BAN TACS
National Accountants Group

NEWSFLASH BOOKLET

Visit us at www.bantacs.com.au

How Not To Be A Developer

SUBDIVIDING THE FAMILY HOME, BUSINESS PREMISES OR FARM

For website technical support, email technicalservices@bantacs.com.au
For all accounting & tax support contact one of our offices or just go to www.taxquestions.com.au

NEW SOUTH WALES

Sydney 1300 367 688
sydney@bantacs.com.au

Burwood 1300 367 688
burwood@bantacs.com.au

Central Coast 02 4390 8512
centralcoast@bantacs.com.au

Hornsby 1300 241 248
hornsby@bantacs.com.au

QUEENSLAND

Brisbane 1300 911 227
brisbane@bantacs.com.au

Caboolture 07 5497 6777
admin@bantacsningi.com.au

Gold Coast 0435 437 586
goldcoast@bantacs.com.au

Mackay & Whitsundays
07 4951 1848
mackay@bantacs.com.au

Ningi 07 5497 6777
admin@bantacsningi.com.au

Toowoomba 07 4638 2022
toowoomba@bantacs.com.au

VICTORIA

Melbourne 03 9111 5150
melbourne@bantacs.com.au

North Melbourne 1300 123 842
northmelbourne@bantacs.com.au

SOUTH AUSTRALIA

Adelaide 08 8352 7588
adelaide@bantacs.com.au

FIND OUT MORE

http://bantacs.com.au/aboutus/

Visit Bantacs.com.au About Us section to view office location details and information about BAN TACS practitioners

Liability limited by a scheme approved under Professional Standards Legislation

Warning

Parts of this booklet have had to be re written even before it was finished due to changes in the law or ATO rulings. This booklet contains too many hot topics to remain up to date for any length of time. Section numbers and rulings are always quoted so it is not hard to check whether there has been any changes. Please make sure you ask a professional to do this for you before you act. We take no responsibility for any action you take as a result of reading this booklet as it is only a guide and professional advice on your particular circumstances is also required.

Important

This booklet is simply a collection of Newsflash articles relevant to how not to be a developer. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

Introduction

This booklet is not for developers who regularly subdivide land. It is only intended for people who have purchased the land for some other purpose and have now decided to subdivide it. We address how to keep the whole transaction as the mere realisation of an asset and not change over to the business of developing land. If the transaction is the mere realisation of an asset the CGT provisions apply rather than normal income tax law. If you have held the property for more than 12 months being taxed under the CGT provisions will at the very least halve your tax bill. If you can retain the asset's status as an active asset in a business you will further be able to reduce your tax bill, possibly down to zero. So read up there is some real tax savings to be made with careful planning.

There are also GST considerations in developing land regardless of whether normal income tax or CGT apply. The GST ramifications can be reduced in some cases by the use of the margin scheme.

The primary consideration in determining how you are taxed on the profits on the subdivision is what your intentions were when you purchased the land. Of course it is up to you to prove what those thoughts were. What can you expect from a tax and welfare system that is based on who you have sex with and how regularly. So watch those thoughts.

In the following reference will be made to whether a profit is capital or revenue in nature. If it is revenue it will be taxed at normal tax rates. If it is capital in nature CGT applies, so if the property has been held for more than 12 months CGT concessions will apply.

The Income Tax Issues

There are three possible outcomes:

1) Merely Realising an Asset – You did not buy with intention of resale at a profit and you are just doing enough to prepare the property for sale at the best price. CGT applies
2) An Isolated Business Transaction – You did not buy the property with the intention of resale at a profit but to use in a business (ie Farm) then later you subdivide and sell the land but it is not in the ordinary course of the business. CGT and Possible Active Asset Concessions.
3) Property Development – The land is held (TD92/124A) even if not initially purchased for the purpose of resale and a business activity which involves dealing in the land has commenced. The activity of subdividing has blown out to a business activity rather than merely realising an Asset. This is not covered is this booklet other than to explain what not to do. TD92/124 was amended to change the word acquired to held which signals the ATO's opinion that even if you did not purchase the land with the intention of reselling it at a profit you can at sometime change your mind and commit it to this purpose and so be taxed at normal tax rates on the profit. Fortunately the courts have taken a very narrow view of when land purchased without the intention of resale at a profit can become part of a business and thus subject to normal income tax rates.

Crossing the Line Between CGT and Normal Tax

If you buy a property with the intention of making a profit on its resale or you at sometime commit the property to a business of selling land for profit (rather than merely realise an asset) you are in the business of trading in property. Even if you purchase a property with the intention of developing it for resale at a profit and for some reason the project is abandoned, you are still liable for normal tax on the resale of the undeveloped land.

If you did not originally buy the property with the primary purpose of resale at a profit it is important that you don't cross the line to making the property part of a business venture. You can have bought a property for some purpose other than resale at a profit but be considered by the ATO to have changed that purpose and commenced the business of development. If you do cross the line and take a property you did not purchase with the intention of resale at a profit, yet put it into a business of property development, normal tax rates will apply to the business's profit. But you will be entitled to bring the property into the business at its market value when the business commenced. This way CGT will apply to the gain up to the market value of when the business commenced. So at least you will get the CGT concessions on some of the profit. If you are

going to get caught here, consider making the most of it by transferring the property to a more tax advantaged entity or person.

To not cross the line and ensure that the profit on the sale of the property is taxed under the CGT provisions it is important that your activities in preparing it for sale amount to no more than the mere realisation of an asset in the most profitable way and not the start of a business.

Some examples

The following are reasons you may have purchased the property other than for resale at a profit and a discussion on some of the tax issues:

Purchased To Use As Your Home:

This section assumes that the property is 2 hectares or less, you have owned it for more than 12 months and you have only used the property as your home up until the subdivision. If the property is larger and/or has also produced income while you were living there, you need specific advice and should read the example for farms.

The property would normally be exempt from tax because it is your main residence. But this is only if you sell it as a home. So if you cut a block off and sell it there will be no main residence exemption at all because you are not selling your home. Your exemption would remain with the block your home is on. Here is another trap, if you demolish that home and sell vacant land you will completely lose the main residence exemption for the whole time you owned the property. To qualify for the main residence exemption there must be a dwelling on the property at time of sale, though this can be a caravan. If you sell vacant land after demolishing your home you will be up for CGT on half (assuming held for more than 12 months) the difference between the price you paid for it plus costs and improvements less the selling price. If you purchased the property after 20th August 1991 you can also reduce the gain by the cost of rates, insurance, repairs, maintenance and interest section 110-25.

If you are a builder or developer by trade and you start to cut up the family property you are more likely than other professions to be considered applying the property to a business. Other professions subdividing their own home into a small amount of lots would be very unlikely to be considered to applying the property to a business rather than merely realising an asset. Though to play it safe don't sell the blocks yourself, organise this through a Real Estate Agent.

If you are subdividing your home block and you do not normally develop land or build houses you need to limit your activities to the extent that you will not be considered in the business of developing the land. If you simply apply to council for approval of the subdivision, and sell your home together with the land up to 2 hectares, to a developer you will not pay a cent in tax because of your main residence exemption. If you cut the land up yourself, you are starting to get involved in development activities and you start to cross over to business operations. You will be subject to tax on each block you sell other than the one with your home on it, but the tax will be at least half if you can stay within the CGT provisions because you are merely realising an asset rather than starting a business operation. More detail on this is in the section Are You Merely Realising an Asset? You should be safe if you simply do nothing more than what the council requires under the conditions of the subdivision (ie water, roads) and then engage a real estate agent to market the lots for you.

To Run a Business On:

This is the best outcome as with careful planning the gain can be completely tax free if it qualifies for the capital gains tax small business concessions. On this basis it would be a major tax blunder to take the development too far or be found to have purchased the land for resale at a profit or have transferred the property into a business of developing land and end up being taxed on a revenue basis. Farms are discussed later, this section is devoted to business premises that are later subdivided.

To qualify for the small business concessions you need to have a turnover of less than $2 million or your's and your associates' assets to be less than $6 million and in some cases satisfy a controlling individual test. The following only addresses the ramifications for the land and buildings not the plant and equipment on it.

The property also needs to pass the active asset test. The property must be used at least half of the time it was owned or 7 ½ years whichever is the shortest period. A property would not be an active asset if it was

used to derive rental income unless the rent was received from an associated (common ownership) business. For more details on how the active asset rules work refer to the section titled Active Assets Concessions.

To Rent Out Domestic Accommodation on the Land:

If you buy land with the intention of building a home on it to rent, when you eventually sell, the profits on the sale are a capital gain and subject to the 50% CGT discount if it is more than 12 months between the time you agreed to purchase the land and the time you agreed to sell the house and land.

Steele's case created the precedent that interest can be claimed as a tax deduction while you hold land with the intention of building a rental property on it.

Be careful here if you sell a home you built, without first using it as a rental for at least 5 years GST will apply to the sale if you are already registered for GST in the enterprise that owns the home. . If you are not registered for GST the sale of a new rental property in less than 5 years will not force you to be registered providing of course you can prove that you built the property to rent not to profit from its resale. This is a little known point so here are the references:

Section 23-5 states that if the annual turnover of supplies you make in the normal course of your enterprise, exceed $75,000 you must register for GST.

Section 185-25 excludes from the calculation of annual turnover the supply of a capital asset. Building the property for rental then selling, is the supply of a capital asset and not included in the annual turnover.

Section 118-15 excludes from annual turnover input taxed supplies so any domestic rent received is not included in annual turnover.

To Farm:

Just being a farmer does not automatically mean developing the land is capital rather than revenue in nature In Crow v FC of T 88 ATC 4620 the profit a farmer received on selling 51 portions of land was assessable as revenue because his intention when buying the property was to make a profit.

Out of all possible reasons for purchasing a property you are subdividing, using it as a farm or business is the most tax advantageous. If you can convince the ATO that you purchased the property to farm, not to subdivide you may be able to eliminate all tax from the transaction by using the active asset concessions. These are discussed in more detail in the section on active assets. The best concession is the 15 year exemption. If you purchased the property over 15 years ago, farmed it for at least half the period of ownership or 7 ½ years and the development is not so elaborate that you are considered to be in the business of developing land, you don't need to pay any CGT.

Another advantage of this method is you do not have to offset the gain against your capital losses first so they are still there for your future benefit. The owner or owners must also retire (a state of mind) then the profits are completely tax free.

If you miss out of the 15 years do not despair, a careful combination of the remaining small business exemptions will give you almost as good a result. For example combine the retirement exemption with the 50% CGT discount and the 50% active asset discount and you will pay no tax but 25% of the profit may need to be contributed to super if you are under 55 years of age. This will not be taxed in the hands of the superannuation fund.

Most farmers would already be registered for GST for the farming enterprise so they will have to charge GST when they sell the lots. Read the section on the margin scheme to minimise the impact of GST. If you were not registered for GST when farming, you need to make sure you do not fit the definition of enterprise when developing the blocks. In other words don't be too business like.

An idea may be to reduce the farming business down to where it has a turnover of less than $75,000 so the farmer can de register for GST, but still be in business so be entitled to the active asset concessions outlined above. You could also consider ceasing the business in order to deregister.

There are further concessions that allow farmers to sell their farm as a going concern or to an associate or another farmer with no GST being applicable.

Building a Spec Home:

GSTR2003/3 states at paragraph 10 "The sale of new residential premises by a registered entity in the course or furtherance of an enterprise it carries on, is a taxable supply for GST purposes." Unlike the rental property

situation discussed above if you build a spec home its sale is part of your normal business turnover so it will cause you to be registered for GST. Section 9-20(1) (b) includes as an enterprise an adventure or concern in the nature of trade. An adventure or concern may be a one-off transaction that is not a continuous business but it must have business like characteristics to be caught. So if you did not build the property to sell, but only to rent, then when you sell it, it is not part of a normal sale in your enterprise of rental properties and as such does not force your taxable supplies over $75,000, if all you are involved in is domestic rentals, you are not required to be registered for GST. Even though the sale of the house would be the first sale of a new residence and therefore subject to GST you are not registered for GST so you are not caught.

If you buy land with the intention of building a home on it to sell then the proceeds of the sale are normal business income, the 50% CGT discount is not available to you and GST will apply. You are entitled to claim GST credits for the cost of building the home and purchasing the land if it was not purchased under the margin scheme. As your buyer is unlikely to be in the business of buying and selling houses they will not be able to claim the GST back.

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 as 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 someway before selling.

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

Active Assets Concession

This is only applicable if the land was not purchased with the intention of resale at a profit, it was owned by a business or an associate of a business and was actually used in the business,

If you farmed the land or used it in a business utilising the active asset rules, in section 152 can take your tax payable down to zero.

Before any of the following apply you will need your assets to be less than $6 million or have a turnover of less than $2 million. The property must also be an Active Asset (Section 152) that is used in the business for at least half of the time it was owned or 7 ½ years. The property would not be an active asset if it was used to derive rental income, unless the rent was received from an associate that used it in a business. The following only addresses the ramifications for the land not the plant and equipment on it. .

a) If you purchased the property over 15 years ago, are over 55, retire when it is sold, have farmed or used it in a business for at least 7.5 years and the development is not so elaborate that you are considered to be in the business of developing land, you are home and hosed you don't need to pay any CGT. Another advantage of the 15 year concession is you do not have to offset the gain against your capital losses first so they are still there for your future benefit. The owner or owners must retire (a state of mind). This would certainly be worth it for the profits to be completely tax free.

b) If you miss out on the 15 years do not despair a careful combination of the remaining small business exemptions will give you almost as good a result. For example combine the retirement exemption with the 50% CGT discount and the 50% active asset discount and you will pay no tax but 25% of the profit may need to be contributed to superannuation if you are under 55 years of age. Despite its name you do not need to retire to utilise the retirement exemption. 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 but you will have to be at least 55 before you can touch it. Companies 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. In Discretionary Trusts the CGT flows through to the beneficiaries so is treated the same as an individual.

All the benefits in a) and b) above are only available if you stay within the CGT provisions rather than enter into the business of property developing. As these effectively mean that you will pay no tax on the profit it is worth dotting your i's and crossing your t's. Also read the section on *Merely Realising An Asset*. Make sure you get professional advice before you act.

