National Tax & Accountants' Association Ltd.
29-33 Palmerston Crescent
South Melbourne
VIC 3205

Phone 1800 808 105 Fax: 1300 306 351
Email: ntaainfo@ntaa.com.au
Website: ntaa.com.au
ABN: 76 057 551 854

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Michelle Gainford
Technical Leadership and Advice
Supporting Individuals and Small Business - Individuals and Intermediaries
Australian Taxation Office (ATO)

By email: michelle.gainford@ato.gov.au

Dear Michelle,

RE: National Tax and Accountants' Association comments on the draft 'vacant land' LCR

Thank you for the invitation to provide comments and feedback for the proposed draft Law Companion Ruling ('LCR') on expenses associated with holding vacant land ('the draft LCR') following the recent introduction of S.26-102 of the ITAA 1997 (i.e., the new 'vacant land provision').

The National Tax and Accountants' Association ('NTAA') is a national member-based not-for-profit association, which currently represents the interests of (and is dedicated to providing support to) over 10,000 member firms, which include tax agents, accountants and BAS agents. The NTAA is also dedicated to ensuring that the interests of Australian taxpayers are always at the forefront of any potential change to taxation law or the administration of the taxation system.

Since the introduction of the new vacant land provision, our organisation has received a number of queries from our tax agent and accountant membership base in relation to the operation of these new restrictions relating to otherwise deductible holding costs.

As a result, we find ourselves well placed to offer a number of practical comments in relation to the proposed ATO guidance relating to these new rules, as outlined below for your consideration.

1. **Primary production fencing as an eligible substantial and permanent structure**

   Paragraph 8 of the draft LCR indicates that (amongst other structures) **fencing** on vacant land used for primary production purposes *would* amount to a substantial and permanent structure which is independent of, and not incidental to, the purpose of any other structure or proposed structure. We note that this view is also expressed in the example titled 'Fencing on farmland a substantial and permanent structure' in the ATO document, *'Deductions for vacant land'*.

   Interestingly, fencing was **not** specifically used as an example in the Explanatory Memorandum ('EM') to *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No.1) Act 2019* which introduced the new vacant land provision.

   As a result, we would like to confirm whether it is the ATO's current view that fencing (e.g., boundary fencing) on land **suitable** for primary production activities (irrespective of whether or not the land is actually used for such activities) would qualify as an eligible substantial and permanent structure. If so, the land in question would **not** be treated as 'vacant land' for the purpose of the new vacant land provision, despite the fact no other structure may be present on the relevant title.

If this is the case, we suggest an example be included in the draft LCR to clearly demonstrate such a conclusion due to its broad ranging impact on many primary production titles of land.

2. **Further explanation and examples of an eligible substantial and permanent structure**

We suggest that more explanation and detailed examples be provided in relation to what would (or would not) be considered an eligible substantial and permanent structure independent of (and not incidental to) other structures.

For example, many of our tax agent members have had queries from clients in relation to mobile phone towers, electricity poles and shelter sheds (e.g., horse shelter sheds).

Additionally, we note that whilst the heading for ***paragraphs 6 to 11*** is *"Permanent and substantial structure"*, the proposed draft LCR provides no detailed discussion or guidance on what these concepts mean. By contrast, the EM talks about *"substantial"* in terms of significant in size, value or some other criteria, and *"permanent"* in terms of fixed and enduring.

For example, a common question we have received with respect to some of the examples listed at ***paragraph 8*** such as silos and sheds is whether they would be regarded as *"substantial and permanent"* for the purposes of S.26-102 of the ITAA 1997 if those structures are demountable.

As a result, we suggest that consideration be given to expanding this segment to provide some practical guidance on when a structure is *"substantial and permanent"*.

3. **Further clarification of Example 1 – Manager's residence**

In ***paragraph 10*** of the draft LCR, an example is provided where a block of land containing an established residential dwelling used as a manager's residence is **not** treated as vacant land for the purposes of the new vacant land provision.

We believe this conclusion would be **incorrect** if the manager's residence had been constructed (or substantially renovated) by the landholder. Our view is based on the extended definition of vacant land with respect to constructed or substantially renovated *residential* premises due to the operation of S.26-102(4).

As a result, we suggest that the example be updated to clearly indicate that the manager's residence was not constructed or substantially renovated by the taxpayer holding the property. This would avoid the example potentially being misleading.

4. **Clarification of when commercial premises are *"in use or available for use"***

Paragraph 13 of the draft LCR confirms that in order to be *"available for use",* premises must be *"capable of being occupied"*.

