TaxTalk—Insights
Real Estate

Housing tax integrity measures deny landlords certain deductions for residential rental properties

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In brief

New laws have been enacted to deny deductions for certain travel expenditure and depreciation for 'previously used' depreciating assets related to the use of a residential rental property. The new laws take affect from 1 July 2017. These measures, which were previously announced in the 2017-18 Federal Budget, will affect individuals, self-managed super funds (SMSFs) and discretionary trusts which invest in residential real estate, and will decrease the after-tax return on the investment.

In detail

As part of the Government's package of housing affordability measures announced in the 2017-18 Federal Budget, new laws have been enacted to deny individuals, self-managed super funds and discretionary trusts which invest in a residential rental property, income tax deductions for:

- travel expenditure relating to the use of the residential premises, and
- depreciation on 'previously used' items of depreciating assets located in the residential premises.

Both of these measures apply to 'residential premises' as defined by reference to the goods and services tax law. This is a broad concept and includes any land or building that is occupied as a residence or intended or capable of being occupied as a residence for residential accommodation. However, because both measures also provide exceptions for any instances where the premises are used in the course of carrying on a business, travel and depreciation costs incurred by a taxpayer who operates the premises as a motel, hotel, aged care facility, student accommodation or commercial business (e.g. shop or doctor's surgery) are excluded.

Travel related to the use of residential premises

From 1 July 2017, affected taxpayers will be denied a deduction for expenditure which is related to travel if it is:

- incurred in gaining or producing assessable income from the use of 'residential premises' as residential accommodation; and
- not necessarily incurred in carrying on a business for the purpose of producing assessable income.

Although this measure may have had its origins from concerns that some taxpayers may have been incorrectly making claims for all costs of travel, including the private proportion, the measure as enacted is a complete denial of all relevant travel.

This means that no tax deduction can be claimed for any costs of travel (including car hire, air fares, associated meals and accommodation) undertaken in relation to the residential rental property. It also means no tax deductions can be claimed for costs incurred to inspect and maintain the property, or costs incurred to attend an owner's corporation meeting, collect rent or visit the real estate agent, even if that is the sole purpose of the travel.

Residential investment property owners with properties in locations in other cities, towns or countries will be particularly impacted by these rules as there is no ability to make a pro rata claim for travel costs, even if a travel diary is maintained.

Furthermore, individuals who might be on a temporary domestic or global secondment and who rent out their home while they are away will also be particularly affected by the new rule as there are no concessions.

Deductions will continue to be available for the cost of property management services.

Costs of travel attributable to residential rental investments incurred by a corporate tax entity (other than in its capacity as trustee of a trust), a superannuation fund 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, remain deductible.

Any disallowed travel expenditure is also prevented from forming part of the cost base of the property for capital gains tax (CGT) purposes, or being deductible over five years under the business related capital cost rules.

Limiting depreciation deductions for assets in residential premises

In simple terms, for affected taxpayers, from 1 July 2017, depreciation deductions for items of plant and equipment (e.g. dishwashers, ceiling fans, carpet, and hot water systems) in residential investment properties will be limited to those assets that have not previously been used.

Specifically, depreciation deductions on assets used in residential premises to provide residential accommodation (other than in the course of carrying on a business) will be reduced where the taxpayer:

- did not hold the asset when it was first used or first installed ready for use (other than as trading stock) by any entity, *except if:*
    - the asset was provided to the taxpayer as part of a supply of 'new residential premises' (including substantially renovated premises);
    - no previous holder of the asset has been entitled to a depreciation deduction on the asset;
    - at the time the taxpayer first held the asset as a result of the supply of the residential premises, it was used (or installed ready for use) in the relevant premises (or other real property in which an interest was supplied in connection with the premises, e.g. as part of common property); and
    - no one resided in any residential premises in which the asset was used before it was held by the current owner; or alternatively, the asset was previously only used or installed in the current premises that were supplied to the current owner within six months of it first becoming 'residential premises'; or
- has either used, or had installed ready for use, the asset:
    - in a residence of the taxpayer; or

  - for a non-income producing purpose that was more than 'occasional'.