Determining Whether you Purchased the Property for Resale at a Profit or Some Other Purpose

Good stuff, this keeps the lawyers in their BMWs. It is simply a question of fact what your intentions were but the circumstances surrounding the events must support your claims.

Whether you purchased the property for resale at a profit is a question of your state of mind at the time. The trouble is proving that was your state of mind. In Case R25 84 ATC 224 a group of taxpayers bought land to resell at a profit, which they did 13 years later. One of the taxpayers argued that his intention was to build a factory on the land not re sell it. The court did not accept this. Be careful to have evidence of a well researched viable use for the land other than development. You will also need to have a reason for selling that doesn't contradict your original intention.

It is very difficult if you are a builder to claim that you purchased a property with an intention other than developing it and reselling, especially if you build a spec home. In case R51 84 ATC 392 a builder who built a block of flats and leased them to tenants for 6 years was still assessed as revenue on the profit on the sale. TD 92/135 states that even if a builder builds a home as a spec but then decides to live in it he or she is not entitled to the main residence exemption or the 50% CGT discount because it was built with a profit making motive so is taxed as normal business income.

If you inherited the property or received it as a gift you are in a good position to argue that you did not acquire it with the intention of resale. Careful, artificially organising this has lots of other problems not least of which in the case of inheriting is possible murder charges. Gifts between husband and wife are unlikely to have a purpose other than a tax benefit, due to the mutuality of marriage, so will be caught by Part IVA or will simply be considered that whatever purpose the original spouse purchased for applies to the spouse receiving the gift.

Are you Merely Realising an Asset?

Even if you can pass the test that you did not buy the property with the intention of resale at a profit, you still need to be careful not to cross the line of later applying that property for a business making purpose. If you are considered to have changed the property from some non business purpose to the business of selling it for a profit you will be taxed as normal income on any profit made between the market value at the time of change of purpose and eventual selling price. You will also be up for capital gains tax on the capital gain made on the market value at the time the property became part of the business of property development. Accordingly, the property will be introduced to the business as a cost at the market value at the time. The actual calculation of the tax is far more complex than this if you do not change entities when committing the land to development. It is also date sensitive and is affected by whether the property is an isolated transaction or trading stock of a developer. Details are not included here as it is not within the scope of this booklet. This is just a warning not to crunch your numbers without having a professional calculate the tax considerations. The actual committing of the land to a business or the subdivision do not trigger a CGT event ie generate a tax liability. So the CGT is not payable until the land is actually sold. But if you transfer the land to another entity for development CGT will be payable in the year of transfer.

If you want to be completely sure the transaction will only be treated as a mere realisation of an asset and you can prove the purchase was not for profit making by resale, don't turn a grain of soil until you have received council approval for the sub division and then sell the land for its market value to another entity. Note if you take this line of action the new entity will have buckly's of arguing it was merely realising an asset and will pay full tax on all future profits because they are revenue in nature. Professional advice should

be sought on the nature of this new entity to minimise the tax consequences, depending on your particular circumstances. If the council require you to undertake work before the subdivision will be approved you have a real problem getting the market value to a decent figure. In Case W59 89 ATC 538 it was decided that the property became part of the business when these works started so market value at this time could not include the fact it was subdividable but there is hope in TD 97/1 which says the market value should include the highest and best use including the potential of consent being given for subdivision.

Factors that suggest you are merely realising an asset rather than operating a business include:

1) Whether there is another valid purpose such as rental or farming that was viable at the time and that this was actually carried out.
2) How quickly you resell the property. The longer you own the property the more likely it is that you held it as an investment rather than for use in the business of property development.
3) A valid reason for changing the use of the land ie being too ill to continue to farm it.
4) Attempts to sell the land undeveloped that had failed.
5) The owner of the property is not a developer, real estate agent or builder by occupation.
6) Don't go transferring the property to a new entity for the development.
7) Many factors inherent in the development itself such as:
    a) The significance of the development costs compared with the value of the undeveloped land. The more money borrowed to finance the development the more likely it is to be a business.
    b) The size of the development.
    c) The business like nature of the activities, avoid letterheads and employing staff.
    d) How involved the land owner is in the process. For example the difference between Cassimaty's case and Stevenson's case (refer below) could be summed up by the fact that Stevenson made the mistake of being actively involved in selling the lots where as Cassimaty left the job to a real estate agent.
    e) The more stages the development is done in the more it will appear to be a business. This can be countered by developing on the basis of need to repay debt or finance living expenses.
    f) The amount of works required for the land to be subdivided. To this end it may be more advantageous to pay a contribution to council to put in kerb and channelling rather than undertake the work yourself. Or paying a developer to take responsibility for all of the works.
    g) Don't quit your day job.
    h) Don't estoppel yourself by trying to claim a tax deduction for expenses such as interest and rates while the development is taking place.

Examples of the points made above can be found in:

Stevenson v Com. of Taxation 1991 29 FCR 282 – Profit on Subdivision of Farm Taxed as Normal Income
446 acre farm owned by family since 1904. 26 acre single block sold 1965. 360 acre block sold 1971. Another 35 acres sold when taxpayer reached 70. The balance was later subdivided and attempts made to sell it with development potential. Council required water and Sewerage. 180 blocks subdivided finance by considerable borrowings. Development done in 8 stages. The taxpayer was very involved in the development right down to selling the land himself rather than appointing an agent. The taxpayer had no previous development experience.

George Casimaty v Com. of Taxation 1997 1388 FCA 10-12-97 – Profit on Subdivision of Farm Capital
Purchased 988 acre farm from father in 1955 and father forgave obligation to pay for the land. 1956 purchased 40 adjoining acres to build a house. 1963 could not sell the property for enough to cover debts. In 1965 diary farming became uneconomical. 1967 to 1969 drought effected. 1972 tried to sell the whole property to state housing department. Rural market depressed so continued farming. Ill-health and high interest payments forced taxpayer to sell off 3 lots in 1975. More financial problems lead to second subdivision of 10 lots in 1977 for which Council required roads, water and fencing. More financial problems in 1983 so 9 lots subdivided included water, roads and fencing. 1988 13 lots roads plus gift of 2 hectares to son. Council required roads, water, fencing and draining a creek. 1992 16 lots water, fencing and roads. 1993 19 lots. Ill-health suffered from early 1970s but continued to live on the property and farm it a third remained un-subdivided. Properties were sold by a real estate agent.

ID 2002/483 – Is an interesting example of when the ATO wanted to argue the other way because the property was sold at a loss. The taxpayer's spouse completed a Real Estate course and they claimed that the

property was purchased for development. Meetings were held with real estate agents and project builders but the local council was not consulted regarding any restrictions effecting the viability of the project nor was a costing analysis done before purchase. When the costing was done afterwards it indicated the project was not going to be profitable so the taxpayer sold the land unimproved. The ATO concluded a profit motive could not be readily drawn from the facts and that the project was approached in a haphazard way with little activity from the taxpayer.

What if Your Activities Amount to Carrying on a Business?

If you didn't initially purchase the property with the intention of resale at a profit but now feel that your activities go beyond the mere realisation of an asset, you need to get professional advice. It is important that you get this advice as soon as you feel there may be a chance you will go beyond merely realising an asset. There are strategies that can reduce the tax consequences. Usually this involves selling the property to a new entity before you go beyond merely realising and asset. But the advantages of changing structure need to be weight up against the stamp duty expense.

The cheapest and most straight forward method is to transfer the property to low income family members. Note transferring to just one member may mean they are pushed into a maximum tax bracket by just a few sales in one year. There is also concern regarding retaining control of the property, the possibility of this person being sued and their level of debt. Both of these problems can be solved by the use of a discretionary trust that can choose who receives the profits each year.

Do not transfer the property into an established entity that may have problems. For example putting the property in to a company that is already trading will leave the property vulnerable if someone sues the company regarding the already existing business.

A company may be the answer due to its tax rate of 30% but when you take the money out of the company you will have to top it up to your marginal rate. Do not use a company if there is a chance that any of the activities will qualify for CGT rather than normal income tax as companies do not get the 50% CGT discount.

Superannuation funds only pay 15% tax on income and 10% on capital gains. Once the member is over 60 and the fund in pension stage the tax is zero. But a superannuation fund can only borrow in limited circumstances and can only purchase business real property from an associate.

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 20th September, 1985. 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. 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 that is post CGT so subject the CGT. If you put building or structure on pre CGT land it is automatically considered a separate asset from the land regardless of its cost, section 108-55(2).

GST and Subdivisions

GST should also be taken very seriously when doing your costing as GST is not a tax on the profit but 1/11th of the selling price which may well be all your profit though you will be allowed input credits.

MT 2006/1 is the ATO ruling on this topic and the short answer is, GST is unlikely to apply if the subdivision is not considered to be a business of developing property and the entity that owns the property is not already registered for GST.

Section 38 (1) of the GST Legislation states that; **an activity, or series of activities** done in the form of a business or in the form of an adventure or concern in the nature of trade, would be a taxable supply, unless specifically exempt. So, a one off subdivision of land, if done in a business like manner, can be subject to

GST. This means that the sale of the blocks is part of the business's turnover and as that is more than $75,000 pa you are required to be registered for GST and charge GST on each block.

While a one off transaction in the nature of a business can be caught by GST, the mere realisation of an investment asset is not subject to GST.

The first sale of a house and land is subject to GST if it happens within its first 5 years and the owner is registered for GST. But if the owner is not in the business of building or developing, the property is not part of the normal turnover so it will not push their taxable turnover over $75,000 so will not force them to be registered. If your turnover is bound to exceed $75,000 you must register for GST and charge it on each block but the sale of the blocks is only included as part of your turnover if you are considered to be in the business of developing or building houses. If your turnover for the year is only domestic rental income which is not a taxable supply the sale of the rental property is not in the normal course of your business so your taxable turnover is under $75,000 and you do not have to register for GST or charge GST on the sale, even if the house is less than 5 years old.

When You are Caught for GST:

If you are already registered for GST because the taxable turnover of the business entity that owns the land exceeds $75,000 you cannot avoid the GST. If you develop the property to such an extent that you place buildings on the land you will be subject to GST on the blocks. If you purchased the property with the intention of subdividing right at the start you will also be subject to GST.

Factors that suggest you did not buy the property with the intention of developing it.

1) Whether there is another valid purpose such as rental or farming that was viable at the time and that this was actually carried out.
2) The length of time you own the property.
3) A valid reason for changing the use of the land ie being too ill to continue to farm it.
4) Attempts to sell the land undeveloped that had failed.
5) The owner of the property is not a developer, real estate agent or builder by occupation.

GST will always apply if you build on the land to sell. MT 2006/1 at paragraphs 273 to 276 gives an example where a taxpayer buys a waterfront property to build a duplex and live in one side and sell the other. GST applied. In paragraph 284 to 287 a couple who demolish their home split the land in half and build two new homes to sell are subject to GST. In paragraph 294 to 296 a subdivision of 9 lots, without buildings and utilising an existing road was not subject to GST.

The area of uncertainty is when you subdivide land into vacant lots, that has been used as part of your farm, home or rental property. The subdivision of such properties can be considered the mere realisation of an asset (not subject to GST) by presenting it for sale under the best possible circumstances rather than be in a business that is subject to GST. If you are personally registered for GST in a completely different business and you are subdividing land unconnected with the business you may still not have to charge GST if you can fit within the following

It is all about how business like the subdivision is. For example GST would not apply to a cutting in half of a 2.5 hectare block because the owners, who live there, are having trouble maintaining it. They continue to live in the house and just sold off the vacant land. The only thing they needed to do was apply to council, no physical changes needed to happen to the land. On the other end of the scale GST would apply to the subdivision of a 500 hectare property, on which the owner was not living, into over 30 lots where roads and services are a major work done in a business like fashion.

MT 2006/1 relies on established case law to determine when a development would be caught as a business for income tax purposes. So the points made back under the heading of Are You Merely Realising An Asset apply. The following factors are relevant in considering if you have crossed the line to being a business. Though several of these elements are usually necessary to be considered a business

As per MT 2006/1 paragraph 265 –

1) There is a change of purpose for which the land is held (ie you move off the land to subdivide rather than just subdivide part of it)
2) Additional land is acquired to be added to the original parcel of land
3) The land is bought into account as a business asset
4) There is a coherent plan for the subdivision of the land
5) There is a business organisation – for example a manager, office and letterhead

6) Funds are borrowed to finance the acquisition or subdivision
7) Interest on loans claimed as a business expense
8) The land is developed beyond what was necessary to secure Council approval for the subdivision, and
9) Buildings are erected on the land (fatal)

Other Factors from Income tax law that point to the business of property development

1) The significance of the development costs compared with the value of the undeveloped land and the more money borrowed to finance the development the more likely it is to be a business.
2) The size of the development.
3) How involved the land owner is in the process, so don't give up your day job.
4) The more stages to the development the more it will appear to be a business. This can be countered by developing on the basis of need to repay debt or finance living expenses.
5) The amount of works required for the land to be subdivided. To this end it may be more advantageous to pay a contribution to council to put in kerb and channelling rather than undertake the work yourself. Or pay a developer to take responsibility for all of the works.

In paragraphs 297 to 302 of MT 2006/1 a 13 lot subdivision the first time and then a further 2 subdivisions were still not subject to GST because of the unprofessional process, the fact the owners continued to live on 70% of the land and the minimal works.

GST and New or Substantially Renovated Houses

The first sale of a new house is always subject to GST if the seller is registered for GST. If the house was built with the intention of resale at a profit then the seller must be registered for GST as the sale is part of the business turnover and that would be more than $75,000. If it was built to live in or rent out the seller would not be required to be registered for GST so when it is sold GST does not apply simply because the seller is not registered.

No GST on sale means no input credit for building costs. Even if the house hasn't been finished for 12 months at the time of sale you will still qualify for the 50% CGT discount on the profit on sale if you have held the land for more than 12 months. All this is only if you built the house for the purpose of rental not resale at a profit. Section 40-65 states even if new residential premises are rented for a period prior to the sale the first sale will still be a taxable supply. Section 40-75 states that premises are not new if they have been used as residential premises for at least 5 years.

