

# CAPITAL GAINS TAX (CGT)

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## Principal Place of Residence CGT Exemption

Basically if you make a capital gain when selling your home it is exempt from capital gains tax but there are some catches and extra benefits. Ensuring that you qualify for the exemption is now more important than ever because indexing for inflation no longer applies. If you hold the property for 20 years it would not be unreasonable to expect it to double in value but with no exemption you could lose 23% of that increase in value in tax. This would mean you would not have the money to buy a similar house elsewhere or possibly not be able to afford to move. The following is a summary of some important points to the exemption. PPR stands for principal place of residence.

- 1) CGT does not apply to your home if it was purchased before 20 September, 1985.
- 2) The PPR exemption can apply to a forfeited deposit or damages received from a defaulting purchaser providing the house is put back on the market and eventually sold.
- 3) A “Spec” builder who lives in the “spec” home technically qualifies for the PPR exemption but is taxable on the profit as normal business income anyway and this overrides the CGT exemption.
- 4) If the home is owned by a trust or company the PPR exemption cannot apply
- 5) Basically if you make a capital gain when selling your home it is exempt from capital gains tax but there are some catches and extra benefits. Ensuring that you qualify for the exemption is now more important than ever because indexing for inflation no longer applies. If you hold the property for 20 years it would not be unreasonable to expect it to double the PPR exemption cannot apply.
- 6) If you move into a house as soon as practical after you purchase it the house is deemed to be your PPR from the time you purchased it. Further, if at the time of purchasing your new house you have not yet sold your old house they can both be your PPR for up to 6 months. Providing during the last 12 months you have lived in your old residence for at least 3 continuous months and it was not used to produce income during the period in that 12 months that it was not your PPR.
- 7) If you sub divide the land your home is on and sell the new block separately from your home the PPR exemption does not apply. If you build another house on the block the PPR exemption can apply for up to 6 months if you sell off the old home in that time. Refer point 5 above and TD2000/13 & TD2000/14.
- 8) Other than the circumstances in point 5 above you can only have one PPR at a time. Providing you have at some time lived in the place (refer point 9 for qualifications) you can choose which house you want to be considered your PPR but only from the time you first lived there (except re point 10) and only up to six years after you move out if it becomes income producing during your absence. The time frame is unlimited if it is not income producing while you are not living there. Note if you move back in and then out again (refer point 9 for qualifications) you are entitled to another 6 years PPR exemption even if it is income producing.
- 9) If you earn income from your PPR while you are living there than your PPR exemption only applies to the percentage of the Capital Gain that represents the percentage of the house used for private use. Note in Walters case a person renting out rooms in the home unit she lived in was only allowed a PPR exemption for the portion of the unit not rented out. Even though the rent was half of the market value. If you are going to take advantage of the circumstances outlined in point 6 but the home was partly used to produce income while you were living in it then you can only get the same percentage PPR exemption during the 6 year period as the percentage the house was used for private while your were living there.
- 10) When considering whether your house is your PPR the ATO considers the following factors (refer TD51) note not all have to be satisfied:
  - (a) Electricity and Phone connected in your name.
  - (b) Registered on the electoral role to that address.
  - (c) The presence of personal effects in the house.
  - (d) The address given for mail deliveries.
  - (e) Where your family lives.
  - (f) The length of time you have lived there.
  - (g) Your reasons for occupying the dwelling.

- 11) You can elect to have vacant land or a property you are renovating classed as your PPR for a period of up to 4 years before you move into it providing you do not have another PPR (other than for the 6 months in point 5). But you must move in as soon as practical after the building is finished and live there for at least 3 months before selling or have died.
- 12) If your house is accidentally destroyed and you sell the land rather than rebuild, your PPR exemption can continue to apply to the land until sold providing you do not claim any other place as your PPR.
- 13) Families are discriminated against in that spouses and their children under 18 can only have one PPR between them no matter where they live. Spouses can elect to claim their spouse's PPR as theirs even if they never lived there and even if their name is not on the deed. If both spouses want their separate homes to be their PPR they only get half the exemption on each place.
- 14) If you acquired your PPR after 20<sup>th</sup> September, 1985 and used it as your PPR until some time after 20<sup>th</sup> August, 1996, when it became income producing you must use the market value of the property at the time it becomes income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after it ceased to be your PPR. It is not optional.

## **Trusts and Capital Gains Tax concessions**

There are many capital gains concessions (see reader's question below for example) for businesses whose "combined assets" are less than \$6 million. The problem lies with the definition of "combined assets" as these include the assets of associates. If you are operating your business as a trust then all the beneficiaries of your trust that are entitled to 40% or more of the profits are associates of your business. Traditionally trust deeds have endeavoured to define beneficiaries as widely as possible to cover all possible future events. The trouble is that the total of all these possible beneficiaries assets could easily reach \$6 million. So it is important to have a clause in your trust deed that any beneficiaries other than the immediate family members are only entitled to a maximum of 39% of the profits in any given year. This ensures their assets are not taken into account when determining whether the assets of the trust and its associates does not exceed \$6m.

If you are operating through a trust but the business is so personalised that there is no chance of selling it to someone else, and there are no significant assets, the above should not be of concern to you as you will not be subject to capital gains tax unless you can sell the business for more than it cost you.

## **Basics for executors of deceased estates**

- 1) Trustee, Legal; and Personal Representative and Executor mean the same thing for the purpose of the following and it is assumed the beneficiary is an individual.
- 2) A deceased estate receives a tax free threshold and stepping of its tax bracket from there for up to 3 financial years after death but note the ATO can cancel this concession if the winding up of the estate is unduly delayed for the purpose of the tax benefit. The deceased also receives the tax free threshold and stepping up of his or her tax bracket for the tax return up to the date of death. This means that effectively two lots of tax free thresholds etc can be utilised in the financial year of death. While in most cases the tax concessions are the same for the deceased as the executor, consideration should be given to this point in deciding whether to pass an asset onto a beneficiary before it is sold.
- 3) To qualify for the 12 month CGT discount, 12 months must have elapsed from when the deceased entered into an agreement to purchase the asset regardless of whether it is held by the trustee or beneficiary when sold.
- 4) In most circumstances death will not trigger capital gains tax but it will start the clock ticking on pre 19<sup>th</sup> September, 1985 assets so it is important to have these valued at the date of death.
- 5) Most pre 19<sup>th</sup> September, 1985 assets will, in the hands of the executor or beneficiary, have a cost base of market value at the date of death. So when sold CGT will be payable on the difference between the selling price and the combination of the selling costs, holding and improvement costs since death and the market value at the time of death.
- 6) The main residence of the deceased will not attract CGT if sold within two years of death whether it was purchased pre or post 19<sup>th</sup> September, 1985 and there are further concessions if a beneficiary continues to live in the house. The main difference between pre and post 85 main residences is the two year concession applies to pre 85 dwellings even if they weren't the deceased's home at date of death whereas post 85 homes only receive the concession if it was the deceased's main residence just

before death and was not also income producing at that time. If the dwelling fails this test it is treated like other assets discussed in point 5 above.

- 7) Any capital loss accumulated by the deceased can only be offset against capital gains made up to his or her date of death. So neither the beneficiary nor the trustee can take advantage of the carried forward capital loss of the deceased.
- 8) Generally the passing of an asset from the deceased to either the Executor or Beneficiary will not trigger a CGT event nor will the transfer from Executor to the Beneficiary.
- 9) The capital gains tax event arises on the date you agree to sell the asset to a particular purchaser, not the settlement date.

## **Becoming a non resident of Australia for tax purposes**

IT 2650 examines the relevant factors in depth. Generally if a person leaves Australia for more than two years and sets up a home in another country they will be considered not to be a resident of Australia for tax purposes right from the time they leave Australia. Note it is possible to become a resident of more than one country at the same time.

Upon becoming a non resident of Australia ITAA97 section 104-160 deems a capital gains tax event to have occurred. This is that you are considered to have disposed of all your assets, that are **not** "connected with Australia" and acquired after 19<sup>th</sup> September, 1985, at their market value. Accordingly, you will be subject to capital gains tax on any increase in value over their cost base. Houses and land in Australia are considered connected with Australia.

Section 104-165(2) gives you the option of ignoring the capital gain accrued when you leave the country but this will effectively mean you are taxed on any gain while you are a non resident. The options offered by Section 104-165(2) are:

- a) Defer the CGT and pay it when the asset is sold but the tax will be on the gain over the whole period up to the sale including when a non resident.

**Or**

- b) Defer the CGT on the basis you will be returning to Australian Residency before you sell it but when you do sell there will be no exemption for the gain made while you were a non resident.

So the choice is pay the tax when you leave and be free of Australian tax on any gain you make while a non resident or defer the tax but widen the period of time you are exposed to Australian capital gains tax.

As your home will be an asset "connected with Australia" you will not be deemed to have disposed of your home by 104-160 if you decide to keep a home in Australia to return to and go overseas for longer than 2 years and lose your residency for tax purposes. If this is the first time you have rented your home out Section 118-192 will reset your cost base to the market value at that time and the CGT clock will start ticking but you can use section 118-145 to continue to exempt it from CGT as your main residence for up to 6 years at a time. You will qualify for another 6 years each time you move back in. If it is not rented out the exemption from CGT is unlimited. .

A non resident is entitled to the 50% capital gains tax discount if they have held the asset for more than 12 months.

You may also have trouble if you are the trustee of your self managed superannuation fund as the trustee needs to be a resident.

## **Reader's question – Inherited shares**

A reader was concerned that she would have to hold onto the shares she inherited from her father for 12 months from the date of death to claim the capital gains tax 50% discount. The discount is available when assets are held for longer than 12 months but in the case of a deceased estate the 12 month holding period starts from the time the deceased bought the shares. Not the date of death. Refer Section 114-10(6) and TD 94/79.

If you are the beneficiary of a deceased estate you should make sure you know the market value, at date of death, of any assets held by the deceased before September, 1985 and the market value of their principle place of residence at the

date of death. For post September, 1985 assets you should ascertain the cost base to the deceased as this will become your cost base.

## Reader's question

### Warning to Readers Renting Out Their Home:

A reader had purchased his family home before property prices stagnated. When he was transferred to another state the value of his home was less than he paid for it so he rented it out rather than sell it. Because the time he first rented it out was after 20<sup>th</sup> August 1996 according to Section 118-192 the property is deemed to have been sold at the time it was first rented out. No capital gain or loss arises at this point in time because it was the reader's main residence until that date. Note he could not leave his main residence exemption with the original property because he purchased a house in his new location and needed to cover it with his main residence exemption. Now that the property market has recovered the client is in a position to sell the original property for close to the amount he originally paid for it but because of section 118-192 he will have to pay capital gains tax even though he made a loss on the transaction. For example:

Imagine the situation where a person buys at \$100,000 with a respectable 20% deposit but \$5,000 is used up in stamp duty, legal fees, bank fees and searches so the bank loan is for \$85,000. Very little is paid off the principle as at the start of the loan it just doesn't happen and then when he or she rents it out he or she changed to interest only. He or she finally sell for \$90,000 but the price had dropped by 20% (it happened around 1996) when they rented it out. They have made a notional capital gain of \$10,000 less selling costs of say 4,000 equals \$6,000 less the discount taxable income will be \$3,000. He or she will have to pay tax on the \$3,000 at their marginal rate even though they made a loss on the house. It may also effect child support payments, Centrelink and the Medicare levy surcharge. So out of the \$90,000 the bank gets \$85,000 the Real Estate and solicitor \$4,000 and the tax man will get at least \$1,000. Not only has he or she blown their \$20,000 deposit (life savings) but if they are in a tax bracket higher than 31.5% they will have to find more money to pay their tax. This is also a double tax because the original stamp duty paid on the purchase is ignored when setting the cost base on only the market value without acquisition costs.

Most people thought section 118-192 was a concession to help out if they hadn't been keeping records because they never intended to rent it out. Very few people realised that this was not an optional election but binding on everyone. The state of the property market when this provision was introduced really means it is another cash grab by the government on the family home for just about everyone except those living in Sydney.

## CGT concessions if you live in a property

Assets purchased after 19<sup>th</sup> September, 1985 are subject to capital gains tax on any increase in their value. This is not intended to apply to your own home but it is important that you are aware of how to ensure your home qualifies for the exemption.

**Section 118-135** Requires you to move into the dwelling as soon as practical after you own it. If you do not do this you will always have a gap in your main residence exemption and so be up for capital gains tax possibly many decades later when you sell. The worst part is you will need to keep all the relevant records. You also need to move into the dwelling before you can start to take advantage of Section 118-145 below. It can cause you a lot of problems to rent your home out when you first buy it and move into it at a later date.

**Section 118-145** If you move out of your main residence you can (although not compulsory) continue to give it your exemption for capital gains tax purposes but you can only use the exemption on one property. Note couples are only entitled to one residence between them. If during the time the property was actually your residence it was also income producing, you will only be able to claim the exemption on the portion that was your residence even if, after you move out, the other portion does not produce income. If, after you move out, you rent the property out, your exemption will only last 6 years but if you move back in, the 6 years clock starts all over again. If you do not rent the property out or produce income from it, during the time you are not living there, your CGT exemption is unlimited.

**Section 118-140** Your main residence exemption applies to two homes for a period of up to 6 months. This is intended to allow you time to sell your old home after purchasing a new one. To qualify:

1) The first home must have been your residence for a continuous period of at least 3 months in the 12 months immediately preceding the date of sale.

2) If you were not living in the first home at any time during the 12 months preceding the date of sale it can not have been used for producing income (i.e. rented out or used as a place of business).

Note section 118-140 is not optional it must apply so if you have made a capital loss during the period of overlap you cannot claim it.

**Section 118-150** A vacant piece of land or a dilapidated house can be covered by your main residence exemption for up to 4 years before you finish building or renovating the dwelling, if all of the following apply:

- 1) You move into the dwelling as soon as practical after it is completed.
- 2) You continue to use that dwelling as your main residence for at least 3 months before it is sold.
- 3) During this time you are not using your main residence exemption on another property though note you are still entitled to the overlap of 6 months under Section 118-140 above.

Section 118-150 can also apply if you move out of your home to renovate it though using 118-145 will give you an indefinite time frame rather than just 4 years.

