TREASURY LAWS AMENDMENT (HOUSING TAX INTEGRITY) BILL 2017

EXPOSURE DRAFT EXPLANATORY MATERIAL

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
CGT	capital gains tax
GST Act	*A New Tax System (Goods and Services Tax) Act 1999*
ITAA 1997	*Income Tax Assessment Act 1997*

Chapter 1
Travel expenditure for residential rental property

Outline of chapter

1.1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that travel expenditure incurred in gaining or producing assessable income from residential premises is:

- not deductible; and
- not recognised in the cost base of the property for capital gain tax (CGT) purposes.

1.2 The amendments improve the integrity of the tax system by addressing concerns that some taxpayers have been claiming travel deductions without correctly apportioning costs, or have claimed travel costs that were for private purposes.

1.3 The amendments are not intended to affect deductions for institutional investors in residential premises, as the same integrity concerns do not arise for such investors. The amendments also do not affect deductions for travel expenditure incurred in carrying on a business, including where an entity carries on a business of providing property management services.

1.4 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 Generally, section 8-1 allows income tax deductions for losses and outgoings that are incurred in the gaining or producing of assessable income, or are necessarily incurred in the carrying on of a business for the purpose of gaining or producing assessable income.

1.6 Prior to the amendments made by this Schedule, travel expenditure for, but not limited to, the inspection or maintenance of a rental property owned by a taxpayer, or travel expenditure to collect rent, was deductible as being incurred in gaining or producing assessable income under section 8-1. Deductible travel expenditure included car, airfare and accommodation costs. Where travel was for a mixed purpose, investors could only claim expenses to the extent they were incurred in relation to gaining income from the rental property.

1.7 In the 2017-18 Budget, the Government announced a package of measures designed to reduce pressure on housing affordability. This Schedule implements one of the reforms in the package to disallow travel expenditure deductions relating to residential investment properties. This is an integrity measure to address concerns that some taxpayers have been claiming travel deductions without correctly apportioning costs, or have claimed travel costs that were for private purposes. The amendments will provide confidence in the tax system by ensuring tax deductions are better targeted.

Summary of new law

1.8 Schedule 1 amends the ITAA 1997 to ensure that travel expenditure incurred in gaining or producing assessable income from residential premises is not deductible unless incurred by certain institutional entities or by an entity in the course of carrying on a business.

1.9 Furthermore, travel expenditure which is prevented from being deducted by the amendments in this Schedule cannot form part of any element of the cost base and reduced cost base of residential premises for CGT purposes.

Comparison of key features of new law and current law

New law	*Current law*
Deducting travel expenditure	
An entity may not deduct a loss or outgoing they incur to the extent that it is attributable to travel if it is incurred to gain or produce assessable income from the use of residential premises as residential accommodation. However, an entity may continue to deduct such losses or outgoings if: • the entity is in an excluded class of entity; or • the losses or outgoings are necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. An entity is in an excluded class if, at any time during the income year in	Generally, an entity may deduct a loss or outgoing they incur in gaining or producing assessable income, or which is necessarily incurred in the carrying on of a business for the purpose of gaining or producing assessable income. This means that an entity may generally deduct losses or outgoings attributable to travel to gain or produce assessable income from the use of residential premises as residential accommodation.

New law	***Current law***
which the loss or outgoing is incurred, the entity is: • a corporate tax entity; or • a superannuation plan that is not a self managed superannuation fund; or • a large unit trust (ie. one with 300 or more unit holders to which section 116-35 does not apply).	
Travel expenditure – cost and reduced cost base	
Travel expenditure which is prevented from being deducted by the amendments introduced in this Schedule does not form part of any element of the cost base or reduced cost base of a residential investment property.	Generally, travel expenditure does not form part of the cost base or reduced cost base of a residential investment property to the extent that a taxpayer has deducted or can deduct it.

Detailed explanation of new law

1.10 These amendments deny deductions for travel expenditure incurred in gaining or producing assessable income from residential premises to address concerns that some taxpayers have been incorrectly claiming travel deductions.

1.11 The amendments do not prevent an entity from claiming such a deduction if:

- the entity is in an excluded class (refer paragraphs 1.24 to 1.30); or
- the losses or outgoings are necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income (refer paragraphs 1.31 to 1.34).

Travel expenditure related to residential investment property not deductible

1.12 The amendments provide that an entity cannot deduct a loss or outgoing incurred under the income tax law, to the extent that it is attributable to travel if it is incurred to gain or produce assessable income from the use of residential premises as residential accommodation. ***[Schedule 1, item 2, paragraph 26-31(1)(a)]***

Residential investment property

1.13 These amendments prevent deductions for travel expenditure related to residential premises being deducted. The term 'residential premises' is defined in the ITAA 1997 as having the same meaning as in the GST Act. The GST Act provides that 'residential premises' means land or a building that is occupied as a residence or for residential accommodation or is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation (regardless of the term of the occupation or intended occupation) and includes a 'floating home' (within the meaning of the GST Act). ***[Schedule 1, item 2, paragraph 26-31(1)(a)]***

1.14 Due to its use in the GST law, this defined term is already the subject of considerable judicial scrutiny as well as interpretative guidance. Broadly, land or a building will be residential premises if it provides, at minimum, shelter and basic living facilities and is either occupied by a person or designed for occupation.

