capital gains tax

Capital Gains Tax

(Kindly produced in conjunction with BANTACS Julia Hartman B.Bus CPA)

CONTENTS

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principal place of residence CGT exemption

Basically if you make a capital gain when selling your home it is exempt from capital gains tax but there are some catches and extra benefits. Ensuring that you qualify for the exemption is now more important than ever because indexing for inflation no longer applies. If you hold the property for 20 years it would not be unreasonable to expect it to double in value but with no exemption you could lose 25% of that increase in value in tax. This would mean you would not have the money to buy a similar house elsewhere or possibly not be able to afford to move. The following is a summary of some important points to the exemption. PPR stands for principal place of residence.

1) CGT does not apply to your home if it was purchased before 20 September, 1985.

2) The PPR exemption can apply to a forfeited deposit or damages received from a defaulting purchaser providing the house is put back on the market and eventually sold.

3) A "Spec" builder who lives in the "spec" home technically qualifies for the PPR exemption but is taxable on the profit as normal business income anyway and this overrides the CGT exemption.

4) If the home is owned by a trust or company the PPR exemption cannot apply.

5) If you move into a house as soon as practical after you purchase it the house is deemed to be your PPR from the time you purchased it. Further, if at the time of purchasing your new house you have not yet sold your old house they can both be your PPR for up to 6 months. Providing during the last 12 months you have lived in your old residence for at least 3 continuous months and it was not used to produce income during the period in that 12 months that it was not your PPR.

6) If you sub divide the land your home is on and sell the new block separately from your home the PPR exemption does not apply. If you build another house on the block the PPR exemption can apply for up to 6 months if you sell off the old home in that time. Refer point 5 above and TD2000/13 & TD2000/14.

7) Other than the circumstances in point 5 above you can only have one PPR at a time. Providing you have at some time lived in the place (refer point 9 for qualifications) you can choose which house you want to be considered your PPR but only from the time you first lived there (except re point 10) and only up to six years after you move out if it becomes income producing during your absence. The time frame is unlimited if it is not income producing while you are not living there. Note if you move back in and then out again (refer point 9 for qualifications) you are entitled to another 6 years PPR exemption even if it is income producing.

8) If you earn income from your PPR while you are living there than your PPR exemption only applies to the percentage of the Capital Gain that represents the percentage of the house used for private use. Note in Walters case a person renting out rooms in the home unit she lived in was only allowed a PPR exemption for the portion of the unit not rented out, even though the rent was half of the market value. If you are going to take advantage of the circumstances outlined in point 6 but the home was partly used to produce income while you were living in it then you can only get the same percentage PPR exemption during the 6 year period as the percentage the house was used for private while your were living there.

principal place of residence CGT exemption

9) When considering whether your house is your PPR the ATO considers the following factors (refer TD51), note not all have to be satisfied:

(a) Electricity and phone connected in your name.
(b) Registered on the electoral role to that address.
(c) The presence of personal effects in the house.
(d) The address given for mail deliveries.
(e) Where your family lives.
(f) The length of time you have lived there.
(g) Your reasons for occupying the dwelling.

10) You can elect to have vacant land or a property you are renovating classed as your PPR for a period of up to 4 years before you move into it providing you do not have another PPR (other than for the 6 months in point 5). But you must move in as soon as practical after the building is finished and live there for at least 3 months before selling or have died.

11) If your house is accidentally destroyed and you sell the land rather than rebuild, your PPR exemption can continue to apply to the land until sold providing you do not claim any other place as your PPR.

12) Families are discriminated against in that spouses and their children under 18 can only have one PPR between them no matter where they live. Spouses can elect to claim their spouse's PPR as theirs even if they never lived there and even if their name is not on the deed. If both spouses want their separate homes to be their PPR they only get half the exemption on each place.

13) If you acquired your PPR after 20th September, 1985 and used it as your PPR until some time after 20th August, 1996, when it became income producing you must use the market value of the property at the time it becomes income producing, as your cost base. Therefore any assessable capital gain will only arise on an increase in the value of the property after it ceased to be your PPR. Though considering the drop in some house prices in 1996 this may work against you. It is not optional.

trusts and CGT concessions

There are many capital gains concessions (see reader's question below for example) for businesses whose "combined assets" are less than $5 million. The problem lies with the definition of "combined assets" as these include the assets of associates. If you are operating your business as a trust then all the beneficiaries of your trust that are entitled to 40% or more of the profits are associates of your business. Traditionally trust deeds have endeavoured to define beneficiaries as widely as possible to cover all possible future events. The trouble is that the total of all these possible beneficiaries assets could easily reach $5 million. So it is important to have a clause in your trust deed that any beneficiaries other than the immediate family members are only entitled to a maximum of 39% of the profits in any given year. This ensures their assets are not taken into account when determining whether the assets of the trust and its associates does not exceed $5m.

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

readers questions

A reader has been operating a business from premises they own. They have sold the business and are now considering what to do with the premises. As it turns out asking this question before 12 months has elapsed since the sale of the business has halved their capital gains tax bill.