If you lose your exemption one of the following scenarios could apply to you:

- If you purchased your home after 19<sup>th</sup> September, 1985 and before 21<sup>st</sup> September, 1999 you have a choice. You can apply inflation from the date of purchase to 21<sup>st</sup> September, 1999 to your original costs (including improvements) and pay tax on the difference between that and the selling price less the cost of selling. But you will miss out on the 50% discount. Otherwise you can pay tax on half the difference between the original costs including improvements and the selling price less selling costs but no allowance for the effect of inflation. Note the tax rate will be the normal rates as there are no longer averaging concessions and the gain can push you into a higher bracket.
- If you miss out on the exemption and your home was purchased after 21<sup>st</sup> September, 1999 you will pay tax at whatever bracket half of the gain pushes you into (assuming you have held the property for 12 months or more). Note there is no indexing for inflation. So if houses in general go up in value you will still be paying tax on the difference between your actual cost base and the selling price regardless of the fact that, after paying the tax, you will no longer have enough money to buy a house of the same value. In other words you will go backwards as a result of the sale.
- If the house is only entitled to your main residence exemption part of the time, the taxable gain will be multiplied by the percentage of time the house did not qualify. Accordingly, you will have to keep records of all capital improvements for the whole period of ownership as the gain for the whole period of ownership has to be worked out first. You will need to be very diligent to record all capital improvements as they include trees, floor tiles, the extra wiring for say an outside light, a hose if there wasn't one there before etc etc. You can also increase your cost base (but not a capital loss) by the holding costs that have not been claimed as a tax deduction against the rent, if you purchased the property after 20<sup>th</sup> August, 1991 section 110-25(4). Holding costs are rates, interest, insurance, repairs and maintenance. So even keep receipts for light globes and lawn mower fuel. Basically you need a big box and just keep receipts for everything to be sure.

As discussed in Newsflash 49 under "Warning to readers renting out their homes", if the home is first rented out after 20<sup>th</sup> August 1996 and has qualified as a main residence up to that date you are forced to set a new cost base of the market value at the time of renting, so holding costs before then are not relevant to your cost base. If you are only ever likely to lose your exemption because you may rent the house out in the future, you really only need to keep the big box after you start to rent it out.

**Note** the title deeds of the house must show the name of the person who is giving the home their main residence exemption. Therefore if your home is "owned" in a parent's name or company or trust it cannot benefit from your main residence exemption. This could end up costing you heaps when you sell.

## The 50% CGT Discount

As you are probably aware you need to hold onto a property for over 12 months from the date of signing the agreement to purchase to the date of signing the agreement to sell in order to qualify for the 50% CGT discount. Some clients have been making a very quick gain on properties and are impatient to sell in case prices fall. The choice is sell now and lose a lot of the profit in tax or hold on and take a risk on future prices. From the buyers point of view they are probably more concerned that prices will continue to escalate but are

not in a rush to start paying interest on the loan. In fact the chance to fix a contract at today's prices but not have to pay anything for several months could be very attractive to some buyers.

ATO ruling TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor is the date of the exercise of the option.

Of course an option gives a purchaser the chance of avoiding entering into the contract to buy the property so you must charge a large enough amount for the option to ensure that the purchaser will exercise it after the date you specify. The ATO is trying to argue that if the price of the option is so high that the purchaser would definitely take it up then the contract was entered into at the time of entering into the option.

## Reader's question - CGT liability

Due to the recent increase in property prices a reader has a nice problem in that the value of their rental property has nearly doubled in the year they have owned it. They are now in a position to sell their own home and the rental property to build their dream home debt free. That was until they realised the huge CGT liability on the rental property.

If they move into the rental property for 12 months until their new home is completed and then sell the rental property, they have halved the portion of capital gains that will be taxable on the sale. But there are even further benefits available from section 118-140 as discussed in Newsflash 50:

**Section 118-140** Your main residence exemption applies to two homes for a period of up to 6 months. This is intended to allow you time to sell your old home after purchasing a new one. To qualify:

- 1) The first home must have been your residence for a continuous period of at least 3 months in the 12 months immediately preceding the date of sale.
- 2) If you were not living in the first home at any time during the 12 months preceding the date of sale it can not have been used for producing income (i.e. rented out or used as a place of business).

**Note:** Section 118-140 is not optional it must apply so if you have made a capital loss during the period of overlap you cannot claim it

The above does not put any restrictions on the new home so it is not relevant that it was owned for more than 12 months before the sale of the original home or that it was rented out for the first 12 months. The reader is still entitled (in fact it is compulsory) to the 6 month overlap that exempts from CGT the new home for the 6 months before they move in. Accordingly, if they sell after owning the property for 2 years and living in it for 1 year, they will now only be taxed on one quarter of the capital gain and that will then be halved to allow for the CGT discount on properties held for more than 12 months.

Tens of thousands of dollars saved by getting the right information first. This just emphasises the need to talk to an accountant before you do anything.

## Part owner of parents' home

A taxpayer who is part owner (as tenants in common) of her parents' home is concerned about the CGT consequences of her parent's death and whether there is any action she can take now to minimise the cost.

**Answer:** As the property is held as tenants in common the deed will show just what percentage each of them own. Let's assume the child is a resident of Australia and owns half so the parents own a quarter each. Assuming the parents will their 1/4 of the house to each other on death then half the house will become part of the estate on the death of the remaining parent. The other half will just be an asset held by the child and subject to CGT via the normal provisions when sold. It is not affected by the death of the other owners of the property. When the last parent dies (assuming he or she lives in the house up until death) the beneficiaries of the estate will not be subject to CGT on their 50% if they sell the property within 2 years of the parents death TD 1999/70. If they do take longer than 2 years to sell the cost base will be the market value at the time of the last parent's death plus the normal extras such as commissions, improvements since death etc and costs of acquiring the asset such as probate. This is the case regardless of whether the house was purchased pre or post 19<sup>th</sup> September, 1985. The only difference joint tenancy as apposed to tenants in common would make is that it would be very difficult to convince the ATO the child owned anything different than exactly 1/3rd of the house.

As you can see the more the child owns of the house the higher the eventual CGT on its sale, even in 100 years time. Depending on the age of the parents it may be worth the stamp duty now to change the deed to only the name of the parents. This would be a deemed disposal and the child would have to pay CGT on the difference between his or her cost base and the market value of their share but at least then the CGT clock would stop until the parents die, assuming the parents live there until death. The child would need to see a solicitor to make sure her legal rights to the house were provided for within the parents will and be confident this was not going to change.

## **Why pre Sept 1985 assets are so valuable**

Pre Sept 1985 assets are valuable because they will never be subject to capital gains tax while their owner is alive and does not do anything to change their pre CGT status. This will normally make the pre CGT asset a better investment than anything you buy post 1985. So think seriously before you sell one.

If you spend more than \$109,447 (as at 2006 indexed each year) improving a pre CGT asset and that amount is more than 5% of the selling price, the improvement will be considered a separate asset from the pre CGT asset. Therefore, if the improvement was made post CGT, it will be subject to CGT on the sale even though the original pre CGT asset will not be (Section 108-70(3)). Note that both the threshold and the percentage test must be met for the asset to be considered separate from the pre 85 asset. But note Section 108-70(3) excludes buildings and structure on pre CGT land from this concession. Post 85 buildings on pre 85 land will always be considered a separate asset section 108-55(2) unless they are inherited.

Even if you do spend too much money improving the asset if you do not sell the asset before you die your heirs will inherit the asset at the market value at your date of death. In other words the separate asset provisions are not triggered and the post CGT improvement is treated the same as the pre CGT asset.

## **Reader's question – CGT basics**

Many Readers have asked the same basic questions about capital gains tax, so while there are no secret plans and clever tricks here it is necessary to provide some clear guidelines on the provisions that affect every home owner. In order to protect your home from Capital Gains Tax (CGT) it must be considered your main residence.

The first condition you need to satisfy is moving into it as soon as possible after purchase. Note there is a 4 year concession if you are renovating or building on land but only if you do not have another main residence at the time. If you do not move in straight away the home will always be subject to CGT on a pro rata basis so you will need to keep records of all the money you spend on it including rates, interest, improvements, plants, insurance, repairs etc.

Once you have established a house as your main residence there are concessions that allow you to move out but leave your main residence exemption with the house.

There is no minimum time set in legislation of how long you have to be in a house to establish it as your main residence, for CGT purposes. Whether the house is your main residence or not is a question of fact. The ATO has issued TD51 as a guideline (not law) of what the ATO considers relevant in establishing your main residence somewhere. The following is an extract from that ruling:

Some relevant factors may include, but are not limited to:

- (a) the length of time the taxpayer has lived in the dwelling
- (b) the place of residence of the taxpayer's family
- (c) whether the taxpayer has moved his or her personal belongings into the dwelling
- (d) the address to which the taxpayer has his or her mail delivered
- (e) the taxpayer's address on the Electoral Roll
- (f) the connection of services such as telephone, gas and electricity
- (g) the taxpayer's intention in occupying the dwelling

The relevance and weight to be given to each of these or other factors will depend upon the circumstances of each particular case. Mere intention to construct a dwelling or to occupy a dwelling as a sole or principal residence, but without actually doing so, is insufficient to obtain the exemption.

An example of how strictly the ATO is scrutinising this is a case where the taxpayer's home was not considered his principle place of residence because he was living and working overseas so had only ever visited the house he owned and in which his adult children lived.

A house can only be classed as your main residence if your name is on the title deed. So in the case above there was no point in arguing that the house was the main residence of the children but the problem could have been solved by buying the property in their name. Further, if you buy your home in the name of a company or trust it will not be protected from CGT by your main residence exemption. As indexing for inflations is now only available in very limited circumstances it is important to protect your main residence exemption. CGT could reduce the proceeds of the sale of your home to the extent that you will not be able to purchase a similar property, simply because of normal increases in prices in line with inflation.

## **CGT catches the family home but no indexing for inflation**

Capital Gains Tax is creeping into traditional family arrangements and catching the family home.

When my widowed Grandmother sold her house to buy a unit near the beach, she made the title of the unit jointly in her name and the name of her youngest daughter who was still single and living with her. My Grandmother did this because all her other children were married and had their own homes so she wanted to make sure that when she died my aunt would have a home of her own. My aunt married a few years later. Do that sort of thing today and there is a good chance that the home will become subject to Capital Gains Tax or Stamp Duty will have to be paid to change the title at a later date. Either way the taxman wins.

All will go well if the daughter continues to live there until after her mother dies. Planning based on this being the most probable outcome is very short sighted. There is a far greater chance that the daughter will eventually purchase her own home. Or worse still, she could marry and her husband may already own a home. You see married couples are only allowed one home totally exempt from CGT between them. Regardless of the fact, that in the case of around 50% of marriages they will eventually need a home each. When the daughter moves out she can choose to leave her main residence exemption with her mother's home but then the home she lives in will become subject to CGT. Assuming the daughter takes her main residence exemption with her, her mother's home will be exposed to CGT. So what happens if the mother needs to sell her home to go into some form of age care facility? It seems to be a fact of life that the cost of moving into one of these units is around the same price as most people can expect to realize from the sale of the family home. As indexing for inflation has very limited application anymore the mother will not be able to afford the aged care facility because the tax man will be taking a large slice of the proceeds of the sale of the family home.

Don't think it is all that bad? Let's crunch the numbers. To be fair I will ignore the fact that, in many areas, property prices have doubled in the last year and stick to a conservative estimate that they will double every 10 years. Say the mother was around 50 when the home was purchased, with a life expectancy of around 40 more years. Assume the daughter moves out 5 years later and her mother lives there until she is 85 and then needs care. The home was originally purchased for \$200,000. After 35 years it should be worth 2.4 million but then so will similar homes and aged care facilities. This is just an inflationary gain. We are talking about a time in the future when the children will have as much understanding of what a cent is as today's children do about a penny. The home has been owned for 35 years and for 30 years only half exempt from CGT. Therefore 43% of the gain will be subject to CGT but the 50% discount will apply. The gain will be 2.4 million less the cost base of the asset which includes the original purchase price of only \$200,000 plus legals, stamp duty, improvements and commission. If the home was purchased after 20<sup>th</sup> August 1991 the cost base includes rates, insurance, interest and repairs during the period of ownership. Note in this scenario interest is unlikely to apply so the gap will be quiet wide and even wider if the home was purchased before 20<sup>th</sup> August 1991.

Of course the cheaper alternative is to pay the stamp duty and change the title when the daughter moves out. Still expensive especially in New South Wales and Victoria but probably cheaper than the CGT. The trouble is nobody thinks of any of this at the time. In fact the first time the issue will come up is when the ATO sends a letter saying our records show you have sold a property yet you have not completed a CGT schedule in your tax return for that year, the penalties plus interest are... Further there is a \$3,000 fine if you have not kept the appropriate records during the last 35 years.

*Professional advice should also be sought if any estate planning in the family includes a life tenancy in a home*

## House swapping

If considering swapping houses to claim rental deductions as discussed in Noel Whittaker's 19-10-03 column make sure you live in the home you purchase before swapping. This will allow you to exempt the home from capital gains tax for up to 6 years. Section 118-145 allows you to move out of your main residence and continue to give it your exemption for capital gains tax purposes. Further at the end of the 6 years you can move back in, then move back out and the 6 years clock starts all over again. TD 51 ([www.ato.gov.au](http://www.ato.gov.au)) list the factors that the ATO takes into account when considering whether the house was your main residence during the time you are actually living there. These include where your personal effects are stored, the connection of utilities in your name, changing your address on the electoral roll etc. Neither the legislation nor the ruling specifies a time period that you are required to live there.

## Demolishing a rental property

The owner of a rental property wishes to demolish it and build a home she can live in on the site. She asks what valuations etc will be required to keep property records of the cost base for CGT purposes.

**Answer:** No need to get valuation. Both the original cost of the property, the demolition costs and construction costs of the new house will be included in the cost base for CGT purposes. This property will always be subject to CGT even though the portion will decrease over the time it is used as a main residence. Accordingly, you need to keep very good records of all expenditure including rates, interest, R&M and insurance while it was your main residence.

### References:

ID 2002/514 if the demolition expenses were incurred to enhance the value of the land, and are reflected in the state of the land when it is sold, they are included in the cost base, even when incurred to facilitate the construction of another dwelling.

TD 1999/79 the demolition of the house is a CGT event. But it does not create a capital loss unless money is received for it (ie insurance). ID 2002/633 says that this is because the building has a zero cost base. Subsection 112-30(5) the original cost base is attributed to the remaining part (ie the land).

## Capital gains tax and shares or managed funds

While capital gains tax (CGT) is not a death tax, it does impose a huge headache on the beneficiaries of your estate to find necessary information when you are not around to help them. The transfer of your assets to your heirs will not trigger CGT but when your heirs eventually sell the assets they need a cost base in order to calculate any CGT payable. The ATO can fine them if they do not have the appropriate records and they could end up paying a lot more tax than necessary.

To keep it simple!! I will just consider the costs base for shares and units in managed funds. The cost base is the original purchase price plus any reinvestments of dividends or distributions, brokerage fees and initial financial advice costs less tax deferred distributions or returns of capital. The capital gain or loss is the difference between the cost base and the selling price. It is helpful if you record the number of units or shares as any discrepancy between this total and the quantity sold will detect an error in the records. Documentation explaining any tax free distributions should be kept safe as they may also effect the cost base. If you have sold some of the parcel, your records should show how the cost base was calculated as this is relevant to determining the cost base of the remaining shares or units. In my experience you cannot always rely on your fund manager to keep for you the information you need to calculate your cost base. If the fund has been taken over the relevant records may no longer be available. The funds are under no obligation to provide this information. It is the owner of the asset, namely you or your heirs, that is required to keep the records necessary to calculate the cost base and liable for a fine from the ATO.

If the thought of having to dig up this information gives you the horrors imagine how difficult it will be for your heirs.