1.15 This is to be ascertained by an objective consideration of the character of the property – the purpose for which an entity may hold the property is not relevant.

1.16 The definition is broad and may include commercial residential premises, such as a hotel or boarding house. However, where travel expenditure is necessarily incurred in carrying on a business, the expenditure will remain deductible under section 8-1 (refer paragraphs 1.31 to 1.34).

1.17 These amendments deny deductions for travel expenditure incurred in producing income that is derived from the use of residential premises as residential accommodation. In other words, the amendments disallow deductions for travel expenditure incurred in producing rental income from residential premises.

1.18 These amendments do not prevent an entity from deducting travel expenditure where they are not using residential premises as residential accommodation, but are using the premises for other income producing purposes. To the extent that the residential premises are used for other income producing purposes, travel expenditure relating to these purposes can continue to be deducted. This would include to the extent that the residential premises are also used to generate electricity from solar panels on the roof (see example 1.2).

1.19 These amendments principally affect owners of residential rental properties. However, the amendments also affect entities that do not have a legal ownership interest in a property but have the right to use the property to produce income from the use of the residential premises as residential accommodation. This would include sublease arrangements (see example 1.3).

Travel expenditure

1.20 These amendments deny deductions for travel expenditure incurred to gain or produce assessable income from the use of residential premises as residential accommodation. This includes travel for activities undertaken to gain or produce rental income from an entity's residential investment property, such as, but not limited to, inspecting, maintaining, or collecting rent for the property. ***[Schedule 1, item 2, subsection 26-31(1)]***

1.21 For the purposes of these amendments, the ordinary meaning of 'travel' applies. Travel expenditure would be expected to include motor vehicle expenses, taxi or hire car costs, airfares, public transport costs, and any meals or accommodation related to the travel.

1.22 The travel will not be restricted to travel to the relevant property. For example, travel undertaken to attend an owner's corporation meeting or visit a real estate agent to discuss the property will also not be deductible.

1.23 The travel will not necessarily be undertaken by the taxpayer. For example, the taxpayer may incur a loss or outgoing attributable to their relative's travel if they reimburse or directly pay for their relative's travel and the travel is related to the rental property. Regardless of who undertakes the travel, these amendments deny deductions for travel expenditure incurred by a taxpayer.

Example 1.1 Travel expenditure for inspecting property and visiting real estate agent not deductible

Michael owns an investment property and engages a real estate agency to manage his property which is located across town. The property is leased for residential accommodation and therefore considered residential premises within the meaning of the GST Act.

Every six months, Michael travels by car to inspect the property. He also meets with the real estate agent once a year, to discuss potential rent increases and any other property management issues. Travel expenditure to inspect the property and meet with the real estate agent is for the purpose of gaining or producing rental income from the use of residential premises as residential accommodation.

Michael incurs fuel costs associated with this travel. The fuel costs are not incurred in carrying on a business. Michael cannot deduct such travel expenditure as it is attributable to travel and incurred to derive income from the use of residential premises for residential accommodation.

Example 1.2 Travel expenditure related to residential premises may be deducted, where use is not for residential accommodation

David owns an investment property in North Queensland which is intended to be occupied, and is capable of being occupied as a residence. The property is therefore considered residential premises within the meaning of the GST Act.

David's property is vacant, but he derives assessable income from selling stored solar energy generated by solar panels attached to the roof of the premises.

David travels from his hometown in Canberra to his property in North Queensland for the sole purpose of carrying out maintenance on the solar panels, which form part of the residential premises. This maintenance activity is to gain or produce assessable income from the use of the residential premises.

David incurs airfare costs associated with this travel. However, David did not incur this travel expenditure in gaining or producing assessable income from the use of the residential premises as residential accommodation. Therefore these amendments do not prevent David from deducting his travel expenditure.

Example 1.3 Travel expenditure related to residential premises subject to a sublease arrangement not deductible

Chris is the legal owner of an investment property, which he has leased out to head tenant Billy. Billy decides to move out of the property but decides not to break the lease. Instead, Billy subleases the property to another tenant, Jared.

Billy collects rental income from Jared and incurs expenditure travelling to the property to inspect it every month. Billy is prevented from deducting such expenditure, which is attributable to travel and is incurred to gain or produce assessable income from the use of residential premises as residential accommodation.

Excluded classes of entity

1.24 These amendments do not prevent an entity from deducting a loss or outgoing attributable to travel related to a residential investment property, if at any time during the income year in which the loss or outgoing is incurred, the entity is:

- a 'corporate tax entity' within the meaning of the ITAA 1997;
- a 'superannuation plan' that is not a 'self managed superannuation fund' within the meaning of the ITAA 1997; or
- a large unit trust (ie. one with 300 or more unit holders to which section 116-35 does not apply).

[Schedule 1, item 2, subsection 26-31(2)]

1.25 The amendments do not apply to deductions for institutional investors in residential premises. Institutional investors usually operate under a corporate structure, are large unit trusts or meet the description of being a 'superannuation plan' that is not a 'self managed superannuation fund' within the meaning of the ITAA 1997. Generally, such investors are considered to have a low risk of incorrectly claiming travel deductions, as these entities are either outside the control of an individual, do not receive tax concessions which flow through to individuals or both. Furthermore, situations where apportionment of expenditure is required because there is a mixed purpose for travel are less likely to arise for such taxpayers.