Unfortunately, this clarification is only provided *"in the context of **residential** premises"* and no guidance is offered with respect to **commercial** premises.

Indeed ***paragraph 14*** goes on to remind taxpayers that *"newly constructed or substantially renovated premises must be 'lawfully able to be occupied'"*. However, as the legislative reference in the footnote to this paragraph highlights (i.e., footnote 7), this requirement only relates to *residential* premises (although paragraph 14 itself does not make this clear).

As a result, it is suggested the final LCR should also clearly address the meaning of being *"available for use"* in the context of **commercial** premises (i.e., non-residential premises).

This will provide clarity as to exactly when a taxpayer who has constructed commercial rental premises may be permitted to claim otherwise deductible holding costs (i.e., when the new vacant land provision would not apply to deny such deductions). Presumably this will be based on the same conclusion made in ***paragraph 13***, being when the premises are ***capable of being occupied*** (e.g., upon the issuance of an occupancy certificate or something similar).

It would also be useful to include an appropriate example in the final LCR of when a commercial rental property would be considered available for use in the context of these provisions.

5. **Use of the term "*newly*" constructed be removed**

Paragraphs 14 and 15 of the draft LCR use the term *"newly"* constructed residential premises. This is potentially misleading given that S.26-102(4) extends the definition of vacant land to all residential premises constructed or substantially renovated whilst the landowner held the land.

Importantly, this extension of the vacant land provisions does not **only** apply to *"newly"* constructed residential premises, but rather, to any residential premises constructed whilst the relevant landowner held the land (i.e., the residential premises could have been constructed many years ago by the current landowner, thereby attracting the operation of S.26-102(4)).

As a result, we suggest removing the word *"newly"* in the final LCR.

6. **Further clarification to be provided in Example 5 (paragraph 18)**

In Example 5, Arun owns a residential rental property that is declared by the local council as being structurally unsafe to occupy resulting in the tenants vacating the property. As a result, Arun demolishes the property and builds new residential premises which subsequently receives an occupancy certificate and is rented out.

It is suggested that this example provide further clarification as to **when** the original property is no longer considered to be *"in use or available for use"*.

For example, with regards to Example 5, it is assumed that the original property ceases to be *"in use or available for use"* when the tenants vacate the property. Therefore, it is expected that deductions can continue to be claimed for any otherwise deductible holding costs incurred in the period after the premises have been declared as being structurally unsafe to occupy. That is, at least while the tenants continue to reside in the property on the basis that the property is still being used (i.e., rented).

7. **Interest incurred after the sale of constructed and/or substantially renovated residential premises**

In ***paragraph 21***, the draft LCR confirms that S.26-102 does **not** limit or deny interest deductions following the sale of land if the interest was deductible immediately prior to the sale. More specifically, the draft LCR states that *"the interest will continue to be deductible if the land was not vacant land immediately before the taxpayer ceased to hold the land".*

It is suggested that an example be included in the final LCR as a warning for taxpayers who sell residential property that was constructed or substantially renovated while they held the land, where the property is sold without a tenant (and is not available for rent at the time of sale) so as to provide 'vacant possession' of the property to potential purchasers. In such circumstances, the new vacant land provision and the restriction for constructed and/or substantially renovated residential premises whilst the landholder held the land would apply to effectively treat the property as vacant land just before the time of sale.

As a result, the example would highlight that a deduction would be denied for post-cessation interest expenses in such common situations. That is, unless the ATO is willing to apply a more pragmatic compliance approach in the final LCR, recognising that such a period of vacancy will commonly occur throughout the life-cycle of a rental property (similar to the approach taken in ***paragraphs 25 to 27***, as discussed below).

8. **Constructed and substantially renovated residential premises and periods of subsequent repairs and renovations between tenancies**

With regards to ***paragraphs 25 to 27*** of the draft LCR, it is pleasing to see the ATO's pragmatic compliance approach in recognising that throughout the life-cycle of a rental property, there will be short periods of time where residential premises (including those that have been constructed or substantially renovated whilst a taxpayer held the property) may be unavailable for lease, hire or licence such as where repairs are undertaken between tenancies.

However, it is suggested that further clarity be provided with respect to a common variation to this scenario, being where a landlord of residential premises conducts **improvements** (as opposed to repairs) to the property between tenancies.