So what can you do to leave your estate in good order? Firstly acquire a big box and then start to do what I have been planning to do over the last 10 years. Include in this box a folder for each investment containing all correspondence. Just because some of the information provided on the taxation statement each year has been included in that year's tax return does not mean that is the end of it. Keep all statements and explanatory information, even if the fund claims the distribution is tax free.

## Sell to a farmer as opposed to a developer

A husband and wife purchased a farm in 1988 which they have farmed, in partnership, continuously for the last 15 years. Their combined assets are under \$6 million. They want to know how much tax they will be up for and whether this changes if they sell to a farmer as opposed to a developer. It is expected that they will get a higher price from the developer but wonder whether this will be worth it after tax considerations. The following only addresses the ramifications for the land not the plant and equipment on it. CGT Considerations:

**15 Year Exemption:** The most attractive CGT concession here is the 15 year exemption. This concession is superior to all other concession if you can qualify as follows:

1) Active Asset Test S152 - Used in the business up to just before sale and for at least half of the time it was owned. If the business ceases before the sale the asset must have been used in the business up to the time it ceased (note the ATO is taking a very strict view here it means right up to the last day) and then must be sold within one year of the business ceasing. The property would not be an active asset if it was used to derive rental income.

2) The asset must have been owned for at least 15 years.

3) Both owners must retire

If they can pass this test the gain is totally CGT free.

### **Retirement Exemption Combined with 50% CGT Discount and 50% Active Asset Discount:**

If they cannot meet the requirements of the 15 year exemption because they are not retiring the next best option is the retirement exemption after utilising the 50% CGT discount and 50% active asset discount. All three of these concessions can be used together but before they are used the capital gain must be offset against any capital losses. In the case of the 15 year exemption they would get to keep any accumulated capital losses to offset against other capital gains.

For example assume the gain on the property was \$100,000 the 50% CGT discount would reduce this to \$50,000 and the 50% active asset discount would further reduce this to \$25,000. Placing the remaining \$25,000 into superannuation would mean that the whole \$100,000 is received tax free. The \$25,000 is not taxed in the hands of the superannuation fund.

**Note:** If they could not use the 15 year exemption because they failed the active asset test as per 1) then they will not qualify for the retirement exemption or the 50% active asset discount.

Despite its name the retirement exemption does not require them to retire. They can just put the money into superannuation instead.

Companies and Fixed Trusts are not entitled to the 50% CGT Discount and the use of the 50% Active Asset Discount creates problems when the asset is owned by a Company or Fixed Trust. In Discretionary Trusts the CGT flows through to the beneficiaries so is treated the same as an individual. Fixed Trusts are all trusts that are not discretionary. Fortunately our Readers owned the farm in partnership.

### **GST Considerations:**

If they sell the land while they are registered for GST they will have to charge GST, unless they sell it as a going concern and the purchaser is registered for GST in which case it will be exempt. Whether the purchaser is a farmer or developer, if they are registered for GST it makes no difference as they can claim the GST straight back off the ATO anyway. So the GST will be just added on to the agreed price.

If the purchaser is not registered for GST they need to try to avoid charging GST on the property. If they can drop their annual turnover to under \$50,000 they could de register for GST before they sell it. They could also consider ceasing the business in order to deregister but they must be careful to sell within 12 months in order to keep the active asset concessions. Upon de registration section 138 would require them to pay back some of the GST claimed on equipment for which all the adjustment periods have not expired but this will happen sooner or later. If it is not possible to de register for GST they could utilise the margin scheme to minimise the GST to a purchaser. A purchaser of land purchased under the margin scheme is not entitled to claim back any of the GST included in the purchase price but is entitled to use the margin scheme themselves, if they are registered for GST when they on sell the land.

**Conclusion:** It makes no difference who they sell the property to as long as it is used in the business up until the time of selling or within 12 months of ceasing business. Careful planning can completely eliminate all CGT and GST. Now that's the way to BAN TACS legally.

## Wraps – vendor finance arrangements

If the Vendor Finance arrangement has the following features the income stream received, once the wrap arrangement has begun, is considered to be principle and interest by the ATO. The income stream received before the wrap arrangement is entered into is considered rent. Reference ID2003/968.

Typical Features of a Wrap (Vendor Finance Arrangement)

- 1) The purchaser pays a deposit at the time of entering into the arrangement.
- 2) The settlement (change of the title deed to the purchaser) does not take place for several years after the arrangement is entered into.
- 3) The purchaser has the right to occupy the property prior to settlement
- 4) The purchaser pays a weekly amount (regardless of the name it is given in the arrangement) for the right to occupy the property
- 5) As part of the arrangement the purchaser pays the rates, taxes and insurances on the property.
- 6) The balance of the purchase price to be paid on settlement of the arrangement is reduced by the weekly installments.
- 7) If the purchaser fails to complete the arrangement the deposit and weekly installments are forfeited.

Now what about the profit on the sale of the property? Is that normal income or capital gain and when is it taxable? Assuming an agreement similar to that described above the answer to this question revolves around whether the vendor is in the business of selling houses or an investor just realising an investment. The key issues in differentiating here, according to ID2004/25, 26 & 27 are:

- 1) The Vendor did not use the property for any other purpose than to enter into the wrap. A straight rental of a property before entering into a wrap arrangement would avoid this point.
- 2) The property was sold at a profit
- 3) The wrap arrangement was entered into within 6 months of the vendor purchasing the property.
- 4) The Vendor is in the business of purchasing properties to resell. It would be difficult for the ATO to argue this case if the Vendor only bought and sold one property.

If you are caught by all of the above then CGT cannot apply to the sale of the property as the profit on the sale is revenue in nature. If a transaction is caught as income, CGT does not apply or in other words CGT is the last option if income tax doesn't catch it. But even if you weren't caught by the above and CGT applied there would be no discount if the property was held for under 12 months. If you did hold the property for less than 12 months before entering into the wrap it is better to argue that you are in business and caught by the above because the profit on sale would be revenue in nature and as a result not assessable until settlement which could be 25 years away (ID2004/27). If you hold the property for less than 12 months but it is subject to CGT you don't qualify for the discount but would be assessable on the profit in the year you entered into the wrap. Though you do not have to actually pay the CGT until settlement. This is done by going back and amending the tax return for the year you entered into the wrap.

Section 104-15(1) of ITAA 1997 states that a CGT event happens when the owner of a property enters into an arrangement with another party to allow them to live in the property and title may transfer at the end of the arrangement. Section 104-10(3) states that the time the CGT event happens is the time of entering into a contract for the disposal of the asset, not when settlement (title passes) takes place. Though the ATO does not make you pay the tax until settlement (change of ownership takes place) so you have to go back and amend that tax return.

For example this means that the vendor who enters into a wrap on a property that has been previously used as a rental and held for more than 6 months will be subject to CGT on the property in the financial year the wrap agreement is entered into. Accordingly, if at this stage the property has not been held for 12 months no CGT discount will be available even if they eventually end up holding the property for 25 years under the arrangement.

# Confusion over rollover relief because U.S. different

No rollover relief is available on investment properties in Australia. The only rollover relief is available to active assets of a business and it specifically excludes assets that have been used to produce rental income section 152-40(4)(e).

## Hot house

Things will get a lot hotter in the Hot House once the tax man moves in!

One couple will eventually win the house but it won't be like winning the lottery, they have worked for the prize. In accordance with IT 167 the value of the prize will be income to them. This value has been highly advertised at \$2 million. For GST purposes they would be considered to be an enterprise (MT200/1 & TR2000/14) as they are providing services, paid on the basis of a result and accept the risk. The ATO will score \$181,818 in GST. This leaves \$1,818,182 combined in taxable income for the 2004 tax year. Assuming they already both have jobs with reasonable pay packets the extra \$1,818,182 is going to attract the maximum tax rate of 48.5%. That is \$881,818 in income tax. They will need to find a bank that will lend them \$1,063,636 to pay the tax if they want to keep the house. Basically the tax man will pick up more than half their prize. Worse still the advertising might say the house is worth \$2,000,000 but a lot of that is hype. By the time they realise the trouble they are in and have to sell it to pay the tax bill they may not be able to find a buyer for \$2,000,000 especially when the whole country knows what went on in the construction. So what happens if a year later when they sell it to pay the taxes and they can only realise \$1.6 million? The ATO would have a good argument to still tax them on the \$2 million, the change in the value since then could be put down to the fickleness of the property market over the year. They now have an asset worth \$1.6million that they, notionally, purchased the year before for \$2 million (IT 2584). If they have lived in it since it was built the capital loss on the sale is private so no tax concessions at all. If they did not live there they can recognise a capital loss but this can only be offset against future capital gains not other income. Let's hope they already have private health insurance because if they don't the income from the house will push them into the Medicare Levy Surcharge which will be \$18,182 on the house income alone plus another 1% on their wages income. To eliminate the surcharge they must have had the insurance from 1<sup>st</sup> July, 2003 and you can't back date the insurance for the love of money. Still not bad for a few months work \$1.6 million dollars less GST of \$181,818, income tax of \$881,818 and \$18,182 in surcharge leaves them with \$518,182. But the taxman scored \$1,081,818 which is more than twice as much as them.

There is also the fact they have been provided with food and accommodation, and because they are not travelling but have set up a new home (MT2030), this will be a non cash business benefit on which they will also be subject to tax. I cannot quantify how much this would be but they will have to find the cash to pay this as well.

So in a year's time when they realise the mess they are in with the ATO they will need to sell the house for more than \$1,081,818 before they make a cent out of their efforts. Now that's the real reality!

The Taxman may do even better if they aren't aware of all the traps. What if after living in it they decided to rent it out. Section 118-192 deems the cost base of the house to be the market value at that time. Making the same assumptions as above that is \$1.6 million. After a few years the property's value reaches maybe \$1.9 million and they sell. The taxman would then assess them on a \$300,000 capital gain (ignore commissions etc). They would receive the 50% discount so would only be taxable on \$150,000. Assuming they still had decent jobs this gain would be taxed at 48.5%. The tax man just made another \$72,750, even if they have learned their lesson this time by having private health insurance. So of the \$1.9 million they end up receiving the taxman takes more than half (\$970,000 income tax, \$20,000 surcharge plus \$72,750 CGT) \$1,062,750 and they are left with \$837,250.

## CGT – 50% discount – timing

In order to qualify for the 50% CGT discount you must hold an asset for more than 12 months. That is 12 months and at least one day from the date of the agreement to buy to the date of the agreement to sell. TD 94/D92 and Case 9451 (1194) 28 ATR state that a simple condition in the contract such as subject to finance will not delay the date of the contract. Only a condition precedent to the formation of the contract delays the date that the contract is deemed to be entered into. Most conditions on contracts are conditions subsequent so

will not delay the contract date. To be a condition precedent it really has to be a condition that must happen before the contract comes into being. Accordingly, it would be difficult to use a condition precedent to delay a contract yet have a binding sale.

## CGT concessions for deceased home

The requirements to qualify for the CGT exemption vary depending on whether the Deceased purchased the property on or before the 19<sup>th</sup> September, 1985 or after that date.

### Pre 20<sup>th</sup> September, 1985

If the Deceased purchased a house on or before 19<sup>th</sup> September, 1985 the CGT exemption continues for a period from the date of death until it is sold if during that period it has only been occupied by the spouse of the Deceased and/or the beneficiary and/or any other person given occupancy rights under the will. In this case the exemption will apply for the whole period. If it is not occupied by these people the exemption only lasts for 2 years.

### Post 19<sup>th</sup> September, 1985

If the Deceased purchased his or her main residence on or after 20<sup>th</sup> September, 1985 the CGT exemption will only apply if the home is sold within two years of death or from the date of death until it is sold if during that period it has only been occupied by the spouse of the Deceased and/or the beneficiary and/or any other person given occupancy rights under the will. But because it is post 1985 the exemption can only apply if the deceased was living in it at date of death and not using any part of it for income producing purposes at the date of death. If part of the home was used for income producing purposes at the date of death the exemption is apportioned under section 118-200. If the whole of the property was rented out at date of death but had been the Deceased's home within the previous 6 years, section 118-190(4) states that the 6 year rule under section 118-145 can deem the home to be the Deceased place of residence at the date of death if no other residence is covered by the Deceased's main residence exemption.

The fact that the deceased may have used the property for income producing purposes at some earlier date is irrelevant providing the property was only used as a main residence for the Deceased at date of death or the 6 year rule applies and it was only used as the Deceased main residence before being rented.

### In All Cases

If selling the home within two years of the date of death it does not matter what the beneficiary or trustee does with the Deceased's home between death and selling. For example it can be rented out - section 118-190(1) and TD 1999/70. This is the case regardless of whether the home was purchased before 20<sup>th</sup> September, 1985 or afterwards.

Please note there are many little peculiarities regarding the concessions for Deceased Estates. The above is only a guideline for simplistic situations.

## Reader's question – CGT on mother's home

**Question** - In 1997, my mother in law signed her home over to my husband and no tax was paid. She has been living there on her own since and has been responsible for all the bills and taxes related to the property. In May 2003, we sold our home and moved in with her due to her ill health. We have now built a larger home. When we sell her house, are we still responsible for capital gains taxes? If so, what home improvements can be added to get our tax base?

**Answer** - Assuming it cannot be argued that the home was signed over to your husband as trustee for your mother-in-law, you have a capital gains tax problem. The cost base is the market value at the time of the signing over plus improvements (the benefit of which are still present), selling costs and holding costs such as rates, repairs and maintenance, insurance etc for the whole period it was in your husband's name providing, it is not rented out. Your husband will be up for tax, at his marginal tax rate, on the difference between the selling price and the cost base apportioned for the period he was not living there. The apportionment is straight forward, for example if he owns the house for 10 years and lives there for 2 only 80% of the gain is taxable. He will also be entitled to the 50% CGT discount.

# When triggering CGT is good for business

Small businesses are entitled to considerable CGT concessions such as a 50% active asset discount and tax free rollovers into a super fund. If properly structured they can make a capital gain of over \$3 million tax free. Usually these concessions are utilised when the business is finally sold. It is worth considering taking advantage of these concessions sooner than later. This can be done by selling the business to a related entity. The idea is to create a capital gains tax event so the new entity acquires the business at today's market value as its cost base. True this does generate a capital gain for the current owner of the business but if the tax can be reduced to zero through the concessions the net result is simply an increase in the cost base of the business when it is eventually sold to a third party. This may be worthwhile for any of the following reasons:

- 1) Tax law is always changing so you may want to take advantage of the CGT concessions while they are available to at least increase the cost base you can apply if the concessions are one day removed. As the concessions can reduce the CGT to zero it is fair to assume there will never be a better option than what is currently available.
- 2) The Small business CGT concessions can only be utilised if the business' and associates' assets are less than \$6 million or qualify to enter STS because their turnover is less than \$2million. If your business is approaching that threshold, triggering a CGT event now, may be the only chance you get at the concessions. For example a business started from scratch eventually sells for \$8 million with \$5 million in goodwill. The other \$3 million being the written down value of equipment and stock:

**Normal Circumstances**

Profit on Sale	\$5 million
Less 50% CGT Discount	<u>2.5 million</u>
<b>Amount Subject to Tax</b>	<b>\$2.5 million</b>

**CGT Event Triggered when worth half the above ie small business concession apply:**

Profit on Trigger Sale	\$2.5 million
Less 50% CGT Discount	<u>1.25 million</u>
	\$1.25 million
Less 50% Active Asset Discount	<u>625,000</u>
Placed into Super for both the Husband and Wife who own the Business	625,000

Therefore no CGT payable and no tax payable by the super fund. The new entity that owns the business has now purchased the goodwill for \$2.5 million. When this entity sells this goodwill for double the amount the small business concessions will not be available because the \$6million threshold is exceeded but the profit is reduced by the \$2.5 million cost base. Therefore the amount subject to tax will be:

Selling price of Goodwill	\$5 million
Less: Purchase Price cost base	<u>2.5 million</u>
	2.5 million
Less: 50% CGT discount	<u>1.25 million</u>
<b>Amount Subject to Tax</b>	<b>1.25 million</b>

The above has effectively halved the CGT applicable.

