GOODALL & CO

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The CGT implications of subdividing and building on the family property

Given the state of the property market in Australia these days, a not-uncommon situation can arise where a residential property owner seeks to demolish and subdivide the block containing the family home and build residential units.

If you have the available land of course, the above is a solid strategy. However it can cause headaches from a tax perspective — and in some cases the ability to access the main residence exemption and even the CGT discount can be compromised.

Divvying up the backyard

A question that arises every now and then concerns the effects on the CGT main residence exemption where the owner decides to subdivide the land containing their principal place of residence, in some cases demolishing the existing home, and build residential units.

About this newsletter

Goodall & Co provides personalised taxation and investment solutions, designed to increase your wealth and help protect and grow your business. As registered tax agents, we complete tax returns for individuals, companies, trusts and partnerships. We specialise in self-managed super funds, advice for small businesses, and investment property returns.

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The CGT implications of subdividing and building on the family property *cont*

The scenarios that are typically raised involve one of the following choices:

1. demolish the main residence, subdivide the land, build two home units, sell one and live in the other
2. subdivide the land, build a home unit on the newly created previously vacant portion, and sell the unit (with the original residence staying intact)
3. subdivide the land and sell the non-main residence block (with original dwelling staying intact).

When dealing with these situations, the following pertinent tax questions may need consideration:

- Would demolition of the original main residence would trigger a capital gain or loss (if any)?
- What are the CGT implications of subdividing the property?
- Is the sale of the home unit or vacant land the "mere realisation" of an asset or is there is a profit-making activity conducted?
- How would the original dwelling/unit, retained and lived in by the taxpayer, be treated for CGT purposes?

Note that there may be some GST implications that are not dealt with in detail here. Suffice to say that any venture undertaken by home owners in building units for the purposes of sale may, from the ATO's viewpoint, constitute an "enterprise" and may necessitate an ABN and registration for GST. Speak to us if you consider that this may be the case.

Scenario 1: Demolish dwelling, subdivide land, build two units, sell one and retain other as main residence

Consider the following scenario:

- Jim acquired a dwelling in May 2012 and resided in the dwelling as his main residence.
- The land is less than two hectares.
- Due to the poor state of the dwelling, it was demolished in June 2016. No consideration was received as a result of the demolition.
- The land was subdivided into two blocks and Jim then commenced to build a unit on each block. Jim continued to be the owner of both blocks.
- Upon completion in January 2017, Jim moved into one of the units as his main residence (as soon as practicable after completion).
- The unoccupied unit was sold in February 2017.
- Jim lived in rental accommodation from June 2016 until January 2017.

The subdivision of land results in each new block registering a separate title. The subdivision itself has no CGT consequences, provided Jim continues to be the owner. However it does create two new separate CGT assets. A further consequence of subdividing the land into two blocks is that the cost base of the land is required to be apportioned to each new block in a "reasonable way" (such as using the land area or a market valuation).

In disposing of the non-main residence unit, a question arises as to whether the building of the unit and its subsequent sale is a "mere realisation" of a capital asset or a profit derived from an isolated transaction. This is not always clear, and requires consideration of all the necessary factors. We can provide guidance should this be a source of confusion.

Unlike the non-main residence unit, the main residence unit continues to qualify for the CGT main residence exemption.

Note also that notwithstanding that the original dwelling has been demolished, Jim can still extend the main residence exemption to the newly built unit provided that certain conditions are met.

Specifically, he can choose to treat the vacant land as his "main residence" for a maximum period of four years from the time that he ceases to occupy the demolished dwelling until the replacement unit becomes his main residence ("the four year rule").

It is therefore possible for Jim to have an unbroken period of "occupancy" from the time that the demolished dwelling was acquired until such time that the replacement dwelling ceases to be his main residence. During this period, once a choice is made, Jim cannot treat any other dwelling as his main residence.