The rules can be complex to navigate. However, some practical implications of the rules are illustrated below:

- An individual purchases a three-year-old apartment that is immediately offered for rent. The carpet installed by the previous owner and a used washing machine that was purchased from a friend and installed in the property would be ineligible for tax depreciation claims as these assets have been previously used. However, a new dryer that is purchased and installed by the new owner would be eligible for depreciation.

- An individual completes the purchase of an apartment acquired off the plan, vacant and fully furnished with new assets. The new apartment is used immediately for rental purposes. The purchaser will be able to claim tax depreciation on the depreciating assets in the apartment (and also on the share of those depreciation assets on common property) on the basis that no entity has resided in the premises before the final settlement. If a second apartment was later purchased in the same complex from the developer as an already tenanted furnished property, provided that the depreciating assets were supplied as part of the 'new residential premises' within six months of the apartment first becoming a residential premises, the purchaser can claim depreciation.

- A couple acquire a new house in a new housing estate from the property developer and use it as their residence before later renting it out. Any depreciating assets in the rental property that were used in the premises while it was their residence would not be eligible for later depreciation claims during the rental period.

- A family trust acquired a new apartment from the developer to be used for commercial holiday renting. Allowing family relatives to reside in the apartment on a long weekend free of charge would be considered to be occasional use (i.e. use that is infrequent, minor and irregular in the context of overall use). Such occasional use on its own would not invalidate a claim for depreciation on the assets in the property in that or a later year.

Similar to the travel related changes discussed above, there is no change to the ability to claim depreciation deductions to the extent they relate to producing assessable income unrelated to use as residential premises (e.g. a detached workshop co-located next to the residential home which is rented out as a commercial property), or incurred in relation to carrying on a business on the premises.

Deductions will also continue to be available for certain 'excluded entities', which includes a corporate tax entity (including a company, but not in its capacity as trustee of a trust), a superannuation plan (other than a SMSF), a managed investment trust, a public unit trust and a unit trust or partnership where members are comprised of these specifically excluded entities.

Although no tax deductions can be claimed for any previously used depreciating assets included in a residential rental property, there is still benefit from having a quantity surveyor report to support any allocation of the purchase price to each of the relevant assets for capital gains tax purposes. Specifically, depreciation amounts that cannot be deducted will be recognised as a capital loss (or in certain circumstances, a capital gain) when the asset ceases to be used or is later sold.

These amendments apply to income years starting on or after 1 July 2017. However, transitional relief is provided for depreciable items used or installed in residential investment properties as of 9 May 2017 (or acquired under contracts entered into before 7:30pm (AEST) on 9 May 2017). An integrity rule also applies to ensure that depreciating assets acquired before this time, and were first used or installed ready for use for a wholly non-taxable purpose, will not be eligible for depreciation. For example, a depreciating asset that was held for personal use as at 9 May 2017 and later moved for use in a rental property at any time from 1 July 2017 will not be eligible for depreciation.

The takeaway

All residential rental property owners need to be cognisant of the changes which take affect from 1 July 2017 to deny any deduction for travel costs relating to a residential rental property, regardless of when that property was first acquired or when it first derived rental income.   This rule will apply in all circumstances, even if the sole purpose of the travel was in connection with the rental property.

From 1 July 2017, the changes to deny depreciation on fixtures and fittings in existing residential premises particularly impacts the after-tax return for a potential investor in any residential real estate property. However, it will continue to be important to maintain appropriate records of the cost of depreciating assets located within such a property at the time of its purchase as this will be relevant in the event that the asset is later scrapped or replaced (including on subsequent renovation and updating) where a capital loss will be available, or when working out relevant capital gains or losses when the property is sold.

Let's talk

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

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