The following exemptions, except point (a)- the 50% capital gains tax discount, are conditional upon the small business test being met i.e. Under $5million in net assets. The definition of net assets includes the assets of all associates.

Capital gains tax will apply to any increase in the value of the premises since purchase (less purchasing costs and selling costs). Note: in some cases indexing may apply but it is rare that this is an option as using it prevents you from using the 50% capital gain discount. The following concessions are permitted regarding capital gains made on assets held for more than 12 months.

The 50% capital gains discount - only half of the gain is included in your taxable income. This concession is not available if the asset is owned by a company.

The 15 year ownership exemption. This requires you to have held the asset for more than 15 years. The asset must be an active asset. You need to satisfy the controlling individual test if the asset is owned by a company or trust. The taxpayer or the controlling individual, if a company or trust, must also be over 55 and retire or be permanently incapacitated.

Retirement exemption – can only apply to an active asset and the taxpayer or controlling individual must retire or put the funds into a superannuation fund. The gain is not taxed when it goes into the superannuation fund and the only limit is that you can only put $500,000 into superannuation this way, in your lifetime. When you retire the money comes to you tax free.

50% discount for active business assets – can only apply to an active asset.
Rollover relief where an active asset can be sold and another active asset purchased within two years.

More than one of the above can be used if you qualify. It is not that difficult to meet the retirement condition but if that is the case you would not be looking to use the rollover relief. You can use the 50% capital gain discount together with the 50% active asset discount to only pay tax on only 25% of the gain.

An asset is not an active asset if it is held merely for the purpose of earning rental income. Section 152-35 states that to qualify as an active asset the asset must be held as an active asset just before the sale or within the 12 months before the sale if the business has ceased. In addition to this, the asset must also have been an active asset for at least half the period of ownership. So our reader will need to sell the asset before 12 months has expired from the business ceasing, to be able to claim the 50% active asset discount.

There are problems if the asset is held in a company. Firstly, the 50% capital gain discount is not available. The controlling individual test cannot be met in many circumstances so the 15 year ownership or the retirement exemption may not be available. The active asset discount stays within the company. If you try and get the money out of the company (without putting it into a superannuation fund) every dollar you receive, including the dollars that the company did not have to pay tax on because of the discount, will be fully taxable as a dividend in your hands. Using the rollover relief provisions is only useful if you are buying another business and it will force you to continue to use the company so continuing the problem next time you sell.

The GST ramifications of selling the building should also be considered. De-registering for GST is a consideration if you purchased the building before GST came in. The margin scheme could be used if this is the first sale of the building since it was built.

reader's question – inherited shares

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

If you are the beneficiary of a deceased estate you should make sure you know the market value, at date of death, of any assets held by the deceased before September, 1985 and the market value of their principle place of residence at the date of death. For post September, 1985 assets you should ascertain the cost base to the deceased as this will become your cost base.

basics for executors of deceased estates

Trustee, Legal; and Personal Representative and Executor mean the same thing for the purpose of the following and it is assumed the beneficiary is an individual.

A deceased estate receives a tax free threshold and stepping of its tax bracket from there for up to 3 financial years after death but note the ATO can cancel this concession if the winding up of the estate is unduly delayed for the purpose of the tax benefit. The deceased also receives the tax free threshold and stepping up of his or her tax bracket for the tax return up to the date of death. This means that effectively two lots of tax free thresholds etc can be utilised in the financial year of death. While in most cases the tax concessions are the same for the deceased as the executor, consideration should be given to this point in deciding whether to pass an asset onto a beneficiary before it is sold.

To qualify for the 12 month CGT discount, 12 months must have elapsed from when the deceased entered into an agreement to purchase the asset regardless of whether it is held by the trustee or beneficiary when sold.

In most circumstances death will not trigger capital gains tax but it will start the clock ticking on pre 19th September, 1985 assets so it is important to have these valued at the date of death.

Most pre 19th September, 1985 assets will, in the hands of the executor or beneficiary, have a cost base of market value at the date of death. So when sold CGT will be payable on the difference between the selling price and the combination of the selling costs, holding and improvement costs since death and the market value at the time of death.

The main residence of the deceased will not attract CGT if sold within two years of death whether it was purchased pre or post 19th September, 1985 and there are further concessions if a beneficiary continues to live in the house. The main difference between pre and post 85 main residences is the two year concession applies to pre 85 dwellings even if they were rented out before and or after death whereas post 85 homes only receive the concession if it was the deceased's main residence just before death and was not also income producing at that time. If the dwelling fails this test it is treated like other assets discussed in point 5 above.
Any capital loss accumulated by the deceased can only be offset against capital gains made up to his or her date of death. So neither the beneficiary nor the trustee can take advantage of the carried forward capital loss of the deceased.

Generally the passing of an asset from the deceased to either the Executor or Beneficiary will not trigger a CGT event nor will the transfer from Executor to the Beneficiary.