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The CGT implications of subdividing and building on the family property *cont*

Scenario 2: Subdivide land, build a home unit on the previously vacant portion, and sell the unit (original residence stays intact)

- Mary and John acquired a dwelling in April 1996, which was their main residence.
- The home had a swimming pool on land adjacent to the dwelling.
- The land is less than two hectares.
- Their adult children have left home and, requiring cash to fund their retirement, Mary and John have intentions of downsizing their living arrangements.
- In December 2016, they removed the swimming pool and subdivided the land into two blocks (retaining their existing home).
- They built a unit on the vacant block, completed in March 2017 and sold in April 2017.

As noted above, the subdivision of land does not trigger a CGT liability provided that Mary and John continue to be the beneficial owners of the subdivided blocks. The cost base of the property would need to be allocated to each block of land on a reasonable basis.

As the unit built on the newly apportioned block was created with an obvious intention of making a profit, and as the owners have continued to use the original dwelling as their home, neither the CGT main residence exemption nor the CGT general discount applies.

The fact that the unit was constructed on land that was originally subject to the main residence exemption (as part of the two hectare area upon which Mary and John's residence was situated) provides no basis to argue that some part of the gain on disposal should be free of tax pursuant to that exemption.

Unlike the non-main residence unit, the block containing the main residence continues to be subject to the CGT provisions, including the main residence exemption.

The subdivision of Mary and John's land therefore has no effect in this regard, however the cost base of the block containing Mary and John's original dwelling would be reduced following allocation of the cost base between the two blocks.

Scenario 3: Subdivision of land with main residence and dispose of vacant block

- Bob acquired a dwelling in August 1996 for $400,000, which was his main residence.
- The land is less than two hectares.
- In September 2012, the property was subdivided into two blocks with one block containing the dwelling (front block) and the other block being vacant (rear block). Bob continued to be the owner of both blocks.
- The legal costs for the subdivision were $10,000.
- At the time of subdivision, Bob's real estate agent advised that the value of front block and rear block should be split 50/50.
- The rear block was sold in December 2014 for $400,000.

Again, mere subdivision does not trigger a CGT liability provided Bob continues to own both, and the new cost base of each must be calculated on a reasonable basis. As the split, based on the agent's advice, is 50/50, the cost base for each block is as follows:

Acquisition cost

(50% of $400,000) $200,000
Legal fees (50% of $10,000) $5,000
Cost base per block...........................$205,000

For its part, the ATO has indicated in various rulings that situations similar to Bob's would not necessarily result in an "enterprise" for GST purposes. For income tax purposes, it follows that the ATO would likely consider that Bob has disposed of the land by way of "mere realisation" of his land as opposed to realising a gain from a profit-making undertaking.

Accordingly, the sale of the vacant block would be on capital account and the CGT general discount would be available if the asset is owned for at least 12 months. Therefore the net capital gain to Bob from the sale of the rear block is $97,500 (that is [$400,000 less $205,000] x 50% general discount).

However the net capital gain on the sale of the vacant land would not attract the operation of the main residence exemption. As a general rule, adjacent land would be subject to the exemption if it was primarily used for private and domestic purposes in association with the dwelling. However the exemption only applies if the land and dwelling are sold together. As a result, the net capital gain of $97,500 would remain assessable to Bob.

Please speak to us to clarify any of the above scenarios should they apply to you. ■

Selling up your business? Don't forget the "going concern" GST exemption

The concept of a "going concern" exemption for the purposes of the goods and services tax (GST) can still cause confusion when businesses are sold.

The sale of a business may be GST exempt if the enterprise is deemed to be a "going concern" — which refers to an enterprise's ability to continue trading. The ATO (and the GST legislation itself) says a supply of a going concern occurs when:

- "a business is sold, and that sale includes all of the things that are necessary for the business to continue operating", and
- the business is carried on, "up until the day of sale".