More specifically, it is suggested that the final LCR clarify whether the ATO would apply the same pragmatic approach in reviewing compliance with S.26-102(4) where a taxpayer continues to meet the requirements for deductibility under S.8-1 of the ITAA 1997 when, for example, they replace a kitchen or bathroom, as opposed to simply conducting repairs.

Furthermore, it is also suggested that more explanation (and examples) be provided with respect to the reference in ***paragraph 25*** to *"minor"* maintenance and repairs undertaken between tenancies of a residential rental property. It is not clear if maintenance would be *"minor"* where, for example, a landlord paints the entire property during a vacancy period.

Ultimately, the NTAA suggests that consideration be given to the removal of the word *"minor"*.

9. **Carrying on a business of leasing (i.e., a rental property business)**

It is suggested that the discussion in the draft LCR as to when land is *"in use or available for use in carrying on a business"* (i.e., ***paragraphs 28 to 35***) also make reference to the scenario of when a taxpayer is regarded as being in the business of leasing properties (i.e., conducting a rental property business – e.g., based on both the number of rental property owned and the level of involvement the taxpayer has in relation to the ongoing management of the properties).

Matters you wanted specifically considered

10. **Multiple titles of land**

We have no direct comments pertaining to the ATO's approach taken in paragraphs 36 to 39 of the draft LCR. The approach taken by the ATO does not differ from how we interpret S.26-102 would apply with respect to separate (multiple) titles of land.

11. **Holding costs definition and interest incurred in relation to construction costs**

In your request for comments on the draft LCR you confirmed that the costs involved in holding vacant land are not defined, although references are made in the relevant EM to various costs including ongoing borrowing costs (such as interest payments on money borrowed for the acquisition of land), land taxes, council rates and maintenance costs.

Furthermore, you asked to the extent that S.26-102(4) applies in relation to constructing or substantially renovating a permanent and substantial structure, what is our view as to interest incurred in relation to construction costs.

It has been our general belief that interest deductions relating to construction costs for a future rental property would also be denied where S.26-102 is applicable to the land in question.

However, we can see an alternative argument that the phrase *"a loss or outgoing relating to holding land (including interest and any other ongoing costs incurred to acquire the land)"* excludes interest on the construction costs which would primarily relate to the construction of a new structure on the land, rather than relating to holding the land.

Despite this, the NTAA fully acknowledges that once construction starts, in property law, the law of fixtures is founded on the '*maxim quicquid plantatur solo cedit',* meaning that whatever is attached to the land becomes a part thereof.

Furthermore, we note that interest on money borrowed to finance capital expenditure incurred to increase an asset's value is deemed a cost of *"owning"* the relevant CGT asset (i.e., the entire property including the land and its structures) according to the CGT cost base rules in S.110-25(4)(e) of the ITAA 1997.

Additional matters we believe should be addressed in the final LCR

In addition to our comments above, the NTAA would also like to highlight some additional issues which have been directly raised with us from our membership base which we believe should be incorporated into the final LCR with respect to the new vacant land provision.

12. **Deductibility of interest of a vacant rental property pending sale (i.e., listed for sale and to be sold with vacant possession)**

Where a rental property is to be sold, it is not uncommon for tenants to vacate prior to sale. This is especially the case with ***residential*** rental properties where a property sold with vacant possession has the potential to attract a broader range of purchasers.

Our concern is that when dealing with holding costs incurred where a tenant has vacated a property pending its sale (i.e., the property is no longer listed as being available for rent so the property can be sold with vacant possession) there is currently a degree of uncertainty as to the deductibility of such holding costs under S.8-1.

As a result, it is suggested that the ATO confirm its view with respect to the deductibility of interest incurred in relation to vacant residential premises held for sale.

This is particularly important in light of the new vacant land provision, as assuming holding costs incurred in relation to a rental property pending sale **are** otherwise deductible under S.8-1, the next hurdle to consider would be the potential application of S.26-102.

During a period of time pending the sale of a rental property there would generally be an eligible substantial and permanent structure on the land being sold (i.e., the rental property) that is *"in use or available for use"*. This is assuming the property is habitable.

Despite this, there is a concern where it comes to the application of S.26-102(4) when dealing with a *residential* rental property that was **constructed or substantially renovated** whilst a taxpayer held the property.

More specifically, if such a *residential* property was untenanted and **not** actively marketed for a period pending its sale, S.26-102(4) could apply to deny deductions for *otherwise deductible* holding costs. This is on the basis that the *residential* property is **not** rented, or at least made available for rent during such a period.

