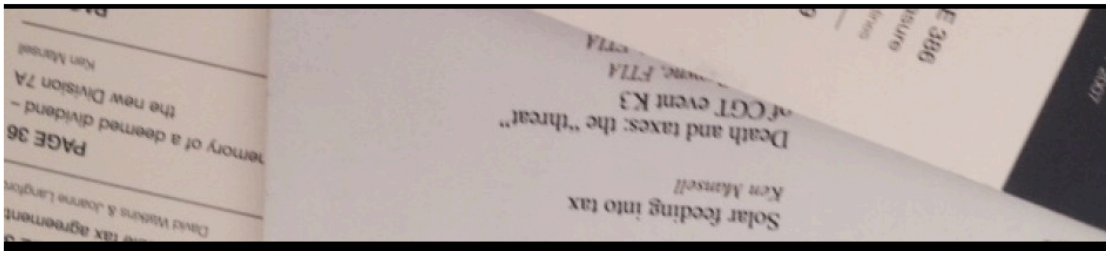
Tax Rambling *The rants of a tax nerd*



AIQS Nov Tax Depreciation Update

Treasury Laws Amendment (Housing Tax Integrity) Bill 2017

The Government has introduced a Bill into the parliament implementing a series of housing measures announced in the 2017-18 Federal Budget. It has passed the House of Representatives and the Senate and currently only awaits Royal Assent.

Therefore, if you produce tax depreciation schedules you need to make sure that you apply these new rules… These rules started denying deductions on 1 July 2017.

Grandfathering

Before we work out what the new tax depreciations rules are, we need to understand when they will apply.

The Bill states this…

> *13 Application of amendments*
>
> *(1) The amendments made by this Schedule apply to an entity, for income years commencing on or after 1 July 2017, for assets:*
>
> > *(a) acquired by the entity under contracts entered into; or*
> >
> > *(b) otherwise acquired by the entity;*
>
> *at or after 7.30 pm, by legal time in the Australian Capital Territory, on 9 May 2017.*
>
> *(2) The amendments made by this Schedule also apply to the entity, for income years commencing on or after 1 July 2017, for any other asset acquired by the entity, if:*
>
> > *(a) the asset's start time is during the income year that includes 9 May 2017 or during an earlier income year; and*

> *(b) no amount can be deducted under Division 40, or Subdivision 328-D, of the Income Tax Assessment Act 1997 by the entity for the asset for the income year that includes 9 May 2017.*

Therefore, from this application section we know that:

- Generally, if you purchased the asset or the rental property with the assets in it before 10 May 2017 you can claim Division 40 depreciation.

- The reason there is the word "Generally" in the first point is that there is a situation where you bought the assets before 10 May 2017 but you won't be able to claim Division 40 depreciation. This is where you bought the property or the assets before 10 May 2017 BUT in the 2016/17 year (normally 1 July 2016 to 20 June 2017) you did not use the property or the asset as or in a rental property.

An example of item 2 would be where a taxpayer owns one home which they live in for years. In 2018, they decide to move to a bigger house but keep their old house as a rental property. They cannot claim Division 40 depreciation on the old property as in the 2016/17 year, the property was not a rental property.

Therefore, in summary, these new rules **DO NOT** apply to properties that were both purchased before 10 May 2017 **AND** where used as a rental property for some time in the 2016/17 tax year.

The first question on your checklist to ask if someone asks you if they can claim Division 40 tax depreciation on a residential rental property is:

Checklist Question 1:

Was the property purchased before 10 May 2017 **AND** if I look at your tax return I can see you claimed deductions on the property as a rental property for some time in the 2016/17 tax year? Remember that you need to ask both questions…

If so, you can claim Division 40 depreciation deductions. Most importantly you can IGNORE the rest of this paper and presentation.

The New Rule… Previously used

Only if you did not pass the grandfathering rules above should you be reading this…

In summary, a new section, section 40-27 of the Income Tax Assessment Act 1997, will deny depreciation deduction for any depreciable asset used in residential rental premises if it was "previously used" by another taxpayer or used by the current taxpayer for a non taxable purpose.

A depreciable asset will be previously used if any of the following three situations apply.

- First, the taxpayer is not the first entity that used the asset other than as trading stock. Retailers and developers will sell new depreciable assets as trading stock so deductions will be available for these assets. For retailers the owner will has purchased the depreciable asset directly so will not be able to use an estimate as the cost of the good.

- Second, the asset is used or installed ready for use in the residence of the taxpayer for any time. Once a taxpayer has installed a depreciable asset in their residence they can never depreciate it ever again.

- Third, the asset is used or installed ready for use for a purpose that is not a taxable purpose, other than incidental or occasional use. This will mean a taxpayer staying at their rental property at the beach will mean now more depreciation deductions ever again on the assets in the beach house, even if it is rented out later. However, this will not occur if the private use of the beach house is merely incidental or occasional.