The capital gains tax event arises on the date you agree to sell the asset to a particular purchaser, not the settlement date.

becoming a non resident of Australia for tax purposes

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

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

1) Land, buildings and structures in Australia
2) An interest or right in land in Australia
3) A strata title flat or home unit
4) A share in a company that owns 1, 2 or 3 above and gives the shareholder the right to occupy.
5) An asset that has been used by its owner at any time to carry on business through a permanent establishment in Australia.
6) A share in a private company that was a resident of Australia when the share was sold.
7) An interest in a trust that was a resident of Australia when the interest was sold.
8) A share in public company that was a resident of Australia when the share was sold and the non resident and associates had control over more than 10% of the shares at any time during the last 5 years.
9) An unit in a unit trust that was a resident of Australia when the unit was sold and the non resident and associates had control over more than 10% of the units at any time during the last 5 years.
10) An option or right to acquire any of the above.
11) Various provisions associated with rollover relief.

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

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

or

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

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

As your home will be an asset "connected with Australia" you will not be deemed to have disposed of your home by 104-160 if you decide to keep a home in Australia to return to and go overseas for longer than 2 years and lose your residency for tax purposes. But note you will have to elect for it to be your main residence otherwise section 118-192 deems there to be a disposal anyway, if it is first rented out after 20th August 1996. If you elect for it to be your main residence but rent it out during you absence the exemption will only last 6 years unless you move back in again. You will qualify for another 6 years each time you move back in. If it is not rented out the exemption from CGT is unlimited. Section 118-145. Note the disposal deemed by section 118-192 does not trigger a capital gain if the house had always been your main resident during the time you owned it but it will start the clock ticking on any gain from that date forward.

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

becoming a resident of Australia for tax purposes

While the ATO likes to hang onto its residents for tax purposes if they are overseas for up to 2 years. On the other side of the coin they will start trying to assess a person from overseas as a resident of Australia once they have been here 6 months and it does not have to be a continuous period of 6 months. But it cannot apply if you have no intention of setting up a residence (normal abode) here. More information is available in IT2681.

Immigrants are considered to be an Australian resident from the time they arrive.

For capital gains tax purposes all assets (other than those acquired before 19th September, 1985) owned by a new resident are deemed to be purchased at the date of residency for their market value. So it would be wise to collect as much information as possible to calculate this cost base. Note this does not apply if the assets are "connected with Australia", in that case the cost base is the original cost.

From the 1st July, 2002 expatriates resident in Australia for less than 4 years will not be subject to capital gains tax on their non Australian assets.

non residents and capital gains tax

Non residents are subject to tax on capital gains made on assets that are "connected" with Australia ITAA97 Section 136-10 if the assets were acquired after 19th September, 1985. But if the Australian assets are actually owned by a non resident company the capital gains tax will not apply. Note the Ralph Review suggested closing this loophole. To be "connected with Australia" (section 136-25) the asset must be:

1) Land, buildings and structures in Australia
2) An interest or right in land in Australia
3) A strata title flat or home unit
4) A share in a company that owns 1, 2 or 3 above and gives the shareholder the right to occupy.
5) An asset that has been used by its owner at any time to carry on business through a permanent establishment in Australia.
6) A share in a private company that was a resident of Australia when the share was sold.
7) An interest in a trust that was a resident of Australia when the interest was sold.
8) A share in public company that was a resident of Australia when the share was sold and the non resident and associates had control over more than 10% of the shares at any time during the last 5 years.
9) An unit in an unit trust that was a resident of Australia when the unit was sold and the non resident and associates had control over more than 10% of the units at any time during the last 5 years.
10) An option or right to acquire any of the above.
11) Various provisions associated with rollover relief.

Accordingly, a non resident will not be subject to capital gains made on shares in Australian public companies or trust if they control less than 10%. But will be subject to CGT on the sale of a house or home unit unless the are utilising the exemption available under section 118- 145 because they have lived in it.

Note some double tax agreements can contradict the above and if so the double tax agreement has authority over Australian tax law.

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

reader's question:

warning to readers renting out their home

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

Imagine the situation where a person buys at $100,000 with a respectable 20% deposit but $5,000 is used up in stamp duty, legal fees. bank fees and searches so the bank loan is for $85,000. Very little is paid off the principle as at the start of the loan it just doesn't happen and then when he or she rents it out he or she changed to interest only. He or she finally sell for $90,000 but the price had dropped by 20% (it happened around 1996) when they rented it out. They have made a notional capital gain of $10,000 less selling costs of say 4,000 equals $6,000 less the discount taxable income will be $3,000. This gain could push many people into the maximum tax bracket so tax could be as much as $1,455 (let alone child support and loss of Centrelink benefits and possible surcharges) on a loss! So out of the $90,000 the bank gets $85,000 the Real Estate and solicitor $4,000 and the tax man $1,455. Not only has he or she blown their $20,000 deposit (life savings) but they now have to find another $455 over the top of the selling price to pay the tax man. This is also a double tax because the original stamp duty paid on the purchase is ignored when setting the cost base on only the market value without acquisition costs.