Note if you are builder you will have two things working against you. Firstly, it will be hard to argue that you did not build it for resale refer Case R51 84 ATC 392 where a builder was found to have built a block of flats with the intention to profit on their resale. Even though the flats were not sold until 6 years after they were built. Secondly you own the property in your own name and are in business as a sole trader you are probably already registered for GST, the only way the sale could be excluded from the GST provisions is to argue that it was not purchased in the furtherance of your business. This would be impossible if you have been claiming input credits on the building costs.

Now if you did not build the house for resale at a profit and are not registered or required to be registered for GST you can sell the house without any GST concerns. If you build the house for resale at a profit you are required to be registered for GST. If you did not build for resale at a profit but you are registered for GST and the sale of the property is part of your enterprise even if it is not part of your enterprise's normal turnover, you will have to rent the property out for 5 continuous years or pay GST on $1/11^{th}$ of the sale price (less if margin scheme applies). Continuity of the 5 years is not broken by short periods between tenants GSTR 2003/3.

Note if you substantially renovate a property it may be treated as a new property.

If you are caught for GST and have used the property partly for rental and partly for resale at a profit you will be entitled to claim back most of the input credits on the cost of the property but you are subject to GST on the proceeds of the sale. The margin scheme can help here refer below. In the Property and Construction Industry Partnership Issues Register item number 4 the ATO has agreed to pro rata the input credits on the

basis of income received. The formula for apportioning input credits between the taxable supply of the home and the input taxed supply of rental accommodation is as follows:

$$\frac{\text{Consideration for the taxable supply of the premises}}{\text{Consideration for the taxable supply of the premises plus rental income}}$$

GST and Sale of Properties Held for Rental

Even holding domestic rental properties is considered an enterprise and qualifies for an ABN but normally landlords don't bother as they are not required to charge GST on rent on residential properties. So even if their turnover is more than $75,000 it is not for supplies to which GST applies to so they are not required to be registered. The eventual sale of the rental property will generate more than $75,000 but this is not included as part of the $75,000 normal turnover unless you are in the business of selling rental properties. So if you are just a normal investor in domestic rental properties your turnover of GST supplies in the course of your business is never likely to exceed $75,000. The mere realisation of an investment does not amount to an enterprise in its own right.

Even though the sale of the property is for more than $75,000 it is not part of your turnover so will not force you to be registered for GST. If you are not registered for GST, you will not have to remit GST on the sale of a rental property. If you are registered for GST the sale of a domestic rental property will still not be subject to GST providing it is not considered the sale of a new home. Refer above.

Landlords are required to charge GST on rent for commercial premises if they are registered for GST. They are required to be registered for GST if their commercial rents for the year exceed $75,000. Now the $75,000 is in turnover so it doesn't include the sale of capital assets but if you are registered for GST when you sell a commercial property you are required to remit 1/11th of the selling price in GST (subject to the margin scheme).

GST Margin Scheme

Basics:

- The margin scheme can only be used with a house and land or land. If the seller is registered for GST the margin scheme can only be used where the property was owned pre 30th June 2000 or purchased under the margin scheme. Or if the seller, who is registered for GST purchased the property from someone who was not registered for GST
- The margin is the amount of the selling price on which GST is calculated.
- The purchaser of a property under the margin scheme cannot claim any GST input credits back on the purchase price. But if they are registered for GST they can claim GST input credits for further expenditure on the property.
- On 17th March 2005 a bill was introduced to Parliament that will require a written agreement signed by both parties on or before settlement for the sale to be subject the margin scheme.

Property Purchased After 30th June 2000:

- If you are selling a property you purchased after 30th June 2000 and the price you paid was calculated under the margin scheme section 75-5 allows you to only charge GST on the difference between the selling price and the cost to you of the asset that was measured under the margin scheme. Note any improvements to the asset after purchase do not reduce the margin. For example a GST registered developer buys land for $66,000 from someone who is not registered for GST. The developer spends $100,000 (after claiming back input credits) putting a building on the land and sells the property for

$200,000. If the GST on the sale is calculated under the margin scheme it will be 1/11th of $134,000 ($200,000 - $66,000). On 17th March 2005 a bill was introduced to Parliament to make it clear the margin must include the cost of improvements and to stop abuses of this area.

- Note there is one dubious exception to the above ID 2002/30 states that the price you paid for the property, as calculated under section 75-10 (i.e. the portion that is not subject to GST when you sell) includes any adjustments for land tax or council rates you may have paid at settlement. But ID 2002/31 states that this does not include legal fees.
- You cannot use the market value to set the cost under the margin scheme if you purchased the property after 30th June 2000. This is the case even if you did not register for GST until after the purchase

Property Purchased Before 30th June, 2000:

- If you owned a property before 30th June, 2000 you need to set the amount that is not subject to the margin scheme. This is the value of it at 30th June, 2000 or when you first became registered for GST, whichever is the latter.
- GSTR 2000/21 details how to set the value as at 30th June, 2000 or when you first became registered but note this is only for property held before 30th June, 2000.
- If the property is fully complete the value can be set by a qualified valuer or the amount set by the government for land tax or council rates purposes.
- If the property is being developed at the time you require the valuation you can use a value set by a qualified valuer or use the cost of completion method.
- The cost of completion method determines what percentage of the total costs the costs that have been incorporated into the project at the date of valuation are. It is this percentage of the selling price that is not subject to GST. Note this method can only be used if the property is sold before 1st July, 2005 and owned by you before 1st July, 2000.

Summary

1) If you buy with the intention to resell at a profit normal income tax and GST apply
2) If you are merely realising an asset purchased for investment or private use CGT applies to the sale
3) Business premises or farms may be able to keep the whole transaction tax free by using the active asset concessions. This involves careful planning before you even start.

Don't do it Again

If you have got through the above and feel you can satisfy the ATO that you are merely realising an asset rather than a business, don't do it again. The ATO has the benefit of hindsight and may say that because you did it a second time you always intended to develop property and that was really your intention in the first place. Or at least wait 4 years from the last tax return involving the first development so the ATO can't come back and amend it but don't expect to get away with it for the second property. At least if you wait the 4 years you have nothing to lose.

Definition of Substantial Renovations

If you are registered for GST and sell a new house or substantially renovated house for the first time you must charge GST. If you did not acquire the house with the intention of reselling it at a profit (ie you acquired it as a rental or to live in) the sale of the house is not part of your normal business turnover so it will not force you to register for GST if you aren't already.

There is a concession, in that if you continuously rent out a property for more than 5 years and then sell it as the first sale of a new or substantially renovated property you do not have to charge GST even if you are registered. In the case of a renovated property the 5 years starts from the last substantial renovation.

People who buy a property with the intention of doing it up and selling it, are considered in business so, if their turnover of sales subject to GST is more than $75,000 they will be forced to register. This is where it is particularly important to know what a substantial renovation is. If it is a substantial renovation and you

bought it with the intention of reselling it at a profit then the sale of the house is part of your normal turnover so you will have to register for GST and charge GST on that sale. But if the next property you renovate is not substantially renovated, even though you are already registered you will not have to charge GST because it is not considered the sale of a new or substantially renovated home, so it is input taxed. This means you cannot claim input credits on the costs associated with it and do not have to charge GST.

If you did not buy the property with the intention of resale at a profit and you are not registered for GST then you do not have to worry about this no matter how substantial your renovations to the house are.

If you renovate properties for profit it is important you understand exactly what a substantial renovation is. GSTR 2003/3 states that a substantial renovation does not have to be structural but it needs to substantially affect the house, so just about every area of the house must be affected. Of course this could simply be the case if you painted it inside and out. But painting is only cosmetic so cannot in itself be a substantial renovation. It is a question of whether a substantial part of the house has been removed or replaced. It gives as an example of a renovation that is not substantial, the removal and replacement of a kitchen and bathroom as well as repainting the whole house.

Replacing the floor boards, electrical wiring or plumbing in a property is dangerous because it usually affects every room in the house and is not merely cosmetic. Moving or replacing walls can have the same effect but only if enough walls are changed that most of the rooms in the house are affected. A combination of various forms of non cosmetic changes that combined, manage to affect every room in the house will be a substantial renovation. Cosmetic work such as painting, sanding floors, changing fittings, curtains and carpet do not in themselves amount to substantial renovations even if they affect every room. Further, cosmetic changes to every room and substantial changes to only a few of the rooms will not amount to substantial renovations because the cosmetic changes are disregarded in considering if all the rooms are affected.

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. **Note** that if the properties are strata planned section 118-142 may allow rollover relief.

Real Estate Development Tax Table

The following table is intended to give the reader, at glance, an idea of the tax consequences of developing Real Estate.

Situation	CGT 50% Disc After 12mths	GST Applies Unless Rental For >5years	GST Applies	Normal Income
Buy with the Intention of Selling for Profit (if this applies go no further)			x	x
Buy as a domestic rental and no real changes	x			
Buy as a domestic rental and add 2 rooms	x			
Buy as domestic rental but do substantial reno	x	x		
Buy Land & Build Domestic Rental (Not GST Reg)	x			
Buy Land & Build Domestic Rental (GST Registered)	x	x		
Rental then small Sub & sell blocks (Not GST Reg)	x			
Rental then small Subdivision & sell blocks (GST Reg)	x		x	
Buy as Rental later Subdivide & Build houses to rent	x	x		

Buy as Rental later Subdivide & Build Houses to sell	x	x	x
Rental later large Business like Subdivision sell blocks	x	x	x

Where both CGT 50% discount and normal income apply the CGT discount only applies to the gain up until the time of the change of use.

Warning to Developers Using the Margin Scheme

In Brady King Pty. Ltd. vs Commissioner of Taxation the ATO won more than it wanted to. The question before the court was could a property where the contract to purchase it was entered into before 1st July, 2000 (the introduction of GST) but not settled on until after that date utilise the valuation method under the margin scheme. The workings of the margin scheme are fully covered in our How not to be a Developer booklet.

Brady King P/L used the property, an old office building, to construct apartments under a strata plan title. The court found that because the identity of the property had changed since the original purchase (from a normal title to strata title) the margin scheme was not available to the developer.

This could have far reaching affects in that all developers of strata plan units will not be able to use the margin scheme. Of course the developers are not going to absorb these costs so it will be the over stretched first home owner market that will bear the brunt of this little win fall for the ATO.

In fairness to the ATO they didn't want this wide an outcome either and they are hoping Brady King Pty. Ltd. will appeal the decision.

Margin Scheme and Developers

For those that have been following the Brady King Case, concerned that every strata plan and subdivision will no longer be able to use the margin scheme you will be as relieved as the ATO that the taxpayer has decided to appeal. The decision, it is still up to the courts to decide but it seems if the court again goes so far as to say that the margin scheme cannot be used when the title has changed then the ATO may ask the government to change the law to allow developers to use the margin scheme.

CGT Rollover Relief When Building a Strata Plan

If you build a duplex or block of units with a business partner you will effectively own all the properties together under the same legal title as you did the original land. This can create a CGT nightmare if you want to own your units individually.

For example you and a friend find a nice block of land that is far too expensive for either of you. But it is large enough to be approved by Council for a duplex development. So you agree to buy the land together build a duplex and then take one each. The trouble is once the duplex is built you will still technically own half of each other's unit just as you had owned half of the land and if you simply subdivided the land and changed the title to sole ownership you would create a CGT event in that you would be deemed to have sold each other at market value half of their unit. On the other hand if you split the duplex under a strata plan you would be entitled to use the rollover relief available under section 118-42 so that no CGT would be payable.

Section 118-42 does not discuss these particular circumstances in fact it is very basic, as follows:

If:

a) You own land on which there is a building and
b) You subdivide the building into stratum units and
c) You transfer each unit to the entity who had the right to occupy it just before the subdivision

A capital gain or capital loss you make from transferring the unit is disregarded.

To your advantage is the fact PBR 17485 specifically discusses duplex and claims that section 118-42 can be used in these circumstances.

Note that PBRs are not binding on the ATO so if you want to be sure you should apply for your own ruling quoting PBR 17485

Budget GST Measure for Developers

The budget included a warning that GST law would be tightened to reduce the tax benefits of combining the going concern or non taxable supply exemptions with the margin scheme. This should not take affect until the new law receives royal accent, so there is a bit of time yet. But when it does become law it is important that developers realise if they purchase land from someone who is registered for GST but the sale is not subject to GST they need to find out the original price paid by the vendor because this will be the new purchaser's base for the purposes of the margin scheme.

For those not familiar with the workings of the margin scheme, it is intended to prevent the ATO from collecting tax on a profit that was exempt from GST in the hands of the previous owner. So if for example a developer purchased a property from someone not registered for GST for $100,000 and then sold it for $150,000 GST would only be payable on the margin of $50,000.

This will limit the use of the margin scheme where the developer purchased the property from someone who was registered for GST but GST did not apply to the contract either because it was a non taxable supply or the supply of a going concern. In these cases the base figure for the margin scheme would not actually be the developer's purchase price but the purchase price of the owner before that. That is the developer would have to pay the GST on the profit made by the person selling them the property but strangest of all this would require the vendor to inform the purchaser of the price they originally paid for the property. This means that the margin ie the portion of the developers selling price that would be subject to GST, is the difference between the developer's selling price and the cost price of the property to the person the developer purchased the property from.

Renovating or Building and Living There Before Selling

I hear over and over again from people in the property market how they are building or renovating homes then living there to apply their main residence exemption before selling and moving onto the next project. I am usually asked how long do I have to live there to cover it with my main residence exemption. They are usually shocked with the answer that it does not matter how long you stay there you are never going to get your main residence exemption on the property.

TD 92/135 states that if a property is built or renovated with a profit making intention the main residence exemption cannot apply. This is because the main residence exemption only applies to profits that are subject to CGT and CGT only applies if normal income tax does not. In the case of building or renovation with a profit motive (rather than as a rental property or private home) the profit would be caught as normal income. Note there are also GST ramifications which are discussed further in this How not to be a Developer booklet.

The example given in the ruling is:

A builder constructs a spec home in which he and his family reside while construction proceeds on another spec home. Any profit on sale which gives rise to income is fully assessable to the builder even if a principal residence exemption is available for CGT purposes.

CGT Rollover Relief When Building a Strata Plan

If you build a duplex or block of units with a business partner you will effectively own all the properties together under the same legal title as you did the original land. This can create a CGT nightmare if you want to own your units individually.