What is incidental or occasional use? How long can I stay at my holiday house before I can no longer claim depreciation on the new assets I bought at Harvey Norman? Here are the two examples the Government has given us…

> *For example, spending a weekend in a holiday home or allowing relatives to stay for one weekend in the holiday home free of charge that is usually used for rent would generally be occasional use*

One weekend… And it also states:

> *staying at the property for one evening while carrying out maintenance activities would generally be incidental use.*

One night… ouch

It is fundamental to warn clients of the consequences of spending a week at their rental property down at the beach before they lose their depreciation deductions.

Exception to the "previously used" rule – Certain entities

There are two of exceptions to this new rule of no depreciation deductions if the asset was "previously used".

The first is this rule does not apply to these entities:

- An entity that is using the asset in carrying on a business (owning a rental property is not a business, owning 10 rental properties is not a business, owning … rental properties is not a business if it is no taking up much of your time managing them);
- The taxpayer Is a corporate tax entity; or
- The taxpayer is a certain type of institutional investor like a Managed Investment Trust, a Public Trading Trust or a Super Fund that is not a Self Managed Super Fund.

Simply, it will be rare that this exception applies.

Exception to the "previously used" rule – New residential premises
There is an additional exception such that these changes will not apply to an asset installed in premises supplied as new residential premises, but only if:

- No one resided in residential premises in which the asset has been used before it was held by the current owner; or

- The asset was used or installed in new residential premises that were supplied to the taxpayer within six months of the premises becoming new residential premises, and the asset had not been previously used or installed in a residence.

Why is there this 6-month rule? Allowing entities to access the exception for assets only used or installed in new residential premises supplied within six months of the premises becoming new residential premises ensures that entities acquiring tenanted apartments are not disadvantaged.

What about assets installed in the common property of apartment complexes of new residential premises? Have they been "previously used" by the first tenant? As the asset is not used in residential premises, the owner may deduct amounts for the decline in value of such assets reflecting the extent of their ownership of the asset unless:

- A previous owner of the same unit or apartment deducted amounts related to depreciation of the asset; or

- The asset has been previously used or installed ready for use in residential premises that were being used as a residence.

The last thing to not regarding buying new residential premises, you can still lose the depreciation deductions on assets if you do either of the following:

- Make the residential premises your residence for any time; or

- Use the residential premises for a purpose that is not a taxable purpose, other than incidental or occasional use. This will mean a taxpayer staying at their rental property at the beach will mean now more depreciation deductions ever again on the assets in the beach house, even if it is rented out later. However, this will not occur if the private use of the beach house is merely incidental or occasional.

So even depreciable asset purchased in new residential premises can become ineligible for depreciation deductions.

Capital Loss Rules

Some Tax Depreciation preparers have told me that they are going to provide full tax depreciation schedules for every client, even if they can't claim any depreciation, as they will assist their clients in claiming capital losses. What do they mean by this…

Where the depreciation deductions are denied, if the depreciable asset is sold or scrapped for a loss, this will create a capital loss. But remember that a capital loss can only be applied against capital gains so many owners of rental properties will just decide to treat the entire purchase price as the price for the land and buildings as capital gains will only arise when they sell the property. For example:

Tom buys a rental property and under the new rules he cannot claim any Division 40 deductions.

He is told to get a tax depreciation schedule to work out what will be the capital loss on the depreciable assets when he sells the rental property and the report comes back and says of the $500,000 he spent on buying the rental property, $20,000 related to depreciable assets.

Tom therefore treats the cost of the building as $480,000, and from the depreciation schedule says he spent $20,000 on depreciable assets.

Tom sells the rental property for $600,000 two years later and states he sold the land and building for $600,000 and the depreciable assets for $0. Tom therefore makes a $20,000 capital loss on the depreciable assets. But he also makes a $120,000 ($600,000 less $480,000) capital gain on the land and building. The net effect is a capital gain of $100,000.

Tom then realises that if he had not have paid for the depreciation schedule he would have treated the $500,000 he paid when he bought the land and buildings and when he sold the land and buildings for $600,000 he would make a $100,000 capital gain.

Exactly the same outcome. Tom now wants a refund of the fee he paid for the schedule.

The only possible potential benefit in getting a schedule is if you scrap the depreciable assets years before you sell the property as the capital loss arises in the year you scrap. But as capital losses can only be offset against capital gains you only get to use the capital losses when you sell something else that has a capital gain... and in many cases this will be the sale of the rental property in a few years time. Once again, no benefit in getting the schedule. And even if there is a benefit, it is merely using the capital loss in an earlier year, so not much of a benefit

Examples that the Government has provided

> *Craig has acquired an apartment that he intends to offer for rent. This apartment is three years old and has been used as a residence for most of this time.*
>
> *Craig acquires a number of depreciating assets together with the apartment, including carpet that was installed by the previous owner. He also acquires a number*

of depreciating assets to install in the apartment immediately prior to renting it out, including:

- *curtains, which he purchases new from Retailer Co; and*
- *a washing machine, that he purchases used from a friend, Jo.*

Craig also purchases a new fridge, but rather than place this in the apartment, he uses it to replace his personal fridge, that he acquired a number of years ago for use in his residence. He instead places his old fridge in the new apartment.