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

CGT concessions if you live in a property

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

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

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

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

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

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

Section 118-150 A vacant piece of land can be covered by your main residence exemption for up to 4 years before you finishing building a dwelling on it, if:

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

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

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

- If you purchased your home after 19th September, 1985 and before 21st September, 1999 you have a choice. You can apply inflation from the date of purchase to 21st September, 1999 to your original costs (including improvements) and pay tax on the difference between that and the selling price less the cost of selling. But you will miss out on the 50% discount. Otherwise you can pay tax on half the difference between the original costs including improvements and the selling price less selling costs but no allowance for the effect of inflation. Note the tax rate will be the normal rates as there are no longer averaging concessions and the gain can push you into a higher bracket.

- If you miss out on the exemption and your home was purchased after 21st September, 1999 you will pay tax at whatever bracket half of the gain pushes you into (assuming you have held the property for 12 months or more). Note there is no indexing for inflation. So if houses in general go up in value you will still be paying tax on the difference between your actual cost base and the selling price regardless of the fact that, after paying the tax, you will no longer have enough money to buy a house of the same value. In other words you will go backwards as a result of the sale.

If the house is only entitled to your main residence exemption part of the time, the taxable gain will be multiplied by the percentage of time the house did not qualify. Accordingly, you will have to keep records of all capital improvements for the whole period of ownership as the gain for the whole period of ownership has to be worked out first. You will need to be very diligent to record all capital improvements as they include trees, floor tiles, the extra wiring for say an outside light, a hose if there wasn't one there before etc etc. Basically you need a big box and just keep receipts for everything to be sure.

As discussed in Newsflash 49 under "Warning to Readers Renting Out Their Homes", if the home is first rented out after 20th August 1996 and has qualified as a main residence up to that date you are forced to set a new cost base of the market value at the time of renting. So if you are only ever likely to lose your exemption because you may rent the house out in the future, you really only need to keep the big box after you start to rent it out.

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

secret plans and clever trick – CGT & non-capital costs

In Newflash 50 there were warnings of various ways you could lose your Main Residence Exemption for CGT purposes. If this has already happened to you don't despair just start collecting records including digging up old bank statements on the loan, asking Council and your insurance company for copies of all that you have paid them since you purchased the house. Section 110-25 subsections (2) to (6) cover all the relevant costs that can be used to reduce your capital gain. Subsection (4) allows owners of homes purchased after 20th August 1991 to claim as a deduction for CGT purposes non capital costs of holding the home if they have not already been claimed as a tax deduction against rent or other income earned from the house. Holding costs are rates, land tax, interest expenses, building insurance, repairs and maintenance. If you have lost the main residence exemption for only part of the period of ownership the holding costs for the whole period of ownership are first taken into account to calculate the whole capital gain and then apportion the percentage subject to CGT.

You should also do this if part of the house has been used for income producing purposes and that part is not considered a separate asset. The portion of the holding costs that have been claimed as a tax deduction cannot be included in the cost base but the private portion that was not claimed can be included in the whole cost base before apportioning the capital gain. Note holding costs cannot be used to increase the capital loss on an asset nor can they be used if the asset is a personal use asset (houses are excluded here) or a collectable.

If in doubt throw it all in a big box. The biggest tax minimisation scheme is just plan keeping records.

reader's question - CGT liability

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

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

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

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

Note section 118-140 is not optional it must apply so if you have made a capital loss during the period of overlap you cannot claim it. The above does not put any restrictions on the new home so it is not relevant that it was owned for more than 12 months before the sale of the original home or that it was rented out for the first 12 months. The reader is still entitled (in fact it is compulsory) to the 6 month overlap that exempts from CGT the new home for the 6 months before they move in. Accordingly, if they sell after owning the property for 2 years and living in it for 1 year, they will now only be taxed on one quarter of the capital gain and that will then be halved to allow for the CGT discount on properties held for more than 12 months.

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

secret plans and clever tricks – divorce rollover relief

The rollover relief that is available, under section 126-5, to couples facing divorce means that assets can be transferred by one spouse to the other without any CGT consequences. If rollover relief does not apply section 116-30 will deem the transfer to take place at market value which may result in a CGT liability for the transferring spouse. For rollover relief to apply there must be a court order or section 87 maintenance agreement under the Family Law Act, corresponding foreign family law or a state or territory or foreign law relating to defacto marriage breakdowns. This is not an option but an unavoidable consequence unless you transfer the property before the court order. Rollover relief is not available to same sex couples.

When a spouse receives an asset under the rollover relief provisions, he or she receives the asset at the cost base of the spouse giving the asset and the spouse giving the asset is not subject to capital gains tax on the transfer. Or if applicable, the asset will retain its pre CGT status.

It is not always advantageous to utilise the rollover relief but if the arrangement is part of a court order rollover relief is not optional. But not all assets need to be covered by the court order. The idea is to sort through the assets as to what needs rollover relief and what doesn't.

