
TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING) BILL
2018

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

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

<i>Abbreviation</i>	<i>Definition</i>
ATO	Australian Taxation Office
CGT	capital gains tax
Exposure draft Bill	Treasury Laws Amendment (Measures for a Later Sitting) Bill 2018
GST Act	<i>A New Tax System (Goods and Services Tax) Act 1999</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>

Chapter 1

Limiting deductions for vacant land

Outline of chapter

- 1.1 The exposure draft Bill amends the ITAA 1997 to deny deductions for losses or outgoings incurred to the extent they relate to a taxpayer holding vacant land.
- 1.2 However, the amendments do not apply to any losses or outgoings relating to holding vacant land to the extent to which:
- they are necessarily incurred by the entity holding the land in the course of carrying on a business in order to earn assessable income; or
 - an affiliate, spouse or child of the taxpayer, or an entity that is connected with the taxpayer or of which the taxpayer is an affiliate, is carrying on a business on the vacant land.
- 1.3 The amendments also do not apply to taxpayers that are:
- corporate tax entities, superannuation plans (other than self managed superannuation funds), managed investment trusts or public unit trusts; or
 - unit trusts or partnerships of which all the members are entities of the above types.
- 1.4 All legislative references in this exposure draft material are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 The income tax law allows taxpayers to claim the costs of holding vacant land if it is held for the purpose of gaining or producing assessable income or carrying on a business for the purpose of gaining such income. However, 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.

1.6 As the land is vacant, there is often limited evidence about the taxpayer's intent other than statements by the taxpayer. The reliance on taxpayer's assertions about their current intention leads to compliance and administrative difficulties.

Summary of new law

1.7 The exposure draft Bill amends the ITAA 1997 to deny deductions for losses or outgoings incurred to the extent they relate to a taxpayer holding vacant land.

1.8 However, the amendments do not apply to any losses or outgoings relating to holding vacant land to the extent:

- they are necessarily incurred in the course of a business the taxpayer holding the land carries on for the purpose of gaining or producing assessable income; or
- an affiliate, spouse or child of the taxpayer holding the land, or an entity that is connected with the taxpayer or of which the taxpayer is an affiliate, is carrying on a business on the vacant land.

1.9 The amendments also do not apply to:

- corporate tax entities, superannuation plans (other than self managed superannuation funds), managed investment trusts or public unit trusts; or
- unit trusts or partnerships of which all the members are entities of the above types.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>A taxpayer cannot claim deductions for losses or outgoings incurred to the extent they relate to holding vacant land.</p> <p>However, the amendments do not apply to any losses or outgoings relating to holding vacant land to the extent:</p> <ul style="list-style-type: none"> • they are necessarily incurred in the course of a business the taxpayer carries on; or • an affiliate, spouse or child of the taxpayer, or an entity that is connected with the taxpayer or of which the taxpayer is an affiliate, uses the land in carrying on a business. <p>The amendments do not apply to:</p>	<p>A taxpayer can claim deductions for losses or outgoings incurred to the extent they relate to holding vacant land if:</p> <ul style="list-style-type: none"> • the losses or outgoings were incurred in gaining or producing their assessable income; or • the losses or outgoings relate to the taxpayer carrying on a business in order to derive assessable income.

<i>New law</i>	<i>Current law</i>
<ul style="list-style-type: none"> • corporate tax entities; superannuation plans (other than self managed superannuation funds), managed investment trusts or public unit trusts; and • unit trusts or partnerships of which all the members are entities of the above types. 	

Detailed explanation of new law

1.1 The exposure draft Bill amends the ITAA 1997 to deny deductions for losses or outgoings incurred to the extent they relate to holding vacant land.

1.2 However, the amendments do not apply to any losses or outgoings relating to holding vacant land to the extent:

- they are necessarily incurred in the course of a business the taxpayer carries on for the purpose of gaining or producing assessable income; or
- an affiliate, spouse or child of the taxpayer, or an entity that is connected with the taxpayer or of which the taxpayer is an affiliate, uses the land in carrying on a business.

1.3 The amendments also do not apply to the extent that the losses or outgoings relate to a period after land ceases to be vacant land.

1.4 The amendments do not prevent certain types of entities from claiming such deductions - refer to paragraphs 1.17 to 1.26.

Vacant land

1.5 Land is vacant, for the purpose of these amendments, if there is no building or other structure on the land that is substantial and permanent in nature and in use or ready for use. In this context, 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 undeveloped, the part of the property title containing the factory has ceased to be vacant land, while the undeveloped area remains vacant land.