The GST exemption has its advantages — a buyer of a business does not have to find extra funds to cover GST that is added to the purchase price. And while the buyer is entitled to get the tax back via the input tax credit system, this cannot happen until some time after the completion of the transaction. It also must be remembered that while the GST is eventually refunded, any stamp duty payable on the sale of a business will include the amount for GST.

What are the requirements for the exemption?

Business owners may be aware of the existence of a GST exemption but not completely understand the way it operates. The GST legislation says that the sale of a going concern will be GST-free if:

- the sale is "for consideration"
- the purchaser "is registered, or required to be registered" for GST, and
- "the supplier and the recipient have agreed, in writing, that the supply is of a going concern".

The sale of business contract will usually specify that the business (that is, the "supply") is a going concern when the contracts are exchanged. This is critical, because it shows that all parties to the sale acknowledge that the business is a going concern.

A vendor is required to supply "all of the things that are necessary" for the continued operation of the enterprise. This does not mean everything that is owned by the business. It does however mean those things without which the enterprise could not function. Generally, this includes the necessary assets such as premises, plant and equipment and customer contracts. It can also include arrangements such as ongoing advertising.

The legislation requires the vendor to carry on the business "up until the day of sale", with it deemed to be transferred on the date on which "effective control and possession" of the business is handed over to the buyer. While this date generally refers to the settlement date, "the day of sale" may occur before or after the settlement date. Importantly, there is no requirement for the purchaser to actually continue carrying on the business.

The tax liability risk (in case the ATO does not view the sale as a supply of a "going concern") ultimately lies with the seller, as it is the "supplier" in any transaction that is required to remit GST to the ATO.

Some vendors seek to avoid this tax liability risk related to the business by including a clause in the sale contract requiring the buyer to indemnify the vendor for any GST that may be payable in the event that the ATO does not view the transaction as one of a going concern. ■

Are personal carer travel costs claimable? It depends...

A recent Administrative Appeals Tribunal decision has ramifications for taxpayers with disabilities, and who are in need of a personal carer.

The decision centres around what is or is not acceptable as a tax deduction in relation to the costs that arise with regard to that carer under certain conditions.

The circumstances of the taxpayer concerned in the case are particularly relevant, so a brief run-down of the facts will be instructional.

The taxpayer was invited to speak at two work-related conferences in Britain, with the costs of his travel expenses covered by his employer, with his and his wife's accommodation costs as well as other out-of-pocket expenses covered by the conference organisers.

The taxpayer suffers from medical conditions that mean he is unable to walk any distance without assistance and cannot stand for any length of time. As a consequence, he needs a carer not only to assist him with standing and walking but to use the toilet, shower and bathe and dress.

His employer was aware of his disabilities but did not provide him with a carer or assistant to travel with him, and none of the employer's other staff members were going to this particular conference.

The taxpayer's wife accompanied him and acted as his carer both on the flights to and from Britain and during their time there. She helped him to dress, assisted with his personal hygiene, showering and toilet needs and supported him when he was walking and standing.

Her assistance was necessary to enable him to travel to, and attend, both conferences. In addition to these, the taxpayer attended a series of meetings related to the duties of his employment.

His wife did not perform any tasks relating to his work duties, was not employed by his employer, and did not receive any payment for the assistance that she gave.

When the taxpayer consequently lodged his next return, he made a claim for his wife's airfares, which the ATO disallowed, saying that its decision was due to the expenses being of a private or domestic nature. The taxpayer submitted that denying him the deduction constituted discrimination due to his disabilities.

Therefore, two key issues arose. The decisions regarding these two issues ended up in the Administrative Appeals Tribunal (AAT). They are:

- whether the travel expenses the taxpayer incurred in relation to his spouse should have been allowed as a tax deduction, and
- whether denying the deduction is contrary to disability discrimination laws.

