Australian National University

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Dr Sonali Walpola
Lecturer, ANU College of Business and Economics
Co-editor, *Austaxpolicy*
Tax and Transfer Policy Institute
Crawford School of Public Policy
ANU College of Asia & the Pacific

[redacted]

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee

Dear Mr Fitt,

Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019

Thank you for the invitation to comment on the *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill* 2019. I provide the comment below regarding Schedule 3 of the Bill, which limits deductions for expenses associated with holding vacant land.

As indicated in the Explanatory Memorandum (EM) to the Bill, this proposal is intended as an 'integrity' measure. The intended denial of deductions for vacant land for individual taxpayers (to be included in a proposed s26-102 of the *Income Tax Assessment Act* 1997 (ITAA97)) is motivated by a concern that there are compliance difficulties with the current income tax position, which allows taxpayers a deduction for the costs of holding vacant land if they have the intention of gaining or producing assessable income on the land.

This comment is specifically directed to three aspects of the proposed measure:

1. The lack of clarity as to whether, and how, the proposed measure changes the substantive law;
2. The approach of (apparently) changing substantive law in order to improve compliance;
3. The exemption for companies and certain other entities.

These issues are addressed in turn.

The lack of clarity as to whether, and how, the proposed measure changes the substantive law

The words used in the proposed s26-102 ITAA97, read together with the related EM, would *appear* to change the substantive law as propounded by the High Court in the leading decision on point, *Steele v DCT*[1] ('*Steele*'), which is very well known among both practitioners and academics, and extensively analysed in the ATO's ruling TR 2004/4 *Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities*.

Practitioners tentatively suggested that the proposed measure would change the law (in *Steele*), following the release of the exposure draft legislation in 2018.[2] In the ensuing paragraphs, it is

[1] (1999) 197 CLR 459.

[2] E.g., see http://pointonpartners.com.au/musings-2018-federal-budget/; https://www.bdo.com.au/en-au/federalbudget2018/integrity-measures/holding-vacant-land-to-become-more-expensive.

explained why it appears that the measure would change the law in *Steele*; the detail below is needed because the EM does not explicitly address the *Steele* case, nor ruling TR 2004/4. This is a deficiency in at least the EM, if not the proposed measure itself.

In *Steele*, the High Court held that interest incurred on funds used to purchase vacant land could be regarded as incurred in gaining or producing assessable income, and therefore deductible under the general deduction provision,[3] if the taxpayer had a clear intention to use the land for income producing purposes, and provided the overall circumstances negated the conclusion that the interest expense was too distant from the generation of assessable income. Critically, in *Steele*, the court rejected the notion that the general deduction provision required contemporaneity in time between the expense and the generation of assessable income.[4] The taxpayer was not carrying on a business at the time of purchasing and owning the vacant land but "pursued, actively and in a variety of ways, the possibility of using the land for motel and residential development."[5] The High Court accepted that the vacant land was a capital asset but it was not disputed that the taxpayer's purpose` was "entirely commercial."[6] The majority found for the taxpayer but remitted to the Tribunal to confirm the taxpayer's purpose; Callinan J concluded on the material before the High Court that the taxpayer's expenditures were made "with one end in view, of gaining or producing assessable income"[7] and found for the taxpayer.

The proposed s26-102 ITAA97 provides that deductions are not permitted for losses or outgoings for holding vacant land *except* to the extent that the land was used or held available for use by the taxpayer *in the course of a business the taxpayer carries on*. The proposed s26-102 does *not* extend the exception (i.e., permitting deductions) to the case where losses or outgoings are incurred in gaining or producing assessable income. Indeed, the table at 3.8 of the EM differentiates the 'new law' and 'current law' specifically on this basis.

Deductibility on the basis of expenses being 'incurred in gaining or producing assessable income' was the phrase relied on in *Steele* as allowing a potential deduction for the costs of holding vacant land where there was a clear intention to produce assessable income in the future. It thus appears, consistent with the inference of practitioners, that *Steele* would no longer apply to permit interest deductions, if the measure was enacted.

Unless the taxpayer is carrying on a business (and it is noted that property developers and primary producers are the examples given in the EM), it would appear that deductions are not available for vacant land in the situation where the taxpayer has the definite intention of having an income producing structure constructed on the land (but has not yet done so). This interpretation is supported by 3.5 of the EM, which states (as an apparent criticism of the current law) that there is 'often limited evidence about the taxpayer's intent' with respect to vacant land.

