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RE: Enhancing the integrity of tax deductions in relation to vacant land (proposed S.26-105 of the *Income Tax Assessment Act 1997)*

Dear Sir/Madam,

The National Tax and Accountants' Association Ltd ('NTAA') welcomes the opportunity to provide comments as part of the consultation process in relation to the proposed introduction of S.26-105 of the *Income Tax Assessment Act 1997* ('ITAA 1997'), as contained in Exposure Draft Treasury Laws Amendment (Measures for a later sitting) Bill 2018: *Limiting deductions for vacant land*.

The NTAA is a national non-profit association, which currently represents the interests of approximately 10,000 member firms, including tax agent practices, taxation accountants and superannuation professionals, including Self Managed Superannuation Fund ('SMSF') auditors.

The NTAA has some concerns regarding proposed S.26-105 of the ITAA 1997 (referred to as 'S.26-105'), as set out below.

(a) **Vacant land used for agistment**

It is not uncommon for a taxpayer that owns a rural property to lease land that is surplus to their requirements to a neighboring farmer. For example, a landowner may allow a neighboring farmer to agist horses or cattle on their property (fenced paddocks) for a fee.

In some cases, the taxpayer may have acquired land that is subject to a pre-existing lease.

In this case, S.8-1(1)(a) of the ITAA 1997 prima facie provides a deduction for losses and outgoings to the extent they are incurred in gaining or producing the assessable agistment income. This deduction may, for example, include interest on funds borrowed to purchase the land in question.

In some cases, the taxpayer may need to examine their motive in acquiring and holding the land, particularly if there is a disparity between agistment income derived and the losses or outgoings incurred. If the land is held for a dual purpose (e.g., partly for the purpose of deriving assessable agistment income and partly for the purpose of achieving capital growth), the deduction amount may be reduced. In this case, deductions are limited to the agistment income and no loss arises (e.g., the deduction may be reduced to the income derived). Refer to *Fletcher & Ors v FC of T 91 ATC 4950* (*Fletcher*) and TR 95/33.

The NTAA is concerned that, if S.26-105 is enacted as proposed, the land owning taxpayer in this case would be denied any deduction for costs associated with holding the vacant land that is leased for agistment purposes, despite the fact the agistment income would continue to be fully assessable to the taxpayer. This is because, proposed S.26-105(1) prevents a deduction in respect of the leased land unless the land is either:

- not vacant, which will only be the case if there is a *substantive permanent building or other substantive permanent structure* on the land*, that is in use or ready for use.* This would often **not** be the case in an agistment scenario where the leased land consists simply of fenced vacant farming paddocks; and/or
- broadly, the land is being used in carrying on a business of the taxpayer or a specified (related) entity. This would also not be the case in an agistment scenario where the land is leased to an unrelated neighbor.

The NTAA is of the view that proposed S.26-105 produces an anomalous outcome in these circumstances. There is a concern that, if enacted as proposed, this measure may unfairly punish the primary production sector in relation to an arrangement that contains no tax avoidance or contrivance. Such an outcome would be very poorly received by a sector of the economy already 'on its knees' as a result of the ongoing drought.

It is suggested that, in addition to the existing exception that applies in respect of vacant land that is used in carrying on a business of a specified entity, proposed S.26-105 should also not apply in circumstances where the land is, at that time, being used by a third party to carry on a primary production business (or, alternatively, where the land is, at that time, producing assessable income for the taxpayer). Such a deduction would, of course, initially be determined under S.8-1 of the ITAA 1997 (and be subject to any adjustment required under *Fletcher* and TR 95/33).

(b) **Building and vacant land leased to an unrelated party**

The NTAA is concerned that proposed S.26-105 may also produce an anomalous outcome in circumstances where a taxpayer owns a substantive permanent building (e.g., an office space, factory) that is leased to an unrelated third party for use in their business, where the lease also includes an adjacent area of vacant land (which may, for example, be used as a car park or for temporary storage for the business).

In this case, under current law, such a land-owning taxpayer (who is not carrying on a business in relation to the leasing activity) would be entitled to deductions under S.8-1(1)(a) of the ITAA 1997 for losses and outgoings to the extent they are incurred in gaining or producing the assessable rental income. Such deductions may, for example, include interest on funds borrowed to purchase the property in question.