You may regret the business structure you have chosen for the business. The sooner you change the less the impact. For example if you are operating in a company you will not qualify for the 50% CGT discount. Obviously the sooner you cut your losses and move the business out of that entity into a better option the lesser the amount of CGT discount you miss out on. Note using a company as a business structure does have other advantages so look at the whole picture and the CGT problem can be solved by liquidating the company.

On the down side is the cost of setting up new structure and possible stamp duty. It is important that you do actually trigger the CGT event so make sure you do not qualify for any of the CGT rollover concessions.

The best CGT concession is the 15 year rule. No capital gains tax is applicable to the sale of a small business that has been owned for more than 15 years. If you trigger a CGT event, as per point 2 above, the 15 year clock starts back at zero. Accordingly, you may regret doing this if you end up owning the business for more than 15 years, the law does not change in the meantime and the business' and associates' assets do not grow beyond \$6 million.

## Occupying a house before buying

CGT event B1 happens when someone has the right to the use and enjoyment of an asset and there is an agreement that the title will eventually pass to that person, Section 104-15. Assuming the house in question is not your main residence so is subject to CGT, this means that the date you cease to own the house for CGT purposes is the date the new potential owners move in.

The potential seller of the property is not required to report the transaction in his or her return until after the actual settlement takes place but as the CGT event is deemed to have happened when the purchaser moves in an amendment to the old tax return may be necessary. Some people include it at the time of preparing that return for simplicity and in fear of being charged interest but **TD 94/89** says the ATO will waive interest if the return is amended within one month of settlement.

There are some possible outcomes you should consider if entering into such an arrangement. If this happens in relation to your main residence and you move into another house you will want to exempt the new house as your main residence. If the purchaser does not follow through and settle then the CGT event B1 is deemed to have never happened and you are exposed to CGT from the time you moved into your new home until you get another contract on the old one. It is up to you which house is exposed to the CGT so it is worth calculating which one has the most to lose. Though it is a burden to carry a CGT liability over your existing home as you do not know what circumstances lie ahead that may force you to sell. If you made a large gain while living in the property the eventual gain on the sale will be calculated from the time you originally purchased to the time of sale and then apportioned on a time basis between when you were living there or when you were not. So some of the gain made while living there could end up taxable. A solution to this problem would be to make sure you charge the prospective buyers rent so you can utilise Section 118-192 to reset the cost base at the market value when they move in. Note this strategy will work against you if the gain is made after you move out. If the gain you make does not cover the cost of improvements and occupancy expenses such as rates and interest while you are living there, the apportionment basis may give you a better result than the market value idea. You can increase the cost base by interest, repairs etc while you were living there if the place was purchased after 20<sup>th</sup> August 1991 Section 110-25 but you cannot utilise these if the legislation requires you to get a market valuation.

Careful planning is definitely required if you enter into such an arrangement.

## Subdividing pre CGT land

Assuming the profit on the sale is capital in nature, no tax should be payable on the sale of the land because it was purchased before 20<sup>th</sup> September, 1985. For the profit to be capital in nature be careful to skirt around the following:

- (i) The land must have been purchased for some other purpose than to subdivide and re sell. Examples of other purposes would be farming, a home or to run a business. And
- (ii) You do not get so involved in an elaborate development process that the whole process becomes more like a business than the mere realisation of an asset.

If the profit is capital in nature and the property is pre CGT no tax will be payable at all on the sale of the divided lots. If you fail the test for capital you may end up paying normal income tax on any profit without even being entitled to the 50% CGT discount.

Section 108-70 states that improvements to pre CGT land will be considered a separate asset from the land if they exceed the threshold and exceed 5% of the capital proceeds. In 2004 the threshold was \$104,377, it is indexed each financial year. Improvements can include most development costs including removal of items from the land. Therefore if development/improvements exceed \$104,377 or 5% of the capital proceeds, the improvements will be considered a separate asset and any profit on that portion of the sale will be subject to CGT. Note buildings are automatically considered separate assets from the land and putting buildings on the land to sell it works against your argument that the profit is capital in nature. In TD5 the ATO states that improvements that do not actually touch the land such as council fees for re zoning are included. In ID 2002/387 the ATO state that the threshold and 5% test apply to each individual block sold so it is unlikely that development costs will trigger a separate asset from the land, if a house is built on the property it is very likely to exceed the separate asset test.

## Rental property CGT audits

Each year around this time there is much talk about an ATO hit list. In my 12 years in practice not many of the threats filter through unless they can be simply generated by a computer.

Most taxpayers know to be very careful with their interest income because the ATO's computer cross matches with the banks. The same reverence should be paid to capital gains made on rental properties. The ATO is well aware that the property boom will be a huge boost to revenue.

The ATO computers have two ways of catching you out. Firstly, the ATO computer will automatically send you a questionnaire if you stop declaring rent income without completing the CGT section of the tax return. If that doesn't catch you out then the ATO's data matching with the titles office is sure to get you.

Unlike audits involving human intervention these computer generated questionnaires will happen 100% of the time so it is not just a case of are you feeling lucky.

## Readers question: Building on vacant land - CGT

A reader is building a house on land purchased 2 years ago. But she does not intend to live there and will sell as soon as possible after the house is finished. She wants to know if she will qualify for the 50% CGT discount even though the building will be less than a year old.

A fixture to land becomes part of the land so at common law the acquisition date for the house would be the date the land was acquired. Section 108-55 of the CGT legislation has some exclusions to the common law principle but they would not apply in your case. They only apply to pre CGT land or depreciable assets under section 40 (not section 43 which is regarding special building write off) and assets for research and development.

In short this means only assets that are separate from the land would have the later acquisition date and these would only be your plant and equipment such as carpets curtains hot water system etc not the actual building.

## Readers question – How CGT calculated

### Question:

How is CGT calculated when selling a property? Does the accumulated depreciation get added back when you sell? Therefore increasing the gross profit before applying the 50% discount and then added on to your normal wages?

### Answer:

If you purchased the property after 13<sup>th</sup> May, 1997 depreciation claimable for the building reduces your cost base before applying the 50% discount. Let's say the building depreciation was \$10,000. The original costs base of the property was \$100,000, selling costs were \$5,000 and the property sold for \$200,000 the calculation would be as follows:

Original Cost	\$100,000
Add: Selling Costs	<u>\$5,000</u>
	\$105,000
Less: Building Depreciation Claimable	<u>\$10,000</u>
Cost Base	\$95,000
Selling Price	<u>\$200,000</u>
Capital Gain	\$105,000
Less: Any Carried forward Capital Losses	<u>0</u>
	\$105,000
Less 50% Capital Gains Tax Discount	<u>\$52,500</u>
Amount to be included in tax return	\$52,500 ie added to normal wages

**Note:** in some circumstances you may have to reduce the cost base of the property by the building depreciation you could have claimed even though you didn't. There is more detail about this in our Rental Property Booklet.

## Will preparation checklist

The following is by no means an all inclusive list it is just an aid to discussions with your solicitor.

- 1) Consider giving the Executor of your estate the flexibility to decide whether to sell the estates assets or pass them to beneficiaries in specie. This will allow your Executor to make the most of CGT concessions and make the most of the differences between the estate's and the beneficiaries' marginal tax rates.
- 2) If you bequeath particular assets to certain beneficiaries make sure you consider the associated CGT liability when considering the value of the asset they receive. For example if you leave your home to one child and your rental property to the other and they both sell the properties within 2 years of receiving them, the child who inherited your home will have no CGT liability but the child who receives the rental property will probably have to pay CGT out of the proceeds of the sale.
- 3) If you intend leaving money to a charity that has tax deductibility status consider doing this before you die so that you can take advantage of the tax deductibility. If the charity receives the funds as a distribution from your estate it is not tax deductible. Not even to your estate. Another strategy is to leave the charity's money to one of your beneficiaries with instructions that it must be donated to the charity. The beneficiary would then be entitled to a tax deduction.
- 4) Don't rely on just one Executor. Make sure you appoint default Executors in case your Executor predeceases you.
- 5) Do not leave an amount to your Executor in your will, as payment for them executing your will as this will be taxable income to them. It should be clear that any amount you leave your Executor is a gift unrelated to the services they perform as Executor.
- 6) Consider a Testamentary trust if your beneficiaries may lose their inheritance through legal action against their personal assets. If you do choose a testamentary trust make sure the deed does not permit the trustee to admit new beneficiaries as this will compromise the trust's status as testamentary.
- 7) If your spouse is receiving the age pension the asset test is much lower for a single person. To assist your spouse in meeting this lower threshold you should consider leaving some of your assets to your children rather than your spouse. Your children would then, hopefully, be in a position to help your spouse out when needed.
- 8) Before you go to your solicitor make sure you have the following information:
  - Personal details (Surname, Given names & Address)
  - Children (Names, Ages & Addresses)
  - Other beneficiaries (Names, Ages & Addresses)
  - Executor
  - "Reserve" executor
  - Summary of assets and details of the ownership of assets
  - Details of any liabilities
  - Details of insurance policies
  - Details of superannuation funds and whether advisory/binding death benefit nomination has been made
  - Wishes in relation to burial/cremation
  - Wishes in relation to guardianship of any infant children
  - Wishes in relation to organ donation

Thanks to Cec O'Dea from Schultz Toomey O'Brien Lawyers for his help in compiling this list. Cec's phone number is (07) 5457-6777

## CGT 50% discount trap for new residents

When a taxpayer first becomes a resident of Australia for tax purposes they are deemed to have acquired any assets they hold, that are not connected with Australia, at the date of becoming a resident and at the market value on that day. Accordingly, the 50% discount is not available until they have been a resident for more than 12 months. This is a real trap for people selling their assets in their country of origin to transfer their wealth to Australia, though as the capital gain is only the difference between the market value and selling price over a period of less than 12 months, it should not be too painful. For details of assets connected with Australia refer our Overseas Booklet. Reference ID 2003/628

## Business CGT concessions

When you sell a small business you should expect to pay little or no capital gains tax. If you have a tax bill you are not utilising the business CGT concessions to the optimum. The concessions only apply to active assets. Active assets normally refers to Goodwill and buildings. Plant and equipment do not qualify as active assets nor is any profit made on them subject to CGT. Any profit made on the sale of plant and equipment over and above its depreciation value is taxed at normal rates.

Individuals, Partnerships and Discretionary Trusts qualify for more concessions than Companies. Companies are not entitled to the 50% CGT discount and there are difficulties involved in getting the tax free portion of the active asset concession out of the company. You would have to look into liquidating a company to get the best CGT outcome.

To qualify for the small business concessions the business and associates net assets have to be less than \$6 million or elect to enter the simplified tax system which requires the turnover to be less than \$2 million. Trusts and companies also have to pass a controlling individual test.

### Concessions:

- a) The 50% capital gains discount - only half of the gain is included in your taxable income. This concession is not available if the asset is owned by a company. Need to hold the asset for more than 12 months. Must use the capital gain to reduce any carried forward capital losses before applying the discount.
- b) The 15 year ownership exemption. This requires you to have held the asset for more than 15 years. The asset must be an active asset. You need to satisfy the controlling individual test if the asset is owned by a company or trust. The taxpayer or the controlling individual, if a company or trust, must also be over 55 and retire or be permanently incapacitated. Not only is the amount CGT free but it does not reduce any capital losses you may be carrying forward.
- c) Retirement exemption – can only apply to an active asset and the taxpayer or controlling individual must retire or put the funds into a superannuation fund. The gain is not taxed when it goes into the superannuation fund and the only limit is that you can only put \$500,000 into superannuation this way, in your lifetime. When you retire the money comes to you tax free.
- d) 50% discount for active business assets – can only apply to an active asset.
- e) Rollover relief where an active asset can be sold and another active asset purchased up to a year before the sale or 2 years afterwards.

These concessions can be used in conjunction with each other, for example:

Gain of	\$100,000
Less 50% CGT Disc	<u>50,000</u>
	50,000
Less 50% Active Asset Disc	<u>25,000</u>
	25,000
Purchase A New Active Asset	<u>25,000</u>
Amount subject to CGT	0

The best strategy depends on the type of business entity and the owners future plans.

## Tax ramifications of selling vacant land

TD 92/127 & TD 92/126 - if a property is acquired for development, subdivision and resale at a profit but the development is abandoned and the land is sold the sale is still in the business of property development so the proceeds taxable as normal income. This is the case if the land is an isolated transaction or part of a property development business because it was purchased for development or subdivision.

On the other hand if land is purchased with the intention of building a house, farming it or constructing business premises CGT applies to the sale proceeds. The only problem being proving that your intention was

not profit making by sale despite the fact you never carried out the activities you intended. This situation gets worse if you develop or improve the land in some way before selling.

If you purchased the land for use in a business and you actually used it even though it remained vacant land you may be able to benefit from the Active Asset CGT concessions discussed later.

## **Readers question - Acreage**

A reader was shocked to find out that they were subject to CGT on their home because the land was larger than 5 acres (2 hectares). After the initial shock they were then left with the question of what was exempt as their main residence and what was not. A phone call to the ATO got them nowhere.

The home and 5 acres of land are exempt from CGT and you can pick which 5 acres as long as it is used for private purposes. The 5 acres can be in various segments all over the property but must include the house. The idea is to apportion the original cost base and the selling price between the CGT exempt portion and the non exempt portion. This is best done by a valuer. Valuers have access to prices back when you purchased the property so can apportion the purchase price to. This is important as you have probably improved the value of the house area.

Don't forget if you purchased the property after 20<sup>th</sup> August 1991 section 110-25 allows you to increase the cost base of the non exempt portion by holding costs such as interest, insurance, rates and maintenance

## **Reader's question – CGT on home & rental property**

### **Question**

I've read a lot of your articles on CGT, and most assume a property purchased pre-19 Sep 1985 (exempt), post 20 Aug 1991 (able to claim interest etc) or post 21 Sep 1999 (can't use indexed cost-base). I read one that had the example of a house purchased after 1985 and rented after 1996. However, my case is sort of the reverse of this. My wife purchased our current home (Property A) in 1989 (\$126,000) and rented it out. We moved into Property A as PPR in June 1995 and have lived there since. I wish to purchase Property A off her mid 2006 (~\$350,000) to free up funds for extension of another property (Property B). When we move into Property B (as PPR) we will rent out Property A one and I will claim any tax benefits arising.