1.26 Corporate tax entity is defined in section 960-115 of the ITAA 1997. It includes entities that are companies, corporate limited partnerships, corporate unit trusts and public trading trusts at the relevant time. It does not include a trust merely because the trustee of the trust is a corporate tax entity.

1.27 'Superannuation plan' and 'self managed superannuation fund' are similarly defined in subsection 995-1(1) of the ITAA 1997.

1.28 To be considered a large unit trust and benefit from this exclusion, a unit trust must have at least 300 different unit holders. This number of unit holders, which is consistent with similar provisions in the capital gains tax law such as the exception from the market value substitution rule in subsection 116-30(2) and the scrip for scrip rollover in Subdivision 124-M, ensures that the trust is sufficiently large that the interest of one unit holder is not significant and it is not practical to establish such a trust solely to benefit from this exclusion.

1.29 A unit trust must also not be a trust covered by section 116-35 – that is, it must not be a trust where 20 or fewer individuals control the trust or the majority of the distributions from the trust or a trust where it could reasonably be concluded that the rights attached to the units could be varied in such a way to bring about this outcome.

1.30 Combined, these requirements ensure that unit trusts must be widely held and genuinely free from the control of any one member to benefit from this exclusion.

Travel expenditure incurred in carrying on a business

1.31 These amendments ensure that deductions for travel expenditure incurred in carrying on a business remain deductible under section 8-1. This means deductions will continue to be available for an entity that carries on a business of property investing or a business of providing retirement living, aged care, student accommodation or property management services. ***[Schedule 1, item 2, paragraph 26-31(1)(b)]***

1.32 Whether a business is being carried on depends on the facts of the particular case. For example, some indicators that the courts have considered relevant are whether the activity has a significant commercial purpose or character, whether there is repetition and regularity of the activity and whether the activity is better characterised as a hobby or recreational past-time.

1.33 An entity that is considered to be carrying on a business of providing retirement living, aged care or student accommodation may incur travel expenditure in carrying on its business. For example, a retirement village operator may incur travel expenditure in having an employee travel from a head office to a retirement village to inspect the property or carry out maintenance. This travel is for the purpose of gaining or producing assessable income from the use of residential premises as residential accommodation. Such entities can continue to deduct travel expenditure necessarily incurred in carrying on their business (refer section 8-1).

1.34 These amendments do not affect the ability of a taxpayer to deduct from their assessable income the cost of property management services under section 8-1, such as where the taxpayer engages a real estate agent to provide these services. As is the case prior to these amendments, the taxpayer is not able to deduct any travel undertaken by the property management service provider as the taxpayer has not directly incurred this cost. However, the cost of the travel will continue to be deductible by the property management service provider, as it is an expense necessarily incurred in the course of carrying on their business for the purpose of gaining or producing assessable income. Those travel costs would be expected to be passed on to the taxpayer as part of the real estate agent's fee for providing property management services.

Example 1.4 Travel expenditure incurred in carrying on a business deductible

Mirela operates a business of leasing holiday flats in Coffs Harbour. She undertakes various tasks such as cleaning, laundry, greeting guests and topping up provisions on a daily basis.

Mirela uses a car to travel between the flats and her garage at home where she keeps her equipment and stock. She uses the logbook method to calculate her travel expenditure.

Her travel expenditure is incurred in the course of carrying on a business for the purpose of producing assessable income and therefore remains deductible.

Example 1.5 Travel expenditure in a mixed use property

Anna owns multiple workshops across Australia as part of her business operations. She owns a two-storeyed brick shop-house in Melbourne. The building comprises of a workshop on the ground floor and an apartment on the first floor.

The apartment is rented out separately to a couple, Leon and Michelle. Therefore, Anna derives assessable income from both her workshop and the apartment.

The apartment satisfies the definition of residential premises within the meaning of the GST Act.

Anna travels from her hometown in Canberra to her property in Melbourne for the purpose of carrying out maintenance on the wall and roof of the building. This maintenance activity is related to gaining or producing assessable income from both the workshop and the apartment.

Anna incurs airfare costs associated with this travel. Anna will have to apportion her travel expenditure.

She can only deduct the amount that is apportioned for the purpose of gaining or producing assessable income from her workshop, as such expenditure is incurred in the course of carrying on her business. The amount of travel expenditure apportioned in gaining or producing income from her rental property in providing residential accommodation is not deductible.

Ensuring non-deductible travel expenditure is excluded from the cost base for capital gains tax purposes

1.35 This Schedule includes amendments to the CGT rules that ensure that losses and outgoings, which are prevented from being deducted by the amendments in this Schedule do not form part of any element of the cost base and reduced cost base of a residential investment property. This will have the effect that the travel expenditure is never included in any of the elements of the cost base or reduced cost base (refer section 110-37). ***[Schedule 1, items 3 and 4, subsections 110-38(4A) and 110-55(9J)]***

1.36 This ensures that the expenses that are no longer recognised on a taxpayer's revenue account are also prevented from being recognised on their capital account.

