



## **Knockdown and Rebuild your Home or a Duplex Tips and Traps**

Before you start make sure you get advice on all the tax considerations, there are hundreds of thousands of dollars at stake!

### **Main Residence Exemption**

If you are considering a knockdown rebuild of your home that you purchased after 19<sup>th</sup> September, 1985, it is important to realise that your main residence CGT exemption is connected to the dwelling you are about to demolish, the land is only covered by association. Demolish your home and you could lose your main residence exemption right back to the day you first purchased the property. To build a bridge between the old home and the new home you have to, very carefully, follow the carve out in section 118-150 ITAA 1997 commonly referred to as the 4 year rule. There are lots of conditions and all must be met to qualify.

- The gap between moving out of the old home and moving into the new home must be less than 4 years.
- You must not cover another property with your main residence exemption during this period, other than under the six month overlap concession.
- You must move into the new home as soon as practicable after the certificate of completion is issued.
- The new home must be covered with your main residence exemption for at least 3 months.

For example, consider that you will probably rent a home while your new one is being built. When your new home is completed, you may delay moving in until the end of the school term or the end of your lease. That is all it takes, not moving in as soon as practicable after completion for the bridge between the two houses not to exist. You have completely lost the main residence exemption for the period between the original purchase of the property and the day you move into the new house. So, one day when you sell the property, you will have to look at the whole capital gain, from original purchase, to the date of sale and apportion that gain between days before you moved into the new house and days after. Paying CGT on the percentage of time that represents the earlier period. A tax on inflation.

Don't risk just trying to appear to be living in the new house, in Erdelyi's case the ATO pointed to a low electricity bill to convince the court that they were not really living in the house.

## **GST**

What about GST? Something could change, for example a cost blow out or need to relocate and you may have to sell this new home. Alternatively, you may have built a duplex and intend selling one side.

You have built a new house, the sale of a new house is subject to GST unless it has been held as a rental for more than 5 continuous years. That is providing the seller is registered or required to be registered for GST. This is the key, whether you are required to be registered. Some conveyancers will tell you to register. If you do that, the sale will most certainly be subject to GST.

You are only required to be registered if you are building the house as part of an enterprise. An enterprise can simply be a one off profit making scheme. If you are trying to argue that you built the house to hold as your family home yet sell soon after you need to have a very good unforeseeable reason for selling. The onus of proof is on you to convince the ATO that you did not build to sell, very difficult when the facts contradict that.

If you can convince the ATO that the house was not built for resale then its sale is not part of your turnover, it is the sale of a capital asset. Accordingly, the sale price of the house is not included in your turnover test. If your turnover is more than \$75,000 you are required to be registered for GST. Once you are registered for GST you must charge GST on the first sale of a new house even if it is held as a capital asset. It all turns on not being registered or required to be registered.

If you end up having to sell the property (even a few years later) that you built to live in, the onus of proof is on you to show that really was your intention to live there as your home, otherwise you're required to be registered and GST applies. Let's face it if you don't live there for long then the facts are against you. There is no chance of slipping under the radar as the purchaser is required to withhold the GST at settlement and send it to the ATO.

Building a duplex and selling the other side is definitely subject to GST, you built it for resale so it counts as part of your turnover. You are profit making (enterprise) like in actually constructing the house and as it is worth more than \$75,000 you need to register for GST.

You are going to get the same price for the house whether it is subject to GST or not. That one eleventh comes out of your pocket. If you face up to this at the time of sale you can put a margin scheme clause in the contract so that GST only applies to the difference between what you paid for the property originally and the selling price. The worse possible outcome is the ATO come along a few years later looking for the GST and it is too late to utilise the margin scheme clause or for you to claim the GST input credits back on the construction costs. Double whammy.

## **Income Tax**

Construction of a house to sell (or one half of a duplex) means you are an enterprise so subject to GST. For income tax purposes at the very least you are entering into a one off profit scheme. The larger the scale and repetition could even go as far as to be considered a business. Either way this means that the CGT discount will have only limited application to the profit you make on the building on the other side of the duplex, that you intend to sell. There will be no main residence exemption at all on that side, as you can only cover one property from the day of original purchase and only then if you follow the guidelines above carefully. You will have a CGT calculation and 50% CGT discount up to the date that portion of the property is committed to the development project. Any gain after that will be normal income so no 50% discount. You need to know the market value of that portion of the property when it was committed to the development so you can apportion the sale proceeds between CGT and normal income tax.

For the average simple one off development both the CGT and the normal income tax will be taxable when it is sold. CGT in the year that the contract to sell is entered into and the income tax side of it in the year that it settles.

The trap is when you are in the business of building homes to sell. An unlikely scenario if all you have ever done is knock down your family home to build a duplex and sell one side. But if you are a builder or you have done this sort of development before The ATO may consider you to be in business (not just a one off profit making operation) for tax purposes then section 70-30 ITAA 1997 applies. This moves an item held on capital account across to trading stock of your business. You have a choice of setting the value of the land at change of purpose to either market value or cost. With cost there is no gain to declare, so no tax until the duplex is sold but it also means that none of the capital gain on the land beforehand, is covered with the 50% CGT discount. Obviously, you want this change of purpose to be at market value. The catch is if the

ATO determines you are in a regular business (not just a one off scheme) you must make a transfer at market value election or you will be stuck with the transfer at cost. Making this election will trigger a CGT event in the year you change the purpose. This means you need to declare a capital gain in that year. Unfortunately, before you get any cash to pay the CGT but if you don't you lose any advantage of the 50% CGT discount on any of the capital gain since you purchased the property.

