Deductions for holding vacant land may now be limited

30 October 2019

Explore more insights 365

In brief

New tax law is in place to deny tax deductions for expenses related to the holding of certain vacant land from 1 July 2019. The changes will affect individuals, self-managed super funds (SMSFs) and discretionary or non-public unit trusts that hold vacant land that is not used in carrying on a business for the purpose of producing assessable income.

Amendments which were made to the provisions as it progressed through Parliament now operate to ensure that a land owner is not denied deductions when structures on the land are affected by natural disasters or exceptional circumstances, or when the land is owned by a primary producer or is subject to an arm's length lease arrangement to an entity who carries on a business on the land.

In detail

Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019 has completed its passage through Parliament and will give effect to the 2018-19 Federal Budget measure to deny tax deductions for costs incurred from 1 July 2019 in relation to certain vacant land holdings. Importantly, the measure will not apply to vacant land held by certain 'excluded entities' which include a corporate tax entity, a superannuation plan (other than a SMSF), a managed investment trust, a public unit trust or a unit trust or partnership where its members are comprised of these specifically excluded entities. For other entities, deductions will not be denied in respect of vacant land that is held for the purpose of carrying on a business by the owner or certain related entities. For instance, the measures will not apply to land used to conduct a primary production business or to a property developer that is holding land for the purpose of carrying on a property development business.

Background to the new rules

Property holding costs (for example, interest, rates and taxes) are broadly deductible to the extent that they are incurred in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing such income. Case law (e.g. *Steele v FC of T 99 ATC 4242*) and historical guidance from the Australian Tax Office (ATO) (e.g. *Taxation Ruling TR 2004/4*) have confirmed that such costs incurred in relation to land that is intended to be developed for future income-producing use is not necessarily regarded as capital in nature, and therefore non-deductible, merely because the income producing activities have not yet commenced.

According to the Explanatory Memorandum (EM) accompanying the Bill that introduced the new measures, the ability for taxpayers to claim deductions for the costs of holding vacant land based on their purpose or intent has made it difficult to determine whether the land has been genuinely held for the purpose of gaining or producing assessable income. The reliance on a taxpayer's assertion about their current intentions has led to compliance and administrative difficulties.

Accordingly, this new law is considered by Government to be an important integrity measure to prevent deductions being claimed in relation to vacant land that may not be genuinely held for the purpose of gaining or producing assessable income.

What 'vacant land' will be affected by the new rule?

The amendments are intended to apply to "vacant land" which does not include land on which there is:

- a substantial and permanent structure in use, or ready for use; or
- residential premises (as defined by reference to the goods and services tax law) that is being constructed, or substantially renovated, but only where it is lawfully able to be occupied and is leased, hired or licenced (or otherwise available for such use).

According to the EM, it is expected that for a structure on the land to be regarded as being 'substantial', it needs to be substantial in size, value or some other criteria of contextual importance, and have an independent purpose or function. This is intended to exclude structures such as powerlines, fences and retaining walls. The EM also confirms that the fact a structure may require some repairs either at the present time or at some future point does not affect its permanency, however, note that the extent of such repairs in relation to residential premises may be relevant in determining whether or not it is lawfully able to be occupied and leased.

During the Bill's passage through Parliament, amendments were made to ensure that a land owner is not denied deductions (for up to three years) when existing structures on the land are rendered unusable by natural disasters or other unforeseeable, exceptional and uncontrollable circumstances. This could, for example, include where the premises are destroyed by fire or following the discovery of a major residential building defect that renders the building unsafe for occupation.

What other exceptions apply?

As mentioned earlier, land held by companies, super funds other than SMSFs, or public unit trusts or managed investment trusts are not affected by the rules.

For other taxpayers, deductions for vacant land holding costs will not be denied to the extent that the land is being used, or held available for use, in carrying on a business by the taxpayer or by certain related entities including the taxpayer's spouse, children under 18 years of age, "affiliates" or "connected entities" (as defined in the small business tax concessions).

For example, the new measures will not apply to deny deductions for expenses associated with holding vacant land by a property developer or a primary producer that is carrying on a business and is holding the land for the purpose of that business. Whether land is used in carrying on a business or held available for use in carrying on a business is a question of fact. For many smaller property investors, these measures are expected to bring into closer focus the often blurred distinction between a profit-making business undertaking or activities that are merely on capital account. Furthermore, there is a requirement to consider the extent to which a property is used or held available for use in carrying on a business - this may need to be determined on a fair and reasonable apportionment basis. For non-business landholders, the question of apportionment of holding costs for some land titles will also need to be considered, particularly for those with certain 'excess' or mixed use holdings.

There is also a further exception that applies to land that does not contain residential premises and it is used to generate income from rent (by way of lease, hire or license) from another entity either:

- where the owner of the land (or a qualifying related entity) is carrying on a primary production business; or
- where the land is used, or available for use, for business purposes under an arm's length rental arrangement.

CGT treatment for deductions denied

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, these non-deductible holding costs may be included in the cost base of the land for capital gains tax (CGT) purposes when working out a future capital gain when the land is later sold (note however, these costs will not increase any capital loss).

The takeaway

Importantly, the new law is not intended to impact the question of deductibility of land holding costs for any taxpayer clearly conducting a property development business or for those who own and lease commercial or residential premises. Companies and other excluded entities also remain unaffected by the changes.

However, individuals and other property investors (including discretionary trusts) who are not in the business of investing in, or developing property, will need to closely review this change to the tax law, including the nature of any buildings or other structures on the land and their use. The loss of deductions during the development phase of a project may be critical for some investors. As the rules apply with retrospective effect in relation to expenses incurred from 1 July 2019, those land holders that have already entered into development agreements with a property developer will also need to carefully review existing costs and operations to consider the potential financial impacts involved.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Keenan Muir, Parramatta
+61 (2) 8266 3183
keenan.muir@pwc.com

Simon Le Maistre, Melbourne
+61 (3) 8603 2272
simon.le.maistre@pwc.com

Samantha Vidler, Brisbane
+61 (7) 3257 8813
samantha.vidler@pwc.com

Cesare Scalise, Perth
+61 (8) 9238 3417
cesare.scalise@pwc.com

James Blackburn, Adelaide
+61 (8) 8218 7100
james.blackburn@pwc.com