TR 2021/D5 - Income tax: expenses associated with holding vacant land

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This document has been finalised by TR 2023/3.

There is a Compendium for this document: **TR 2023/3EC** .

Status: **draft only – for comment**

Draft Taxation Ruling

Income tax: expenses associated with holding vacant land

Relying on this draft Ruling

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

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What this draft Ruling is about

1. From 1 July 2019, deductions are limited for losses or outgoings that relate to holding vacant land. Some exclusions apply. This draft Ruling[1] explains the Commissioner's view of the application and the exclusions of section 26-102 of the *Income Tax Assessment Act 1997*[2]. This draft Ruling also sets out practical compliance approaches for some situations in Appendix 1.

Scope of this ruling

2. Section 26-102 applies only when a loss or outgoing would otherwise be deductible under section 8-1 or another provision of the tax law. This draft Ruling does not provide advice on any other provision governing deductibility, including section 8-1. The reasoning and conclusions expressed here should not be used in the context of any other provision.

3. The examples used in this draft Ruling all assume that the losses or outgoings described would be deductible if section 26-102 did not apply.

Date of effect

4. The legislative changes received royal assent on 28 October 2019. They apply to costs incurred on or after 1 July 2019, even if the land was held before that date.

5. This draft Ruling will be finalised as a public ruling, effective from 1 July 2019, being the application date of section 26-102.

Ruling

6. Broadly, subsection 26-102(1) denies a deduction for losses or outgoings relating to holding land on which there is no substantial and permanent structure in use or available for use. In certain circumstances you may be excluded from the operation of the

[1] All further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.
[2] All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

section, such as if you use the land in carrying on a business[3], you lease the land to an entity carrying on a business[4] or you are a particular kind of entity.[5]

7. Leaving aside business or entity exclusions, three tests determine whether the section applies to a land holding:

- Is there a substantial and permanent structure on the land?
- If there is a structure, is it in use or available for use?
- If there is a structure available for use, is it independent of and not incidental to the purpose of any other structure, or proposed structure on the land?

8. A substantial structure is significant in size, value or some other criterion of importance in the context of the property.[6] To be permanent, a structure needs to be fixed and enduring.[7]

9. We must consider whether any substantial and permanent structure has an independent purpose in the context of the land on which it is located. Structures that have the purpose of increasing the utility of another structure are not considered independent.[8]

10. For example, in the context of primary production, fencing, silos and sheds are substantial and permanent structures that serve independent purposes.

11. By contrast, in the context of residential land, fencing or a garage (though substantial and permanent structures) do not have a purpose independent of the main residence. Rather, the purpose of these structures is to increase the utility of any existing or proposed residence on the land.[9]

Example 1 – manager's residence

12. *Jamilla owns a 100-hectare block of farmland on a single title that includes an established house previously used as a manager's residence. The house is currently vacant but is capable of being occupied.*

13. *The house is a substantial and permanent structure with an independent purpose that is not incidental to the purpose of any other structure. It enables someone to live on the land and oversee farming activities.*

14. *Subsection 26-102(1) does not apply to deny a deduction for the holding costs in relation to the land as the land is not vacant. This is the case, even though the area that contains the home is minimal compared with the farming land.*

Example 2 – residential vacant land

15. *Lien owns a vacant block in a residential area on which she intends to build a rental property. The block is fenced on three sides and has a small shed. Lien stores tools and equipment in the shed to maintain the block. The fence and shed are not substantial and*

[3] See subsection 26-102(2). The business must have a purpose of gaining assessable income of you, your affiliate, spouse, child under the age of 18 or an entity connected with you.
[4] See subsection 26-102(9).
[5] See subsection 26-102(5). There are other exceptions to this subsection. However, the operation of these exceptions is not addressed in this draft Ruling.
[6] Paragraphs 3.18 to 3.19 of the Explanatory Memorandum to the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No.1) Bill 2019 (the EM).
[7] Paragraph 3.20 of the EM.
[8] Paragraph 3.21 of the EM.
[9] Paragraph 3.23 of the EM. See also Example 3.1 in the EM.

permanent structures with a purpose that is independent of any other proposed structure on the residential block. They exist to support the use and function of the proposed rental property. For the purposes of subsection 26-102(1), the land is considered vacant and deductions for the costs of holding the land are denied.

