8 November 2018

Manager
Individuals Tax Unit
Individuals and Indirect Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: vacantland@treasury.gov.au

Dear Sir/Madam

Limiting deductions for vacant land – draft legislation

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to comment on the exposure draft legislation (ED) and explanatory material (EM) to implement the 2018-19 Budget announcement to deny certain deductions for expenses associated with holding vacant land.

To implement this measure, the ED introduces a new section 26-105 into the *Income Tax Assessment Act 1997* and makes consequential amendments. The purpose of this measure is to address integrity concerns that deductions are being improperly claimed for holding vacant land where the land is not genuinely held for the purpose of earning assessable income. We are of the view that the proposed measure is too broad and increases complexity in order to address the specific integrity concern.

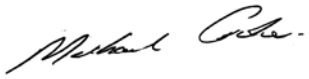
Broadly, our key concerns with the ED and EM are:

- The requirement to apportion the land under the proposed subsection 26-105(1) needs further clarification
- The carve-out for land used in carrying on a business needs to be expanded
- The impacts of the ED in non-business scenarios where the land is deriving assessable income.

We provide general comments on the measure and detailed comments on the ED and EM in our submission.

If you wish to discuss our comments please contact at first instance Karen Liew on 02 8078 5483 or me on 02 9290 5609.

Yours sincerely



Michael Croker
Tax Leader Australia
Chartered Accountants Australia and New Zealand

General comments

Based on the "Context of the amendments" in the EM, the integrity concern is:

- some taxpayers have been claiming deductions for costs associated with holding vacant land when it is not genuinely held for the purpose of gaining or producing assessable income; and
- there is often limited evidence about the taxpayer's intent other than statements by the taxpayer which leads to compliance and administrative difficulties.

We find that the proposed amendments to address the integrity concern are too wide reaching to address a very specific situation and increases complexity.

Firstly, landholders of large pieces of land with smaller buildings or structures will have to start apportioning their land according to areas which are not developed and then apportion the vacant land further to see what land is being used in carrying on a business before they can work out what land holding costs they can claim for deduction.

There is also complexity around the meaning of "use". For example, an undeveloped part of a land could be used as a car park for customers – how much of this land is "used", do you look at markings and what if the land has no markings for car parking?

All this additional complexity just because it is hard to provide objective evidence of a landowner's purpose of holding vacant land. We understand that it is difficult for the Commissioner to rely on the subjective statement of the landowner in determining whether the landowner is genuinely holding the land for the purpose of gaining or producing assessable income. Nevertheless, ultimately, the Commissioner has the legislative power to make his own assessment of the taxpayer[1] and it is up to the taxpayer to prove that the Commissioner's assessment is excessive.[2]

To address the concern, could a different measure be considered instead which provides more bright line rules? For example, as a starting point, a timeframe could be provided for the land to start gaining or producing assessable income in order to maintain the claim for land holding costs deductions, i.e. if the land is not being used to gain/produce assessable income within X years of acquisition, then the landowner will have to add back the deductions claimed.

We also find that denying deductions for holding costs of land used to develop residential property until the occupancy certificate is granted is a rather harsh consequence on genuine mum and dad residential property investors as there is often a long lead time involved before occupancy certification. With financial institutions already increasing the cost of loans and tightening lending, limiting deductions on holding costs incurred during the construction period will add further to the cost of the residential property.

[1] Under section 167 of the *Income Tax Assessment Act 1936*, if the Commissioner is not satisfied with the return furnished by any person, the Commissioner may make an assessment of the amount upon which in his or her judgment income tax ought to be levied and that amount shall be the taxable income of that person.

[2] A taxpayer may object to the Commissioner's assessment and has the burden of proof that the assessment is excessive under section 14ZZK of the *Taxation Administration Act 1953*.

Comments on the ED and EM

1. Apportionment of land needs further clarification

Proposed subsection 26-105(1) states:

(1) If, at a particular time:
(a) you incur a loss or outgoing relating to holding land; and
(b) on the land, there is no substantive permanent building, or other substantive permanent structure, that is in use or ready for use;
you can only deduct under this Act the loss or outgoing to the extent that the land is being used at that time in carrying on a *business for the purpose of gaining or producing the assessable income of one or more of the entities covered by subsection (2).

Based on the way this subsection is currently drafted, it seems that if you hold land and it has a substantive permanent building on it which is being used or ready for use, then subsection 26-105(1) does not apply. Therefore, if the land has a factory on it which was being used, i.e. a substantive permanent building, then subsection 26-105(1) should not apply to limit the deduction for land holding expenses.

However, paragraph 1.5 on page 5 of the EM says that *"land does not have to refer to the whole of the land on a property title but could refer to part of the land on a property title. For example, if a property title includes two areas of land, one containing a factory and the other underdeveloped, the part of the property title containing the factory has ceased to be vacant land, while the undeveloped area remains vacant land*".

This paragraph seems to suggest that even if there is a substantive building on the land that is being used, subsection 26-105(1) can still apply if there is a part of the land that is vacant. That is, you apportion the land between the part that has a substantive building/structure and the part that is vacant. Then you further apportion the expenses relating to that vacant part of the land between the portion that is used in carrying on the business by certain entities and the portion that is not used in determining what you can deduct. Therefore, we are of the view that the EM commentary is inconsistent with the way section 26-105(1) is currently drafted.

Furthermore, the use of a factory in the example in paragraph 1.5 without reference to the land area, e.g. 25% of the land area or some other measure, increases the uncertainty as to what would be a "substantive permanent building or structure".

CA ANZ recommends:

- The EM commentary be revised so that it reflects the way subsection 26-105(1) is drafted
- The example in paragraph 1.5 be revised to include references to some measure against the land area to provide further clarification as to what would be a substantive permanent building/structure.

