NEWSFLASH

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Welcome to the BAN TACS News Flash. Our aim is to provide short but succinct updates on all tax issues

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.

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One very generous askbantacsers have allowed their question and answer to be posted on the notice board. http://www.bantacs.com.au/QandA/index.php?xq=792 Capital Gains Tax On A Holiday Home.

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 On the other side of the coin by the time you read this information it may be out of date.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