That the law in *Steele* would be changed by the proposed measure is a reasonable conclusion after a reading of the EM, particularly the table at 3.8 (the 'new' and 'current' law comparison). However, we should not have to engage in inference, and extended analysis, to know that this has occurred. On other occasions, amending legislation has been far more direct that its intention is to change the

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3 At that time this was s51(1) *Income Tax Assessment Act* 1936 (ITAA36), which is recognised as being equivalent to the current s8-1 ITAA97 for present purposes: TR 2004/4, para 3.

4 (1999) 197 CLR 459, 474-475 (Gleeson CJ, Gaudron and Gummow JJ).

5 Ibid 464 (Gleeson CJ, Gaudron and Gummow JJ).

6 Ibid 466 (Gleeson CJ, Gaudron and Gummow JJ).

7 Ibid 498.

effect of a court decision, with the EM explicitly referring to the relevant court decision.[8] If it is the Bill's intention to change the law in *Steele*, it is recommended that the EM be revised to directly set out this intention and effect, in the interests of certainty for taxpayers and their advisors, as well as tax scholars.

The approach of (apparently) changing substantive law to improve compliance

The EM does not directly criticise the existing substantive law. Rather, the perceived problem with the status quo, and the rationale for the limitation in the proposed s26-102 ITAA97, is said to be that 'reliance on a taxpayer's assertion about their current intention leads to compliance and administrative difficulties.'[9] Relatedly, the EM states that 'some taxpayers have been claiming deductions for costs associated with holding vacant land when it is not genuinely held for the purpose of gaining or producing assessable income.'[10]

The obvious question that arises is why the Government has not considered enacting measures to address the asserted compliance problem instead of this (apparent) change to the substantive law. A more direct way of addressing the compliance issue is to impose a requirement that taxpayers must be able to substantiate their intention to generate assessable income on the land, as a pre-condition for claiming a deduction e.g., by providing written evidence of an independent nature. For example, in *Steele*, the taxpayer certainly had objective written evidence of her intention to generate assessable income on the land (including applications for planning approval, architects' plans, engineering advice), and if a more targeted measure were adopted, such cases could continue to be eligible for deduction. Specific substantiation requirements could be enacted, similar to the approach adopted in other areas (there are many ITAA provisions that require substantiation e.g., business travel expenses in Subdivision 900-D ITAA97). A requirement of substantiation of intention (e.g., by requiring written evidence) would meet the stated policy objective of the proposed measure without causing injustice in particular cases.

The exemption for corporate and the other entities

The proposed measure exempts companies,[11] superannuation plans (but not self-managed superannuation funds), public unit trusts, managed investment trusts and partnerships. The stated basis for exemption is that 'such investors are considered to have a low risk of incorrectly claiming deductions in relation to vacant land, as these entities are either not controlled by an individual, do not receive tax concessions which flow through to individuals, or both'.[12]

Accordingly, the wider scope to claim deductions under *Steele* would still be available for companies and the other entities that are exempted.

With respect, the stated reason for exemption in the EM merely asserts that the excluded entities are less of a compliance risk than individuals, but does not provide a reason why these entities should not be subject to the same (stricter) deductibility rule in the proposed s26-102 ITAA97.

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8 E.g., see the EM to the *Tax Laws Amendment (2011 measures No.5) Act* that permitted the streaming of capital gains in trusts, which directly acknowledged that it intended to override the conventionally held assumption that the High Court's decision in *Bamford v FCT* 240 (2010) CLR 481 was inconsistent with an ability to stream capital gains.

9 EM 3.5.

10 EM 3.6.

11 'Corporate tax entities' as defined in s960-115 ITAA97 are exempted; this is, inter alia, defined to mean a 'company,' which under s995-1 ITAA97 extends to all bodies corporate and unincorporated associations.

12 EM 3.43.

Under the proposed measure, it appears that an individual in the position of the taxpayer in *Steele* would not be able to claim a deduction for interest expenses in connection with vacant land even if there is clear evidence of an income producing purpose. But a company (e.g., a proprietary company) in the same position would be able to claim a deduction. This seems anomalous. An individual could escape the operation of the proposed measure by incorporating a proprietary company to undertake the purchase. As suggested above, a fairer and more targeted measure that meets the stated policy objective in the EM would be to require the purchaser to substantiate their intention to generate assessable income on the land.

Yours Sincerely,

Dr Sonali Walpola
Lecturer, Research School of Accounting, ANU College of Business & Economics
Co-editor, *Austaxpolicy*
Tax and Transfer Policy Institute, Crawford School of Public Policy, ANU College of Asia & the Pacific