However, on these facts, the application of proposed S.26-105 would deny the taxpayer a deduction in respect of expenses relating to the vacant portion of the land (notwithstanding the rental income in relation to this land continues to be assessable to the land-owning taxpayer). This is because, whilst proposed S.26-105(1) does *not* prevent a deduction in respect of the portion of land on which the building stands, it does prevent a deduction in respect of the adjacent area of land that is vacant, unless that portion of the land is being used in carrying on a business of a specified entity.

The NTAA is of the view that this is an unintended outcome. It is suggested that, in addition to the existing exception that applies in respect of vacant land that is used in carrying on a business of a specified entity, proposed S.26-105 should also ensure that a deduction is not denied in circumstances where the land is, at that time, producing assessable income for the taxpayer (i.e., in this case, assessable rental income).

From the lessee's perspective

For completeness, we note that no issue appears to arise from the lessee's perspective in relation to this example. Whilst the lessee is holding land for the purposes of proposed S.26-105, there is no limit on the deduction allowed under the proposed provision as the lessee is carrying on a business and, thus, can argue that the building *and* the adjacent area of vacant unimproved land (that is used in the lessee's business as a car park or for business storage) falls into the exception provided for business use.

As an aside, if the lessee decided **not** to use the vacant portion of the leased land for a car park and/or storage (or perhaps decided to use only a portion of the vacant land in that way), it would appear that, based on proposed S.26-105(1), the lessee would be required to apportion the deductibility of the lease payments. The NTAA is of the view that such an outcome would be unduly onerous as it creates unnecessary complexity.

This complexity is due to the extremely narrow drafting of the phrase: *"...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 assessable income of one or more of the entities covered in subsection (2)."* [Emphasis added]

The NTAA believes it is unnecessarily restrictive to limit a deduction otherwise allowed under S.8-1 of the ITAA 1997 based on whether the land is **actually being used at that time** in the relevant business. A preferred approach in relation to this aspect of the proposed provision would be to import the wording of S.8-1(1)(b), such that a deduction would be allowed to the extent the loss or outgoing is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income of one or more of the entities covered in subsection (2).

(c) **Vacant land held in an SMSF**

It is noted that the deductions of an SMSF can be limited under proposed S.26-105(1) (refer to proposed S.26-105(4)(b)). The NTAA has concerns in this regard, as, if enacted as proposed, it will mean that many SMSFs will no longer be able to claim a deduction for losses or outgoings in relation to vacant land (even though income derived on vacant land will be assessable income of the fund, at least to the extent the land is held to support one or more accumulation interests in the fund).

For example, it is very common for an SMSF that owns farming land to lease the land to a related party of the fund for use in its primary production business (e.g., to one or more fund members, or a trust controlled by one or more fund members). Under current law, the fund would be entitled to claim a deduction under S.8-1 of the ITAA 1997 for losses and outgoings to the extent they are incurred in gaining or producing the assessable income of the fund.

However, under proposed S.26-105, a deduction for expenses associated with holding vacant farming land (i.e., being any part of the land upon which there is no substantive permanent building or structure) will be denied unless the land is leased to a specified entity (and is used in carrying on the business of that entity). In this regard, a specified entity includes an entity 'connected with' the SMSF (refer proposed S.26-105(2)). The meaning of 'connected with' for this purpose is the meaning provided in S.328-125 of the ITAA 1997. Under S.328-125, an entity is 'connected with' another entity if:

- either entity controls the other entity in a way described in the section; or
- both entities are controlled in a way described in the section by the same third entity.

The NTAA has concerns with applying the 'connected with' test in the context of an SMSF given the Commissioner's view in TD 2006/68, which is broadly that neither the trustees nor the members of a complying superannuation fund (e.g., an SMSF) beneficially own, or have the right to acquire beneficial ownership of, the required interests in the fund. Therefore, the fund is **not** connected with the members or trustees under S.328-125(1)(a) of the ITAA 1997 and nor is it connected with another entity under S.328-125(1)(b) of the ITAA 1997.

It is noted that proposed S.26-105 provides that a deduction will not be denied to the SMSF if the vacant land is used in carrying on a business of the SMSF. However, it is generally unlikely an SMSF will be carrying on a business in relation to its leasing activities.