Structure 'in use or available for use'

16. In addition to there being a permanent and substantial structure on the land, subsection 26-102(1) requires the structure to be 'in use or available for use'. The purpose of the structure will partly determine what 'in use or available for use' means in context.

17. In the context of residential premises, to be available for use premises must be capable of being occupied. Established residential premises are considered to be available for use unless they have been deemed unsafe to occupy by a council or relevant body.

18. Residential premises constructed or substantially renovated while you hold the land must be 'lawfully able to be occupied' and this would occur when the certificate of occupancy (or other local council approval) is received. They must also be leased, hired or licenced or available for lease, hire or licence.[10] These requirements are addressed in greater detail in paragraphs 21 to 24 of this Ruling.

Example 3 – demolishing an established house

19. *Arun purchased an established house which he has used as a rental property for several years. On 1 July 2019, he decides to demolish the existing house to build a townhouse. The tenants vacate the property in October 2019. The house is demolished in December 2019. The property was in use or available for use until the date of demolition. Any holding costs that Arun may otherwise be entitled to deduct until the property was demolished would not be limited by section 26-102.*

Example 4 – existing residential premises that are not in use or available for use are demolished

20. *Continuing on from Example 3 of this Ruling, the tenants vacate the property in October 2019 because the residential premises has been declared by the local council as being structurally unsafe to occupy.*[11] *Arun demolishes the property in December 2019. Any holding costs that Arun would otherwise be entitled to deduct from October 2019 when the residential premises were not legally able to be occupied would be limited by section 26-102 as the house is not 'in use or available for use'.*

Residential premises constructed or substantially renovated while you hold the land

21. Pursuant to subsection 26-102(4), residential premises that you construct or substantially renovate are disregarded as a 'substantial and permanent structure' unless

[10] Subsection 26-102(4).
[11] In Example 4 of this Ruling, we assume that there was not an exceptional circumstance or natural disaster under subsection 26-102(6) that led to the residential premises being structurally unsafe to occupy.

they can lawfully be occupied and are leased, hired or licensed (or available for lease, hire or licence).

22. 'Substantial renovations'[12] is defined in section 195-1 of *A New Tax System (Goods and Services Tax) Act 1999* as being:

> … renovations in which all, or substantially all, of a building is removed or replaced. However, the renovations need not involve removal or replacement of foundations, external walls, interior supporting walls, floors, roof or staircases.

23. Subsection 26-102(4) applies throughout your ownership period of the land. This means that at all times, newly-constructed or substantially-renovated residential premises must be:

- lawfully able to be occupied, and
- either
  - leased, hired or licensed, or
  - available for lease, hire or licence.

24. Information regarding our compliance approach where newly-constructed or substantially-renovated residential premises are temporarily unavailable for lease for short periods is given in paragraphs 46 to 47 of this Ruling.

Example 5 – new construction

25. *Harry purchases vacant land on 1 July 2019 and builds a house on the land. He obtains the occupancy certificate on 9 February 2020. Harry lists the property with a real estate agent for lease on 1 March 2020. Any holding costs that Harry would otherwise be entitled to deduct from 1 March 2020 will not be denied by section 26-102, as from this date the house is lawfully able to be occupied and available for lease*.

Loss or outgoing relating to holding land

26. Subsection 26-102(1) clarifies that any interest or borrowing costs to acquire land are included as a cost of holding land. Examples of other costs of holding land include council rates, land taxes and maintenance costs.

27. In the context of section 26-102, we do not consider the costs of constructing a substantial and permanent structure on the land, or any interest or borrowing costs (to the extent they are associated with construction), to be a loss or outgoing related to holding land.