Non-deductible travel expenditure also not deductible as black hole expenditure

1.37 Travel expenditure is not deductible under section 40-880 (which makes certain business related capital expenditure, known as 'black hole expenditure', deductible) to the extent that it is not deductible under these amendments (refer paragraphs 40-880(5)(g) and (h)).

Consequential amendments

1.38 This Schedule includes consequential amendments adding references to the new rules to the guidance material in section 12-5 (which contains a list of provisions about deductions). ***[Schedule 1, item 1, section 12-5]***

1.39 This Schedule also includes consequential amendments adding notes to assist users of the legislation. ***[Schedule 1, items 3 and 4, note to subsections 110-38(4A) and 110 55(9J)]***

Application and transitional provisions

1.40 The amendments apply to any loss or outgoing incurred on or after 1 July 2017. ***[Schedule 1, item 5]***

Chapter 2
Limiting deductions for plant and equipment in residential premises

Outline of chapter

2.1 Schedule 2 to the Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to deny income tax deductions for the decline in value of 'previously used' depreciating assets (plant and equipment) an entity uses in gaining or producing assessable income from the use of residential premises for the purposes of residential accommodation.

2.2 However, the amendments do not affect deductions that arise:

- in the course of carrying on a business; or
- for corporate tax entities, superannuation plans (other than self managed superannuation funds) and large unit trusts.

2.3 The proportion of the decline in value of the asset that cannot be deducted is recognised as a capital loss (or in certain circumstances a capital gain) when the asset ceases to be used.

2.4 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

Operation of existing law

2.5 The ITAA 1997 contains different sets of rules for recognising the cost of different types of capital assets. Deductions for depreciating assets – assets that have a limited effective life and can be reasonably expected to decline in value over their period of use (see section 40-30) – are generally governed by the uniform capital allowance rules in Division 40.

2.6 Under these rules, entities may deduct the amount of the decline in value of a depreciating asset over the period they hold the asset during an income year (see section 40-25).

2.7 However, this deduction is only available to the extent that the decline in value of the asset is not attributable to it being used or installed ready for use for a purpose other than a taxable purpose. Taxable purposes include a purpose of producing assessable income as well as certain purposes relating to mining and environmental protection (see subsections 40-25(2) and (3)).

2.8 Depreciating assets include most items of plant and equipment – that is fixtures and fittings that are associated with real property but do not merely function as part of the structure of the property – or which are machinery (see the definition of plant in section 45-40).

2.9 Generally, when an entity permanently ceases to use a depreciating asset, such as by selling the asset, a balancing adjustment event occurs. This requires the entity to make a balancing adjustment to its taxable income if the final value of the asset (its termination value as defined in section 40-300) is greater than the cost of the asset reduced by the decline in value of the asset calculated under Division 40 (its adjustable value). The balancing adjustment effectively ensures that the tax benefits the entity has received for holding the asset are aligned with the final valuation of the asset at the time use ceases.

Budget announcement

2.10 In the 2017-18 Budget, the Government announced a package of measures designed to reduce pressure on housing affordability. As part of this package, the tax law is to be amended to improve the integrity of the tax system for deductions relating to investment properties by limiting deductions for property investors relating to the decline in value of plant and equipment and travel expenses for residential rental property.

Summary of new law

2.11 Schedule 2 reduces the amount an entity can deduct for a depreciating asset under Division 40 or Subdivision 328-D of the ITAA 1997 to the extent that the asset is a second-hand asset used for the purposes of gaining or producing assessable income from the use of residential premises for residential accommodation. If a depreciating asset is used wholly for this purpose, no deduction will be available.

2.12 This reduction does not apply to a deduction that arises in the course of carrying on a business or for corporate tax entities, superannuation plans (that are not self managed superannuation funds) or large unit trusts.

2.13 To the extent that an entity’s deductions for an asset are reduced because of these amendments, when the entity ceases to use the asset the amount of any balancing adjustment is reduced and the proportion of the decline in value of the asset is recognised as a capital loss (or in certain circumstances a capital gain).

Comparison of key features of new law and current law

<table>
<tr><th>New law</th><th>Current law</th></tr>
<tr><td colspan="2">Deducting amounts for depreciating assets</td></tr>
<tr><td>Entities may only deduct amounts under Division 40 or Subdivision 328-D for depreciating assets used in gaining or producing assessable income from the use of residential premises for residential accommodation if:
• the entity is a corporate tax entity, a superannuation plan that is not a self managed superannuation fund or a large unit trust;
• the deduction arises in the course of carrying on a business;
• the entity:
– held the asset at the first time it was first used or installed ready for use by any entity; and
– has been able to deduct amounts for the decline in value of the asset in all prior income years in which it has held the asset; or
• the entity:
– first came to hold the asset when it was used or installed ready for use in new residential premises;
– prior to this time, no entity had either resided in premises in which the asset was used or installed or been entitled to deduct any amount for the decline in value of the asset; and
– has been able to deduct amounts for the decline in value of the asset in all prior income years in which it has held the asset.</td><td>Entities may deduct amounts under Division 40 of the ITAA 1997 for depreciating assets used in gaining or producing assessable income from the use of residential premises for residential accommodation.</td></tr>
</table>