A very good example of how this relief can be used to your advantage is combining it with the main residence exemption under Division 118 to exempt the property, from CGT, for the whole period of ownership. For example: B owned a main residence and a rental property at the time of marriage. At all times up until the time of divorce the properties were always used as a main residence and a rental property respectively. An agreement stamped by the court awards the rental property to B's spouse. B retains the main residence and continues to use it as such. The main residence will be exempt from CGT from the time of purchase right through the divorce up to a time B either sells it or elects not to have it considered his or her main residence. Due to rollover relief B will not be subject to CGT on the disposal of the rental property to his or her spouse. B's spouse's cost base of the rental property is the same as B's original cost base plus transfer fees and capital expenditure. So B's spouse may end up bearing the CGT on this property. But if B's spouse uses the rental property as his or her main residence from the time of the transfer up until it is sold, the main residence exemption will protect B's spouse from any CGT because, under section 126-5 the transfer date is the acquisition date so for the whole time of ownership it has been B's spouses main residence. Note for the purposes of section 115-30 the acquisition date is B's acquisition date so that the 50% discount will be available immediately to B's spouse if B had held the property for more than 12 months.

The above will not work if the property is transferred from a company rather than a spouse. Rollover relief under Section 126-5 is still available but, under section 118-180(1), the spouse is considered to have acquired the property at the date the company or trust originally acquired it so the property will always not be considered the spouse's main residence for the period it was owned by the company or trust.

the 50% CGT discount

As you are probably aware you need to hold onto a property for over 12 months from the date of signing the agreement to purchase to the date of signing the agreement to sell in order to qualify for the 50% CGT discount. Some clients have been making a very quick gain on properties and are impatient to sell in case prices fall. The choice is sell now and lose a lot of the profit in tax or hold on and take a risk on future prices. From the buyers point of view they are probably more concerned that prices will continue to escalate but are not in a rush to start paying interest on the loan. In fact the chance to fix a contract at today's prices but not have to pay anything for several months could be very attractive to some buyers.

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

Of course an option gives a purchaser the chance of avoiding entering into the contract to buy the property so you must charge a large enough amount for the option to ensure that the purchaser will exercise it after the date you specify.

realising capital losses to offset a capital gain

A reader has made a large capital gain. He has made some paper capital losses on some shares but will need to actually sell the shares to be able to offset the loss on them against his capital gain. He does not want to sell the shares as he believes they will come good again. The obvious solution is to sell the shares and then buy another parcel of the same company's shares back immediately, hopefully at the same price. Thus crystallising the losses yet still holding onto the future potential. He wants to know could the ATO use Part IVA to deem the transaction void as a scheme to reduce tax.

Part IVA gives the ATO very wide powers to squash just about anything so we need to look to ATO commentaries on when it considers that it would not use Part IVA or section 260 (a predecessor to Part IVA). In IT 2330 the ATO states:

> "A simple disposition of income producing assets does not attract the operation of section 260."
>
> "Notwithstanding that an arrangement may not be capable of explanation by reference to ordinary business or family dealing and even though it may be entered into to avoid tax, it will not attract the operation of section 260 if its purpose is to take advantage of a specific or particular provision in the Income Tax Assessment Act and complies in every respect with the requirements of the specific or particular provision, i.e., the choice principle."
>
> " ….. in the situations where an income splitting arrangement survives the operation of section 260, it may be expected that it would not be affected by Part IVA".
>
> "As a practical matter, therefore, the views expressed earlier as to the impact of section 260 have broadly the same application in relation to Part IVA."

In TD 95/4 the ATO states:

> "Of itself, the simple disposition of an income producing asset by a natural person to a wholly owned private company is not an arrangement to which the Commissioner will seek to apply Part IVA of the Income Tax Assessment Act 1936 (the Act)."

CGT – changes to calculations

Major changes have been made to the way capital gains tax will be calculated. The changes will apply to any sale after 21st September, 1999. In particular, the averaging provisions have been abolished for any asset sold after 21st September, 1999. This makes a dramatic difference to taxpayers who have carefully planned their income around the sale of an asset. Note it is retrospective so you might have shifted your income all over the place to accommodate but if you hadn't sold the asset by 29th September 1999 it is a total waste.

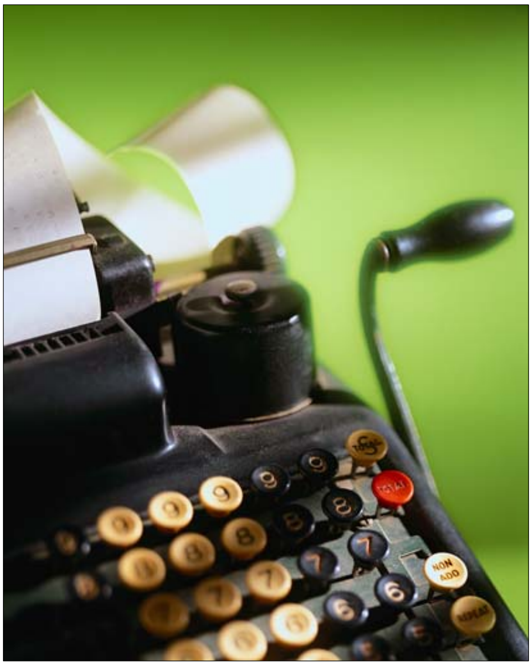
The CGT changes include:

Assets held before the end of September 1999 can be indexed only up to that date and if you choose to utilise the indexing provisions you cannot take advantage of the 50% reduction of your capital gain, refer 2.
All assets (other than pre 21st September 1999 assets that elect to use indexing) will now have their capital gain calculated without regard to increases in the CPI. If the asset is held for more than a year only half of the gain calculated will be taxable capital gain.