The question is: What CGT are we liable for? Is it percentage based (ie it was rented 6/17 of the time we've owned it)? Or is it based on the market value at the time she ceased renting it out (~\$150,000)?

### **Answer**

For the reset market value rule to apply it has to be first rented after 1996 so this rule does not apply to property A while owned by your wife. Therefore the gain will be on a pro rata basis. When you buy the property off your wife the ball game starts all over again and the market value reset rule will apply when you rent it out. Also section 110-25 allows you to increase the cost base by the holding costs while you live there but of course this will not apply to holding costs before it was first rented out if Section 118-192 resets the cost base to the market value.

## **Watch out with vacant land**

Innocent aspiring home owners are now being systematically caught out by the ATO. CGT is a tax on inflation so if over the last few years you purchased land with the intention to build a new home but for one reason or another sold it to buy a different home you will be paying tax on the increase in property prices over that short period of time despite the fact that it is still going to cost you the same to buy elsewhere so you have really made no gain at all.

There is no escape from this tax because the ATO is using land title records to systematically catch each and every sale. Further when they catch you they will apply penalties to your case because you did not use reasonable care when you prepared your tax return. In other words you were supposed to know that CGT applied to a property you had intended to use as your home. We are fast reaching the era where the premise that ignorance of the law is not an excuse, has become a ridiculous assumption. Penalties on top of this are nothing more than slicing out a bigger obligation to contribute to the public purse to those that cannot afford legal advice as opposed to those that can and therefore avoid tax completely. Several times this month I have come across people in rental accommodation who sold the land they intended to build their home without

thinking to declare the sale in their income tax return. These people could have saved themselves between \$50,000 and \$100,000 in tax by having enough knowledge of the law to have built a home on the land and lived in it for three months and so not been up for any tax or penalties. Now they no longer even have a deposit for a block of land thanks to the ATO.

## **Reader's question - CGT on home while overseas**

### **Question:**

A friend owned a home, lived in it for a while then worked overseas for less than 6 years and became a non resident for tax purposes. Then he returned to Australia. He has had advice that the sale is CGT exempt but one Accountant disagrees claiming the non-residency cancels the 6 year exemption rule.

### **Answer:**

Section 118-145 is the section on the 6 year rule, at sub section (4) it gives the following example: "You live in a house for 3 years. You are posted overseas for 5 years and you rent it out during your absence. On your return you move back into it for 2 years. You are then posted overseas again for 4 years (again renting it out), at the end of which you sell the house. You have not treated any other dwelling as your main residence during your absences. You may choose to continue to treat the house as your main residence during both absences because each absence is less than 6 years. You can make this choice when preparing your income tax return for the income year in which you sold the house."

Section 118-110 states the basic case for the main residence exemption and does not mention at any time that you need to be a resident for tax purposes.

## **Helping your children buy a house**

CGT event B1 happens when someone has the right to the use and enjoyment of an asset and there is an agreement that the title will eventually pass to that person, Section 104-15. An example of this would be parents helping their child buy a home by applying for the loan in the parents' name. The bank is very likely to want the title of the property to be in the parents name as well. The plan being when the child has enough equity to borrow in his or her own right the title will be transferred to the child. The obvious CGT nightmare this will create can be avoided with the correct documentation.

In ID 2005/216 the ATO accepts that where there is a formal agreement that the child will receive the property at a set time and in the meantime have the use and enjoyment of it, for CGT purposes the home is considered transferred at the date of making the formal agreement. The transfer is deemed to have taken place at market value and as this formal agreement is likely to be entered into the minute the house is purchased the market value would be the purchase price so the parents make no capital gain, maybe a small loss on the stamp duty costs. The child's cost base starts at the market value but if he or she always lives there it will be exempt from CGT. Note TD 1999/78 states that this will not happen under a loose family arrangement where the title to an asset may pass at an unspecified time in the future. So it is very important to have the correct paperwork in place right from the start or the parents may end up with a capital gains tax bill.

For CGT purposes the date of settlement is not relevant it is the date that an agreement is made to transfer the property that is relevant not the actual date of the transfer, even if there are several years in between.

## **CGT from the fridge to where your children live**

Taxpayers are just starting to realise that CGT can seep into every avenue of normal family life. Have you thought about its effect on your furniture, boat or caravan? Or what about parents who have bought their children a house or unit to live in closer to their place of education. Does this qualify for the main residence exemption and whose name should it be held in?

A family is only allowed one house between them exempted from CGT as their main residence. Only individuals over 18 or under 18 but financially independent of their parents are entitled to the main residence exemption. Section 118-175 states – If at a particular time a dwelling is your main residence and another dwelling is the main residence of a child of yours who is under 18 and is dependent on you for economic support, you must choose one of them as the main residence for both of you. So the only way you could get the main residence exemption for a child under 18 is if they were not dependent on you. Nevertheless it is probably still better to buy the house or unit in the child's name as at least once they turn 18 it can have their main residence exemption. This would never be the case if it was in the parents' name.

Cars are never subject to CGT. The personal use asset provisions cover things like boats, caravans, houseboats, furniture, clothing, sporting equipment, cameras, white goods, horses used as a hobby etc. But do not include items attached to land or collectables. For personal use assets CGT only applies if the original cost of the asset is more than \$10,000. Losses on personal use assets are ignored. Nevertheless record keeping is required.

## **Travelling worker's & CGT main residence exemption**

In order to be able to claim their food and accommodation travelling workers must have a home base. More information refer our *Claim Your Trip Around Australia as a Tax Deduction Booklet* on our web site. Make sure you consider the CGT consequences when decided where your home base is.

If you still own a home while you are travelling you will want to take advantage of the 6 year absence rule to continue to exempt it from CGT as your main residence while renting it out. Note you can only do this if you have first lived in the house. Renting out part of the house and leaving the other part to be considered your home base will mean expenses and CGT will need to be apportioned. You cannot use the absence rule if you are still classing part of the home as your main residence accordingly only that part will be exempt from CGT not the portion of it that is rented out. If the house was first rented after 20<sup>th</sup> August, 1996 this will reset the cost base at the market value when it first became income producing. On the other side only a portion of the interest, rates and other expenses on the home will be tax deductible because part of the home is used as your private residence.

It is much simpler to set up home somewhere else. The longer you can live in this new home before you actually travel the better your argument that it is truly your home base.

## **Reader's question - NZ property**

A reader purchased a house in New Zealand in 1989 and used it as their main residence until 1992 when they rented it out. In 2001 they moved to Australia and sold the NZ property in 2005. They were advised that they would have to pay Australian CGT on the increase in the value of the property between 1989 and 2005 multiplied by the percentage of time it was not exempt as their main residence.

True they could not use section 118-192 which resets the cost base to the market value of the PPR when it was first rented because this only applies to properties first rented after 20<sup>th</sup> August, 1996. They were also unlucky in that they purchased the property before 20<sup>th</sup> August, 1991 so were not entitled to include holding costs such as interest, rates and maintenance while they were living there, in the cost base under section 110-25(4). As the holding costs are taken into account before apportioning for the time it was not a main residence it would have reduced the taxable gain considerably.

But their advisor had missed one vital issue. They became residents of Australia in 2001. Upon becoming residents of Australia non Australian assets are considered to have been acquired at their market value at the time of becoming a resident. ID 2003/628 states that the 50% discount is only available if they have been an Australian resident for more than 12 months even though they have owned the property for more than 12 months. This means the ATO accepts that the purchase date is also reset when they become a resident. Accordingly, their cost base is reset to the market value of the property in 2001 and they qualify to increase their cost base by any holding costs such as interest and rates that have not been claimed as a tax deduction against the rent.

## **Converting your home to commercial premises**

The capital gains tax main residence exemption only applies to dwellings. ID 2005/19 states that commercial premises do not meet the definition of a dwelling. The 6 year absence rule, section 118-145, also only applies to dwellings. So if like the taxpayers in ID 2005/19 you convert your home into commercial premises you cannot use the 6 year absence rule while the conversion is taking place. ID 2005/19 is a poorly reasoned ruling but I agree with the conclusion after the May 2005 amendment. Section 118-115 (1) (a) (ii) defines a dwelling to include a building that consists wholly or mainly of residential accommodation. So if there is no longer residential accommodation in the building it is not a dwelling and therefore not entitled to any of the concessions available to main residences.

The actual wording of the main resident exemption in section 118-110 (1) is:

*“A capital gain or capital loss you make from a CGT event that happens in relation to a CGT asset that is a dwelling or your ownership interest in it is disregarded if ...”*

This effectively requires the asset to be a dwelling when the CGT event happens for the exemption to apply. Accordingly, if a home is converted into commercial premises and then sold no main residents exemption is available for any of the period of ownership no matter how long it was used as the taxpayer's home! ID 2005/19 originally stated that a portion of the gain would be exempt but that part of the ruling has now been withdrawn because the ATO is “reconsidering their view”. I think that is ATO speak for they were wrong.

This problem also arises if the home is demolished and sold as vacant land though it can be avoided by selling a caravan with the land. A caravan will not help with commercial premises because the asset must be mainly residential accommodation.

The cost to the taxpayers under these circumstances would have been huge because houses have gone up so much in value in the last couple of years. If the house was purchased after 20<sup>th</sup> August 1991 (section 110-25(4)) you can include in the cost base the rates, insurance, interest, repairs and maintenance costs incurred during the whole period of ownership. But these expenses cannot be used to create a capital loss.

As CGT is a tax on inflation, not real profit, it is important to consult an accountant before you do anything to your home, even simply running a business from home. Make sure you know the ramifications before what seems to be a simple decision means you end up paying thousands in tax on your own home.

## **The 6 year CGT Rule in a nutshell**

The first major point of the 6 year rule is that you cannot apply it until after you have lived in the house. Factors that the ATO consider relevant in determining if you have lived in a house: include your address on the electoral roll where your family resides whether utilities are connected in your name and where your personal effects are kept.

Assuming you have lived in the home you can rent it out for up to 6 years at a time and continue to give it your main residence exemption. Of course during this time you cannot exempt another property as your main residence even if you are living in it. Couples are only entitled to one main residence between them. If you move back in after renting the property out for 6 years and then move out and rent it out again you are entitled to another 6 years and so on. If you vacate the property for more than 6 years in a row you can still use the 6 year rule to exempt it for the first 6 years. Further if you live in that house when you die your heirs will inherit it as if you had lived there the whole time since you purchased it. And yes you can use the 6 year rule to be deemed to be living there when you die even though it is really rented out and you are in a nursing home.

Another name for the 6 year rule is the absence rule. If you are not absent you are not entitled to use it. So if you rent out part of your home ie a granny flat or rooms in the house the 6 year rule cannot apply. Instead your main residence exemption is limited to the part of the property you use personally. Further, if this is the first time you have earned income from your home it will cause your cost base for your whole home to be reset at the market value at the date it first started earning income. This can be the case even if you are just renting out a room in your home.

If you move out of your home and do not rent it, for example your adult children continue to live there while you work overseas, you are not limited by the 6 year rule. The property can be protected by your main residence exemption indefinitely because it is not income producing. But again make sure you live there first! There is a case of parents who bought a family home but only ever stayed there when on holidays in Australia. They worked overseas and their adult children occupied the house. The parents could not give it their main residence exemption as they were considered to be residing overseas for all of the period of ownership and as their children were over 18 but not on the title deed they could not cover the property with their main residence exemption either.

As you can see from the above it is not hard to wind up with some CGT applicable to your home. But while CGT may apply keeping good records can help you minimise its effect. Section 110-25 applies to properties purchased after 20<sup>th</sup> August, 1991. The CGT cost base for these properties includes holding costs, such as interest, repairs, rates, insurance and land tax that are not otherwise deductible. Though holding costs cannot be used to create a capital loss. Holding costs increase the cost base before it is apportioned between exempt and non exempt days so the holding costs while you are living there can reduce the gain incurred while you are not.

If your cost base is reset to the market value when your house first produced income but you move back in, or where living there as well, make sure you keep a record of all your holding costs from that point onwards as they can be used to increase the reset market value cost base. When you start to think about what is covered by repairs there is some real money to be made in remembering to keep a receipt for everything, even a light globe!

Note all of the above is only applicable to properties purchased after 19<sup>th</sup> September, 1985. Capital Gains Tax does not apply to properties purchased before that date unless they change hands or significant money is spent on them.

## **Crystallising a Loss to Offset a Capital Gain Update**

Losses made on the sale of capital assets cannot be offset against other income, they are quarantined to only be offset against capital gains in the current year or future years. The tragedy is when a gain is made in one year and a loss the following year without any prospect of another capital gain in the near future. Another trap to watch out for is that the gain is taxable in the financial year the agreement to sell is entered into not when title transfers.

A wash sale is when an asset, typically shares, is “sold” but still retained in some way such as selling to a trust you control or a family member. Wash sales allow you to crystallise a loss yet still retain the asset if you think it has a prospect of future gains. The ATO is attacking wash sales that it feels are nothing more than tax avoidance. Though it cannot catch normal dealings so don't do these transactions off market and do not set up an entity to receive the shares. The ATO would be really struggling to catch you if you sold your shares on the market and by coincidence your spouse purchased a similar parcel the same day. If the reason you want to hold onto the shares is simply due to the market they are in then sell your loss shares and buy in another company but in the same industry.

## **Divorce and CGT**

To encourage couples to settle outside of the courts, and save the Government money, the rollover relief that was once only available to property settlements that went through the courts is now available to all binding agreements on these matters. As you will see in the following it is not always to a taxpayer's advantage to utilise the rollover relief yet it automatically applies to court settlements. If couples did not want rollover relief to apply to their circumstances they could enter into a binding agreement and settle out of court. This option is no longer available and rollover relief will apply to all binding property settlements.

Rollover relief means that a taxpayer can transfer property to their spouse without triggering a CGT event but the downside is that in most cases the CGT liability also transferred to the spouse who received the property so in reality they were not receiving as much as they thought, after the tax was paid.

Unlike single individuals or same sex couples, heterosexual couples are only allowed one main resident exemption between them. The little piece of incidental legislation tacked onto the bill removed what I thought was a way of compensating separating couples for this inequity. After all around 50% of couples will one day need two houses. Before the bill was passed if a taxpayer transferred a house that had previously been used as a rental to property to their spouse and the spouse used it as a main resident then no CGT would be payable by either party, due to rollover relief it is deemed to be a main resident the whole time of ownership. On the other hand if a taxpayer transfers their main residence to a spouse who uses it as a rental property no CGT is payable by the transferring taxpayer but the spouse will have to pay CGT when he or she sells and the cost base will be the cost base of the spouse that transferred the property to them. In other words they would have to pay CGT on the gain during the time it was their spouse's main residence as well as during the time it was their rental property. Still not a real good outcome but at least the tax bill stayed with the person who could afford to use the property as a rental property so didn't hit a taxpayer's home.