Example 6 – interest expense for multiple purposes

28. *Giovanna takes out a mortgage to purchase a vacant block of land in September 2019. Giovanna intends to build a house on the land (which she will rent out). Giovanna does not carry on a business. Giovanna takes out a separate loan for the construction of the house. Giovanna will not be able to claim a deduction for her interest*

[12] Further guidance on what comprises a 'substantial renovation' is contained in Goods and Services Tax Ruling GSTR 2003/3 *Goods and services tax: when is a sale of real property a sale of new residential premises?*

expense which relates to acquiring the land until the house is lawfully able to be occupied and leased or available for lease. If a deduction is otherwise available for the construction loan interest expense, Giovanna will not be prevented from deducting the expense by section 26-102.

Third element costs of a CGT asset

29. The third element of the cost base of a CGT asset is the costs of owning the asset including interest, rates and land taxes.[13] Where section 26-102 prevents a deduction for holding costs, the expenses may form part of the third element costs of owning the asset.

Interest incurred after land is sold or business activity has ceased

30. Taxation Ruling TR 2004/4 *Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities* considers the deductibility of interest expenses incurred before income earning activities have begun and after they have ceased.

31. Paragraphs 10 to 11 of TR 2004/4 note that where interest has been incurred over a period after the relevant borrowings (or assets representing those borrowings) have been lost to the taxpayer and relevant income earning activities (whether business or non-business) have ceased, it is apparent that the interest is not incurred in gaining or producing the assessable income of that period or any future period. However, the outgoing will still have been incurred in gaining or producing the assessable income if the occasion of the outgoing is to be found in whatever was productive of assessable income of an earlier period.

32. If you sell the land, the critical time for considering the application of 26-102 to deductible expenses is just before you ceased to hold the land.[14] The interest will continue to be deductible[15] if the land was not vacant immediately before you ceased to hold the land.

33. If you cease carrying on a business and a cost of holding vacant land relates to an earlier time or period, the expense will still be deductible to the extent that the land was being used to carry on a business at that earlier time or period.[16]

Land in use or available for use in carrying on a business

34. Subsection 26-102(1) does not limit deductions for holding costs of vacant land to the extent that the land is in use, or available for use, in carrying on a business for the purpose of gaining assessable income of you, your affiliate, any entity of which you are an affiliate, your spouse, your child under the age of 18 or an entity connected with you.[17]

[13] Subsection 110-25(4).
[14] Subparagraph 26-102(1)(b)(ii).
[15] The interest expense must have been deductible under section 8-1 or another relevant provision, and not specifically denied by section 26-102.
[16] Subsection 26-102(3).
[17] See subsection 26-102(2). An entity is connected with you in the circumstances described in section 328-125.

35. In addition, subsection 26-102(1) will not apply to limit deductions where the land is leased at arm's length to another entity and that land is used or available for use by that entity in carrying on a business.[18]

36. Whether the activities on the land amount to 'carrying on a business' is a question of fact, determined by reference to the indicia of carrying on a business as set out in the case law.[19] Practical guidance on determining if a lessee is using vacant land to carry on a business is provided at paragraphs 49 to 50 of this Ruling.

Example 7 – carrying on a business

37. *The John and James Smith Partnership operates a property development business and, as part of its business, acquires land in preparation for the development of a new apartment complex. As the land is being used in carrying on a business, subsection 26-102(1) does not limit the holding costs that can be deducted by the partnership.*[20]

Example 8 – land used in family business

38. *Amanda owns 1,000 hectares of bare cropping land over multiple titles. Amanda leases her land to a trading entity that is controlled by her parents. The trading entity runs a business selling the produce from the land. Amanda is employed by the trading entity but is not an affiliate of, or connected with, the trading entity.*[21] *The rent on the land is at market value. The exception in subsection 26-102(9) applies to Amanda as the lease was the result of an arm's length dealing and the lessee is using the land in carrying on a primary production business. Accordingly, subsection 26-102(1) will not prevent Amanda from claiming deductions in relation to her land.*

Multiple titles of land

39. In most cases, section 26-102 will apply to land under a single property title.[22] It is not necessary that all the land under a single title be in use or available for use.