For example you and a friend find a nice block of land that is far too expensive for either of you. But it is large enough to be approved by Council for a duplex development. So you agree to buy the land together build a duplex and then take one each. The trouble is once the duplex is built you will still technically own half of each other's unit just as you had owned half of the land and if you simply subdivided the land and changed the title to sole ownership you would create a CGT event in that you would be deemed to have sold each other at market value half of their unit. On the other hand if you split the duplex under a strata plan you would be entitled to use the rollover relief available under section 118-42 so that no CGT would be payable.

Section 118-42 does not discuss these particular circumstances in fact it is very basic, as follows:

If:

d) You own land on which there is a building and

e) You subdivide the building into stratum units and

f) You transfer each unit to the entity who had the right to occupy it just before the subdivision

A capital gain or capital loss you make from transferring the unit is disregarded.

To your advantage is the fact PBR 17485 specifically discusses duplex and claims that section 118-42 can be used in these circumstances.

Note that PBRs are not binding on the ATO so if you want to be sure you should apply for your own ruling quoting PBR 17485

Budget GST Measure for Developers

The budget included a warning that GST law would be tightened to reduce the tax benefits of combining the going concern or non taxable supply exemptions with the margin scheme. This should not take affect until the new law receives royal accent, so there is a bit of time yet. But when it does become law it is important that developers realise if they purchase land from someone who is registered for GST but the sale is not subject to GST they need to find out the original price paid by the vendor because this will be the new purchaser's base for the purposes of the margin scheme.

For those not familiar with the workings of the margin scheme, it is intended to prevent the ATO from collecting tax on a profit that was exempt from GST in the hands of the previous owner. So if for example a developer purchased a property from someone not registered for GST for $100,000 and then sold it for $150,000 GST would only be payable on the margin of $50,000.

This will limit the use of the margin scheme where the developer purchased the property from someone who was registered for GST but GST did not apply to the contract either because it was a non taxable supply or the supply of a going concern. In these cases the base figure for the margin scheme would not actually be the developer's purchase price but the purchase price of the owner before that. That is the developer would have to pay the GST on the profit made by the person selling them the property but strangest of all this would require the vendor to inform the purchaser of the price they originally paid for the property. This means that the margin ie the portion of the developers selling price that would be subject to GST, is the difference between the developer's selling price and the cost price of the property to the person the developer purchased the property from.

Best Question of the Property Expo

No it is not the easiest question but the one that made me think outside the square, a bit of a challenge. This one goes to the person who owned a property they intend to subdivide, keeping the current house intact on a smaller block.

The property is owned in the name of a trust to maximise the tax benefits when distributing the profits from the subdivision. The trouble is they have moved into the original house. As the property is in the name of the trust it cannot qualify for their main residence exemption and once the development is finished it will realise a considerable capital gain on the cost base left after apportioning the original cost base amongst all the subdivided blocks.

So the problem is how to transfer their main residence exemption to the original house now while it is still owned by the trust. A CGT event B1 is the answer. B1 states that if there is a contract between two parties that the property will eventually transfer to the occupant at some future date then the CGT event is deemed to have happened at the date of entering into that agreement so the purchaser's main residence exemption can be covering the property from the date of the agreement rather than the date of settlement, which will be much later when the blocks are subdivided.

Renting Out a House You Built to Sell

There has been much written about this in Newsflash and our How Not To Be A Developer booklet. Basically if you are registered for GST and build a house for resale but then change the purpose by renting the house out you have to pay back the input tax credits on the property. You see a property held for rental is input taxed so no GST credits are available on the cost of building it. If you have been claiming them because

you intended to sell the property so will have to charge GST on the sale, then later change your mind or can't sell it. Then using it as a rental property will mean quite a large amount of GST has to be paid back.

Now I imagine you are starting to think that it is not as black and white as that. You may not have changed the purpose at all it is just logical to collect rent for the property while the market is slow. I imagine there were some developers caught between a rock and a hard place. They can't possibly afford to pay back the GST but could really benefit by receiving some rent to help meet the overdraft.

ID 2008/114 examines purpose beyond the current use and recognises a property can still be held for resale while it is rented. The following paragraph from the ID gives a clear guideline as to what would be considered holding a property for resale:

> Determining whether or not new residential premises have been actively marketed for sale will require consideration of all the relevant facts and circumstances. Although no single factor by itself is conclusive, the active marketing of new residential premises for sale may encompass activities such as listing the property for sale with a real estate agent or agents, advertising the premises for sale in relevant publications or via Internet advertising websites for real property, arranging 'open for inspection' times and/or showing prospective buyers through the premises. In the case of stratum units, actual arm's length sales of some of the listed units would be further evidence of active marketing. Listing premises for sale at a price that is significantly above market value may be an indicator that the premises are not being actively marketed for sale.

ID 2008/114 is only an interpretive decision so you cannot hold the ATO to its content unless you are the applicant. Accordingly, if you want to use this interpretation to your advantage you should apply to the ATO for you own ruling quoting ID 2008/114 as a precedent.

By the way you do not have to pay the GST back immediately, even if you are caught. You are only required to consider this issue once a year, when preparing your BAS for 30th June. You do not even have to consider an adjustment to the GST at the first 30th June after the original input credit has been claimed it is not until a full 12 months after the first 30th June that an adjustment must be made. Now if the property has at anytime been used for a rental then some adjustment needs to be made. But it may only be minor. Certainly if the property has now become a rental and it does not meet the available for sale status discussed above then you need to pay back all the GST. On the other hand with a property still available for sale, you only need to pay back a small portion of the GST. This portion is calculated by adding the estimated rent you expect to receive to the expected sale price then look at what percentage the rent is of this. This is the percentage of the GST credits you have to pay back. Yes, very vague but each 30th June you will have to re work this calculation until you sell it (assuming it is sold within 5 years) so eventually the right amount will filter through.

Interestingly the ATO has recently issued a warning to property owners or developers who are registered for GST that their June BAS should have included an adjustment if they are now renting the property out. The warning goes on to encourage readers to fess up and correct their BAS now before they are found out in an audit were the penalty could be as much as 90% of the tax not paid.

GST and Vacant Land

The ATO issued an Addendum to GSTR 2003/3 pointing out that the exemption from GST on domestic properties that are not brand new does not apply to the sale of land cut off from such a property.
Even if you are registered for GST you do not have to charge GST on the sale of a house if it is not the first time it has been sold as a residential property. Note if you undertake substantial renovations that affect every room in the house then the next sale of the house will be subject to GST because it is considered new again.

In order to qualify for the concession the house and land have to have been sold previously as a package. Vacant land can never qualify for the concession. This is the case even if there was once a house on the land or the block has been cut off from a house and land. Relocating a home onto land and selling it will still be considered the first sale of the house because it is the first time that piece of land and that house have been sold together.

If you buy a house and land, move the house to one side and subdivide the land GST is not applicable to the sale of the house side because that land and house have previously been sold together but of course GST will apply to the separate sale of the vacant land. On the other hand if you add land to an existing house and

land package you will have to charge GST on the sale of that part of the land because that land had never been sold with that house before.

Note if you are not registered for GST and you are not selling the land as part of your actual business activity then even though the sale maybe for more than $75,000 you are not required to register for GST. The $75,000 threshold, at which you are required to register for GST, only includes turnover that is subject to GST from normal business operations, even domestic rents are not included in this threshold because they are not subject to GST.

For more detail go to our GST Booklet available under the freebies section of our website.

Demolishing a Rental Could Expose it to GST

Before you go picking up that sledge hammer thinking you will get more for your rental property as vacant land have a read of ID 2009/20 and ID 2009/19.

In these examples the owners of both these rental properties were registered for GST because they did some development and held some properties simply as rentals.

Subsection 9-30(4) of the GST Act states:

> A supply is taken to be a supply that is input taxed if it is a supply of anything (other than new residential premises) that you have used solely in connection with your supplies that are input taxed but are not financial supplies.

Input taxed means you do not have to remit GST on the income you receive. One property had a demountable home on it which the owner sold off separately and the purchaser of the demountable home was required to remove the house at their own cost. In this case the ATO considered that the property had at all times been used solely as a domestic rental and was input taxed so the sale of the vacant land was not subject to GST.

In the other example the owners decided to demolish the property themselves. The ATO considered this to be using the property other than for input taxed supplies so GST applied to the sale of the vacant land.

Of course if they simply left the house on the land, GST would not apply either because it only applies to the first sale of residential property and then only if it has not been used as a rental for a continuous period of more than 5 years. Removing the house changed it from residential property to simply vacant land.

GST and Transferring Property to a Partnership

GSTR 2009/1 deals with the GST consequences of transferring a property into a business partnership or transferring it out. Examples of this would be a group of neighbours coming together to develop their blocks into units or a warehouse owner joining with others in a business venture that will use the warehouse as a place of business. Note it is not automatic that the property is transferred into the partnership. It is all up to the wording of the partnership agreement. Partners can own property used in the partnership without having to transfer it into a partnership. In fact at law a partnership cannot own property anyway and it would simply be held in trust for the partners by whoever is on the deed.

The trouble starts because GST unlike other laws considers a partnership to be a separate legal entity from its partners. This means that the transfer of property in or out of a partnership can be a supply that is subject to GST if the transferer is registered or required to be registered for GST. If the property was not used in an enterprise, ie. was your home or was solely used for input tax purposes such as a domestic rental then GST will not apply to the transfer to the partnership. Nor will it apply if the transferer is not registered for GST and the property is not considered part of the normal business turnover of the owner. So in most cases, the transfer to the partnership will not be subject to GST, so later when the partnership sells the property or units developed on the property the margin scheme can be used to calculate the GST payable. This will mean that GST will only apply to the difference between the market value at the time of the transfer to the partnership

and the selling price by the partnership. Apportionment of the market value of the land over each unit would be necessary in the case of a unit development.

The owner of the warehouse may already be registered for GST because he or she is charging commercial rent. So if the warehouse is transferred to the partnership, GST will have to be charged but the margin scheme can be used on this end of the transaction if the warehouse owner did not receive an input credit when he or she purchased the warehouse. If the margin scheme is used then the partnership will not be entitled to claim the GST back as an input credit but can use the margin scheme when it sells the property. On the other hand if the margin scheme is not used when the partner transfers the property to the partnership, the partnership will have to remit 1/11th of the full selling price to the ATO as GST if it ever sells the warehouse as it will not qualify to use the margin scheme but it would have been entitled to claim the GST input credit on the transfer from the partner. The outcome is much better if the margin scheme is used all the way through as this means GST is never payable on the original cost of the property to the owner but if the warehouse is going to be held for a long time the partnership may prefer not to use the margin scheme so that it can get all the GST back on the transfer and worry about the GST on the sale if and when it happens.

Now if on the dissolution of the partnership a partner chooses to take the property back this is also a supply to which GST could apply at the market value.

Note to use the margin scheme there must be a written agreement between the parties before the transfer.

GST When You Sell a House You Built as a Rental

The following section references are provided to assist readers whose accountants are advising them that they must pay GST if they sell a rental property less than 5 years after they build it.

If you are not already registered for GST you are not required to do so just because you choose to sell a property you built with the intention of holding as a rental. Section 23-5 states that if the annual turnover of supplies you make in the normal course of your enterprise, exceed $75,000 you must register for GST. Section 185-25 excludes from the calculation of annual turnover the supply of a capital asset. Building the property for rental then selling, is the supply of a capital asset and not included in the annual turnover. Section 118-15 excludes from annual turnover input taxed supplies so any domestic rent received is not included in annual turnover.

Developers who hold to Rent

GSTR 2009/4, in a very timely fashion addresses the GST considerations when you build a property to sell but due to poor market conditions decide to rent it out for a while.

The problem is that during the construction period you would have claimed all the input credits back. If a property is used to produce domestic rental income then you are not entitled to claim the GST back on the costs of its construction.

Don't panic, you do not have to pay the GST back straight away and you may only have to pay back a very small portion if you continue to list it for sale while you are renting it out. Or intend only renting it for a short period of time and then putting it back on the market.

You do not have to worry about paying back any input credits until the first adjustment period which is 12 months after the first 30th June after you claimed the GST and you only have to look into invoices for more than $1,000 GST exclusive.

Now if you have taken it off the market completely and decided to keep it as a rental for an indefinite period of time then you will have to pay back the GST. If, instead you are still holding it to sell or will at least put it back on the market in the near future then you can use the following formula to determine how much the GST you are entitled to keep.

$$\frac{\textbf{Selling Price}}{\textbf{Selling Price Plus Rent Received}}$$

So if the selling price is 950,000 and the rent received is $50,000 then you are entitled to still keep 95/100ths or 95% of the GST so only 95% needs to be paid back. Note the selling price used has to be what you could sell it for in the current market.

If you are living in the property while you are waiting to sell it you can substitute market rent in the above formula. Adjustments do not need to be applied to costs associated solely with selling the property such as advertising it for sale.

Developers - When Can a House go From Being Taxable on Revenue Account to Qualifying for the CGT Discount?

If you have built a house for resale at a profit but have now decided to keep it as a rental you maybe very interested in PBR 90780 which recognises that you can actually change the status of the house from trading stock to investment. This means that the profit on sale could qualify for the 50% CGT discount.

There are also GST consequences of this change of purpose. These were covered in Newsflash 191.

If you change the purpose of holding the property from sale to investment you are deemed to have sold it and then re purchased the property at its cost, thus transferring the profit across to a capital gain. Note you can elect to transfer the property at its market value instead. This may be necessary if it cost you more to build it than it is now worth. From that point onwards CGT will apply and the 50% discount if you have held the property for more than 12 months since you purchased the land.

PBR 90780 even gives you the option of, after changing it from trading stock to an investment, changing it back to trading stock by the same method. This will also mean you are entitled to some of the GST back but probably not all of it because some of the adjustment periods may have passed.

Another interesting point that stems from this PBR is that the tenant is actually a director of the company that owns the property. The ruling points out that while the interest etc will be tax deductible it will only be up to the amount of rent received. Any remaining amount is to be included in the cost base for CGT purposes. In other words interposing the company will not allow the director to negatively gear his or her own home.

Caution here, this is a private ruling only binding for the person who applied and once again the ATO has answered a particular question but not addressed the possibility of whether they would apply Part IVA (scheme with the dominant purpose of a tax benefit).