The new law will change this around to reflect the actual circumstances and coincidentally means that CGT will be more likely to apply. A taxpayer who transfers a rental property to their spouse will still not pay CGT but even though their spouse lives in the property as their own home, maybe for 80 years, the spouse receiving the property will have to pay CGT on a percentage of the gain when they sell the property and they will need to know their ex's cost base. Now there is a legal battle in itself and there is nothing in the bill requiring the ex to provide this information. During the period of ownership the spouse who received the house will be required to keep all records necessary to calculate the cost base these include rates, interest, insurance, repairs,

maintenance (ie light globes), improvements and costs of receiving the property. If these are not kept for the whole time of owning the house an ATO fine is applicable. By the time you add these to the cost base there may not be any CGT applicable but you still have to keep the records to do the calculation.

Now if this applies to you and you decide you do not want to be taxed on the inflationary gains on your home for the next 80 years, you may consider selling it and making a fresh start elsewhere. You will still be up for CGT when you sell the house you received as settlement so will have less with which to buy a new home and on top of that the Government will make a tidy stamp duty profit out of your misfortune.

On the other hand a spouse that receives their ex's main residence and uses it as a rental property will not be liable for CGT on the period of time it was their ex's main residence.

None of this applies to same sex couples. Nor do they need it as they are entitled to exempt a house each as their main residence even though they may only be living in one.

This bill was introduced by Mal Brough. Is this how he supports family values? By taxing the homes of sole parent families!

Now that I have had my say I should address more of the nitty gritty detail of the new legislation.

If the spouse that originally owned the property first used it as a main residence and then rented it out after 20<sup>th</sup> August, 1996 section 118-192 would still apply to reset the cost base to the market value when it was first rented out and it is this cost base that would become the receiving spouse's cost base. Further the spouse that originally owned the property can use the 6 year rule to exempt the property as their main residence after it is rented out and this advantage transfers to the receiving spouse though this sort of arrangement would have to be documented in the property settlement and the receiving spouse cannot not make this choice for their ex spouse.

All of the rules discussed above also apply to part ownerships of property so in the case of a jointly owned property the rules simply apply to each half depending on the circumstances.

## **Update to CGT and Foreign Residents**

Foreign residents will now only be subject to capital gains tax on real (real estate) property they personally hold in Australia or any property that they use in carrying on a business that is permanently established in Australia. If more than 50% of a foreign interposed entity (and its associates) assets are Australian real property CGT will also apply. Though for this to apply to an overseas resident they must have more than a 10% interest in the entity.

## **Rollover Relief Catch**

In most cases the capital gains on the sale of a small business can be reduced to zero by carefully utilising the small business CGT concessions. For more detail on these concessions refer our Capital Gains Tax Booklet available under free publications on our web site. The 50% CGT discount (not directly available to companies) reduces the gain by half then the 50% active asset discount can reduce the gain down to only 25%. The remaining 25% can be placed into superannuation under the retirement concession or taken in cash if the owner is over 55 years of age. Alternatively the remaining 25% can be rolled over to purchase another active asset. This new active asset has to have been purchased within one year before or two years after the capital gains tax event. The trap is that if you elect the rollover relief but at the end of the two years have not yet purchased a rollover asset you must pay tax on that portion of the gain. You cannot then decide to utilise the retirement exemption to put the funds into superannuation. Note a replacement asset can be a car or any other plant and equipment used in the business as well as the actual purchase of another business.

## **Warning – Don't Rent Out Part of Your Home**

With the housing shortage in Mining towns it is very tempting to rent out part of or a room in your home. The trouble is the rent you receive will be taxable and it will mean that part of your home is not protected by your main residence exemption. The 6 year rule will not protect you here because you are still living there, it only applies if you are absent. IT2167 discusses when you are considered to be renting out part of your home. If your tenants pay you more than just their share of expenses such as electricity, phone and food then you are

in a profit making arrangement and should declare the rent you receive. If your tenants make a contribution towards your mortgage this is not part of sharing the expenses this crosses the line to having to declare the income.

## Interesting ATO IDs on Capital Gains Tax

**ID 2006/185** – A home is covered by the main residence exemption even though at times it was rented out, demolished and replaced. This is by careful use of the 6 year absence rule section 118-145 and the 4 year to build your home on vacant land rule section 118-150. For example the main residence exemption applies at all times during the following:

Late 1996 to mid 1998	Late 1998 to Early 2002	Mid 2002 to Late 2002	End 2002 to Late 2004
Lived in the House	Rented House Out	Demolished House and	Move back into New House
Main Residence	6 years absence rule	Built New One	As soon as complete
Exemption	Section 118-145	Section 118-150	Must live there for at least
Prerequisite for 118-145	Elect as Main Residence	Elect Land as Main	3 months before selling
To apply		Residence.	

**ID 2006/189** – Now here is a neat trick, use your 6 years absence rule to reach the 3 months that section 118-150 requires you to live in a house after you have built it, in order to exempt the vacant land as your main residence before you built. Note you would still have to have moved into the house as soon as it is completed and you cannot sell it until the 3 month period is complete but once you have established it as your main residence you can move out and rent it before the 3 months is complete. In this ruling it was considered that it was sufficient to have lived in it for 2 ½ months to have established a main residence exemption.

Other than when applying the main residence exemption to vacant land as above, the law does not specify how long you have to live in a place before you are considered to have established your main residence there. In fact some ATO staff advise people that they have to live in a house for at least 3 months before it can be exempt as their main residence. This ID certainly makes it clear that a main residence can be established in a period shorter than 3 months.

**ID 2006/179** – The cost base of an asset for capital gains tax purposes can include legal costs incurred after the sale of the asset because the purchaser took legal action regarding the selling price.

## Readers Question - Rolling Over A Farm

Q. I purchased a farm in 1990 as an investment, never living there but employing a manager to run the business. Can I sell this farm and buy another one to roll over the capital gain and not have to pay tax?

A. Rollover relief is not normally available on investment properties but as this one has been used in a business you are entitled to roll it over if you qualify for the small business concessions. Businesses in the simplified tax system (STS) qualify for the small business concessions but they must have a turnover of less than \$2,000,000 to enter the STS. If you are not in the STS you can still qualify for these concessions if the business' and associates' net business assets are less than \$6,000,000.

My concern is that if you simply roll over into the next property you may not be able to use these concessions next time so you should utilise the other concessions to get as much of the gain out tax free and just roll over anything that is left. If you are over 55 years of age it looks like you would qualify for the 15 year exemption which means the whole gain is tax free and you do not have to offset any of it against any other capital losses you may have saved up. Otherwise I suggest you reduce the capital gain by the 50% CGT discount and then the 50% active asset discount so that only 25% of the gain is rolled into the next property.

## Selling Your Business

If when you sell your business part of the contract involves future payments contingent upon certain profit forecasts being met you need to consider this article. The right to these future payments are referred to as "earn out rights". That is when you sell the business you may receive some cash and an agreement that

further payments will be made conditional upon performance. In the financial year that you sign the agreement to sell your business you will be assessable on the difference between the cost base of your business and the sale proceeds which are the cash you receive and the market value of the earn out right.

If you qualify for the small business capital gains tax concessions you will probably pay very little tax on the sale of your business. Businesses in the simplified tax system (STS) qualify for the small business concessions but they must have a turnover of less than \$2,000,000 to enter the STS. If you are not in the STS you can still qualify for these concessions if the business' and associates' net business assets are less than \$6,000,000.

The earn out right is a new asset that comes into existence when the contract to sell the business is signed and its cost base is the market value plus any associated costs such as legal fees. ID 2002/766 states that an earn out right is a C2 CGT asset. Unlike other CGT assets a C2 asset is deemed to be disposed of when the actual payment is received, not when the contract is signed. An earn out right is not an active business asset so will never qualify for the small business concessions but if there is 12 months or more between the signing of the contract to sell the business and receiving the payment then the 50% CGT discount can apply (ID 2002/941). If the performance criteria is not met so no payment is made this triggers a capital loss which can only be offset against future capital gains. The loss is the cost base or the portion of the cost base applicable to that payment. So you can see that the notional gain created by the market value of the earn out right when the business is sold is not reduced and all the seller is left with is a capital loss that cannot be utilised unless future capital gains are made. Accordingly, agreeing to an earning out right and setting the market value needs to be carefully examined. If the buyer wants this sort of security the seller needs to be compensated for waiting for his or her money, the risk that the buyer defaults or ruins the business and the fact that more tax will be payable on the future payments because they will not receive the small business CGT concessions.

The key factor here is determining the market value as this draws the line on how much will be taxed at the small business concession rates and how much will receive the 50% CGT at best. Setting a high market value will mean more of the sale proceeds relating to the earn out rights is taxed at the start but if the small business concessions apply this tax may be negligible. The high market value becoming the earn out right's cost base will result in very little gain in the future when only the 50% CGT discount is available but if the payment is not received this will increase the loss that may never be utilised. On the other hand it may be a very cheap way of generating a future capital loss if you have an expectation of offsetting it against other capital gains that do not qualify for the small business concessions.

Of course in a perfect world market value would be market value but this one is very much in the eye of the beholder. Market value is the price a willing but not anxious buyer, dealing at arms length would pay for the asset. I personally would not pay much for an earn out right due to the high number of risk factors. What if the buyer ruins the business, defaults or other economic factors effect the industry, unlike the seller I would not have a knowledge of the sustainability of the business and be very weary of why he or she was selling. There is also the time value of money. Accordingly the market value of the earn out right would be considerably less than the total of the expected cash flows so unless the seller defaults there should always be a capital gain.

## **Warning When Moving House**

Another reason to get a big box and keep all the receipts associated with your home because it is just too easy to lose the protection of your main residence exemption. Not only are you required by law to keep the receipts for the past if in the future you do get trapped but keeping the receipts could save you paying tax on a gain you never made. Make sure you keep even the receipts for a replacement light globe, lawn mower fuel, anything to do with the house, throw it in the box.

If you buy a new house before you sell the old one you are allowed to cover both residences with your main residence exemption for the 6 months preceding the sale of the old house (Section 118-140). But you can't rent out the old house within 12 months before selling it. If you hold both houses for longer than 1 day or more past the 6 months you have to choose which house you are going to expose to capital gains tax. Some would choose the new home as they may never sell again or it is too far in the future to worry about. That's fine but keep the big box just in case. Even though the new home may only be exposed for 1 day you still have to calculate the capital gain over the whole period of ownership and apportion it. If you don't like the thought of being taxed on the inflationary gain on your house many years in the future then you may choose to pay the tax now and declare the gain on your old home. But what is your cost base? When you first rent

out a property that was your home the cost base is reset at the market value when it was first rented out so that people who never expected to rent out their home are covered. But this market value reset rule only applies if you rent the old house out and if you do this you cannot have any of the 6 months overlap so you still have a capital gains tax problem unless you make the old house available for rent the minute you move into the new house and you move into the new house immediately after settlement. Now if you didn't have that insight or worse still were ignorant of the law (which is no excuse) you now have to try and work out what the cost base of the old house is. Not because you are going to be up for a large amount of CGT but because you have to go through the exercise. If you purchased the house after 20<sup>th</sup> August, 1991 section 110-25 includes in your cost base all your holding costs such as rates, interest, insurance, repairs and maintenance. If you purchased the house before 20<sup>th</sup> September, 1985 CGT does not apply and maybe you should consider keeping the house. If you purchased the house between 20<sup>th</sup> September, 1985 and 20<sup>th</sup> August, 1991 you are only allowed to include the original purchase price, improvements, buying and selling costs in your cost base and no doubt you will have a considerable capital gain.

## Inheriting a House

### Avoiding CGT on Death

There is no Capital Gains Tax (CGT) payable on death unless the beneficiary is a non resident for tax purposes, a superfund or an entity exempt from tax. Section 128-15 ITAA 1997 covers the basic rules. It states that any capital gain tax event is disregarded on the transfer from the deceased to a beneficiary or to the executor and then to the beneficiary. The trouble is transfers to a testamentary trust are not included in the legislation so the transfer to the testamentary trust is exempt as it is considered the beneficiary but when the testamentary trust ultimately transfers to the beneficiary that transfer is not exempt. In PSLA 2003/12 the ATO recognises that this is the case at law but has agreed to treat a transfer from a testamentary trust to a beneficiary as exempt. A testamentary trust is one created by a will. This may be fine if you are currently a beneficiary of a testamentary trust but it does create an element of doubt if you are preparing your will as PSLAs are only ATO statements of practice and can be withdrawn at any time.

Note disregarding the capital gain event does not mean the asset is exempt from CGT while in the testamentary trust, the clock is ticking but a transfer from the trust to a beneficiary does not trigger a tax liability, the beneficiary takes over the asset at the cost base to the trust.

### How the Cost Base Is Calculated

Hopefully, the above means the beneficiary has now received the house tax free. Section 128-15 also explains how the cost base is set. For houses acquired by the deceased prior to 19<sup>th</sup> September, 1985 the cost base is simply the market value at the date of death. This is regardless of where the deceased was living and whether the house was a rental property.

If the house was acquired post 20<sup>th</sup> September, 1985 its cost base is the deceased's cost base unless it was the deceased's home at date of death, then it is inherited at the market value at the date of death. It does not matter if during the time the deceased lived there it was also used to run a business or partially rented out as long as this was not the case at the date of death ie it was only used as their home. Note section 118-190 states you can use section 118-145 to have a house that was previously the deceased's home and not partially rented or used to run a business while the deceased was living there, considered the deceased's home at date of death even though he or she was not living there. This applies for up to 6 years before death if the home was rented out while the deceased was absent and indefinitely if it wasn't rented. Of course the concession associated with the deceased's home only applies to one property so if possible it should be applied to a post 20<sup>th</sup> September, 1985 property if the deceased had once lived there. If the deceased's home was purchased post 20<sup>th</sup> September, 1985 and he or she was partially using it to produce income at the date of death ie running a business from home or had boarders then the market value concession is not available.

Accordingly, it is inherited at the deceased's cost base

### Extending the Exemption Beyond Death

Section 118-195 allows an inherited house to continue to be exemption from CGT in certain circumstances. These concessions apply to a house that was the deceased's home at date of death or is deemed to be the deceased's home under section 118-145. They also apply to a house that was purchased by the deceased prior to 20<sup>th</sup> September, 1985 even if the deceased never lived there. So again, just as is the case with the cost base rules, if the deceased has lived in more than one property in the 6 years prior to death and you can choose between a pre 19<sup>th</sup> September, 1985 property and a post 20<sup>th</sup> September, 1985 property it

is best to choose that the post 20<sup>th</sup> September, 1985 is the main residence. Note if the post 20<sup>th</sup> September, 1985 property was the deceased's home but was also used to produce income at the date of death (for example taking in boarders or running a business from home) then these concessions do not apply

If you sell a property that qualifies above then there is no CGT payable if it is sold within 2 years of the date of death. But be careful 1 day over the 2 years and you will have to pay CGT on the difference between the market value at date of death plus any non deductible costs associated with it and the selling price. This is where diligent record keeping can save you heaps. You can increase the cost base by any cost of acquiring title in the property, selling it, improvements and any holding costs you have not claimed against rental income. Holding costs include rates, interest, insurance, land tax, repairs and maintenance (Section 110-25). It is the repairs and maintenance that has huge potential, you need to get a big box and keep receipts for lawn mowing, plants, even changing a light globe, etc.