New law	***Current law***
Balancing charge and capital gains tax consequences	
When an entity ceases to use a depreciating asset, a balancing adjustment may need to be made to the entity's taxable income. The amount of this adjustment is based on the difference between the actual value of the asset at that time and the value based on deductions previously claimed. If the entity's deductions in respect of an asset have been reduced because the entity used the asset for a purpose other than a taxable purpose *or because of these amendments*, the amount of this adjustment is reduced. Further, CGT event K7 will occur and may result in a capital gain or loss for the entity to account for the proportion of the change in value of the asset attributable to the use of the asset for a purpose other than a taxable purpose *or for which deductions were not available because of these amendments*.	When an entity ceases to use a depreciating asset, a balancing adjustment may need to be made to the entity's taxable income. The amount of this adjustment is based on the difference between the actual value of the asset at that time and the value based on deductions previously claimed. If the entity's deductions in respect of an asset have been reduced because the entity used the asset for a purpose other than a taxable purpose, the amount of this adjustment is reduced. Further, CGT event K7 will occur and may result in a capital gain or loss for the entity to account for the proportion of the change in value of the asset attributable to the use of the asset for a purpose other than a taxable purpose.

Detailed explanation of new law

Denying deductions for depreciating assets used in residential premises

2.14 Schedule 2 amends Division 40 and Subdivision 328-D of the ITAA 1997 to reduce the amount that can be deducted by an entity for the decline in value of a depreciating asset (i.e. plant or equipment) for an income year to the extent that the asset:

- is used or installed for the purposes of gaining or producing assessable income from the use of residential premises for the purposes of providing residential accommodation; and
- has been previously used by another entity or for a private purpose.

[Schedule 2, item 4, subsections 40-27(1), (2) and (4)]

2.15 This reduction does not apply if the entity is:

- a corporate tax entity;

- a superannuation plan that is not a self managed superannuation fund; or
- a large unit trust (a unit trust with at least 300 unit holders that is not a trust to which section 116-35 of the ITAA 1997 applies).

[Schedule 2, item 4, subsection 40-27(3)]

2.16 The reduction also does not apply if the asset is used in carrying on a business. ***[Schedule 2, item 4, paragraph 40-27(1)(b)]***

2.17 The intended effect of these amendments is that certain entities will only be able to deduct the decline in value of depreciating assets used in gaining or producing assessable income from residential premises if the asset is acquired new for that purpose. Broadly, the amendments ensure that entities cannot claim overstated deductions relating to their rental properties by 'refreshing' the values of previously used depreciating assets used or installed ready for use in relation to those properties.

Gaining or producing assessable income from residential premises

2.18 The reduction only applies to the asset if it is used for the purpose of gaining or producing assessable income from the use of residential premises. ***[Schedule 2, item 4, paragraph 40-27(1)(a)]***

2.19 The term 'residential premises' is defined in the ITAA 1997 as having the same meaning as in the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act). The GST Act provides that 'residential premises' means land or a building that:

- is occupied as a residence or for residential accommodation; or
- is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation.

2.20 The definition specifies that land or a building that meets these requirements is residential premises regardless of the term of the occupation or intended occupation. It also specifies that residential premises include a floating home.

2.21 Due to its use in the GST law, this defined term is already the subject of considerable judicial scrutiny as well as interpretative guidance. Broadly, land or a building will be residential premises if it provides, at minimum, shelter and basic living facilities and is either occupied by a person or designed for occupation.

2.22 This is to be ascertained by an objective consideration of the character of the property – the purpose for which an entity may hold the property is not relevant.

2.23 Residential premises need only be suitable for occupation, rather than long-term occupation – they include, for example, a hotel room that may only be suitable for short term accommodation. However, it does not include things that people may occupy that are not land or a building, such as a caravan. It also does not include premises that may provide shelter and basic living facilities where it is clear from the design and structure of the premises that this is incidental to the character of the premises. For example, while hospitals will often have facilities to permit extended occupation by patients, this does not mean that a hospital is occupied or intended for occupation as a residence.

2.24 Additionally, for the reduction to apply, the use of the asset must be related to the use of residential premises to provide residential accommodation. This means that assets used in other income generating activities in residential premises will not be affected. For example, an entity continues to be entitled to deduct the decline in value of solar panels to the extent the solar panels are used for the purpose of generating income from the sale of electricity.

2.25 This means that deductions continue to be available for assets that are used for other taxable purposes, for example, exploration and prospecting or gaining income from employment.

2.26 This is the case even if an asset may be used in residential premises in the course of this other purpose. For example, a home cleaning service may use depreciating assets in residential premises, but its income does not come from the use of the premises for residential accommodation but from its cleaning activities.

Previously used

2.27 The reduction also only applies if the asset has been 'previously used'.

2.28 An entity will have 'previously used' an asset if either:

- the entity is not the first entity that used the asset or installed the asset ready for use (within the meaning of Division 40) other than as trading stock; or
- the entity had used the asset wholly for purposes that were not taxable purposes (within the meaning of Division 40) for an income year.

[Schedule 2, item 4, paragraphs 40-27(1)(c) and (d)]

2.29 Effectively, an asset will be previously used if there has been any prior use of the asset for which the entity that now holds the asset was not entitled to a tax deduction, with the exception of use as trading stock.