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Business costs and deductibility of interest expenses

If a business racks up an interest bill from borrowing funds to pay for the expenses of running the business, or to acquire other income-producing assets or investments, this expense is generally allowed as a tax deduction for the relevant year.

For business taxpayers under the accruals accounting method, a claim can be made for the calculated interest liability to the end of the income year (usually June 30), provided the interest on the debt accrues on a daily basis (which would usually be the case).

Deductions for interest incurred

The availability of deductions for interest are typically affected by the following factors:

- interest must have a sufficient connection with the income earning activities of the taxpayer
- interest on a new loan is deductible if the new loan is used to repay an existing loan, which, at the time of the second loan, was used to produce assessable income or as part of a business to produce assessable income
- interest on borrowings will not continue to be deductible if the borrowings cease to be employed in the borrower's business or for some income producing activity, or which are used to earn exempt income
- interest may still be deductible even if the borrower's business has ceased. This rule can apply to other assessable income-producing activities but would not apply to the derivation of exempt income
- interest may be deductible if incurred prior to a business commencing or assessable income being derived
- the character of the interest is generally determined by the use to which the borrowed funds are put
- the "rule of 78" may be used in limited circumstances to calculate the interest component of instalments paid under a fixed term loan or extended credit transaction
- penalty interest for early repayment of a loan may be deductible, and
- an interest deduction can be claimed for money borrowed for the business to pay a tax debt.

Companies

Interest costs incurred by companies may be deductible if the money:

- is used to repay share capital to shareholders if that capital was employed as working capital in the company business and is used to derive assessable income, or
- funds the payment of a declared dividend to shareholders where the funds representing that dividend are employed as working capital in the company business and it is used to derive assessable income.

A deduction is not allowed if the borrowed funds are used to:

- repay share capital to shareholders to the extent it represents bonus shares paid out of an unrealised asset revaluation reserve or other equity account (for example, internally generated goodwill), or
- pay dividends out of unrealised profit reserves.

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Business costs and deductibility of interest expenses *cont*

Borrowing expenses

If costs are incurred to obtain a loan, the costs of arranging it are allowable as a deduction to the extent the loan is used to produce assessable income. Expenses claimable under this heading include:

- legal expenses associated with mortgage documents
- valuation fees incurred
- procuration fees and mortgage insurance (if any)
- stamp duty payable on mortgage documents, and
- any other cost items for taking the loan.

If the total cost of these expenses is less than $100, it can be claimed in the income year the expense is incurred. However if more, the claim will need to be spread equally over the lesser of the loan term, or five years commencing from the date the loan was entered into.

If you incur borrowing costs on a number of dates for different facilities you cannot simply add them to the opening balance of your yet-to-be-deducted borrowing costs for that year. It is necessary to do a separate calculation for these new borrowing costs.

Not only but also

When early repayment of a loan occurs, and some of the eligible costs of borrowing have not been claimed, these may be deducted in the year in which the borrowings are paid out.

Generally any so-called "rebate" given when a loan is paid out is merely a figure to adjust the interest. Any refund would diminish the final claim for borrowing costs.

Note also that mortgage protection insurance premiums for a bank loan used to purchase an income-producing asset is generally deductible. Penalty interest on early repayment of the loan may also be deductible.

The tax law also allows a taxpayer to claim in full the cost of discharging a mortgage where the money was used (whether or not in a business) for producing assessable income. If only part of the borrowings were used for that purpose, apportion the discharge expenses. ■

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Deductibility

As has been noted above, the ATO denied the claim for carer costs as the role was private or domestic in nature, and the carer was not engaged by the taxpayer's employer. In regard to the deductibility of costs incurred in circumstances where a disabled taxpayer engages an assistant, the AAT held that this all depends on the nature of the assistant's tasks.