2. Carve-out for land being used in carrying on a business

The proposed limitation to deductions for the costs of holding vacant land does not apply to the extent that the land is used at that time in carrying on a business for the purposes of gaining or producing assessable income for certain entities. Broadly, these entities are you, your affiliate, your spouse, your minor children or an entity connected with you (subsection 26-105(2)). We believe the carrying on a business carve-out should be extended to include adult children, and third parties to cover the situation where a party has entered into a commercial agreement with the landowner to enable the party to use the land in carrying on a business.

For example, based on the current drafting of section 26-105, there is no exclusion for land being used by a third party in carrying on its business which has leased the land from a landowner under commercial terms.

Given the many types of business that may use land for a variety of purposes, we believe some landowners may be inadvertently excluded from claiming deductions for their land holding costs even though they are deriving assessable rental income and the land is being used in carrying on a business by the lessee of the land.

For instance, say a company is in the shipping business and owns shipping containers. It enters into a lease agreement over land with an individual landowner to store its shipping containers. The company and the landowner are unrelated. As the storage of shipping containers does not need a large permanent building, just a large area of land, the land only has a small administration office and would be considered “vacant” under the proposed section 26-105(1). However, as the land is not being used in carrying on a business to derive income for the land owner or any of the land owner’s affiliates, spouse, minor children etc, it appears the land owner cannot claim a deduction for his/her land holding costs. As the landowner is deriving assessable rental income from the lease of the land, and that land is being used in carrying on a business, from a tax policy perspective he or she should be able to claim a deduction for the land holding costs.

In addition, the carrying on a business threshold for claiming a deduction will operate to exclude taxpayers that are using a property for producing assessable income, but not in a manner that amounts to the carrying on of a business. For example, a property may be acquired, developed and held for the purposes of deriving rental income. The renting of properties will generate assessable income but will often not meet the requirements to be considered the carrying on of a business. Another similar example is where the land is used for the agistment of livestock belonging to a third party and the landowner receives fees in return. The legislation needs to be expanded to accommodate these “build and hold” and agistment scenarios.

The concept of an affiliate and a connected entity is appropriate in the small business context, where they concepts are drawn from. Where it ceases to be appropriate is in the “mid size” business context where multiple unrelated parties may hold ownership interests in businesses. A situation (drawn from an actual taxpayer scenario presented to us) that would appear

problematic under the new laws but would not appear to be the type of arrangement that the laws are intended to capture is:

- A business is operated by a company that is owned by five unrelated parties through their controlled entities
- The same unrelated parties, through a unit trust owned by different controlled entities, acquire land to be developed into a factory complex that will be leased to the business
- The leasing of the factory does not amount to carrying on of a business
- The land remains vacant during the rezoning process and at times during the development process.

Expanding the law to deal with commercial arrangements between third parties, not just connected entities, should address this issue.

It is recognised that an objective of the new law is to overcome the current situation where the test for nexus to the derivation of assessable income can be subject and difficult to evidence. Expanding the tests in the proposed legislation to deal with the situations outlined above may also have the unintended consequences of permitting deductions to be claimed by taxpayers who are the intended targets of this change.

The proposed legislation sets out an "all or nothing" approach, i.e. that the legislative tests are met and deductions are available, or the tests are failed and the deductions are not available. Given the situations that have been identified that would fail the legislative tests, but would not appear to involve the mischief that is sort to be addressed by this legislation, there may be merit in providing a discretion to deal with these in between cases.

An approach may be for the legislation to contain tests that if satisfied enable a taxpayer to claim a deduction, but allow the Commissioner a discretion to allow deduction in other situations if the taxpayer can provided evidence of the connection to the derivation of assessable income. The legislation would need to set out factors that the Commissioner would need to take into account in forming his view. If this approach was one that was considered to have merit, we would be happy to provide further input on its design.

CA ANZ recommends that:

- subsection 26-105(2) be amended to cover the situation where an adult child or third party has entered into a commercial agreement with the land owner to enable the party to use the land in carrying on a business
- the legislation be expanded to include "build and hold" and agistment scenarios
- a Commissioner's discretion be included to deal with cases where the factors are not so clear.

3. Clarification for landholders in commercial joint venture/development agreements

We suggest that an example on a joint venture property development scenario be included in the EM to provide discussion around whether a landowner which provides the land in a joint venture property development is carrying on a business of property development.

A similar issue as 2. above also arises if a third party joint venture partner, which is the property developer, is not considered an "affiliate" of the landowner. That is, although the land is being used in carrying on a business of property development, it is not being used by the landowner, or the other entities currently listed is subsection 26-105(2) and so the landowner cannot claim the holding costs of the land.

4. Deduction limitation in non-business situations

CA ANZ is concerned about the impact of the complete denial of deductions (i.e. no chance to claim in later years) for land holding costs where the land is deriving assessable income in the following non-business scenarios.

(a) The "all or nothing approach" to the proposed legislation produces an inequitable result for a landowner who is deriving significant assessable rental income from the land but is still denied deductions for the land holding costs for the period the land was considered vacant.
(b) The impact on landowners involved in a one-off profit-making venture to develop the land. We note that paragraph 1.27 on page 10 of the EM states that the "losses and outgoings that are not deductible in an income year as a result of these amendments are not able to be deducted in later years. However, they may be included in the cost base of the asset for CGT purposes." Nevertheless, allowing denied costs to be included in the cost base for the asset does not assist where the ATO makes the finding that the land is actually a revenue asset. The inability to claim deduction for the holding costs where the landowner sells the land as a revenue asset also produces an inequitable result.

Appendix B

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We focus on the education and lifelong learning of members, and engage in advocacy and thought leadership in areas that impact the economy and domestic and international capital markets.

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