The 2 year limit is extended indefinitely while the house is the main residence of the spouse of the deceased or a person given the right to occupy the house under the will (ie life tenancy). There is a further concession if the occupier of the house from date of death until the eventual transfer of the house is a beneficiary entitled to receive all or part of the house (but not a life tenant). They would not be subject to CGT on what is technically their share of the sale proceeds. But if they had to buy out their fellow beneficiaries those beneficiaries will be subject to CGT on the proceeds unless they qualify for one of the other exemptions under section 118-195 as discussed above.

Note if you sell a pre 20<sup>th</sup> September, 1985 property or the deceased's home within 2 years of the deceased's death it does not matter who lives there or even if it is rental (118-190(1)), no CGT applies.

If the deceased made considerable post 19<sup>th</sup> September, 1985 improvements to a pre 20<sup>th</sup> September, 1985 property section 108-70 would have classed these improvements as a separate asset and thus subject to CGT. Fortunately, this problem dies with the deceased so such a property is simply inherited at the market value of the whole property even if the deceased never lived there. The same concessions apply if the deceased had used a post 20<sup>th</sup> September, 1985 property as a rental or for income producing purposes while living there. If the deceased had sold the property while alive he or she would have had to pay CGT on a portion of the gain. Apportionment is not necessary if the property is sold by a beneficiary or executor of the estate as providing at the date of death the property was not partially used for income producing purposes ie it was totally the deceased's home or vacant or totally rented out but covered by the 6 year absence rule then it is simply inherited at the market value at date of death (Section 118-195).

### **Tips**

. The 50% discount is available on the sale of a house you have inherited even if you have not held it for 12 months, providing it is 12 months since the deceased entered into the agreement to purchase it. Section 114-10(6) and TD 94/79.

Any capital losses accumulated by the deceased are lost on death ie the estate cannot utilize them. When planning your estate it may be worth churning some post 20<sup>th</sup> September, 1985 assets to offset the loss and reset their cost base at higher rate for the benefit of your beneficiaries. This may not be economical considering the transaction costs associated with houses but may be worth it for shares.

Leaving a beneficiary the right to occupy the house can cause major restrictions and CGT nightmares if things do not go specifically according to plan. Many of the problems surrounding this issue have not yet been addressed by the courts or ATO rulings so I cannot draw conclusions but the CGT laws as they currently stand could be interpreted to mean that should the person entitled to life tenancy ask the eventual beneficiaries of the house (remaindermen) to sell the home so they can move elsewhere such as a retirement village both the remaindermen and the life tenant could be subject to CGT on the transactions with a zero cost base.

There are more sections of CGT law relevant to this topic but they cover less common circumstances, and many little traps, in particular life tenancies are a minefield. So it is important to seek professional advice on your particular circumstances before you act on this information

## **Using Superannuation to Minimise CGT**

Most people are aware that a superannuation contribution can minimise the effect of an abnormally large capital gains tax bill but they don't quite understand how. You will still be assessed on the capital gain in the usual way. You can either offset it by claiming a tax deduction for a superannuation contribution or if you receive employer support by reducing your wages by salary sacrificing into superannuation. The superannuation will be taxed at 15% when it goes into the superannuation fund so this strategy moves the funds from whatever tax bracket the gain has pushed you into to the 15% rate but the downside is the earliest

you can access it is after your 55<sup>th</sup> birthday, even later if you were born after 30<sup>th</sup> June, 1960. If you were born after 30<sup>th</sup> June, 1964 you cannot access your superannuation until you are 60 and if you were born between June 1960 and June 1964 the preservation age will be between 56 and 60. There are also tax incentives that may mean you decide to leave it there until you are 60 anyway.

Before you start anything make sure you qualify to make the superannuation contribution. Basically if your employer makes superannuation contributions for you, you do not qualify to claim a tax deduction for any superannuation contributions you make. If your employer does not make contributions but is required to make contributions then this qualifies as employer support and you cannot claim a tax deduction. The only exemption here is if there is no chance that your employer will ever make the contribution ie they are in liquidation (ID 2001/39). If you are caught as an employee you can make the superannuation contribution through salary sacrifice instead. Instead of receiving your wage you ask your employer to deposit the money into a superannuation fund for you and you live off the proceeds of the capital gain. You can only salary sacrifice future earnings so this method is not very effective if you sell the property towards the end of the financial year.

There is a window of opportunity for those taxpayers who only earn a small portion of their income through an employer, it is called the 10% rule. When applying the 10% rule most tax deductions are not considered as it is measured on assessable income not taxable income. The 10% rule is discussed in detail in TR 2005/24. The formula for the 10% rule is the assessable income, exempt income and reportable fringe benefits from employment must be less than 10% of the person's total assessable income and reportable fringe benefits for the year. But assessable income only includes the net capital gain ie after offsetting capital losses and reducing it by the 50% CGT discount, if applicable. Note the legislation refers to assessable income from employment not the amount that your employer is required to pay superannuation on. So for example if one month you earned less than \$450 so no superannuation was paid for you that month that \$450 would still be included in the amount you are trying to keep under 10%. Though if for the whole year all your employment income was under \$450 each month you would not qualify for any employer support so you would be entitled to claim a deduction for your superannuation contributions without even having to consider the 10% rule. You would simply qualify because you did not have any employer support. You would also not be considered to have employer support if the superannuation contributions your employer made for you only covered your death benefit to your estate (AAT Case 31/96).

Now assuming you have got this far and one way or another qualified as not receiving employer support the next step is do you personally qualify. Once you reach 65 years of age you have to satisfy a work test to be able to claim a tax deduction for your superannuation contributions. The work test is at least 40 hours work over 30 consecutive days in the financial year you contribute. In the 2006/2007 financial year you cannot claim a tax deduction for your superannuation contribution once you are 70, in the 2007/2008 financial year the threshold is 75. You have up to 28 days after your birthday to make the contribution.

The amount you can contribute varies depending on your age and the year you make the contribution. The limits apply whether you make the contribution for yourself or your employer makes the contribution. Though in the 2006/2007 year the age base limit applies to each employer ie if you have two employers you could sacrifice into superannuation twice your age base limit. Any contribution over this limit would be considered undeducted so not taxable in the hands of the superannuation fund.

2007/2008:

The maximum deductible contribution you can make to a superannuation fund is \$50,000 unless you are over 50 years of age when you can contribute \$100,000.

2006/2007:

People over 50 are entitled to claim up to \$105,113, people under 35 only \$15,260 and between 35 and 49 \$42,385. Note for the 2006/07 year, if you are making the contribution for yourself you are only entitled to a tax deduction in full for the first \$5,000 you contribute. You will only be entitled to a tax deduction for 75% of any amount over the \$5,000 and then only up to your age base limit.

Remember you pay CGT in the year that the contract is signed, not on settlement. This creates two possible dangers. The settlement may be delayed passed the end of the financial year and you will not have

the cash to make the superannuation contribution anyway or if you are salary sacrificing you do not have enough salary left in the balance of the financial year to make a large enough contribution.

If you want to completely eliminate your CGT bill by a superannuation contribution the tax deductible portion of the contribution only needs to be as much as the net capital gain. That is after offsetting losses, applying the 50% CGT discount and any other applicable concessions.

## **Inheriting a Home Left In Two Parts**

A house can be more than one asset for CGT purposes. For example, when a couple who own a house as tenants in common leave the property to the same person. Normally a couple would hold their home as joint tenants so if one of them dies it is automatically inherited by the other one. The surviving tenant would continue to live there so when he or she dies the whole house passes to his or her heir as the deceased's residence with all the concessions attached. The most important of these concessions being the flexibility to take 2 years to sell it with no CGT consequence.

Sometimes rental properties are held as tenants in common for tax purposes and then later become the main residence. In the case of a second marriages they may each want their share of the house left to the children of their first marriage. To facilitate this they must hold the house as tenants in common so upon their death their share of the house goes to their estate and is dealt with according to their will. But what happens if a few years down the track they have a child of their own or take on someone that they both decide they want to have the house when they die? They change their wills so this can happen but if that beneficiary is not living in the house the main residence exemption is lost for half of the house. This gives the tax man a slice of the house if the beneficiary is kind enough to allow the remaining spouse to stay on in the house until they die.

When both members of the couple die the beneficiary inherits two CGT assets one half inherited at the market value when the first spouse died and the other when the second spouse died. Under normal circumstances a beneficiary would have 2 years in which to sell the house without a CGT liability but for half the house the 2 years started when the first spouse died. So it is more than likely half the house will be subject to CGT on the sale. There is a small reprieve here. If the remaining spouse was given a right to occupy the house under the late spouses will the house would remain fully CGT exempt (section 118-195) while the spouse is alive but the minute they die the CGT clock would start ticking on half of the house because the 2 years in which to sell can only apply from the owner's date of death.

Assuming the first spouse to die died in 2000, the last spouse died in 2003 and then it took you a year to sell it. You inherited half in 2003 which will have no CGT liability but the half you inherited in 2000 will have a cost base of its market value in 2000 plus costs of securing title and half the selling and holding costs (ie rates, insurance, repairs). You will be up for CGT on half the difference between this and the selling price.

The moral of the story be very careful in deciding whether to be tenants in common or joint tenants when you buy a house. Another solution would have been for the couple to change their wills that they each inherited each other's share of the house on death and when they had both died it goes to the beneficiary. In the example above this would have meant you would only be up for on 75% of half of the difference between the cost base and the selling price. IT 2664 discusses rights to occupy given under a will.

## **CGT Small Business Concessions When Earning Rent**

Paragraph 152-40(4)(e) of the 1997 Act excludes from all the lovely CGT small business concession any asset whose main use is to derive rent. TD 2006/78 gives examples of when the main use is considered to be to derive rent. Industrial sheds leased for over a year were considered to be deriving rent and not entitled to the concession but self storage sheds with a manager, a boarding house and managed holiday units were consider not to be used mainly for the purpose of deriving rent.

Factors that are considered relevant are the length of the tenancy, whether cleaning services are provided, where the owner or manager lives or works, whether the owner or manager retains the right to enter the premises at any time, the selling of other items to tenants such as boxes, equipment hire etc. It does not matter that the rentals are on such a large scale that they are considered to be a business, for income tax law purposes, rather than an investment.

In the case where the same piece of land is used for two different purposes apportionment is not necessary. It is what the main use is that will determine the fate of the whole property. For example a business owns commercial premises that it operates the business from but rents out part of the premises that it does not use. Providing the part of the premises used by the business is substantial, but it can be less than half, the decision is made on the basis of the amount of income generated. So if the rent you receive is less than the turnover of the business the premises are mainly used to derive business income not rent so the CGT concessions are available.

## Owning Your Home in a Trust

The most significant reason you do not want to own your home in a trust is because it will not be covered by the main residence exemption. Capital Gains Tax is a tax on inflation. Without the main residence exemption it would be difficult to move homes. Assuming all properties have gone up by a similar amount, if you have no exemption you would have to pay tax on the increase in the value of your own home even though it would cost you the same for a similar house elsewhere. This could leave you with insufficient funds to purchase the new home. Section 118-110, which covers the basic circumstances that give rise to the main residence exemption states as its first requirement that the owner be an individual.

Some people put their home in a trust for asset protection purposes. The ATO has no objection to this if you are not trying to rent it back to yourself in an attempt to claim the interest, rates, insurance, repairs, maintenance etc as a tax deduction.

If your only reason for holding your home in a trust is for asset protection, consider one of the following alternatives:

1) Set up a mortgage trust and hold the property in your own name. Then in a round robin of cheques in your bank manager's office gift the trust the value of all the available equity in your home. The trust then takes a second mortgage (assuming your bank already has the first mortgage) on your home and lends you back the amount you gifted to it. You use this money to pay back your bank manager for covering the original amount you gifted to the trust. The mortgage trust does not need to lodge tax returns or charge you interest. This is not an arrangement with any tax advantage it is purely driven by asset protection so you do not have to worry about Part IVA. A bankruptcy trustee can claw back transactions intended to protect the asset from creditors but there is a time limit. Ideally, any creditor wanting to get their hands on your house will decide it is not worth it because by the time they sell you up and pay out the bank and mortgage trust there will be nothing left for them.

2) Hold your home in your spouse's name. Your main residence exemption can apply to a house held in your spouses name only, so if you have a spouse who is unlikely to be sued, this is an even simpler method.

Note before acting on the above you should seek legal advice on your particular circumstances, timing and areas of risk to ensure that such an arrangement will protect you.

If you are thinking of holding your home in a trust so you can rent it to yourself and negatively gear it, you will be challenged by the ATO. In *Tabone v FCT* 2006 ATC 2211 the taxpayers held their home in a unit trust then rented it to themselves and claimed a tax deduction for all the expenses associated with owning the house. The AAT disallowed the deductions. In TR 2002/18 the ATO states it will not allow these arrangements to be negatively geared.

There were some interesting statements made by the AAT in Tabone's case:

1) The AAT found that the interest was incurred to provide a family residence and not expected to produce assessable income.

2) When the taxpayers tried to argue that they did not set up the trust for the tax advantage but for asset protection purposes the AAT would not accept this because they were employees so the need for asset protection was minimal. This point should be noted by anyone considering setting up an entity that provides both asset protection and tax benefits. Many accountants will argue that if the dominant purpose was asset protection, Part IVA cannot apply just because there was also a tax advantage. Now that the relevance of the need for asset protection is considered, it cannot be assumed that asset protection will shield a tax benefit if you are not exposed to any real risk.

3) The trust was a unit trust and as the taxpayers owned the units in the trust the AAT pointed out that no asset protection existed because creditors could access the assets of the trust because they were entitled to the units should the taxpayers become bankrupt. On this basis only a discretionary trust would provide effective asset protection but the losses from the property would be locked into a discretionary trust so unless other income can be channelled into it to offset the losses there is no tax benefit in holding the house in a discretionary trust.

4) Because the taxpayers borrowed the money used to purchase the units jointly and they both contributed to the repayments Mr Tabone, who used the money to buy the majority of units in the trust, would, if the interest was deductible, have only been entitled to claim a deduction for half. This finding is in conflict with other cases. Banks normally force couples to borrow in both names so just to be on the safe side, it is important that you can show a paper trail to the repayments with their source coming from the member of the couple who is claiming the deduction. Better still try and persuade the bank to accept the guarantee of the non borrowing member of the couple instead of showing their name on the loan.

The Tabones holding their home in a trust was just a win win for the ATO. The net loss on the property was not allowed and the Tabones would have to pay CGT to the ATO when they sold the property.