The subsequent decision handed down was that if the tasks are directly associated with the disabled taxpayer's work, the expense is deductible. A typical example is someone engaged by the taxpayer as an administrative assistant, who undertakes tasks such as typing, taking dictation, retrieving, moving and opening files, and photocopying documents. These tasks are carried out so that the disabled taxpayer can perform his employment duties, and are in the course of the taxpayer undertaking duties that are characterised as being incurred in the course of gaining or producing assessable income.

However the AAT also determined that if the tasks are not directly associated with the disabled taxpayer's work, the expense is not deductible. A typical example is a taxpayer who hires someone to assist him with his personal needs, such as standing and walking, using the toilet, showering and bathing and dressing. Such expenses are incurred in the course of enabling the taxpayer to undertake duties that are characterised as having a private or domestic nature.

The tribunal also commented on a section of the relevant legislation that imposes a blanket prohibition on making claims for costs incurred by a relative of a taxpayer who accompanies them on work-related travel.

Unless the relative performed substantial duties in the role of either staff of the taxpayer's employer or as the taxpayer's own employee, it would not be reasonable to conclude that they would have accompanied the taxpayer regardless of their personal relationship. It found that there is no room in the legislation to read an exception to the blanket prohibition if the relative is tagging along as carer unless they are being employed as such.

Discrimination

For the discrimination aspect of the case, the AAT concluded that the ATO's decision to deny the deduction was not discriminatory under the disability discrimination laws. It stated that the ATO conclusion would have been the same if the taxpayer did not have disabilities that required him to be accompanied by a carer. ■

Company tax franking implications

The recent cut to the tax rate for incorporated businesses that turnover less than $50 million a year, while generally welcomed, can bring with it some important considerations when it comes to distributing franked dividends.

The rate change to 27.5% is to be staggered, starting with companies that turnover up to $10 million a year, with retrospective effect from July 1, 2016. It will then apply to companies turning over up to $25 million in 2017-18, and to $50 million turnover companies for 2018-19.

Note: These tax cuts only apply to companies that actively “carry on a business”.

From 2016-17, a company’s maximum franking will be based on the company’s corporate tax rate for a particular income year, worked out having regard to the company’s aggregated turnover for the previous year.

This is because a company will not know its aggregated turnover for the year in which it pays a dividend (and therefore its corporate tax rate for the year) until after the end of that year.

How this works

In the 2015-16 income year, Company ABC has an aggregated turnover of $9 million. In the 2016-17 income year, its aggregated turnover increased to $11 million.

Therefore, for the 2016-17 income year, Company ABC will have:

- a corporate tax rate of 30% (having regard to its aggregated turnover of $11 million in the 2016-17 income year)
- a corporate tax rate for imputation purposes of 27.5% (based on an aggregated turnover of $9 million in the 2015-16 income year), and
- a corporate tax gross-up rate of 2.64 — that is, (100% - 27.5%)/27.5%.

As a result, if Company ABC makes a distribution of $100 in the 2016-17 income year, the maximum franking credit that can be attached to the distribution is $37.88 — that is, $100/2.64.

Possible broader impact on shareholders

Companies will benefit from the rate cuts provided that the funds are retained. However the tax burden will be shifted to the shareholder upon distribution of a franked dividend.

Australian resident shareholders will pay more top-up tax on dividends received from companies eligible for the tax cuts as the company tax rate decreases.

Ultimately, the total tax liability on the company’s pre-tax profits will still be at the shareholder’s marginal rate, but a greater proportion of the burden will shift from the company to the shareholder over time. As the table below shows, the net cash received in relation to the dividend will remain the same. ■

Company-aggregated turnover below $50m	**2015**	**2030**
Company pre-tax profit	$100	$100
Company tax rate	30%	25%
Franked dividend received	$70	$75
Franking credit (100% franked)	**$30**	**$25**
Total assessable	$100	$100
Gross tax payable (marginal rate 37%)	$37	$37
Less: franking credits	($30)	($25)
Top-up tax payable	*$7*	*$12*
Net cash received (dividend received less tax payable)	$63	$63