2.30 For example, where an individual is substantially renovating residential premises and living in the premises while doing so, they would be considered to be using the premises. Any assets installed in the premises while they are living there would therefore be previously used and any deductions for the decline in value of the assets for any subsequent owner would be subject to the reduction.

2.31 This ensures that the reduction is targeted to situations in which there is a particular risk of overvaluation of previously used depreciating assets. When assets are purchased new, there are fewer integrity concerns about the valuation of the assets. If they are purchased after being used by another entity or applied to a taxable purpose after a period of private use, their value is less clear and there is more scope for the entity holding the asset to adopt a 'refreshed' valuation that increases the amount deductible.

Example 2.1 – Previously used assets

Craig has newly acquired an apartment that he intends to offer for rent. This apartment is three years old and has been used as a residence for most of this time.

Chris acquires a number of depreciating assets together with the apartment, including carpet. He also acquires a number of depreciating assets to install in the apartment, including:

- curtains, which he purchases new from Retailer Co; and
- a washing machine, that he purchases used from a friend, Jo.

Craig also purchases a new fridge, but rather than place this in the apartment, he uses it to replace his personal fridge, that he acquired a number of years ago for his personal use. He instead places his old fridge in the new apartment.

The amendments do not permit Craig to deduct an amount under Division 40 for the decline in value of the carpet, washing machine or fridge for their use in generating assessable income from the use of his apartment as a rental property as both are previously used. The carpet and washing machine are both previously used assets as it is the previous owner or Jo rather than Craig who first used or installed the assets (other than as trading stock). The fridge is previously used as, while Craig first used or installed the fridge, he has used it wholly for purposes other than taxable purposes in prior years.

The amendments do not affect Craig's entitlement to deduct an amount under Division 40 for the decline in value of the curtains. They are not 'previously used' under either limb of the definition.

Previous use and assets installed in new residential premises

2.32 A qualification applies to the requirement that the asset must not have been previously used.

2.33 Often developers will acquire and install various depreciating assets in the course of constructing or substantially renovating residential premises. In some cases the property may already have an owner, but in others, the developer or other entity may hold the land and it will not be sold until after construction and installation.

2.34 In these situations, in which a new asset is installed in new premises, the value of the asset has not yet declined and there is no risk of the valuation of the asset for the purposes of depreciation being refreshed.

2.35 Accordingly, the amendments do not apply to an asset installed in new residential premises (including substantially renovated premises) if no entity has previously been entitled to any deduction for the decline in value of the asset and no one has resided in the premises in which the asset has been used. ***[Schedule 2, item 4, subsection 40-27(4)]***

2.36 The term 'new residential premises' has, for the purposes of the amendments, the same meaning as in the GST Act. Section 40-75 of the GST Act defines 'new residential premises' as, broadly, premises that have not been previously sold or leased as residential premises, or have been subject to a substantial renovation or replacement of existing premises. 'Substantial renovations' is also defined in the GST law as, broadly, renovations in which substantially all of a building is removed and replaced (though it does not always need to involve structural alterations). For example, the installation of a new kitchen and bathroom in an existing home is not, on its own, 'substantial renovations'.

2.37 Interpretative guidance has been issued in relation to the meaning of 'new residential premises', 'substantial renovations' and other related concepts – see for example GST Ruling GSTR 2003/3 'Goods and services tax: when is a sale of real property a sale of new residential premises?'.

Example 2.2 – Assets installed in new residential premises

Hannah purchases a new apartment off the plan from Developer Co.

Developer Co has fitted out the apartment, installing ready for use depreciating assets including curtains and furniture prior to settlement and the transfer of title to Hannah. Developer Co has also fitted out the shared areas of the complex in which the apartment is located, installing ready for use a range of deprecating assets that are the joint property of the apartment owners.

All of these assets are new at the time of installation. As these assets were first installed by Developer Co, not Hannah, they are previously used and a deduction would not be available under the general rules established by these amendments.

However, a deduction is still available to Hannah for the depreciating assets (including Hannah's share of the assets installed in the shared areas of the apartment) for the period she holds the assets as:

- the assets have been installed ready for use in new residential premises;
- Developer Co has not claimed any deduction for the decline in value of the assets (and nor has any other entity); and
- no entity has resided in premises in which the assets have been installed.

Exception for certain entities

2.38 The reduction in the amount that can be deducted also does not apply at all to deductions incurred by an entity for an income year in which the entity is:

- a corporate tax entity;
- superannuation plan that is not a self managed superannuation fund; or
- a large unit trust (i.e. one with 300 or more unit holders to which section 116-35 does not apply).

[Schedule 2, item 4, subsection 40-27(3)]

2.39 As discussed in paragraph 2.17 above, these amendments are intended to address incentives to obtain excessive deductions. These incentives primarily exist for individuals, who are most likely to be in a position to apply such deductions to reduce tax payable on income from employment and other unrelated activities and receive favourable tax treatment for capital gains. The incentives also exist for entities that individuals can control and which either can pass income (including capital gains) or deductions through to individuals or receive similar tax concessions.