Active business assets for business under $5million that are not owned by a company will receive a further 50% reduction in CGT on assets held for more than a year. Rental properties are not active assets. .
Averaging is gone for any asset sold after 21st September, 1999 i.e all of your taxable capital gain will be added to your other taxable income and can if high enough push you into higher tax brackets just like any other income. Items 2) and 3) above are the compensation for this.

The cost includes commission, stamp duty, legal fees, purchase price, and cost of improvements. When the property was purchased after 21 August 1991, interest, rates, insurance and repairs can also be included in the cost base (Sec. 160ZH (6)) providing they have not previously been claimed as a tax deduction.

If you purchased the property before 19 September 1985 capital gains tax does not apply. This is another reason to try and rent your old home and claim the new loan as a tax deduction (refer Claimable Loans). If you lived in the property before you rented it out and do not wish to protect your current home with the principle place of residence exemption, you may elect to apply this to the rental property for up to six years (118-14 1997 Act). The election does not have to made until the property is sold. Further, if you rent the house out for six years and you move back in again you can then move out and rent the house out again for another six years exempt from capital gains tax. In other words, as long as you live in the house every six years it can continuously have your principle place or residence exemption.



reader's question – CGT basics

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

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

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

To qualify for the stamp duty discount, in Queensland, on your main residence, you must live there for the first 6 months. There is no such minimum time limit on how long you have to be in a house to establish it as your main residence, for CGT purposes. Whether the house is your main residence or not is a question of fact. The ATO has issued TD51 as a guideline (not law) of what the ATO considers relevant in establishing your main residence somewhere. The following is an extract from that ruling:

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

(i) the length of time the taxpayer has lived in the dwelling
(ii) the place of residence of the taxpayer's family
(iii) whether the taxpayer has moved his or her personal belongings into the dwelling
(iv) the address to which the taxpayer has his or her mail delivered
(v) the taxpayer's address on the Electoral Roll
(vi) the connection of services such as telephone, gas and electricity
(vii) the taxpayer's intention in occupying the dwelling

The relevance and weight to be given to each of these or other factors will depend upon the circumstances of each particular case.

Mere intention to construct a dwelling or to occupy a dwelling as a sole or principal residence, but without actually doing so, is insufficient to obtain the exemption.

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

A house can only be classed as your main residence if your name is on the title deed. So in the case above there was no point in arguing that the house was the main residence of the children but the problem could have been solved by buying the property in their name. Further, if you buy your home in the name of a company or trust it will not be protected from CGT by your main residence exemption.

As indexing for inflations is now only available in very limited circumstances it is important to protect you r main residence exemption. CGT could reduce the proceeds of the sale of your home to the extent that you will not be able to purchase a similar property, simply because of normal increases in prices in line with inflation.

If the above leads you to believe you may be caught please e-mail us for a free copy of our Capital Gains Tax Booklet for more detail on the concessions that are available.

tax minimisation schemes alert

The ATO has been looking into arrangements that attempt to use trusts to eliminate Capital Gains Tax. It has issued TA2003/3 and is still investigating other arrangements. The ATO web site has the full details. The ATO's main arguments against the schemes seem to concentrate on the fact they are.

1) Being set up by promoters of the arrangement rather than them being a normal business arrangement.
2) The result is contrived from the use of a number of trusts.

In short the ATO is not concerned with trusts set up to legitimately run a business it is more looking into trusts that are set up with no other clear purposes than to be part of an arrangement to launder a capital gain.

CGT catches the family home

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

When my widowed Grandmother sold her house to buy a unit near the beach, she made the title of the unit jointly in her name and the name of her youngest daughter who was still single and living with her. My Grandmother did this because all her other children were married and had their own homes so she wanted to make sure that when she died my aunt would have a home of her own. My aunt married a few years later.

Do that sort of thing today and there is a good chance that the home will become subject to Capital Gains Tax or Stamp Duty will have to be paid to change the title at a later date. Either way the taxman wins.

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

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

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

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

why pre Sept 1985 assets are so valuable

Most importantly pre Sept 1985 assets are valuable because they will never be subject to capital gains tax while their owner is alive and does not do anything to change their pre CGT status. This will normally make the pre CGT asset a better investment than anything you buy post 1985. So selling to invest somewhere else is unlikely to be a good move.

If you spend more than $101,239 (as at 2003 indexed each year) improving a pre CGT asset and that amount is more than 5% of the selling price, the improvement will be considered a separate asset from the pre CGT asset. Therefore, if the improvement was made post CGT, it will be subject to CGT on the sale even though the original pre CGT asset will not be (Section 108-70(3)). Note that both the threshold and the percentage test must be met for the asset to be considered separate from the land, so if one of them is not met the improvement will be considered pre CGT. But note Section 108-55(2) excludes buildings and structure on pre CGT land from this concession.