GST When You Sell a House You Built as a Rental

The following section references are provided to assist readers whose accountants are advising them that they must pay GST if they sell a rental property less than 5 years after they build it.

If you are not already registered for GST you are not required to do so just because you choose to sell a property you built with the intention of holding as a rental. Section 23-5 states that if the annual turnover of supplies you make in the normal course of your enterprise, exceed $75,000 you must register for GST. Section 185-25 excludes from the calculation of annual turnover the supply of a capital asset. Building the property for rental then selling, is the supply of a capital asset and not included in the annual turnover. Section 188-15 excludes from annual turnover input taxed supplies so any domestic rent received is not included in annual turnover.

Subdividing the Farm

Section 38-475 of the GST Act is intended to allow farmers to subdivide and transfer part of their farm to another associated entity to develop it into residential blocks without any GST being payable on the transfer. One of the conditions of this section is that “the land is subdivided from land on which a farming business has been carried on for at least 5 years”.

That is an exact quote from the legislation. Now what do you think that means in regard to when the farming must finish? I would have thought “has been carried on” means if you had used it as farming land for 5 years at some time during the time you owned it then you were in. But not so according to the ATO in ID 2009/131 where they claim that had the legislator intended a property that was no longer used as a farm to qualify, then the legislation would have said ‘was carried on’.

Now there are a few of flaws in my mind, with this argument.

1) The legislator would not have used the words 'was carried on' because the ATO would them have tried to argue that if farming continued in anyway on any of the land then the transaction did not qualify.
2) To say that the legislator intended the property to be used as a farm right up to the point of subdivision creates an almost impossible situation for the farmer so no one could qualify to use this section.
3) If the legislator had a problem with there being a gap between the farming period and the development period they would have set a limit as to how wide this gap would be.

Nevertheless we are stuck with this ridiculous interpretation so if you intend using this concession I suggest you get your surveyors some gumboots for Christmas.

Probably a more workable solution, if you purchased the property before GST, would be to reduce the farm turnover to the stage where you could deregister for GST anyway.

Before even considering transferring the property to an associated entity think this through as there are many GST and income tax concession that would be available to the original owner of the farm that would not be available to the associated entity.

The Margin Scheme When You Develop a Block Where You Didn't Claim Back the GST on Its Purchase

If you are considering developing a block of land to an extent that you are considered to be in business (Refer our How not to be a Developer booklet) then if you haven't claimed GST back on the original purchase of the land, you need to understand the margin scheme.

GST is 1/11th of the price you sell the property for, you will get an input credit for any GST you pay on you development costs. The trap is if you didn't pay GST on a council fee or employed a tradesperson who was not registered for GST you will have to charge GST on the effective value they add to the property even though you did not qualify for an input credit on that cost. So you may sell a property for $110,000 and have to send $10,000 off to the ATO this leaves you $100,000. If you have spent $60,000 on bringing the property into existence for sale but there was $5,000 in costs to which GST did not apply then your input credit is only going to be $5,000 (1/11th of $55,000) so the net GST you pay on the project is $5,000 even though your profit is only $45,000: that is the GST ends up being 1/9th of your profit.

Note the margin scheme can only be used if the original purchase was not subject to GST because the seller was not registered or the supply was under the margin scheme originally, the purchase happened before GST was introduced or the purchase was not a supply subject to GST because it was a residential building but not the first sale since construction. The margin scheme does not apply if GST didn't apply to the original purchase due to one of the exemptions such as going concern applying ie the property was actually a GSTable supply but a special exemption was used to avoid charging the GST. The margin scheme can only be used with a house and land or land.

The margin scheme is intended to minimise the GST when the original purchase did not include GST. The margin scheme cannot be used on any development costs even if no GST has been charged. The idea of the margin scheme is to make sure that the GST you pay on the sale is only on the margin between the selling price and the original purchase price of the property, if you did not have the benefit of claiming input credits on the purchase of the land.

If you buy a property under the margin scheme then you are not allowed to claim any GST back on its purchase but you are also entitled to use the margin scheme when you sell so it all comes out in the wash. . A sale that is subject to the margin scheme must have a written agreement signed by both parties on or before settlement for the sale, stating this.

If you purchased the property before GST was introduced, which was 1st July 2000 then you are entitled to use the margin scheme when you sell it, even if the latter sale is of a unit or portion of the land (references Section 75-15 GST Act). In these circumstances the margin is the difference between the selling price and the market value at either 1st July 2000 or the date you became registered, whichever is the most recent.

How Tax is Calculated on a Development

For all the background information on this topic refer our How Not To Be A Developer Booklet. This article simply addresses the tax calculation when a property has been held as a home, investment or business premises but is later developed into vacant lots on a large scale or even on a smaller scale when there are homes built on the blocks. In other words when a property changes to being a business' trading stock after being held in a way that would mean CGT would apply to any profit made on sale, if it happened prior to the development.

The profit made from the business venture will be taxed as normal income but there are provisions to ensure you still get the CGT concessions you would have been entitled to if you had sold the property before you developed it into trading stock.

The way the legislation works is basically, if normal income tax applies then CGT doesn't. It is only if you slip through normal income tax that the CGT provisions are considered. This is the reason that if you buy a property with the primary intention of selling it at a profit then living there will not give you any benefit of the main residence exemption.

But what we are looking at here is if you purchased with the intention of holding as a rental, business premises or your home but later changed your mind. Section 70-30 of the 1997 ITAA allows you the choice of taking the original property across to the business of development at its original cost or its market value. You want the value that the property is taken into the business to be the highest possible because it is from this point onwards that it will be taxed as normal income. So if the property has improved in value you would want to take it across at market value. This will trigger CGT event K4 which specifically states at section 104-220(2) that the CGT event happens when you start to hold it in the business, so unless the asset has been completely exempt as your main residence to date, you are going to have to pay some capital gains tax without actually receiving any cash. This may encourage you to want to transfer it at cost instead so the tax on any profit can be delayed until you sell the property. This would be a very costly move because you would be depriving yourself of the 50% CGT discount assuming you have held the property for longer than 12 months, at this stage. If it has been held as business premises not utilising CGT event K4 may deprive you of the small business concessions such as the 50% active asset discount on top of the 50% CGT discount and then rollover relief or exemption up to $500,000 of the balance under the retirement exemption. All this may mean just like the main residence exemption no tax would be payable anyway.

If the property has gone down in value then you would be better off transferring it at cost. Section 118-25, in the case of transferring at costs allows any capital gain or loss to date to be disregarded.

Becoming a Property Developer

If you have a property that you want to develop but until now it has been held as a rental or your own home, there is probably already considerable capital growth. This article explains how this growth is treated for tax purposes.

The first question is why did you buy the property? If it was for the primary purpose of eventually developing it, then you are gone, any gain from that point of purchase forward will be taxable as normal income.

But what about section 70-30 and 70-80 that allows an item to change from trading stock to investment or private use at whim. This is a relative new law so will override our traditional case law on the issue and is worthy of consideration if you had development on your mind at the time of purchase.

Now back to the question at hand what happens when you take a property that was purchased as your home or rental and develop it. There are three possible catagories you could fall into:

Merely Realising an Asset	One off Profit Making Scheme	Serious Development
ie cutting off a few blocks	Business like but small ie specie	ie units, townhouses, complex subdivision
CGT	CGT, GST and Income Tax	CGT, GST and Income tax

A more detailed discussion on this topic is in our how not to be a developer booklet available under freebees on our web site.

If you are merely realising an asset that was once a rental then the tax treatment doesn't change but if this property was also entitled to your main residence exemption then you need to be careful to preserve it. You

would only be entitled to cover one of the properties with your main residence exemption and then only if it is sold with a dwelling on it.

One off profit making scheme. This is when you are considered to have changed the purpose for which you have held the asset but the development is not so business like that you produce trading stock. In this case you rely on the Whitford Beach case of 1982 which divides the eventual profit into capital gains and revenue in a very complicated formula that nevertheless manages to protect your gain up until development from normal income tax. The trap here is it may not protect your main residence exemption if the property is not sold with a dwelling on it.

Serious development is where your property becomes trading stock. The outcome here is clearly defined in section 70-30. You can introduce it to the business at cost but that is only a good outcome if it is now worth less than you paid for it. Instead you trigger CGT event K4 which deems you to have disposed of it at market value and the business to have purchased it at market value so from that point onwards any gain is taxed as normal income but the K4 event will mean that any gain to date is taxed under the CGT provisions whether it be the 50% discount or your main residence exemption. The trap here is you have to pay your CGT in the year you start the development even though you have not sold anything, so it may be difficult to find the cash. Nevertheless, it maybe safer to argue that your development amounts to trading stock and utilise section 70-30 because your rights are clearly defined in legislation as opposed to relying on Whitfords Beach case which was heard before the changes were made to section 70-30.

From Property Development to Investment Property

Section 70-110 of the 1997 ITAA states that you can stop holding a block of land or building as trading stock and start to hold it as a rental property or for private use even though your original intention when purchasing the block was to develop it.

Until this section was included in the legislation, an item of trading stock was always considered trading stock no matter how long you held it, its character could never change. There are so many precedents still around that back date to before this legislation that many people don't realize it is no longer the case.

All you have to do is simply stop holding it as trading stock and it will be considered to have been acquired by you at that time for its cost. There is a ruling about the GST consequences of a partnership making a supply to its partners but that would be the case if the name on the title was changing. In the case of a partnership between husband and wife who where then going to hold the property together as a rental, all that would be happening is a change of purpose not a change of ownership. The change of purpose will mean GST credits would have to be paid back. Deregistering for GST would also trigger the same paying back of GST credits (section 138). Though it only applies to GST on invoices exceeding $1,000. Invoices exceeding $1,000 will have to have their GST paid back if their adjustment periods have not expired. Invoices for $1,001 to $5,000 have two adjustment periods. So their adjustment period does not expire until two years after the first 30th June after the BAS in which the GST was claimed. Invoices for $5,001 to $499,999 have 5 adjustment periods. Of course the amount of GST you pay back will increase the cost base of the lots to you because the cost currently recorded in the accounts would be the net of GST amount.

Scrapping When You Demolish the Whole House

In ID 2010/35 the taxpayer demolished a house that still had some building depreciation left to claim. Generally when an item included in building depreciation is destroyed a full and immediate deduction can be claimed for any remaining unclaimed building depreciation on the original cost of the item.

It gets a bit messy when the whole house is demolished, because, for starters, there wouldn't have been a tenant in the residences at the time, so is it a rental when it is destroyed?

The interpretive decision states that section 43-40(1)(c) can only be satisfied if no entity has used the house for any purpose since it was last used by the taxpayer for the purpose of producing income. Unfortunately for the taxpayer in ID 2010/35 he or she moved into the house just before it was demolished in order to clear it out and organise the demolition so absolutely none of the remaining unclaimed building depreciation was claimable even though it had been a rental before the taxpayer started using it for private purposes.

GST and Transferring Land Between Co Owners

The catch when you subdivide land, build a duplex or townhouses with a business partner is that, assuming you jointly owned the original property, then all of the lots or units are going to be jointly owned by you both. If you transfer the titles around so that you each own particular properties individually, then you are making a supply to each other and this may well be subject to GST.

The first question is whether the activity is an enterprise and then whether you are in partnership or merely co owners of the property. In technical terms the word partnership in this article and in the relevant ruling GSTR 2009/2 refers to a general law partnership which is a business enterprise. Co owners is referring to something less, i.e. not a profit making motive from selling the property. A non profit making motive, from selling, would be when two people buy and develop so they can have a home or rental property each.

If you are in a general law partnership it is the partnership that is supplying the whole property to you not just the other partner's share. So GST would be payable on the whole value of the property (possibly reduced by the margin scheme). Mere co owners of property would only have to pay GST on the fraction of the property transferred and that is only if they are required to be registered for GST which quite often would not be the case for mere co owners because the property is not part of their normal turnover so their turnover is under the $75,000 threshold.

It is all about your intentions. That age old question of whether you are merely realising an asset or in business to make a profit. A general law partnership is about a profit making venture. So if you purchased the property to hold as a rental or your home you would not be in a general law partnership as the rent is passive investment income. But if you then go into a business by demolishing the rental and building townhouses you are into a profit making venture and GST would apply if you sold the townhouses rather than continue to hold them as rentals. Selling vacant blocks of land can sometimes be considered merely realising an asset rather than a business but only if your original intention when purchasing the property was not to subdivide. Our how not to be a developer booklet (in the freebies section of the web site) discusses the ATO's jagged line on when it thinks you may have crossed over from merely realising an asset. This topic is also discussed in MT 2006/1.

All we are looking at here is what happens when you are doing **more** than merely realising an asset and you want to take away from the project, properties in your individual names rather than just sell off to the public. Remember the most common outcome would be for the partnership to sell to the public or the co-owners to keep the units for rental or private use. We are now really just looking at the unusual circumstances of when the development is business like ie profit making (must register for GST) ie general law partnership but for some strange reason the partners decide to transfer the properties (or at least some of them) out of the partnership and into their own names. In the particular case that led to this article a solicitor decided to transfer the titles around between the owners before the properties were then on sold to the public.

Let's consider a town house development which is business like with a profit motive, yet the partners will take away a townhouse each and sell the rest to the public. For GST purposes this is a supply by the partnership to the partners so the partnership must charge the partners GST. Note for income tax or CGT purposes the partnership is not even recognised as owning the property, the individual partners are, let's not even go here at this point but it is suffice to say do not apply the GST principals here to any income tax issues.

The GST effect of the partnership being the transferrer is that even though one partner might already have their name on half the title, when the townhouse is transferred to them GST would be payable by the partnership on the value of the whole townhouse (though the margin scheme maybe still used to reduce the GST). This is an important reason why you need to avoid being considered a general law partnership if you don't intend on selling the property.