2.40 The same incentives do not arise for corporate tax entities, superannuation plans (that are not self managed superannuation funds) and large unit trusts. They are either outside the control of an individual, do not receive tax concessions or both. Given this, the amendments do not apply to these entities.

2.41 Corporate tax entity is defined in section 960-115 of the ITAA 1997. It includes entities that are companies, corporate limited partnerships, corporate unit trusts and public trading trusts at the relevant time. It does not include a trust merely because the trustee of the trust is a corporate tax entity.

2.42 ‘Superannuation plan’ and ‘self managed superannuation fund’ are similarly defined in subsection 995-1(1) of the ITAA 1997.

2.43 To be considered a large unit trust and benefit from this exclusion, a unit trust must have at least 300 different unit holders. This number of unit holders, which is consistent with similar provisions in the capital gains tax law such as the exception from the market value substitution rule in subsection 116-30(2) and the scrip for scrip rollover in Subdivision 124-M, ensures that the trust is sufficiently large that the interest of one unit holder is not significant and it is not practical to establish such a trust solely to benefit from this exclusion. ***[Schedule 2, item 4, paragraph 40-27(3)(c)]***

2.44 A unit trust must also not be a trust covered by section 116-35 – that is, it must not be a trust where 20 or fewer individuals control the trust or the majority of the distributions from the trust or a trust where it could reasonably be concluded that the rights attached to the units could be varied in such a way to bring about this outcome. ***[Schedule 2, item 4, paragraph 40-27(3)(c)]***

2.45 Combined, these requirements ensure that unit trusts must be widely held and genuinely free from the control of any one member to benefit from this exclusion.

Carrying on a business

2.46 Similarly, deductions also continue to be available to the extent that an asset is used in the course of carrying on a business, even if that business is carried on for the purpose of gaining or producing income from the use of residential premises for residential accommodation. For example, an entity operating a hotel continues to be entitled to deduct the decline in value of the depreciating assets used for the purposes of the business in the hotel premises. ***[Schedule 2, item 4, paragraph 40-27(1)(b)]***

2.47 Whether a business is being carried on depends on the facts of the particular case. For example, some indicators that the courts have considered relevant are whether the activity has a significant commercial purpose or character, whether the activity is repeated and regular and whether the activity is better characterised as a hobby or recreational past-time.

Application to small business entities

2.48 Entities that are small business entities may choose to calculate their deductions for the decline in value of depreciating assets they hold using Subdivision 328-D rather than Division 40.

2.49 These amendments will have limited application to the assets of small business entities. Small business entities must, among other things, carry on a business and the assets they use in carrying on their business are excluded – see paragraphs 2.46 to 2.47 above.

2.50 However, while an entity must be a small business entity to apply Subdivision 328-D, the application of the Subdivision is not limited to assets used in carrying on the business – small business entities that choose to apply Subdivision 328-D generally must apply it in respect of all depreciating assets they hold, even those that are not used in carrying on a business – see section 328-175.

2.51 This means that while it is unusual, it is possible for depreciating assets to which these amendments generally apply – assets used in gaining or producing assessable income from the use of residential premises to provide residential accommodation other than in the course of carrying on a business – to be subject to the small business depreciating rules in Subdivision 328-D.

2.52 To address this, the amendments prevent an entity deducting amounts under Subdivision 328-D for an asset to the extent that the entity could not deduct amounts under section 40-25 because of these amendments for that asset. ***[Schedule 2, item 11, subsection 328-175(9A)]***

Application to low value pools

2.53 Entities may choose to allocate certain assets (generally assets with a value of less than $1000 in the year in which the asset is first used by the entity for a taxable purpose) to a low value pool for an income year (section 40-425).

2.54 The decline in value of assets placed in a low value pool is calculated on a fixed basis for the whole pool – see section 40-440. The amount that can be deducted is not reduced for the use of the assets for a purpose that is not a taxable purpose (subsection 40-25(5)).

2.55 Instead, an entity must make a reasonable estimate of the percentage of its total use of an asset that will be used for a taxable purpose when the asset is first allocated to a low value pool. Only this percentage of the value of the asset will be placed in the pool – see section 40-440.

2.56 The amendments provide that the amount an entity can deduct for assets is similarly not specifically reduced as described in paragraphs 2.14 to 2.17 above. However, to the extent an asset is estimated to be put to a use for which the amendments prevent a deduction from being available, this use is treated as use for a purpose that is not a taxable purpose. ***[Schedule 2, item 7, subsection 40-435(2)]***

2.57 This reduces the taxable purpose proportion for such assets and hence the amount that is included in the low value pool to be deducted. It results in an equivalent outcome for these assets that is consistent with the operation of the low value pool rules.

Subsequent implications of denied deductions

2.58 Schedule 2 also amends the rules in the ITAA 1997 to modify the consequences if an entity sells or otherwise ceases to use an asset. As a result of the amendments, any balancing adjustment the entity must make is adjusted to account for any reductions in the amount the entity can deduct and any amount of the decline in the value of the asset that the entity has not been able to deduct because of these amendments is treated as a capital loss (or gain if the asset has appreciated rather than declined in value). ***[Schedule 2, items 5, 8 and 9, section 40-291, paragraph 104-235(1)(b) and paragraph (a) of the definition of sum of reductions in subsection 104-240(1)]***

Balancing adjustments

2.59 First, if the decline in value of the asset has been worked out under Division 40, and the termination value of the asset (the value of the asset when it was sold or otherwise ceased to be used) differs from its adjusted value (its cost less its decline in value), the entity must make a balancing adjustment. The entity makes this adjustment by including the amount of the difference (adjusted to account for any use of the asset for a purpose that is not a taxable purpose) in its assessable income or deducting the (adjusted) amount.