A joint venture is unlikely to avoid the tax problems, in fact you a poorly set up arrangement may cause even more tax problems.

## **Consider Subdividing and Selling Vacant Land Instead**

Subdividing off part of your home block and selling the vacant land, is not as likely to attract GST or lose the 50% CGT discount. If you have held the property for a long time and have not purchased it with the primary intention to subdivide to sell, then you could be considered to be merely realising an asset, so not in business or even a one off profit making scheme. It is the building of a home on the vacant land where the problems start. While vacant land is also subject to GST, if you are merely realising an asset the sale price is not part of your turnover so you are not required to register for GST. If you are not registered or required to be registered then you do not have to pay GST on the sale. Just do the bare minimum required by council to subdivide, do not get too business like. Considering the risks involved in construction and the GST and income tax consequences, is it worth the trouble of building?

## **Pre CGT Property**

If you owned this property before 20<sup>th</sup> September, 1985 then building a new home or duplex on the land will not change the land's pre CGT status but the new buildings will be considered a separate asset from the land and CGT will apply to them. One should be covered by your main residence exemption but the other will be exposed to CGT if you have kept it as an investment. When you eventually sell this new house built on pre CGT land you will need to split the sale price between the value of the land and the value of the building. The latter being exposed to tax. The cost base will start with the building costs, add to that any other costs associated with the building that have not been claimed as a tax deduction and its share of the selling costs. This cost base will need to be reduced by any building depreciation claimable against the rent.

The real tax trap with a pre CGT property is building a house on the land to sell. Taking a pre CGT property into a one off profit making operation will remove the pre CGT status from that point. Though the land will start out with the market value at the time it becomes part of the development with no tax payable before that.

The pre CGT concession finishes at date of death of the owner or on the transfer of the property. So, it is important not to change the ownership of a pre 1985 property if

you can help it. The longer you can keep the owner on life support the more tax free capital gain.

A transfer before death would be deemed at market value. Though there are a lot of issues to weigh up, probably the most important one being what the bank want and it may be difficult to borrow for the development without a younger family member with income being on the title. But if you can keep the property in the older family member's name even when building two new homes on it that will at least keep the land pre CGT. Though consider that only one of those homes are likely to be able to be covered by the owner's main residence exemption, there are advantages in transferring the other side that need to be considered.

This is better explained by an example. In the circumstances where you are considering building a duplex to give Mum a more modern home and living in the other side yourself. If it continues in Mum's name but is later sold to two different people there will be CGT on the second building, which could have been covered by the child's main residence exemption if a change of ownership on that side had been done when the duplex was completed. In the case that the child will always cover the property with their main residence exemption there is no harm in transferring a pre 1985 property to the child even though it will become a post 1985 property. The trouble is you do not have a crystal ball.

If simply renting out the other side, then it is well worth leaving the property in Mum's name as probably the biggest capital gain is on the land. Maybe with a mortgage on the property in favour of the children to cover their contribution in case her will is challenged.

Just be careful that the property is really Pre CGT. It might have been in the family since before 1985. Nevertheless, if it was inherited after 19<sup>th</sup> September 1985 it is now a post CGT asset. This can also apply to a property held before 1985 by a husband and wife but now only one owner survives and the other owner died after 19<sup>th</sup> September 1985. In that case the property is treated as two separate assets. Half of the property being subject to CGT.

## **CGT Tip for Joint Tenants**

If for one reason or another you have exposed a post CGT home to CGT, that you hold with your spouse, change the ownership from joint tenants to tenants in common. If the property is your home when one of you die and the spouse inherits half the property through the deceased's will, rather than by survivorship (joint tenancy) then the cost base of that half will be reset to market value at date of death regardless of the previous CGT exposure. There is no need to do this on a pre CGT home as there is a reset to market value for joint tenants as well.

This strategy needs to be balanced with the risk of a double death tax if the estate of one owner is not wound up before the death of the other owner. Joint tenancy minimises this risk. Refer <https://www.bantacs.com.au/Jblog/double-death-tax/#more-1999>

## **Records to Keep**

It is wise to not rely on your CGT main residence exemption. Subdivision, living overseas when you sell, wanting to cover another place instead, divorce and plenty of other unintended outcomes could leave you scrounging around looking for records to calculate your cost base. This is particularly important when a property has been your home at least part of the time. The cost base can include holding costs associated with the property that have not otherwise been claimed as a tax deduction. Holding costs would include rates, insurance, interest, repairs and maintenance while you are living there. The way the formula works is even if during the time you live there it is covered by your main residence exemption the apportionment of the whole gain on days not covered by the main residence exemption means that a portion of the costs associated with the period you lived there reduce the CGT on the period you did not.

### **Spreadsheet to keep the right records**

<https://www.bantacs.com.au/shop-2/protecting-your-home-from-cgt/>

### **Askbantacs how this applies to your particular circumstances**

<https://taxquestions.com.au/>

### **If you would prefer to talk through your options with Julia a zoom consultation can be arranged**

<https://www.bantacs.com.au/shop-2/consultation-with-julia-hartman/>

### **Further Reading**

<https://www.bantacs.com.au/Jblog/building-a-duplex/#more-222>

<https://www.bantacs.com.au/Jblog/small-developments/#more-248>

<https://www.bantacs.com.au/Jblog/do-not-let-your-conveyancer-talk-you-into-registering-for-gst/#more-948>

<https://taxquestions.com.au/category/capital-gains-tax-your-home/>

<https://www.bantacs.com.au/Jblog/sale-of-1-47-hectares-one-off-profit-making-scheme/#more-1448>