The very fact that you don't intend on selling supports the fact that there is not a general law partnership anyway. Paragraphs 79 to 85 of GSTR 2009/2 recognise that two people can come together to do a development with different purposes in mind. If in this case you were the one building to sell and the other co owner was building to live in then you really have to look at the one property as two separate assets. The first sale of a new residential property is subject to GST but not any subsequent ones unless it is substantially renovated. So if you received half the property from the other co owner with no GST being charged because they weren't registered then when you sell only half the property is being sold for the first time so only half of it would be subject to GST. The trap is when you transfer your half of the live in co owner's property to them you will have to charge GST because you built that half with the intention of making a profit as part of your

enterprise. So in the end the full GST is paid. Half of the value of your unit on the transfer to the other co owner of half of their unit and the other half of the GST is paid (on half the value of your unit) when you sell to the public. You only charge half the GST on this latter sale because only half the unit is being sold for the first time. The other half was sold to you earlier by the other co owner with no GST charged because they did not have a profit making motive so they were not required to be registered for GST.

A joint venture is a different situation to the partnership discussed above though GSTR 2009/2 asserts the transfer should still be a taxable supply despite subsection 51-30 stating that a transfer to joint venturers is not a taxable supply.

Don't forget if you are not already registered for GST and the units are not built to be sold as part of your normal business turnover then their sale will not force you to register from GST because you taxable supplies from your normal turnover are not over $75,000.

Margin Scheme Developing Pre 1st July, 2000 Property

The government is about to change the law to ensure that the base used for the margin scheme is calculated the same way regardless of whether the original property is sold as is or subdivided. Until now there has been some uncertainty due to the wording of the section but the ATO has nevertheless treated subdivision the same as other properties.

If you qualify to use the margin scheme (refer our how not to be a developer booklet) you are only required to pay GST on the margin between the selling price and the price you paid for the property. There is an exception to this if you acquired the property before 1st July, 2000 or inherited it from someone who acquired it before 1st July, 2000, in this case the base amount for the margin scheme would be a market valuation. The date of the valuation would be as follows:

You were registered for GST on or before 1st July, 2000 – The base amount is the market value at 1st July, 2000.

You were not registered for GST on 1st July, 2000 – The base amount is the market value when you register for GST, generally when the development starts.

Deceased Registered for GST – The base is the market value at the date the deceased registered for GST or 1st July, 2000 whichever is the latest date or the deceased's acquisition cost.

Deceased Not Registered for GST - You have a choice of the deceased's acquisition cost, market value at 1st July, 2000, market value at date of death or market value when you register for GST.

If the property has a pre 1st July, 2000 building on it that is included in the valuation, even if it is demolished for the development, ask the valuer to then apportion the total amount between the blocks or units you are developing.

Renovating for Profit

If you buy a property with the intention of doing it up and selling it then you are in business. The property is not an investment so it is not subject to CGT or your main residence exemption. Instead you purchased it with the intention of resale at a profit so the profit is taxed as normal income. Further, if your renovation is substantial you will also have to charge GST when you sell but you can claim input credits and possibly utilise the margin scheme.

If you rent the property out before you renovate you may qualify for large tax deductions when you scrap part of the house or plant and equipment. So you need to consider whether you should get a quantity surveyor in before you start. A deduction for scrapping is only available if the property is rented out during the renovation or it is rented out immediately before the renovation begins and you do not live in the property during the renovation.

If you are in the business of renovating to sell you will have to charge GST if the renovation is substantial. Fortunately, 'substantially renovated' is really that; it takes quite a considerable amount of changes before you will trigger GST. *Section 195-1* of the *GST Act* states "substantial renovations of a building are renovations in which all, or substantially all, of a building is removed or is replaced. However, the renovations need not involve removal or replacement of foundations, external walls, interior supporting walls, floors, roof or staircases".

GSTR 2003/3 is the ATO's ruling on the matter. It is not just based on how significant the renovation is but whether it affects a substantial part of the original property. For example, you could put an extension on the back of a property that is twice the size of the original house but if you don't renovate the original house then there is no substantial

renovation. Superficial changes to all the rooms in the house do not make the renovation substantial either, even though all rooms are affected. An example of this would be painting all the walls.

GSTR 2003/3 specifically states at paragraph 76 that replacing a kitchen, bathroom, repainting the whole property and doing minor repair work, in most circumstances would not be a substantial renovation. Cosmetic work, such as painting, sanding floors, replacing light fittings, curtains or carpets are not substantial renovations even if they affect every room in the house. Replacing the floorboards or electrical wiring in a property gets you into dangerous territory, however, because they usually affect every room in the house and are not merely cosmetic.

Pre CGT Property

A pre 19th September, 1985 property should be the last property you ever sell because the longer you keep it in your name the longer the capital growth will be CGT free. Subdividing it or renting it out won't change its pre CGT status.

If you subdivide and change the name on the title ie give a block to your child, that block will lose its pre CGT status. Better that the child inherits it as the longer you live the longer the capital growth will be exempt from CGT and there is no stamp duty. On the other hand if the child has no other property they are covering with their main residence exemption, they are going to live there and the block is less than 2 hectares the only downside of transferring before you die is the stamp duty costs and the risk they may not always be able to cover it with their main residence exemption. Also consider that the best form of asset protection for your children is for their assets to be held in your name if you are less likely to be sued.

When you die your heirs will inherit any pre CGT assets you own at the market value at the date of your death. If the asset is a dwelling they have up to 2 years in which to sell it and no CGT will be payable. This 2 years can be extended if there have been undue delays at probate or the dwelling is occupied by a person who was given the right to occupy under the deceased's will.

For Our Seasoned Property Developers

There comes a time in every property developer's life when they should consider undertaking the development through a SMSF. The primary reasons for this are the 15% tax on the profits, maybe even zero tax if you put the fund into pension phase, can satisfy a condition of retirement and are 55 years or older. SMSFs are also an excellent method of asset protection. Enough said on that I am sure you are now convinced. Next I examine the hurdles and myths that keep most developers away from SMSFs.

SMSF are not allowed to borrow for development – This is the major hurdle but a "seasoned" property developer should have the cash by now to fund the development. Of course there is the small problem of getting that cash into the SMSF. If you are under 65 years of age each member can contribute up to $450,000 in undeducted contributions in one year as long as they don't contribute any undeducted contributions the next year. You can also roll into the SMSF superannuation from most other funds plus each member is entitled to put in $25,000 a year as a deductible contribution but this includes amounts paid by your employer. If this is not enough each member can contribute $150,000 this year, hopefully this is enough to secure the land and start the process with council then 1st July, 2013 put in another $450,000 per member. So you can see there is very little barriers to getting money inside a SMSF if you have the cash. If you have to borrow to make any of these contributions you will have to use assets held outside of the SMSF as security and the interest will not be tax deductible but considering the tax rate and possible short term of the project that may still be an option.

SMSF are not permitted to run a business – Myth, certainly most business would involve issues such as providing and receiving credit that could breach the SMSF rules but if you get professional advice on how to stay within the rules the ATO will accept SMSFs undertaking the business of development.

Not Being Able to Access the Profit – There are various rules regarding drawing funds, tax free, out of your SMSF before you are 60 but between 55 and 60 it is possible to access some of your super tax free. The question is at this stage in your life why would you want to? Leave it there and to bank roll the next development.

Clauses In Real Estate Contracts

Not all Real Estate contracts are the same, not only should you read them before signing but you should take it to your Solicitor first. Don't let a pushy Real Estate agent talk you into signing up without professional

advice. Think about the huge amount of money involved, here are just a couple of examples of what can go wrong. A client went to an auction not expecting to buy so had not had the contract checked out. She assumed it would be just like any other contract. She was buying the property to use as her home in about a year's time so was pleased to agree that the seller could continue to use it in his business for 12 month after the sale. The contract said the vendor would be providing vacant possession and that GST did not apply to the sale. But here is the kicker, have a look at this clause:

> *No GST Payable By Vendor*
> *The Purchaser warrants that the property is intended to be occupied, and is capable of being occupied, as a residence. If this warranty is false and the vendor is obliged to pay GST,* ***the purchaser hereby indemnifies the vendor in respect of his obligation to pay such GST and any accrued interest or penalty thereon****.*

This is a typical reaction by the vendor's solicitor to uncertainty about the operation of the GST Act. They just push all the responsibility onto the purchaser rather than find an answer. Of course the poor purchaser can't even find out whether GST is likely to apply to the transaction because they don't know enough about the vendor's personal circumstances. If the ATO look into the transaction the vendor has no reason to fight the ATO and the purchaser has no right to fight the ATO.

So the moral of this story is read the contract, get advice and never ever agree to be responsible for someone else's GST even if you think it won't apply. Right or wrong, confidentiality means you will have no right to argue your case, you must just pay up another $1/11^{th}$ of the purchase price, over $50,000 in my client's case. Mind you I have my doubts that such a clause could be successfully enforced through the courts.

Ok now that the nagging is over let's have a look at the issues the solicitor should have examined to give his client the correct advice rather than just trying to dump responsibility onto the purchaser.

The first sale of a residential property is subject to GST but any sales after that are exempt from GST. This property had been sold as a residential property before so if it was still considered a residential property no GST would apply. But the house was actually being used as a medical practice. If the property is considered commercial rather than residential GST will apply to the sale. So when is a house a commercial premises?

It is all about the condition the property is in at the time of sale yet the solicitor, again in a slap dash approach of who cares about the law we will just contract our way out of any liability rather than look it up, also wanted the purchaser to sign another clause in the contract stating that she would use the premises as residential property after the sale. Effectively, now because my client didn't read the contract, by simply signing a contract agreeing to purchase the property she was committing fraud because she had already agreed to rent the premises back to the seller for commercial use for a year. Oops on the soap box again, anyway here is what GSTR 2000/20 states about residential premises:

> *Residential premises is defined as land or a building that:*
> *(a) is occupied as a residence or for residential accommodation; or*
> *(b) is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation;*
> *(regardless of the term of the occupation or intended occupation)*
> *…. It is their physical characteristics that mark them out as a residence. In turn, these characteristics determine when the use or proposed use is for residential accommodation.*
> *….. To be residential premises as defined, a place need only provide sleeping accommodation and the basic facilities for daily living, even if for a short term.*
> *24. The definition of 'residential premises' in section 195-1 refers to land or a building that is occupied as a residence or for residential accommodation or is intended and capable of being occupied as a residence or for residential accommodation.*
> *26. The physical characteristics common to residential premises that provide accommodation are:*
> *(i) The premises provide the occupants with sleeping accommodation and at least some basic facilities for day to day living.*
> *(ii) The premises may be in any form, including detached buildings, semidetached buildings, strata-title apartments, single rooms or suites of rooms within larger premises.*
> *28. The definition states that residential premises must be capable of occupation as a residence. To be a residence in this sense, a place normally should have the facilities required for day to day living. These*

characteristics are inherent in the fabrication of the structure itself. The premises should have such things as areas for sleeping, eating and bathing, but it is not necessary that these things be arranged in a similar manner to a conventional house or apartment.

29. *Premises that lack these basic features, may not be either residential premises or commercial residential premises. Supplies of buildings or other structures without these characteristics are subject to GST under the basic rules, regardless of whether or not they are or have been at one time, occupied as some form of residence.*

There is much more in GSTR 2000/20 if you need further clarification but the paragraph that caught my client in particular was:

31. *In some cases, the purpose for which the premises are to be used will be evident from their form or fit-out. This is most clearly the case where premises have been fabricated, or altered, to accommodate commercial or professional activities.*

The property was used to provide professional medical service before and at the time of the sale and my client had agreed to continue to use them as such. So this was not the sale of residential premises it might have all the things necessary to be a house but it was commercial premises and the supply of commercial premises is subject to GST, that is, if the seller is registered for GST.

This was her out. She asked for more information about the seller and the entity that operated the business. They were different. The medical practitioner operated his business in his own right but owned the premises in partnership with his wife. Yes, the medical practice was registered for GST. My client could find this out by doing a search on http://abr.business.gov.au/LookupTool.aspx She also found out that the Practitioner and his wife were not registered for GST and that their partnership that owned the premises (not the medical practice) did not have a turnover of more than $75,000 per annum. Accordingly, they are also not required to be registered for GST. The trick here is that as the sale of the property is the sale of a capital asset, it is not part of turnover so it will not push them to register, if they are not registered they do not have to charge GST even though the sale is of an asset that would be subject to GST. Here is the important references:

Section 23-5 states that if the annual turnover of supplies you make in the normal course of your enterprise, exceed $75,000 you must register for GST. Section 185-25 excludes from the calculation of annual turnover the supply of a capital asset.

Next Edition of Newsflash we will look at the problems a going concern clause can cause in a contract and why you must have vacant possession.

More on Real Estate Contract Clauses

Following on from Newsflash 261 where we examined the nightmare a GST clause can cause we now look at vacant possession and a going concern clause which can be equally as catastrophic, so never ever sign a contract without getting advice.

Going Concern:

If the sale of a commercial property qualifies as the sale of a going concern the seller will not have to pay the ATO any GST when they sell the property. The trouble with property is its market value seems to ignore the GST component. This means that the seller may well get the same price for the property whether they charge GST or not, the difference being whether they have to send 1/11th of the selling price off to the ATO, So sellers are always on the lookout for a way to avoid this. A going concern clause, is a dream come true for a seller of a commercial property. It pushes the GST obligation onto the unsuspecting buyer who has already paid full market value for the property.

A going concern clause only ever has a good outcome for the buyer if they just can't afford the funds up front to pay the GST and then wait for the ATO to refund it. Before a going concern clause can apply both the buyer and seller must be registered for GST. If the contract was subject to GST then the buyer would be entitled to claim it all back from the ATO anyway.

Say the market value of a property is $550,000 if the contract is subject to GST then the seller would have to send off $50,000 to the ATO and only end up with $500,000 in the hand. The buyer may hand over $550,000 but in the next BAS he or she will get $50,000 back as an GST input credit so is really only out of pocket $500,000. This means that if the sale is going to be subject to the going concern provisions the property should really change hands for $500,000. I don't like your chances of talking the seller into that

when they know the valuation is $550,000. So just don't agree to the going concern clause, register for GST and pay the full $550,000.

The main reason you don't want to agree to a going concern clause is because if you ever de-register for GST or stop using the property in a business, for example as per last edition, the purchaser was eventually going to turn the professional offices back into a house, then you have to pay back the "notional" GST input credit you received. In the example above, that means effectively paying another $50,000 for the property. Notional, because you didn't actually receive it, it was just that the seller didn't have to pay it to the ATO, but the law is like this because the going concern exemption from GST is intended to make the property cheaper by the value of the GST. This is something that does not always happen unless the purchaser is well informed and a very good negotiator.