## **Correction Re Marriage Rollover Relief**

In Newsflash 138 I announced that rollover relief would now apply to all marriage and de facto marriage breakdowns whether the couple wanted it to or not. This was misleading as the rollover relief would not apply if there is no agreement. For example the couple agree one gets the home and the other the investment property and they just transfer the title without drawing up a legally binding agreement that settles the property of the marriage. We certainly don't recommend that clients do this because the matter is not finalised in fact in a worse case scenario property acquired after the separation could still be considered matrimonial assets when one party decides they want a formal agreement.

Rollover relief is available if the court orders the transfer of the property as part of a marriage break down or de facto marriage break down hearing. In order to reduce the demands on the court system the new legislation adds that rollover relief also applies to binding financial agreements or arbitral awards under the Australian Family Law Act 1975 or corresponding foreign law and a written agreement that is binding via the various state and foreign laws on de facto relationships providing that the only reason a court could ever override the agreement is if it was unjust.

## **How to Include the Holding Costs of Pre 1991 Property in its Cost Base**

Here is a nice little twist on the letter of the law in the taxpayers favour. Properties purchased between 20<sup>th</sup> September, 1985 and 20<sup>th</sup> August, 1991 are in some cases more highly taxed than properties purchased after that date. This is because section 110-25(4) which allows the cost base of a property to be increased by the holding costs that have not been claimed as a tax deduction, only applies to properties purchased after 20<sup>th</sup> August, 1991. Holding costs include interest, rates, land tax, insurance and repairs and maintenance.

There is a little trick available to people juggling their main residence exemption. For example you may have lived in two of your properties and choose to use the 6 year rule to exempt one of them as your main residence while you live in another. This may be because you feel the one you aren't living in will produce more capital gain or you may just see the benefit of not exempting the house you live in for CGT purposes because by the time you add the holding costs to your cost base there will be no capital gain and in the meantime you want the negatively geared advantages of the one that is going to make the higher gain. That is the beauty of being able to choose where you leave your main residence exemption (providing you have lived there first) a water front property that has high interest repayments and high capital gains potential can be rented out for the negative gearing benefits still using your main residence exemption to make sure the capital growth side of the investment does not come back to bite.

Now to the situation on the home you are living in. Assuming you have always lived there except for a small period when you lived at the other place carrying your exemption. Section 118-192 resets the cost base and the date you acquired the property to the market value and date when it first produced income so a pre

20<sup>th</sup> August, 1991 property can become a post 20<sup>th</sup> August, 1991 property by simply renting it out then moving back in.

Section 118-192 will also be triggered if the house produces income while you are living there so simply taking in a boarder for a week could gain the same reset advantage. The set of the purchase date is of great advantage in these circumstances, because of the way the CGT calculation works for homes partly used to produce income, it is of great advantage to be able to include holding costs. If say your home was half used to produce income (taking in a boarder or home business) for half the time you owned it then 25% of the gain on the sale is taxable. The gain is calculated first including in the cost base the holding costs applicable to the non income producing use. So holding costs for your private use of the property can effectively reduce the CGT on the income producing use of the property.

## **The Rush To Minimize Tax Before June 30<sup>th</sup>**

The silly season is upon us. Time for all those schemes to minimise your tax to come out of the wood work. If you are facing a large capital gains tax bill the tax payable may seem so extreme that your attitude has become less conservative. Don't lose sight of the fact that really the tax you will be paying on a capital gain is very likely to be at a lower rate than your normal income. I assume if you have a large capital gain you have held the property for more than 12 months so the highest rate of tax you will pay is 50% of the maximum rate, 23.25%. If you earn over \$25,000 you are already paying 31.5% on each extra dollar you earn so you should at least take as protective an attitude in how you invest the money from your capital gain as you should be regarding your wages.

It is also the time of year that the ATO attempts to scare people from these activities. This year the ATO has released TR 2007/D2. The ruling is directed at registered agricultural managed investment schemes. It is only a draft ruling at this stage and I would not expect it to be finalised until at least this time next year at the earliest. The ATO also intend running some test cases. Some readers might recognise that as a ploy to create enough uncertainty to squash the industry before the ATO has to prove its position. We have seen this before regarding partnership income splitting and salary sacrificing rental property expenses.

In the media release accompanying the draft ruling the ATO states that investments in agricultural managed investment schemes that are covered by existing product rulings will not be affected by the draft ruling.

In summary the draft ruling is based on the theory that investments in agricultural managed investments are capital in nature and therefore not deductible. The argument that the ATO use is that the taxpayers investing in the scheme are simply paying for a right to a future passive income, they are not involved in anyway so not actually in business it is the manager of the scheme that produces sells the produce so it is the manager that is in business. The draft also suggests that now the scheme manager will have to pay tax on the scheme's income before distributing it to the investors with a franking credit. The worst proposition in the draft is that all proceeds received from the scheme are taxable as normal income with no deduction ever being allowed for the original investment, which by the end of the scheme will be worthless. Accordingly, the amount invested will become a capital loss to be offset against future capital gains from other investments only. This outcome is enough to take AMISs from a most tax advantaged investment to the other end of the scale as the worst investment for tax purposes.

## **More Travel Costs Qualify for CGT Cost Base**

In April 2006 changes were made to section 110-25 which lists the items that are included in an asset's cost base. In particular section 110-25 (4) was amended to remove the word non capital. This means that, provided the property was purchased after 20<sup>th</sup> August 1991 the section now covers all types of ownership costs that have not otherwise been claimed as a tax deduction. The interesting thing about section 110-25 (4) is it differs from the other subsection that are very specific as to what can be included in the cost base. Section 110-25 (4) uses the word "include" and then lists examples of ownership costs. This and the removal of the word non capital costs opens up a whole new area of cost base items.

For example ID 2007/67 released on 20<sup>th</sup> April, 2007 states that even though expenses such as motor vehicle costs associated with initial repairs could not be included under section 110-25 (5) because they were not specifically capital improvements, they can now be included as a cost of ownership under section 110-25

(4). Previously ID 2004/732 excluded motor vehicle costs associated with initial repairs from section 110-25 (4) because they were capital in nature. ID 2004/732 has now been withdrawn.

The January 2007 changes to section 110-25 (4) are back dated to cover any CGT event that happened on or after 1<sup>st</sup> July 2005. This means that travel costs incurred before 1<sup>st</sup> July, 2005 are included in the cost base of an asset sold on or after 1<sup>st</sup> July, 2005. But note any costs that qualify under section 110-25 (4) cannot be used to increase an assets cost base if it made a capital loss.

## **Inheriting a Rental Property Trick**

If you inherit a house that was a rental property of the deceased and he or she purchased after 19<sup>th</sup> September, 1985 it probably has a large capital gain attached to it. If you are in business or can think of a business you would like to dabble in, move the business into the rental property. This will make the rental property a small business active asset which qualifies you for additional CGT concessions if you elect to operate the business in the simplified tax system or you and associates have net business assets of less than \$6,000,000.

As long as more than 12 months has passed since the deceased purchased the property you will qualify for the 50% CGT discount when you sell the property. As a result of moving a business into the property you will qualify for further 50% discount if the property is considered an active asset (refer section 152 1997 Act). To be an active asset the inherited house needs to be used in your business for at least half the time you own the house or 7.5 years whichever is the shortest. The period starts from the time you inherited the property not from the time the deceased purchased it so it will not be hard to use it in the business for half the time you own it.

By the time you utilise the 50% CGT discount and the 50% active asset discount you are left with only 25% of the gain taxable. If you are over 55 years old you can utilise the retirement exemption to receive the remaining 25% tax free. If you are under 55 and you don't want to pay tax on this remaining 25% you can roll it over into another active asset for your business or contribute it to a superannuation fund until your are 55. Note this contribution will not be taxable in the hands of the superannuation fund.

## **When Does A Home Become Your Main Residence For The CGT Exemption?**

In *Erdelyi v FC of T* June 2007 the AAT decided that a home the taxpayers had constructed on vacant land was not covered by their main residence exemption because they had not lived there for at least 3 months. Note the full 3 months was only required because the house was constructed on vacant land but nevertheless this case is relevant in showing what constitutes making a house your main residence. The factors the AAT held against the taxpayers were the limited amount of furniture and household items kept in the house, the electricity consumption that was far too low for them to have spent much time there, the lack of a kitchen stove during that time and the lack of evidence that they had changed their address. The taxpayers tried to argue that they had intended to sell their daughter's home to pay for the new house and as they could not sell her home they sold their's instead. This argument was weakened by the fact that they had since purchased another home for themselves. The taxpayers may not have covered their tracks very well in this case but it is also evident that to exempt a house as your main residence is not an automatic right. You have to have legitimately made it your home.

## **Inheriting a Pre CGT Property**

. Section 128-15 determines the cost base at which you will inherit the property. If the property had never been the deceased's home you inherit it at the same cost base as the deceased unless it was a pre CGT property to the deceased.

Pre CGT properties are inherited with a cost base of their market value at the date of death and they are deemed to have been acquired at the date of death. This means that the beneficiary will not be entitled to the 50% CGT discount until more than 12 months from the deceased's date of death. On the other hand a post CGT asset is deemed to be acquired at the date the deceased acquired it so the beneficiary will be entitled to

the discount immediately if the deceased had owned the property for more than 12 months before death. Reference section 115-30.

## **Claiming Rental Property Travel Expenses - Update**

Travel re Purchase and Signing of Contract to Buy or travel to improve the property - Part of cost base for CGT purposes, if the property was purchased after 20<sup>th</sup> August, 1991, section 110-25(4).

Travel to Improve the Property – Part of cost base for CGT purposes section 110-25(4)

Travel to Repair & Maintain the Property While Rented – Claimable against current year income

Travel to Repair & Maintain the Property While Not Rented – Part of the cost base for CGT purposes section 110-25(4) if the property was purchased after 20<sup>th</sup> August, 1991. This is the case even if you are living in the property at the time of the travel but for some reason during the time you own the property it is not covered by your principal place of residence exemption.

## **Main Residence Trap**

Now, I know the following is very much old news to our long term readers but I have seen too many people, lately, caught in this trap, not to mention it again. To fully exempt a home as your main residence you must move into it as soon as “practicable” after settlement section 118-135.

It is a bit like musical chairs, really, you must grab the house as soon as the music stops or in this case when settlement happens. If you don't do this the house will be subject to capital gains tax on a pro rata basis for the rest of the time you own it. This means you need to keep records of all expenses associated with it, for the whole time you own it, to firstly avoid an ATO fine and secondly to minimise the effect of CGT. You can increase the cost base of the property by any costs associated with holding it (section 110-25(4)) if you purchased it after 20<sup>th</sup> August, 1991. These costs include light globes, cleaning products, travel to the hardware store, interest, rates, insurance, everything, just keep the record. Keep the receipts for the whole period you owned the property as the way the formula works the expenses associated with you living there can decrease the CGT for the period you did not.

If these expenses have already been claimed as a tax deduction against rent received on the home they are not permitted to increase the cost base.

Examples of the sort of circumstances that will be caught are when you purchase a property with existing tenants and let them finish their lease or when you are away for work or a holiday and can't get back to the area the house is in immediately. In these circumstances you would be better off to delay settlement. The 6 years absent rule will not protect you until after you have first lived in the house.

## **Using Small Business Concessions on Your Home**

In ID 2002/753 the ATO accepts that the portion of a house used in a business can be an active asset. In the Interpretive Decision a company purchase 30% of a house with the remaining 70% of the house being in the names of individuals who intend using it as their main residence except for 30% of the area which will be a place of business. In this decision the company was looking to use the Rollover relief available under the small business concessions which require you to purchase an active asset.

Apply this concept to a typical mum and dad partnership, where the business is run from home, could produce significant tax savings. If your home is also a place of business you are not entitled to exempt the business portion with your main residence exemption. Don't worry this doesn't apply just because you take work home, or give music lessons or do a bit of baby sitting. It is applicable when part of the house is set aside for business purposes. So let's assume Mum and Dad are running a tradesman's partnership so the office in the house and the shed out the back are used solely for business purposes and they represent 30% of the area. As a result they only get their main residence exemption on 70% of the capital gain made on the property, assuming all the time it was owned it was used at this ratio. The remaining 30% of the gain is subject to CGT but if it has been owned for more than 12 months there is the 50% CGT discount then as it is an active asset another 50% discount applies so we are down to only 25% of the gain on the 30% used for business purposes, being taxable. They can then choose to use the retirement exemption or rollover relief to exempt the remaining 25% of 30% of the of the gain on the house from tax.

If they are over 55 the retirement exemption means they get the money tax free. If they are under 55 using the retirement exemption means they have to put the money into superannuation but it will not even be taxed in the hands of the super fund. The retirement exemption can only be used to cover a maximum of \$500,000 worth of capital gains in a life time.

To utilise rollover relief they need to buy or improve another active asset for the business to the value of the remaining taxable gain. This could simply be a new vehicle for the business or just roll it over into the new house if it is going to be used in the business.

This active asset concession is part of the Small Business CGT concessions so let's just check what is necessary to qualify.

To qualify as a Small Business:

You and your associates need to have net business assets of less than \$6million or have elected to enter the simplified tax system (referred to from 1<sup>st</sup> July, 2007 onwards as small business entities). which requires your turnover to be under \$2million (net of GST). Net business assets in the above example would mean the 70% of the value of the house which is used for private purposes would not be included in the test. Other personal assets such as superannuation are also ignored.

To qualify as an Active Asset:

The asset must have been used in the business for at least half the time it was owned or 7 ½ years whichever is the lesser. Note an active asset can be owned by an associate rather than the business entity and still qualify.

## **Building a Duplex with a Friend**

What are the CGT consequences of buying a piece of land as tenants in common with a friend on which you build two homes under separate titles so you can have one each? PBR 30342 looks at a rather more complex situation but answers this question quite well.

Two relatives buy a house together as tenants in common. Eventually they build two houses on the property and subdivide the title so that they can independently own a house each. The catch is the ATO sees this as each relative transferring their share of the other's house. So they are each up for CGT on the gain on half the other's house.

## **New Rollover Strategy**

If you utilise the CGT small business concessions rollover relief on part of your capital gain you delay paying tax on that gain until you sell the asset you roll the gain into. Even at that stage you can rollover again or use the retirement exemption. You have to buy the replacement asset or improve an asset you already own, within 2 years (or 1 year previous) of making the capital gain.

From the 1<sup>st</sup> July, 2007 if you don't buy the replacement asset you have to include the gain in the tax return for the year in which the 2 year period expires, Previously you had to go back 2 years and amend the tax return where the gain was made.

This allows a tax planning opportunity. If your taxable income is high the year you made the capital gain use the rollover provisions to move the gain into a tax return 2 years in the future.

Note rollover relief isn't the be all and end all of the small business concessions. Before even considering its use you should utilise at least the 50% CGT discount, the 50% active asset discount and if you are over 55 or under 55 and happy for the money to go into super, the retirement exemption. Rollover relief has only limited possibilities but maybe useful if after the business is sold and everything is settled you were planning a long overseas holiday so won't have any taxable income in the financial year 2 years after the sale of the business.

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Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.