2.60 The balancing adjustment ensures that the entity has only been able to deduct the amount by which the value of the asset has actually declined over the period it has been used by the entity (and brings to account any gain if the asset has appreciated).

2.61 The amendments reduce the amount of the balancing adjustment to account for the proportion of the decline in value of the asset that the entity has not been entitled to deduct because of these amendments. ***[Schedule 2, item 5, section 40-291]***

2.62 This is consistent with the treatment of balancing adjustments for assets for which an entity has not been able to deduct amounts because the asset has been used for a purpose other than a taxable purpose. It ensures that when an entity ceases to use an asset, the total amount they are able to deduct for the decline in value of the asset (or, in some cases, required to pay) is consistent with the final value of the asset.

CGT event K7

2.63 Second, if a balancing adjustment event occurs in relation to a depreciating asset that has not been wholly used for a taxable purpose, CGT event K7 applies.

2.64 An entity makes a capital gain or capital loss as a result of CGT event K7 equal to the proportion of the decline in value of the asset (the difference between the termination value of the asset and its cost) it has not been able to deduct as it has used the asset for a purpose other than a taxable purpose.

2.65 Unlike most other CGT events, a gain or loss from CGT event K7 is not disregarded if it happens in relation to a depreciating asset an entity holds.

2.66 The amendments extend the circumstances in which CGT event K7 occurs, so that it will occur if a balancing adjustment event occurs for a depreciating asset that has been used for a purpose of gaining or producing assessable income from the use of residential premises to provide residential accommodation other than in the course of carrying on a business. ***[Schedule 2, items 8 and 9, paragraph 104-235(1)(b) and paragraph (a) of the definition of sum of reductions in subsection 104-240(1)]***

2.67 The amendments also change the amount of the capital gain or loss that occurs as a result of CGT event K7 so that it includes the proportion of the decline in value of the asset (the difference between the termination value of the asset and its cost) that an entity has not been able to deduct due to these amendments.

Example 2.3 – Resale of a property including associated plant and equipment

Gunther purchases a two year old property for $500,000 on 10 May 2017. Of this payment, $30,000 relates to previously used depreciating assets that are included with the residential premises.

Gunther rents out the property. He is unable to deduct the decline in value of the depreciating assets he acquired with the property as they are previously used. On 10 May 2021, Gunther sells the property, including these depreciating assets, for $700,000 (of which $20,000 relates to the value of the depreciating assets).

The sale of the property is a balancing adjustment event.

As Gunther has not been able to deduct any amount of the decline in value of the depreciating assets, Gunther does not need to make any adjustment to his assessable income for the income year.

However, as a balancing adjustment event occurs in relation to depreciating assets for which the available deduction has been reduced by these amendments, CGT event K7 occurs.

As a result of CGT event K7 occurring, Gunther has a capital loss equal to the proportion of the decline in value of the assets that Gunther has not been able to deduct either because of these amendments or because the amount deductible was reduced under section 40-25.

In this case, the difference between the termination value of the assets ($20,000) and the cost of the assets ($30,000) is $10,000 and all deductions for the decline in value have been denied (so the proportion of total deductions denied is 10,000/10,000 or 1). Therefore the amount of Gunther's capital loss because of the disposal of the assets is $10,000 ((30,000 – 20,000)*1 = $10,000).

Consequential amendments

2.68 Schedule 2 also makes a number of minor consequential amendments to the ITAA 1997 to reflect the principal amendments, including updating guidance material. ***[Schedule 2, items 1 to 3, 6 and 10, the item headed capital allowances in the table in section 12-5, subsection 25-47(4), the note to subsection 40-25(2), subsection 40-435(1) and paragraph 250-290(2)(c)]***

Application and transitional provisions

2.69 The amendments apply to income years starting on or after 1 July 2017 to assets acquired at or after the time the measure was publicly announced (7.30 pm on 9 May 2017) unless the asset was acquired under a contract entered into before this time. ***[Schedule 2, subitem 12(1)]***

2.70 The amendments also apply to assets acquired before this time if the assets were first used or installed ready for use by an entity during or prior to the income year during which this measure was publicly announced (generally the 2016-17 income year), but the asset was not used at all for a taxable purpose in that income year. ***[Schedule 2, subitem 12(2)]***

2.71 These application rules are intended to limit the effect of the measure to assets being newly used after Budget night for purposes that permit deductions for the decline in value of the asset, whether this is because the asset is newly acquired or newly applied for a purpose that allows its decline in value to be deducted.

2.72 The application to assets used for wholly non-taxable purposes in the income year in which this measure was announced avoids creating unintended incentives for individuals to move personal assets into rental properties and addresses the potential for the value of those assets to not properly account for the decline in value of the asset during the period in which this decline was not deductible.