All this may lead you to decide to sell the property and cut your losses. That won't get you out of it either. Let's assume you decide this rather quickly so the property is still only worth $550,000 but what if your purchaser is not as gullible as you were? If the purchaser does not agree to use the going concern exemption (and they only should if you sell it below market value) you are going to give the ATO $50,000 of your sale proceeds even though you may still owe the bank the $550,000 you paid for it.

Vacant Possession:

This is a much more straight forward problem. It is only an issue if you intend to use the property as your home. If you don't move into the home as soon as practical after settlement then you will not be able to begin to cover the property with your main residence exemption until you actually move in. Sure it may be only a short time before the tenant moves out. It is not the portion of the gain that you will pay tax on that is the problem. It is the fact that you will need to keep records for the whole time you own the property in order to be able to calculate the whole gain to apply that small percentage to.

Going Concern Clauses In Real Estate Contracts

Interesting, fresh after our discussion on the horrors of a going concern clause in a real estate contract in the 1st February edition of Newsflash, the decision in MBI Properties Pty Ltd v FC of T 2013 ATC 20-372 was handed down on the 12th February. MBI had to pay back $215,000 in GST even though they had paid full market price for the property. So please don't read the article on clauses and think it couldn't possibly be that bad.

In the MBI case they should not have agreed to the contract being one for a going concern because they intended to lease the apartments back to a hotel group. As it was the hotel group operating the business not MBI all MBI were doing was renting residential property to the hotel group. Residential property rents are not subject to GST. To qualify for the going concern concession you need to be making supplies that are subject to GST.

Please note that despite market price being paid for the property the purchaser had to then pay the ATO another 1/10th of the purchase price because they didn't use the property for the correct purposes. The ATO still considers them to have benefitted from a discount by not paying the GST. The unfortunately reality in most of these cases is that it is really the seller who has benefited by not having to send of 1/11th of the selling price to the ATO yet still managing to sell for full market value.

If you must enter into a contract to buy a property as a going concern make sure you pay at least 1/11th below the market value because if you ever stop using that property to make GST supplies you are going to have to pay the ATO back the GST discount that you supposedly received.

Don't be misled into thinking that a going concern sale avoids GST. All it does is remove the obligation from the seller to send 1/11th to the ATO and the ATO to send that 1/11th back to the buyer. This helps with cash flow at settlement that is all. The buyer is still considered to have received the GST input credit so must charge GST when they sell (or sell 1/11th below market value) and they must pay the GST back if they de register or stop using the property for GST purposes, for example change of use to a residential rental property.

In MBIs case they acquired apartments that would be leased to an entity that provided serviced apartments. Sure this is a commercial use of the apartments by the other entity but MBI was doing nothing more than renting residential property to that entity.

Fortunately, MBI is a related party to the seller so it will all come out in the wash but there are Mum and Dad investors also caught up in this. Their cases are yet to be heard by the courts.

Subdividing and Building your Home

This article is about the effect of subdividing your home block and building a new house to live in, has on your CGT main residence exemption.

Consider the situation where you buy a property with a house on it and then subdividing the property to build a new house for yourself on the land you have subdivided away from the old home. Then you sell off the old home but you want your new home to be fully covered by your main residence exemption. The question is whether the 4 year rule applies. This rule allows you to cover vacant land with your main residence exemption for up to 4 years before you move into your new home providing you move in there as soon as practical after construction is completed. Remember that subdivision does not change the acquisition date or trigger a CGT event. So if the new home is built within 4 years of the original purchase of the whole block then it could well be fully covered by your main residence exemption if section 118-150 can apply. The trouble is the second last paragraph of the legislation

118-150(5)

*If there was already a *dwelling on the land when you *acquired your *ownership interest and you or someone else occupied it after that time, the period in subsection (2) and paragraph (4)(b) starts when the dwelling ceased to be occupied.*

This could create a problem if you live in the old house while the new house is being built and on page 168 of Winning Property Tax, after consulting with the NTAAs on the matter, we concluded that it prevented you being able to use section 118-150 further back than the time you moved out of the old house. Well page 168 of the book is wrong! Since then I have discovered TD 2000/14
http://law.ato.gov.au/atolaw/print.htm?DocID=TXD%2FTD200014%2FNAT%2FATO%2F00001&PiT=99991231235958&Life=20000412000001-99991231235959
It gives a very good example with the following note

Note 2

11. If there is an existing dwelling on land (dwelling A), you subdivide the land into 2 blocks and you construct a new dwelling (dwelling B) on the vacant block and this dwelling becomes your main residence, section 118-150 operates in relation to the subdivided land as if there was no existing dwelling on the subdivided land when you acquired it. This means that subsection 118-150(5) does not operate to alter the start of the period for which you may choose dwelling B to be your main residence in subsection 118-150(2) and paragraph 118-150(4)(b). The period for which you may choose to apply the main residence exemption under subsection 118-150(2) and paragraph 118-150(4)(b) commences from when you acquired your ownership interest in the land, namely, the date you acquired the original land.

What this all means is that you can buy a house on a large block and live in that house while you subdivide and build a new house. Then as long as you move into the new house as soon as practical after it is finished and that date is less than 4 years since you purchased the property, the new house can be completely covered by your main residence exemption. That is providing you choose not to cover the old house with your main residence exemption while you were living there. Though in limited circumstance you can use the 6 months overlap rule to cover both properties for the 6 months before the old house is sold.

CGT Consequences of Depreciation

Building Depreciation:

If you purchased you property after the 13th May, 1997 then any building depreciation that you could have claimed against your income must also reduce your cost base for CGT purposes. Generally, choosing not to claim the depreciation will not help you avoid the add back for CGT purposes. The legislation refers to depreciation that you were entitled to claim, not whether you claimed it or not.

There is a small window of opportunity here if you have not claimed building depreciation and do not know the amount that you would qualify to claim. It is intended to prevent people having to obtain a quantity surveyors report just to calculate their CGT when they have not had the benefit of the tax deductions over the years.

PLSA 2006/1 states that if you have no other way of obtaining the original building costs than paying for a quantity surveyors report and you have never claimed building depreciation in your tax return then you do not have to reduce your cost base.

TD 2005/47 addresses the situation where you do know the building costs ie you were the original owner, yet you have not claimed depreciation at all. In this case you only have to increase your cost base by the depreciation you could claim if you amended your tax returns. This limits your add back to the number of years you would be allowed to amend your tax return to claim the missed depreciation. Taxpayers with simple tax returns are only supposed to be able to amend back two years so you would only need to increase the cost base by two years depreciation. Note that the two years is from the assessment date. In a recent case the ATO was successful in arguing that in most cases a 4 year limit applies because beneficiaries of trusts have a 4 year limit and most trust deeds have such a wide definition of beneficiary that just about anyone could be caught. It is not necessary that they receive a distribution from the trust, it is enough that they technically could. As a result of this case the government's reduction of the amendment period for average tax payers to 2 years has been completely circumvented by the ATO.

Depreciation of Plant and Equipment:

It may surprise some readers to find out that there is no CGT on plant and equipment. It is subject to normal income tax ie no 50% CGT discount. If you have been using the ATO rates for your depreciation the ATO will generally accept that the original purchase price of your plant and equipment is the same as the start figures in your depreciation schedule and that the value of the plant and equipment on sale is the same as the balance of unclaimed depreciation in the schedule, so there are no tax consequences.

But this means that the first element of your cost base on an investment property, for CGT purposes, is the purchase price less the start value of the plant and equipment. Further, the sale price included in the CGT calculation is the sale proceeds less the remaining unclaimed depreciation in the schedule. Note if there was a period where the depreciation was not claimed ie the property was used for private purposes, the balance in the depreciation schedule should still have been reduced.

Property Business or Merely Realising an Asset?

In August v FCT 2012 FCA 682 a taxpayer failed to prove that when they purchased a property 9 years ago it was not their intention to sell it for a profit but to hold it as an investment thus qualifying for the 50% CGT discount.

The taxpayer acquired various shops in the same centre from 1997 to 1999, did them up, put tenants in them on long term leases then sold them in 2006. The Federal Court found that Mr August's primary intention in buying the properties was to resell them at a profit so he was not entitled to the 50% CGT discount.

The last shop was put under a long term lease in June 2004 and the biggest mistake Mr August made was that in June 2005 he consulted a Real Estate Agent to find out how much he thought the properties were worth. The court found that this was too soon after the last shop secured a long term lease and was a sign that way back in 1997 he must have purchased the properties with the primary intention of selling them for a profit. Mr August says he was merely interested in gauging what they were worth but the Real Estate agent hounded him and having obtained a very good offer for the shops Mr August was persuaded to sell, even though his original intention was to keep the shops until he died.

The courts did not believe that he merely consulted the Real Estate agent to obtain a valuation as the bank had valued the property just less than 6 months before hand. It seems considering that a bank valuation may not be realistic so wanting to get another opinion 6 months was a big mistake. The court said this suggested that several years earlier Mr August's thoughts when buying the properties were to sell them as soon as they had been renovated and leased out.

By the way the selling price was $2.33 million yet the bank valuation was $1.83 million. Now despite the court claiming he had no reason to require another valuation as he had one from the bank they would not accept Mr August's explanation that he only sold because of the extremely high price offered. Otherwise, he would have continued to hold the shops until he died. The courts found that the selling price was not a "mad price" so was not the motive for selling. This seems a contradiction to me. Which is it? It was either a "mad price" or bank valuation was unrealistic so the taxpayer was justified in seeking another opinion?

The courts found that another sign of Mr August's plan, right from the start, was to resell at a profit was because he had consulted a family friend on where to buy a property and this family friend was in the business of buying shops doing them up and selling them for a profit. The family friend testified that he advised that the purchase was unlikely to be a bad move because it was so undervalued that he would always be able to sell for more than he paid.

The courts also said that there was no change in Mr August's circumstances to justify selling so it must have been his intention from the start.

Against Mr August's argument, was the fact he had bought and sold other properties holding them for around a year. Nevertheless, this is not to say his intention was different with the property in question, it certainly seemed to be considering the length of time he kept it.

This case seems to add a whole new set of rules to make sure you are considered a property investor not a developer. Basically they can be summed up as avoiding making any good decisions in regard to your property investing. For example do not consult a Real Estate agent on what your properties maybe worth, no matter how curious you are. Do not seek advice from successful property developers even if they are family. Don't sell just because it is a great time in the market to do so, you need to have a change of circumstances that motivated you. Do not buy undervalued properties!

Buying A Property As Tenants In Common Then Subdividing

This is usually referred to as partitioning. Sometimes the courts can even order that a property be subdivided and partitioned to settle a dispute but here I am just talking about when two or more people buy a property together, subdivide it and then take a block each to own in their own right.

The catch is when you subdivide a block you own jointly or as tenants in common the title deed will come back with all the names that were on the original title, on every subdivided block. Each party to the partition has to then transfer part of each block, except the one they are going to keep, to the other co owners. This is really just the same as selling them part of the block.

This article does not cover a joint venture between a land holder and another party, probably a developer. In those cases it is unlikely that the land will change hands before the project starts so the developer will probably just take a lien over the title. Accordingly, there is no partitioning between owners, the property is still owned by one party, who then sells off the units or lots to pay the developer, so all this partitioning information does not apply.

So how does partitioning work for GST, CGT and income tax purposes? Good question, not easily answered and it differs depending on your circumstances. First some basic rules then some practical examples. It is important that as you read this you are careful to note whether I am talking about GST or CGT and income tax, otherwise at times the statements will appear to be complete contradictions.

Joint Ventures, Partnerships and Co Owners:

The definition of partnership differs depending on whether you are looking at GST or CGT and Income tax.

In most cases a jointly owned property will be considered to be owned by the co owners in their own right for CGT and income tax purposes. The property would only be treated as being owned by a partnership for CGT and income tax purposes, if it appeared in the partnership's balance sheet.

Joint venture is a very wide term, the legal and tax consequences of which vary from one agreement to another. It is not wise to rely on any general advice that says - because you are in a joint venture ….. as the law does not conclusively define a joint venture. All advice needs to take into account the particular terms of your particular joint venture agreement.

A joint venture agreement does not prevent the arrangement being considered a partnership for tax purposes, even when the agreement specifically states it is not a partnership, refer example 2 in GSTR 2004/2. Nor does a joint venture agreement guarantee that a partnership exits between co owners.

A joint venture means nothing for CGT and income tax purposes. All that is relevant in this case is the ownership on the title.

GST law does recognise joint ventures but only for administration purposes. The joint venturers can lodge a combined BAS so that the administration process is easier but this simply means the joint venturer lodging

the BAS does so on behalf of all members of the joint venture arrangement. You need to apply to the ATO on a form for a joint venture BAS arrangement. GST law considers the owners of the property to most likely be in partnership though they can be co owners in very limited circumstances.

For GST purposes a partnership is considered to own the property as a separate entity from the co owners. This means that when the owners partition the property between themselves the whole of the property is being supplied by the partnership to the individual partners so GST (if applicable) applies to the whole value of the property.

If you are merely considered co owners, not a partnership, then the partitioning of the property only means part of the property is being supplied, this will mean less GST payable. For example if the co owners are only two people then each of them is supplying half of their half of the property to the other. Assuming GST applies, it has to be paid on that supply but of course this means GST is only payable on half the value of the property as only half is changing hands. On the other hand if considered a partnership, all of the property is changing hands. Note the constant reference to whether GST applies.

Basically, GST applies if you are registered for GST or make the supply in the furtherance of an enterprise to the extent it is part of the business's turnover, therefore forcing you to register for GST. This is very important if you intend keeping the property after the partition and even more so if you are deemed a partnership. If you are going to sell after the partition or the property is commercial, this issue is not so important because you will either soon be liable for the GST anyway or will get that GST back.