40. Where land is held under separate multiple titles, you need to determine whether the land under each title is vacant. Subsection 26-102(1) limits any otherwise deductible holding costs associated with a particular land title if there is no permanent and substantial structure in use or available for use on the land under that title.

[18] See subsection 26-102(9). This exception will not apply if the land contains residential premises or such premises are being constructed on it.

[19] The Commissioner's views on whether a self-managed superannuation fund is carrying on a business are discussed in Self Managed Superannuation Funds Ruling SMSFR 2009/1 *Self Managed Superannuation Funds: business real property for the purposes of the Superannuation Industry (Supervision) Act 1993*. Guidance relevant to identifying whether an individual is carrying on a business is contained in Taxation Ruling TR 97/11 *Income tax: am I carrying on a business of primary production*?

[20] Paragraph 3.31 of the EM.

[21] For the purposes of this example, it is assumed that Amanda is neither 'connected with' nor an 'affiliate' of the trading entity. Whether an entity is connected with or an affiliate of another entity within the meaning of sections 328-125 and 328-130 will depend on the relevant facts and circumstances. If Amanda was either 'connected with' or an 'affiliate' of the trading entity, subsection 26-102(2) would apply (and there would be no need to consider the exception in subsection 26-102(9)).

[22] Paragraph 3.15 of the EM.

41. Where the land is vacant, you need to determine whether the land is used or available for use in carrying on a business. This will be a question of fact and it is possible that the land under some titles will be used in carrying on a business while others are not, as illustrated in Example 11 of this Ruling.

Example 9 – multiple titles, residential rental premises

42. *James purchases a vacant block of land in October 2019 and subdivides the block shortly thereafter. James intends to build a new house on each of the new lots (which he will rent out). James does not carry on a business and each of the lots is on a separate title. The house on Lot A is completed in August 2020 and the certificate of occupancy issued in September 2020. James immediately lists the house for rent with a local real estate agent. James needs to consider, separately for each lot, whether section 26-102 applies to limit any otherwise deductible holding costs. Holding costs associated with Lot A are not deductible until September 2020 when the house can be lawfully occupied and is available for lease.*[23] *Any holding costs associated with Lot B will not be deductible as the land remains vacant and the requirements of subsection 26-102(1) are not satisfied.*

43. *James needs to distinguish between holding costs that relate to individual titles (such as council rates) and holding costs that relate to both titles (such as interest on the loan obtained to purchase the land).*

Example 10 – multiple titles where all the land titles are used in carrying on a business

44. *A family trust holds 10,000 hectares of farming land. The land is on five separate titles which are not co-located. The land is leased to Allan and Mary who, in partnership, carry on a wheat-growing business on the land. Allan and Mary have reduced their capacity to farm the land over several years. In the current year, they have left two of the five titles to rest because access to external water sources on those titles is expensive. Section 26-102 does not limit any otherwise deductible holding costs that the trustee can claim in relation to the land used by the partnership in carrying on its wheat-growing business. The exception in subsection 26-102(9) applies even though two of the individual titles are not presently being used because they remain available for use in carrying on a business.*

Example 11 – multiple titles where only some of the land titles are used in carrying on a business

45. *Continuing on from Example 10 of this Ruling, rather than leaving the two titles of land to rest, the trustee as owner of the land terminates the lease in relation to those titles so that it can construct a residential rental property on each title. The exception in subsection 26-102(9) does not apply to those two titles of land as they are no longer leased and available for use in carrying on a business. Assuming the trustee is not in the business of property development, it will need to apply section 26-102 to each title separately to determine whether the provision limits any otherwise deductible holding costs associated with each title. The trustee will also need to determine when the two titles ceased being used or available for use in carrying on a business so that, if necessary, any expenses can be apportioned. Any apportionment should be done on a fair and reasonable basis. Once the residential premises are complete and the conditions in*

[23] See subsections 26-102(1) and (4).

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subsection 26-102(4) are satisfied, any otherwise deductible holding costs would no longer be limited by section 26-102.