1.6 To be substantive, a building or structure needs to be substantial in size and have an independent purpose or function (not ancillary in nature to other structures or proposed structures on the land such as is the

case for retaining walls or fences), rather than only be functional in conjunction with other structures on that land or the part of the land that would otherwise be vacant. *[Schedule #, item 3, subsection 26-105(1)]*

Example 1.1: vacant land

Chelsy owns a block of land. She intends to eventually build a rental property on the land. However, while the block of land is fenced and has a large retaining wall, it currently does not contain any substantial or permanent building or other structure. As the property does not have a substantial permanent building or structure on it, it is vacant land and Chelsy cannot deduct any holding costs she may incur in relation to the land.

1.7 The measure does not apply to a loss or outgoing to the extent that it is reasonably attributable to land that is *not* vacant or is being used by the owner or a related party of the owner to carry on a business.

1.8 The reference to ‘to the extent that’ ensures that the amendment does not exclude the whole area of land from the principle because a small part of the land is being used for carrying on a business. For example, where a business is operated on one part of a property but the remainder of the land is unoccupied and unused. In this case, the entity can only claim a deduction for the costs of holding the land that is used to carry on the business, rather than the costs of holding the entire property.

1.9 Similarly, this also ensures that if an entity has vacant land adjacent to land with a rental property on it then the principle only applies to the vacant land and does not prevent the holder of the land deducting the costs of the adjacent land with the rental property on it.

Example 1.2: expenditure for mixed use land

Howard owns a country house with a pool on a hectare of land in Queensland. He uses one third of the land for carrying on his firewood sales business. His house and firewood business are separated by a fence and the remainder of the land is unoccupied and unused. Howard intends to build a rental property on the unoccupied land.

Howard is eligible to claim losses and outgoings relating to holding the part of the land that he uses for carrying out his firewood business, to the extent that the loss or outgoing is necessarily incurred for the purpose of gaining or producing the assessable income from the business. He cannot deduct any expenses associated with the cost of holding the land on which his country house is built because that part of the land is used for private use.

The remainder of his land is unoccupied and is not used in carrying on his business and therefore Howard is not entitled to claim any deductions relating to the costs of holding this part of the land even though he intended to derive income from it in the future.

Holding cost of vacant land incurred in carrying on a business

1.10 These amendments do not deny deductions to the holder of vacant land for the costs of holding that land to the extent they are incurred in carrying on a business by the taxpayer (for example a property development or primary production business) or for costs incurred in holding land that is used in carrying on such a business by certain entities related to the taxpayer. *[Schedule #, item 3, subsection 26-105(1)]*

1.11 The amendments apply to the costs of holding land. This can be costs incurred in the capacity of the owner of the freehold interest in the land or of a long term leasehold interest in the land. Alternatively, where the owner leases the land to another party, the amendments also apply separately to any costs incurred by the lessee in relation to their interest in the land as the lessee is also considered to hold the land under the terms of the lease.

1.12 The related entities that enable the holder of land to satisfy the test concerning a business being carried on the land are:

- an affiliate of the holder of the land (broadly an entity controlled by the entity that holds the land - see section 328-130);
- an entity of which the holder of the land is an affiliate (see also section 328-130);
- a spouse, or a child aged under 18 years, of the holder of the land (see section 152-47); or
- an entity that is connected with the holder of the land (see section 328-125).

[Schedule #, item 3, subsection 26-105(2)]

1.13 The leasing of land to related parties is common in the agricultural sector for family enterprises and the special rule for related parties will ensure that the amendments do not adversely affect primary producers using such arrangements.

Example 1.3: Expenditure incurred in carrying on a business deductible

Ainslie carries on business as a property developer and owns a significant property portfolio of vacant land in Melbourne. She incurs outgoings relating to holding the vacant land including interest payments and council rates.

As she incurs the expenditure to hold the land in carrying on her business for the purpose of producing assessable income it is deductible.

Example 1.4: Expenditure incurred in carrying on a business by a related party of the holder of land

Gina owns vacant land in New South Wales which she rents to her spouse Robin for use in a farming business he carries on. Robin, as Gina's spouse, forms part of the class of related parties (spouses, children under 18 years old, affiliates and connected entities) that allow Gina to deduct her costs of holding the land. This is because Robin is carrying on a business on it to produce assessable income.

Land will be treated as vacant land until residential premises exist on the land

1.14 A special rule applies to land that contains residential premises within the meaning of the GST Act. Such structures are disregarded and the land is treated as remaining vacant for the purposes of these amendments until the residential premises are:

- able to be occupied under the law; and
- leased, hired or licensed or available for lease, hire or licence.

[Schedule #, item 3, subsection 26-105(3)]

1.15 This test means a taxpayer cannot deduct the costs of holding land containing residential premises until the taxpayer is actively seeking to derive income from the property.