In contrast, a taxpayer who purchased a **pre-existing** property (that they did not substantially renovate) and later sought to sell it with vacant possession following the end of a tenancy (i.e., where the property was not rented or made available for rent during the sale period) would **not** be impacted by S.26-102(4). This would mean that S.26-102 would **not** operate to deny *otherwise deductible* holding costs incurred during the rental property's sale period.

As a result, it is suggested that the ATO address the application of the new vacant land provision to interest expenses (and other holding costs) incurred during a period of time a vacant rental property may be on the market (i.e., for sale) and/or awaiting settlement and is therefore not available for rent.

Furthermore, we would suggest that the ATO take a similar pragmatic administrative view with regards to interest incurred on residential rental premises (that were constructed or substantially renovated by the taxpayer) that are vacant pending sale, as is taken when such a property is temporarily vacant between tenancies and not available for rent while the property is being repaired (i.e., in ***paragraphs 25 to 27*** of the draft LCR).

13. **Holding costs for property built as an isolated profit making transaction**

While the 'carrying on a business' exception will assist many property developers in avoiding the application of the new 'vacant land' provision in S.26-102, it does **not** automatically afford protection to all property transactions assessed on revenue account.

This will certainly be the case for taxpayers entering into development activities treated as 'isolated profit making transactions' for tax purposes. For example, reference can be made to *FCT v Myer Emporium Ltd* [1987] HCA 18 and TR 92/3 which sets out the ATO's view on when profits arising from an 'isolated transaction' will be considered to be income on revenue account (i.e., a profit-making scheme), despite the fact that a taxpayer is not carrying on a business.

Some common examples of such transactions include where a taxpayer who, as a one-off venture, acquires a block of land and builds two townhouses 'on spec' or subdivides their backyard and builds a house/unit with the intention of selling it. As a result, it is suggested that the final LCR with respect to the new vacant land provisions address the question of whether it has application to the taxation of an isolated profit making transaction.

The NTAA is of the view that S.26-102 would have **no** application to the calculation of any net profit (or loss) from an isolated property making transaction. This is because any net profit arising from such a property disposal would be taxed as ordinary income under S.6-5 and *also* under the CGT regime, although an anti-overlap provision (i.e., S.118-20) would apply to prevent double taxation.

Therefore, such taxpayers would not actually claim a deduction for holding costs (including interest) under S.8-1 as they are incurred. Rather, such expenses would simply be netted-off against any eventual sales proceeds to determine the net assessable profit (i.e., under S.6-5) or loss deductible under (i.e., under S.8-1). Despite our view, we believe it would be appropriate to specifically address this issue in the final LCR on the new vacant land provision.

14. **Clarity to be provided that LCR not covering exceptions to S.26-102**

In the executive summary provided in the request for feedback and comments on the proposed draft LCR on the new vacant land provision, it was made clear that the LCR would not address the exceptions to S.26-102 (other than the carrying on a business exception).

However, this is not obvious from our reading of the draft LCR, except for the occasional footnotes (e.g., footnote 3 and 4). As a result, to avoid confusion, we would suggest the ATO consider clearly specifying these exclusions, perhaps at ***paragraph 4***, which outlines the scope of the guidance provided.

15. **Application of S.26-102 applicable to other provisions of the tax law**

It is suggested that at ***paragraph 26*** of the draft LCR, the ATO consider adding the words *"or another provision of the tax law"* (consistent with paragraph 3) at the end of the last line to clarify that the application of S.26-102 is not limited to deductions otherwise allowed under S.8-1.

16. **Leasing vacant land to another entity**

Paragraph 32 of the draft LCR states that when leasing vacant land to another entity, entities should make a reasonable assessment of the other entity's use of the land.

It is suggested that further explanation be provided regarding whether this is a one-off assessment (e.g., to be made at the commencement of the lease) or whether it needs to be made on an on-going basis (e.g., over the term of the lease). For example, referring to Example 8 of the draft LCR, is there an expectation that Jill should do an annual check to ensure that the lessor is still using the land in carrying on a business?

17. **Minor administrative suggestions**

At ***paragraph 39*** of the draft LCR – change the reference to Example 12 (not Example 13).

At ***paragraph 43*** of the draft LCR – change the reference to *"she"* in the second line to *"it"*.

Again, thank you again for the opportunity to submit our comments and feedback relating to the draft LCR on the new vacant land provision.

Yours faithfully

Geoff Boxer
Chief Executive Officer
NTAA