So how do you keep the arrangement low key enough that you are only co owners not a partnership for GST purposes? It is really very hard. GSTR 2004/6 at paragraph 62 makes it close to impossible not to be considered a partnership. It states that having an agreement between co owners regarding the property, a joint bank account, borrowing together, purchasing the property under one contract or acting together to lease the property are all individually, pointers that there is a partnership for GST purposes. Obviously the ATO want GST to apply to the whole value of the property not just the portion actually being transferred between the owners. The only glimmer of hope is a private ruling (so not binding on the ATO) PBR 1012917587954 https://www.ato.gov.au/rba/content/?ffi=/static/rba/content/1012917587954.htm where the owners were not considered a partnership that was an enterprise for GST purposes even though they borrowed together. This was because they all intended to use the partitioned blocks just to build their own homes, so it is more that they were not an enterprise than not a partnership. The block they purchased had an old house on it but they never rented it out. The PBR may have had a completely different outcome if they had rented the house out before demolishing it as that would have been an enterprise. They would have been jointly in receipt of income so a partnership for GST purposes.

There are three possible uses of the portion you keep for yourself. You may use it as your own home, a residential rental or sell it to a third party. How you are going to use the property you finally receive in your own name, determines the tax treatment of the portion you sell off to your co owner.

1) If you are merely partitioning so that you can get a home of your own, then this is not part of an enterprise; so the portion you sell to your co owner is not subject to GST [reference GSTR 2009/2 paragraphs 79 to 85 which appears in detail further down].
2) If you are partitioning to hold as a rental property, then holding rental properties is an enterprise but residential rents are not subject to GST. Assuming you are not already registered for GST the question comes down to whether you are required to register for GST. To be required to be registered for GST your turnover of supplies that are subject to GST needs to exceed $75,000, reference section 185-25 of the GST Act. The construction of the portion of your co owner's house that you transferred to them was not part of your enterprise's turnover, only your rents count towards turnover in this case. So you are not required to be registered. If you are not required to be registered then you don't have to charge GST. Note this is just an opinion shared by many advisors in the industry. The ATO has not made a statement on this situation, in fact it has, suspiciously, always skirted around the issue so you might like to get a private ruling.
3) If you are going to sell off the property you receive as part of the partition then your involvement is in this development is part of your enterprise and your enterprises' turnover of GSTable supplies is more than $75,000 because the new house you sell to a third party will be part of your turnover. So you must register for GST and pay GST on the portion you transfer to your co owners.

Further, if for GST purposes you and your co owners are considered to be in partnership then it is not just a transfer of part of the property it is the partnership transferring the whole of the property to the individuals and GST is payable on the whole transfer.

An example of this would be when as co owners you first held the property as a rental property. A rental property is an enterprise and for GST purposes it would be the partnership that is the entity so the transfer into your individual names would be a transfer of the whole property.

An expensive mistake is registering for GST when you don't have to because the supply you are making is not part of your turnover as per example 2) above. Bad advice can trigger a GST bill simply because you are registered. I have seen this happen a few times. Make sure your Accountant has experience in property development.

All supplies, that are not exempt from GST (examples of exempt from GST would be residential rents and the second sale of residential premises) and are made as part of the enterprise of an entity that is registered for GST are subject to GST even if they are not part of the normal business turnover. This means you should be very careful about registering for GST. When your turnover of supplies that are subject to GST exceeds $75,000 you are required to register for GST.

It is the turnover of supplies that are subject to GST that counts for the purposes of the $75,000 threshold, not all the supplies you make. You are looking for sales that relate to the purpose of your business. If the purpose of your business is simply renting out residential properties then it is the rents that are you turnover. You do not need to register for GST because the rents are not subject to GST so your GSTable turnover is zero. The turnover does not include sales of capital assets of your business even if that is an item that would be subject to GST, such as the first sale of new residential premises.

If you are a property developer, the land and buildings you sell are part of your turnover; but if you upgrade the ute you use in the business that is the sale of a business asset, so is not part of the turnover. Nevertheless, if you are registered for GST when you trade in the ute you have to pay the ATO GST on the trade-in price you receive.

This turnover test is very important for small subdivisions. The idea is to keep the property sales as merely realising an asset rather than turnover of a business. To do this you need to not go so far as to be considered that the subdivision is a profit making venture. In PBR 1012917587954 https://www.ato.gov.au/rba/content/?ffi=/static/rba/content/1012917587954.htm above the houses they transferred between themselves where not part of the business so no GST but they had a 4th house that they sold to a third party. That was subject to GST because they built it with the intention of resale for profit, the building was business like (enterprise) profit making not just doing the minimum necessary to be able to sell that block. There is much detail on this in our How Not To Be A Developer Booklet http://www.bantacs.com.au/booklets/How_Not_To_Be_A_Developer_Booklet.pdf

Supplies that are subject to GST – In the developer's example above the sale of the ute would be subject to GST (if the owner is registered for GST) even though it is a capital asset. Supplies that are not made in the furtherance of the enterprise are not subject to GST. For example you may be registered for GST because you have a business in your name but when you sell a car that has not been used at all in the business that sale is not subject to GST because it is not a sale in the furtherance of an enterprise. Note, if more than one enterprise is being carried on by an entity and one of those enterprises is registered for GST all the other enterprises are registered for GST. In this case the only way you are going to get out of GST is to argue that the sale is not part of an enterprise at all.

So if you are a self employed plumber operating as a sole trader and own the property in your personal name, then if the plumbing business is registered for GST the land owner is also registered for GST if the partition is considered an enterprise. The partition would be considered an enterprise unless you are going to simply partitioning to obtain a home to live in. If the partition is part of an enterprise (ie built to hold as a rental or sell to a third party) and the owner is registered for GST then you need to pay GST on the portion you transfer (or the whole portion if considered a partnership GST purposes). That is unless the property being transferred is a residential building that has been sold before and has not been substantially renovated.

Vacant land, commercial property and the first sale of residential property or substantially renovated residential property (refer GSTR 2003/3) are subject to GST. So, if the owner of these properties is already registered for GST then they must pay GST when they transfer these properties to a co owner.

If you did not qualify to claim GST input credits on the purchase of the land and it was not purchased under the farm land concession or a going concern clause then you are entitled to use the margin scheme on the transfer between co owners but you must have the appropriate clause in the contract. If later you are going to use the margin scheme when you next sell that property you need to get some specialist advice. Reference GSTR 2006/8.

Now let's look at the income tax or CGT ramifications. The big question is whether it is normal business profit so taxed as normal income or whether you are merely realising an asset so qualify for the 50% CGT discount if you have held it for 12 months.

There is no doubt that when you partition a property you are making a sale of your share of the other party's block and they are selling to you their share of your block. The sale price is the market value. If you are undertaking the arrangement as a profit-making venture ie you are going to build on and sell your block then the sale to your co owner is also considered a profit making venture so normal income tax applies. This means no 50% CGT discount even if you own the property for over a year.

If this is just an arrangement where you are going to build a rental property or your own home then the partitioning would not be considered a business venture. So, CGT would apply to the gain you make on the transfer to your co owner and if it has been more than 12 months since the original purchase of the block then the 50% CGT discount can apply providing you do not own the property in a company.

Note your primary goal can be considered to have changed if you do something more than merely realise the asset. For example, you may have held the property for years as a rental with just the thought in the back of your mind that one day it would make a good development block. When that day comes if you simply subdivide the block and sell the individual lots you are merely realising an asset but if instead you build townhouses and then sell them you have become more business-like so the profit you make will be taxed as normal business income, in other words not 50% CGT discount. Though you will get the 50% CGT discount on the capital gain on the property up to the time you committed it to the development.

This is a test about what your thoughts were at the time your purchased the property and whether you have since changed the purpose for which you hold the property. For example:

You held the property with a friend as a rental for 10 years and when you purchased it, you thought well maybe one day it will be worth subdividing but that wasn't your primary reason. If when the time finally comes you simply demolish the old rental property subdivide and take a block of land each. Your transfer of the half to each other is merely realising a passive investment so the 50% CGT discount applies.

On the other end of the scale is the buying of a property with a business associate so you can get straight into it and subdivide, maybe even build on it, but with the intention of selling off quickly. This is a business arrangement. A profit motive not a passive investment, no 50% CGT discount.

Note simply owning a rental property is not considered a business pointer for income tax and CGT purposes but it is considered an enterprise pointer for GST purposes. It is important not to apply the concepts rules for GST to CGT and income tax.

Practical Applications:

Taking into account the rules stated above here are a couple of examples of partitioning -

1) An example taken from GSTR 2009/2 paragraphs 79 to 85. This shows how, for GST purposes, the purpose that you put your final share of the property to determines how you treat the transfer to your co owner.

"Two friends, Caroline and Shaun, purchase a block of land as tenants in common in equal shares with the intention to subdivide the land, to construct two houses and to take a house each. Caroline's intention in entering into the arrangement is to use the house she acquired as her primary residence. Caroline is not carrying on an enterprise in these circumstances. In Caroline's case, the purpose of the arrangement is private and domestic in nature.

Shaun's intention in entering into the arrangement is to sell the house he acquires for a profit. Shaun is carrying on an enterprise in these circumstances because the activities are business activities or activities in the conduct of a profit making undertaking or scheme and therefore an adventure or concern in the nature of trade.

Shaun and Caroline agree that Shaun will take Lot 1 which includes House 1 and Caroline will take Lot 2 which includes House 2. Caroline and Shaun give effect to the partition, after the completion of construction, by Shaun transferring his interest in Lot 2 to Caroline and by Caroline transferring her interest in Lot 1 to Shaun. The transfer by Caroline of her interest in Lot 1 to Shaun is not in the course or furtherance of an enterprise she carries on. Caroline's transfer of her interest in Lot 1 to Shaun does not have any connection with an enterprise that she carries on. In contrast, the transfer by Shaun of his interest in Lot 2 to Caroline is in the course of furtherance of an enterprise he carries on. Shaun's transfer of his interest in Lot 2 to Caroline is connected with his enterprise of selling new residential premises for profit."

In short Caroline does not have to pay GST on the market value of the lot she transfers to Shaun but Shaun has to pay GST on the market value of the lot he transfers to Caroline.

Now applying income tax or CGT to this same scenario. Shaun has to pay normal income tax on the portion that he transfers to Caroline as it is all part of his business operations. Caroline has to pay CGT on the portion that she transfers to Shaun, no main residence exemption as the portion she is transferring to Shaun is not part of her home it is part of the house he is going to sell. When Caroline eventually sells her home to a third party she will be entitled to the main residence exemption. When Shaun sells he will be taxed on the profit as normal business income so no 50% CGT discount.

2) Co owners of a long term rental demolish and build two new rentals to partition and hold one each. They are already an enterprise and in partnership for GST purposes because they are jointly in receipt of rental income. GSTR 2004/6 sees the partitioning as the partnership coming to an end and making a supply to the individual partners. The whole property will be supplied to the individual co owners so GST payable on the whole market value **if** the partnership is registered or required to be registered for GST. Note the margin scheme can apply if all the normal requirements are met.

The trick here is that the building of the two new rentals to simply transfer to each other is not part of the partnership's normal turnover. The sale of brand new residential property is subject to GST if the owner is registered or required to be registered for GST. If there is nothing else in this partnership and it is not already registered for GST then its turnover, which is simply residential rents will not force it to be registered for GST.

If you were going to build two separate free standing houses anyway it would be wise to build the new rental properties until after the partition has been completed. This keeps stamp duty low.

As for CGT and income tax purposes the plan all along has been to hold an investment property not profit making by building houses so the 50% CGT discount should apply. This is put beyond doubt if you delay building the new houses until after the partitioning.

If you are going to partition under a strata plan then you can't partition before building but this has a better outcome for CGT purposes anyway. Section 118-42 allows a concession when tenants in common strata plan a property refer TR 97/4 and PBR 17485 for a practical example https://www.ato.gov.au/rba/content/?ffi=/static/rba/content/17485.htm . There is a roll over available so that a CGT event is not triggered when the strata plan gives you an individual title. The gain on the value of the property at that stage is rolled into the gain you will eventually pay tax on when you sell the property to a third party.

3) Buying a property to build two homes on, to each live in

There is a fine line here for GST purposes. You see if you build, say a duplex to sell off to a friend, family or member of the public so that you can afford to live in the other half the GST would apply to this profit making venture reference MT 2006/1 paragraph 273. But even though the same result is achieved by going into this arrangement with a co owner of the original piece of land GST will not apply because there is no enterprise or profit making venture you are simply building homes to live in.

Capital gains tax will apply on the half you transfer to each other, unless you use a strata plan to partition (section 118-42 ITAA 1997). Assuming no strata plan there will be no main residence exemption on the portion you transfer to your co owner because you have lived in the house you are keeping not the house you are transferring half of. You will be entitled to the 50% CGT discount if it is over 12 months since you purchased the original property. The subdivision does not restart the 12 months clock.

4) Buying a property to build two homes to sell

This is a business venture without a doubt. You have clearly bought the property to make a profit from selling it once you have built on it. As a business venture you will have to pay GST on the selling price but you will be entitled to GST input credits on the construction costs. If you didn't qualify to claim a GST input credit when you purchased the original property and that sale was not under the going concern or farm land concessions, you will be entitled to use the margin scheme to reduce the GST, if the buyer agrees in writing.

There will be no 50% CGT discount on the profit because it is normal business income, a profit making motive.

If you are going to sell anyway there seems no point in partitioning, transferring ownership between the co owners as this is just an extra cost when you are not intending to continue to hold them anyway. There are new GST laws in place that prevent the partnership's transfer to you at a low cost being the first sale of the house. Effectively the GST taxing point is moved to the amount paid when it is sold to a third party.

No it is not just you, these explanations do come close to contradicting themselves. If in any doubt you should apply to the ATO for a ruling. You see the ATO is informed by the titles office of all transfers so they will find out about it. No chance of flying under the radar. The trap is that if GST did apply to the transaction then you could probably have used the margin scheme to considerably reduce that GST, this is difficult to do once the transfer has taken place. Further, there is a 4 year limit on being able to go back and claim back the GST input credits on the construction costs, that you would be entitled to if you have to charge GST. It is far better to get it right so you can minimise it than coping full GST possibly losing your input credits and lots of fines and interest.

Ask BAN TACS

For $79.95 at Ask BAN TACS, https://taxquestions.com.au/ you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

More Information

Please make sure you continue to keep your knowledge up to date by subscribe to our Newsflash reminder. There are many other booklets available on our web site https://www.bantacs.com.au/media-library/booklets/ in fact the whole web site is full of useful information so also have a look around under topics.

How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

.....and the list goes on!

To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

Disclaimer: The information is presented in summary form and could be out of date before you read it. It is only 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.