Commissioner of Taxation
4 August 2021

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Appendix 1 – Compliance approach

This Appendix sets out a proposed practical administration approach to assist taxpayers in complying with relevant tax laws. When this ruling is finalised, provided you follow the advice in this appendix in good faith and consistently with the Ruling section, the Commissioner will administer the law in accordance with this approach.

Newly-constructed property temporarily unavailable for lease, hire or licence

46. We recognise that there will naturally be short periods of time when residential premises are unavailable for lease, hire or licence for reasons other than an exceptional circumstance or natural disaster.[24] For example, it would be expected that between tenancies there will be a brief period when the premises cannot practically be made available for lease because it is necessary for the owner to undertake minor maintenance and repairs.

47. These circumstances are outside the contemplation of subsection 26-102(4) and we will not apply resources to review compliance with subsection 26-102(4) provided that you continue to meet the requirements for deductibility under section 8-1 or another provision of the tax law.

Example 12 – short absence to undertake repairs

48. *Mohammad owns a residential rental property that he constructed on land that he holds. The tenants vacate the property leaving minor damage to some of the walls and fixtures. Mohammad is keen to maximise the amount of rent from the property and decides to repair the damage to the property before relisting it for rent. The property is off the market for four weeks while the repairs are undertaken. Mohammad's intention is always to lease the property and his holding costs remain deductible under section 8-1. This short period of vacancy is a normal incidence of the transition between tenancies. In these circumstances, we would not seek to apply subsection 26-102(1) to deny Mohammad's deductions for holding costs during the vacant period.*

Determining if a lessee is using land to carry on a business

49. We accept that when leasing vacant land to another entity, it will not always be obvious whether the lessee is carrying on a business. The holder of the land may not have sufficient information to ascertain whether the usual indicia of a business are present in the activity conducted by the lessee.

50. When leasing vacant land to another entity, you should make a reasonable assessment of the other entity's use of the land. Considerations include, but are not limited to:

- whether the lessee has an active Australian business number
- whether the lessee is registered for goods and services tax
- whether the lessee requires a tax invoice or receipt for lease payments

[24] Subsection 26-102(6) contains an exception to the general rule in cases of structures affected by natural disasters or other exceptional circumstances.

- the lessee's stated intention regarding use of the land – using the land for primary production is likely to indicate that the lessee is carrying on a business
- the amount of the lease payments – nominal or sub-commercial rates may indicate that the lessee is not in business
- the terms of a formal lease agreement may be an indicator that the lease is commercial in nature, and therefore more likely that the lessee is carrying on a business, and
- where the lessee is an entity of the type that is referenced in subsection 26-102(5), this may indicate that the lessee is in business.

Example 13 – lease to another entity in business

51. *Jill is a retired primary producer. She owns a 50-acre paddock that is completely vacant. Jill enters into a formal agreement with her neighbour to lease the land. The lease agreement outlines the neighbour's intention to grow hay on her land, for use in their primary production business. The lease amount is commensurate with normal commercial rates. Jill is not prevented from deducting holding costs in relation to her land as the lessee's use of the land is in the course of carrying on a business.*

Appendix 2 – Your comments

52. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

53. A compendium of comments is prepared when finalising this Ruling, and an edited version (names and identifying information removed) is published to the Legal database on ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **17 September 2021**

Contact officer details have been removed following publication of the final ruling.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

GSTR 2003/3; SMSFR 2009/1; TR 97/11; TR 2004/4

Legislative references:

- ITAA 1997 8-1
- ITAA 1997 26-102
- ITAA 1997 26-102(1)
- ITAA 1997 26-102(1)(b)(ii)
- ITAA 1997 26-102(2)
- ITAA 1997 26-102(3)
- ITAA 1997 26-102(4)
- ITAA 1997 26-102(5)
- ITAA 1997 26-102(6)
- ITAA 1997 26-102(9)
- ITAA 1997 110-25(4)
- ITAA 1997 328-125
- ITAA 1997 328-130
- ANTS(GST)A 1999 195-1

Other references:

Explanatory Memorandum to the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No.1) Act 2019

ATO references

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