The amendments do not permit Craig to deduct an amount under Division 40 for the decline in value of the carpet, washing machine or fridge for their use in generating assessable income from the use of his apartment as a rental property as both are previously used. The carpet and washing machine are previously used as the previous owner or Jo rather than Craig first used or installed the assets (other than as trading stock). The fridge is previously used as while Craig first used or installed the fridge, he has used it in premises that were his residence at that time.

The amendments do not affect Craig's entitlement to deduct an amount under Division 40 for the decline in value of the curtains. They are not 'previously used' under either limb of the definition.

But as Craig bought the curtains from a retailer he knows what they cost so cannot use an estimated cost in a tax depreciation schedule.

Hannah purchases two apartments off the plan from Developer Co. The apartments are supplied three months after completion – one is already tenanted and the other is vacant.

In addition to the construction of the apartments, Developer Co has fitted out the apartments, installing ready for use depreciating assets including curtains and furniture prior to settlement and the transfer of the title to Hannah. Developer Co has also fitted out the shared areas of the complex in which the apartment is located, installing ready for use a range of deprecating assets that are the joint property of the apartment owners.

All of these assets are new at the time of installation. As these assets were first installed by Developer Co, not Hannah, they are previously used and a deduction would not be available under the general rules established by these amendments.

However, a deduction is still available to Hannah for the depreciating assets (including Hannah's share of the assets installed in the shared areas of the apartment) for the period she holds the assets as:

- *The assets have been installed ready for use in premises that were supplied to Hannah as new residential premises or in other real property supplied as part of the supply of residential premises;*

- *Developer Co has not claimed any deduction for the decline in value of the assets (and nor has any other entity); and*
- *either (excluding assets installed in the common property):*
  - *for assets in the first apartment, the assets were only used or installed in the apartment, which was supplied to Hannah as new residential premises within six months of the apartment first becoming residential premises; or*
  - *for assets in the second apartment, no entity has resided in residential premises in which the assets have been installed before Hannah held the assets.*

There is hope for new residential

> *If a developer installs an asset in premises it intends to sell, this will generally constitute use as trading stock. If the developer rents out the property containing the asset while it seeks to find a purchaser, the property and hence the asset are used, at least in part, for a purpose other than as trading stock and the asset would be previously used in the hands of any subsequent purchaser (subject to the exception outlined below for assets used or installed in certain new residential premises).*

No depreciation deductions if a developer rents out the premises and then sells it…

> *If an individual acquires a new apartment and uses it as their residence in an income year before renting it out, any assets used in the premises would generally have been used wholly for personal use or enjoyment during that income year. The individual would not subsequently be able to access any deductions for the decline in value of those assets while it is being rented out.*

No depreciation deductions if you have every lived in the house…

Checklist

Question 1:

Was the property purchased before 10 May 2017 **AND** if I look at your tax return I can see you claimed deductions on the property as a rental property for some time in the 2016/17 tax year? Remember that you need to ask both questions and the answer need to be yes to both questions. If so, you can claim Division 40 depreciation deductions. Most importantly you can IGNORE the rest of this checklist.

Question 2:

Is the entity that owns the property and the depreciable assets a company, a large super fund (not an SMSF) or a large investment vehicle? If so, they can claim Division 40 depreciation deductions. And you can ignore the rest of this checklist.

Question 3:

Is the owner of the e they carrying on a business which involved 30+ of properties taking up most of their week in managing or running a hotel? If so, they can claim Division 40 depreciation deductions and you can ignore the rest of this checklist.

Question 4A:

Was the property "new residential premises" from a developer when you purchased it (or you purchased it from the developer less than 6 months after the developer tenanted it out)? You might be able to claim depreciation deductions but these will be limited by Question 4B and 4C …

Question 4B:

Has the property ever been your residence or will it ever become your residence? If it has or will be then from that date there will be no more depreciation deductions ever again…

Question 4C:

Have or will you or your family or friends stayed in it for more than a couple of nights? If this has or will happen then from that date there will be no more depreciation deductions ever again….

Question 5:

Are there assets that you bought from a retailer new (not second hand), that has not been used in your residence and has not been used by you or your family and friends in a private way. Then deductions can be claimed on these assets.

Checklist Summary for most individual taxpayers

1. Did you buy it before 10 May 2017 and use it as a rental property in the 2016/17 year? OR
2. Where the assets in new residential premised you bought that you and your family and friends have never stayed in or used? OR
3. Did you buy any depreciable assets from a retailer you put in a rental property that you and your family and friends have never stayed in or used?

1. will slowly disappear over time as we get further away from 9 May 2017. For 3. The taxpayer has an invoice so cannot claim an estimate cost in a tax depreciation schedule. Many 2. Holiday homes will lose their depreciation deductions when owners stay in them for a week.

So what is left in the long run is new residential premised that the owners never ever use.