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

house swapping

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

demolishing a rental property

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

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

References:
ID 2002/514 if the demolition expenses were incurred to enhance the value of the land, and are reflected in the state of the land when it is sold, they are included in the cost base, even when incurred to facilitate the construction of another dwelling.
TD 1999/79 the demolition of the house is a CGT event. But it does not create a capital loss unless money is received for it (ie insurance). ID 2002/633 says that this is because the building has a zero cost base. Subsection 112-30(5) the original cost base is attributed to the remaining part (ie the land).

part owner of parents' home

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

Answer:
As the property is held as tenants in common the deed will show just what percentage each of them own.

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

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

sell to a farmer as opposed to a developer

A husband and wife purchased a farm in 1988 which they have farmed, in partnership, continuously for the last 15 years. Their combined assets are under $5 million. They want to know how much tax they will be up for and whether this changes if they sell to a farmer as opposed to a developer. It is expected that they will get a higher price from the developer but wonder whether this will be worth it after tax considerations. The following only addresses the ramifications for the land not the plant and equipment on it.

CGT Considerations:

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

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

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

3) Both owners must retire

If they can pass this test the gain is totally CGT free and does not even count towards their RBLs.

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

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

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

Note:

- If they could not use the 15 year exemption because they failed the active asset test as per 1) then they will not qualify for the retirement exemption or the 50% active asset discount.
- Despite its name the retirement exemption does not require them to retire. They can just put the money into superannuation instead.
- Companies and Fixed Trusts are not entitled to the 50% CGT Discount and the use of the 50% Active Asset Discount creates problems when the asset is owned by a Company or Fixed Trust. In Discretionary Trusts the CGT flows through to the beneficiaries so is treated the same as an individual. Fixed Trusts are all trusts that are not discretionary. Fortunately our Readers owned the farm in partnership.

sell to a farmer as opposed to a developer

GST Considerations:

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

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

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

wraps – vendor finance arrangements

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

Typical Features of a Wrap (Vendor Finance Arrangement)

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

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

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

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

Section 104-15(1) of ITAA 1997 states that a CGT event happens when the owner of a property enters into an arrangement with another party to allow them to live in the property and title may transfer at the end of the arrangement. Section 104-10(3) states that the time the CGT event happens is the time of entering into a contract for the disposal of the asset, not when settlement (title passes) takes place.

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

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

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

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

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

Now that's the real reality!

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

CGT concessions for deceased home

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

Pre 20th September, 1985
If the Deceased purchased a house on or before 19th September, 1985 the CGT exemption continues for a period from the date of death until it is sold if during that period it has only been occupied by the spouse of the Deceased and/or the beneficiary and/or any other person given occupancy rights under the will. In this case the exemption will apply for the whole period. If it is not occupied by these people the exemption only lasts for 2 years.

Post 19th September, 1985
f the Deceased purchased his or her main residence on or after 20th September, 1985 the CGT exemption will only apply if the home is sold within two years of death and only if the deceased was living in it at date of death and not using any part of it for income producing purposes at the date of death. If part of the home was used for income producing purposes at the date of death the exemption is apportioned under section 118-200. If the whole of the property was rented out at date of death but had been the Deceased's home within the previous 6 years, section 118-190(4) states that the 6 year rule under section 118-145 can deem the home to be the Deceased place of residence at the date of death if no other residence is covered by the Deceased's main residence exemption.

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

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

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

occupying a house before buying

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

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

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

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

CGT – 50% discount – timing

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

the problems with life tenancies

Life tenancy is where the deceased grants a beneficiary of his or her will the right to occupy the deceased's home after the deceased's death up until the time of the beneficiaries death. After the death of the beneficiary the home normally passes to the deceased's children. Such tenancies are becoming more popular as the traditional family unit erodes.

The trouble with these arrangements is that the life tenancy beneficiary is not the owner of the house so cannot give the home his or her main residence exemption during the time he or she occupies it. Accordingly, (if the home is not a pre 1985 asset to the deceased) the capital gains tax clock will start within two years of the date of death of the original owner. Remembering that indexing for inflation is no longer effective for CGT purposes so the tax can simply be a tax on an inflationary gain.

There are even more problems if the life tenant decides to do a deal with the deceased children and say, in return for enough money to enter a nursing home, relinquishes his or her life tenancy. The disposal will be deemed to have happened at market value not the amount that changes hands. But this is the market value of the right to occupy the house not what the house is worth. The outcome here has not been tested in the courts. It is more than likely that this will result in a capital gains tax event with no cost base to the life tenant so he or she will be subject to tax on the whole amount of the market value of the right to occupy based on their life expectancy, probably less the 50% CGT discount and possibly taking them into the 48.5% tax bracket. Worse still if the deceased's children dispose of the property before the life tenant dies, division 128 appears to deem the cost base to be nil so the whole proceeds of the sale of the property are subject to CGT but they will probably receive the 50% discount.

In short life tenancies are dangerous and should only be used if there is no other suitable alternative.

reader's question – CGT on mother's home

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

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

when triggering CGT is good for business

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

Tax law is always changing so you may want to take advantage of the CGT concessions while they are available to at least increase the cost base you can apply if the concessions are one day removed. As the concessions can reduce the CGT to zero it is fair to assume there will never be a better option than what is currently available.

