (so its original cost of $1,000 has been fully claimed by Owners A and B), no further depreciation should be able to be claimed by any owner, current or future. Therefore, if Owner B sells the property to Owner C four years after purchasing it, Owner C cannot claim any further deductions in respect of the oven as it is now six years old and beyond its useful life for tax purposes. This will protect the integrity of the tax system by ensuring that depreciation deductions cannot exceed the original cost of any depreciable asset.

Owners wishing to claim depreciation deductions for plant and equipment contained in existing residential investment property must be able to provide evidence of the asset's age. This could be by way of a receipt or other proof of purchase from the existing owner, or by engaging a suitably qualified quantity surveyor or other expert who can estimate the age of the plant and equipment and therefore determine whether it has any useful/depreciable life remaining.

Yours sincerely,

Marcus Lim