1.16 The test is only relevant once land has a substantive permanent building or structure on it that is in use or ready for use – before this time the basic requirements for deductibility are not satisfied as the land will be vacant. Once this occurs the holding costs of the land may still not be deductible if the permanent building is residential premises that cannot be lawfully occupied as residential premises or have not been leased etc or made available to lease etc. *[Schedule #, item 3, subsections 26-105 (1) and (3)]*

Example 1.5: New residential premises available for rent

Anna purchased a block of vacant land and built new residential premises on it. Occupancy permits are issued for the residential premises once the building is considered suitable for occupation.

The building is available for lease and advertised in various property websites which give it broad exposure to potential tenants. Anna can deduct the cost of holding this block of land to the extent expenses relate to the period when the property is legally available for occupation and is leased etc or otherwise available for lease etc.

Excluded classes of entity

1.17 These amendments do not prevent an entity from deducting a loss or outgoing to the extent that it relates to holding vacant land, 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;
- a public unit trust (within the meaning of section 102P of the ITAA 1936);
- a managed investment trust within the meaning of section 275-10; or
- a partnership or unit trust if all of the members of the partnership or trust are entities included on this list (including this item).

[Schedule #, item 3, subsection 26-105(4)]

1.18 Effectively this means that the amendments do not apply to deductions for institutional investors in residential premises. Institutional investors usually operate under a corporate structure, are public unit trusts, managed investment trusts, or meet the description of being a ‘superannuation plan’ that is not a ‘self managed superannuation fund’ or are unit trusts or partnerships that are ultimately held by these entities. Generally, such investors are considered to have a low risk of incorrectly claiming deductions in relation to vacant land, as these entities are either outside the control of an individual, do not receive tax concessions which flow through to individuals or both.

1.19 Corporate tax entity is defined in section 960-115. 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.

1.20 ‘Superannuation plan’ and ‘self managed superannuation fund’ are defined in subsection 995-1(1).

1.21 Public unit trust is defined in section 102P of the ITAA 1936. Broadly, a unit trust will be a public unit trust if the units in the trust are listed for quotation in the official list of a stock exchange, offered to the public in a public offer, held by more than 50 people or where a tax-exempt investment vehicle, such as a foreign superannuation fund, is a substantial unitholder (see subsections 102P(1) and (2) of the ITAA 1936). However, a trust will not be a public unit trust if 20 or fewer people hold the beneficial interest in 75 per cent or more of the income or property of the trust, or if other integrity rules are not satisfied (see section 102P of the ITAA 1936).

1.22 Trusts are also excluded if they are managed investment trusts within the meaning of section 275-10.

1.23 In all cases these requirements ensure that trusts must be widely held and genuinely free from the control of any one member to benefit from this exclusion.

1.24 The final exclusion is for unit trusts or partnerships if all of the members of the entity (i.e. the unit holders or partners) are listed as excluded entities. This exclusion ensures that where all the benefit of deductions goes to excluded entities, the deductions continue to be available. This includes situations where the excluded entities receive the benefit of deductions through a chain of unit trusts or partnerships.

1.25 The entities to which the measure does not apply are consistent with the excluded entities for the purposes of section 26-31 concerning travel related to use of residential premises as residential accommodation and section 40-27 that relates to reduction of deductions for second-hand assets in residential property.

1.26 References to entities holding vacant land in this exposure draft material exclude the above entities for which this measure does not apply.

Denied deductions for cost base expenses included in the cost base

1.27 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, resulting in a corresponding reduction in any capital gain when a CGT event happens if they meet the cost base criteria. The relevant CGT event would typically be the sale of land (CGT event A1) but could include other CGT events such as granting, renewing or extending an option to purchase land (CGT event D2) or entering into a conservation covenant over land (CGT event D4).

1.28 This CGT treatment is consistent with the tax treatment that applies for holding vacant land for private use. For instance, an individual who buys land to later build a holiday home solely for private use can include expenses, such as rates and borrowing expenses, in their CGT cost base upon sale if they have never been entitled to claim the expenses as deductions and they are ordinarily a cost base element.

Consequential amendments

1.29 The exposure draft Bill includes a consequential amendment to add a reference to the new rules to the guidance material in section 12-5

(which contains a list of provisions about deductions). *[Schedule #, items 1 and 2, section 12-5]*

Application and transitional provisions

1.30 The amendments commence from the start of the first quarterly period commencing after the day of Royal Assent of the exposure draft Bill.

1.31 The measure applies to losses and outgoing incurred on or after 1 July 2019 regardless of whether the land was first held prior to this date. *[Schedule #, item 4]*