Furthermore, whilst proposed S.26-105 also provides that a deduction will not be denied to the SMSF if the vacant land is used in carrying on a business of the SMSF's affiliate (or of an entity of which the SMSF is an affiliate), it is unlikely this exception could be met in the context of an SMSF. In this regard, S.328-130 provides that only an individual or a company can be an affiliate, and only where the individual or company acts, or could reasonably be expected to act, in accordance with the directions or wishes of the SMSF, or in concert with the SMSF, in relation to the business affairs of the individual or company. Given the regulated environment in which an SMSF operates, the NTAA considers that it would generally be unlikely that this exception would apply. As such, we believe that an SMSF that leases farm land to a related party would be unable to claim deductions against any rental income received from the related party. Such an outcome arises even though the lease between the SMSF and the related party is permissible under Part 8 of the SIS Act and the arrangement is undertaken on an arm's length basis.

The NTAA believes the outcome above is unintended and considers it appropriate for an SMSF to be listed as an excluded type of entity in proposed S.26-105(4).

(d) **Clarifying the meaning of substantive permanent structure**

The NTAA considers the term 'substantive permanent structure' for the purposes of proposed S.26-105(1) requires further clarification. This is an important term given that land on which a substantive permanent structure is situated (that is in use or ready for use) is not subject to the deduction limitation in S.26-105(1).

For example, the NTAA believes that clarification be provided as to whether the following structures would be considered a *'substantive permanent structure'* for the purposes of proposed S.26-105(1):

- A (fenced in) tennis court, on grass or other material?
- A large shed attached to the ground with (or without) a concrete slab (e.g., the type used for storing hay)?
- A horse or livestock shelter?
- A car park (and clarification of whether it would it make a difference if lines are marked or unmarked, or if the car park consisted of a grassed area versus stones or bitumen)?

Clarifying the meaning of when a property is considered to be 'ready for use'

Further to the above, the NTAA is of the view that the phrase 'ready for use', as it is used in proposed S.26-105(1) requires further clarification.

This is an important phrase given that, for commercial buildings and certain residential properties (being those that have **not** been constructed or substantially renovated whilst held by the taxpayer), the limitation of claiming deductions for associated expenses is only lifted when the building/property is in use or is **ready for use**.

Some common scenarios that may require further guidance include:

- If a taxpayer borrows to acquire an existing rental property and spends 2-3 months after settlement undertaking general maintenance and repairs before advertising the property for rent (such as cleaning inside and outside the property, painting and gardening), is the property 'ready for use' from the date of settlement (such that a deduction for associated expenses is not denied at any point under proposed S.26-105)?
- In other words, must a residential rental property actually be available for rent (e.g., advertised looking for tenants) for it to be 'ready for use'?
- Does it make a difference if the taxpayer in the above scenario only spent, say, 1 month after settlement undertaking the general maintenance?
- Does it make a difference in the scenarios raised above if the taxpayer only has to undertake repairs and maintenance outside the home (such that the interior of the home is in a position to be rented, prior to the house actually being advertised for rent)?
- What if an existing rental property is acquired and leased to tenants for some time but it is later taken off the rental market between tenants in order for general maintenance and repairs to be undertaken. The house is subsequently advertised as available for rent on a timely basis. Is the property considered to be 'ready for use' during the period of repair?
- When is a commercial property considered to be ready for use? Must it actually be advertised for lease for it to be considered 'ready for use'?

The NTAA view in relation to this matter is that the meaning of 'ready for use' in this context is different to 'available for rent'.

It is argued that the phrase 'ready for use' requires a less onerous standard be met when compared with 'available for rent'.

The NTAA believes that a rental property should be considered ready for use (i.e., ready to be rented) if it is fit for tenants, subject to the owner needing to undertake general maintenance and repairs (whether inside or outside the premises), provided the maintenance and repairs are completed, and the property is ultimately marketed for rent, in a timely manner.

Proposed application date

If enacted as proposed, S.26-105(1) will apply in relation to losses and outgoings incurred on or after 1 July 2019, regardless of when the land was first held.

The NTAA believes that the proposed change should be limited to land acquired after a specified dated (e.g., budget night), particularly given that this proposed amendment appears to extend beyond that originally foreshadowed in the 2018/19 Federal Budget (e.g., where agistment income is involved).

Alternatively, the start date of this proposed measure should be extended to give taxpayers further time in which to get their affairs in order.

Yours faithfully,

Geoff Boxer
CEO