The Small business CGT concessions can only be utilised if the business' and associates' assets are less than $5 million. If your business' assets are approaching that threshold, triggering a CGT event now, may be the only chance you get at the concessions. For example a business started from scratch eventually sells for $8 million with $5 million in goodwill. The other $3 million being the written down value of equipment and stock:

Normal Circumstances

Profit on Sale	$5 million
Less 50% CGT Discount	$2.5 million

Amount Subject to Tax	$2.5 million

CGT Event Triggered when worth half the above:

Profit on Trigger Sale	$2.5 million
Less 50% CGT Discount	$1.25 million

	$1.25 million
Less 50% Active Asset Discount	625,000

Placed into Super for both the Husband and Wife who own the Business	625,000

Therefore no CGT payable and no tax payable by the super fund. The new entity that owns the business has now purchased the goodwill for $2.5million. When this entity sells this goodwill for double the amount the small business concessions will not be available because the $5million threshold is exceeded but the profit is reduced by the $2.5 million cost base. Therefore the amount subject to tax will be:

Selling price of Goodwill	$5 million
Less: Purchase Price cost base	$2.5 million

	$2.5 million
Less: 50% CGT discount	$1.25 million

Amount Subject to Tax	$1.25 million

The above has effectively halved the CGT applicable.

when triggering CGT is good for business

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

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

The best CGT concession is the 15 year rule. No capital gains tax is applicable to the sale of a small business that has been owned for more than 15 years. If you trigger a CGT event, as per point 3 above, the 15 year clock starts back at zero. Accordingly, you may regret doing this if you end up owning the business for more than 15 years, the law does not change in the meantime and the business' and associates' assets do not grow beyond $5 million.

rental property CGT audits

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

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

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

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

readers question – building on vacant land - CGT

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

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

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

readers question - travelling costs re rental properties

Travelling costs to purchase a property are a capital expense so not deductible against the rent. Even though they are capital costs they are not included in the cost base on sale either, because they do not fit within the definition of the 5 elements that make up the cost base as per the legislation. This opinion is covered by the ATO in ID 2003/771.

will preparation checklist

The following is by no means an all inclusive list. It is simply a summary of the issues discussed in our Estate Planning Seminar. This list should only be used as an aid to discussions with your solicitor.

Consider giving the Executor of your estate the flexibility to decide whether to sell the estates assets or pass them to beneficiaries in specie. This will allow your Executor to make the most of CGT concessions and make the most of the differences between the estate's and the beneficiaries' marginal tax rates.

If you bequeath particular assets to certain beneficiaries make sure you consider the associated CGT liability when considering the value of the asset they receive. For example if you leave your home to one child and your rental property to the other and they both sell the properties within 2 years of receiving them, the child who inherited your home will have no CGT liability but the child who receives the rental property will probably have to pay CGT out of the proceeds of the sale.

Avoid granting a life tenancy on your home if it was purchased after 19th September, 1985.

If your estate is unlikely to have much income but considerable capital gains make John Howard the only income beneficiary and leave the capital to your heirs. According to PS LA 2004/3 John Howard will have to pay all the Capital Gains Tax.

If you intend leaving money to a charity that has tax deductibility status consider doing this before you die so that you can take advantage of the tax deductibility. If the charity receives the funds as a distribution from your estate it is not tax deductible. Not even to your estate. Another strategy is to leave the charity's money to one of your beneficiaries with instructions that it must be donated to the charity. The beneficiary would then be entitled to a tax deduction.

Don't rely on just one Executor. Make sure you appoint default Executors in case your Executor pre deceases you.

Do not leave an amount to your Executor in your will, as payment for them executing your will as this will be taxable income to them. It should be clear that any amount you leave your Executor is a gift unrelated to the services they perform as Executor.

Consider a Testamentary trust if your beneficiaries may lose their inheritance through legal action against their personal assets. If you do choose a testamentary trust make sure the deed does not permit the trustee to admit new beneficiaries as this will compromise the trust's status as testamentary.

If your spouse is receiving the age pension the asset test is much lower for a single person. To assist your spouse in meeting this lower threshold you should consider leaving some of your assets to your children rather than your spouse. Your children would then, hopefully, be in a position to help your spouse out when needed.

will preparation checklist

Before you go to your solicitor make sure you have the following information:

- Personal details (Surname, Given names & Address)
- Children (Names, Ages & Addresses)
- Other beneficiaries (Names, Ages & Addresses)
- Executor
- "Reserve" executor
- Summary of assets and details of the ownership of assets
- Details of any liabilities
- Details of insurance policies
- Details of superannuation funds and whether advisory/binding death benefit nomination has been made
- Wishes in relation to burial/cremation
- Wishes in relation to guardianship of any infant children
- Wishes in relation to organ donation

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

CGT 50% discount trap for new residents

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

capital gains tax and shares or managed funds

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

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

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

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

some **work** others **network**

learn how to

drastically advance **your financial future**

through property and personal investment

Australian Property Investors Network (APIN)

www.apin.com.au

What does **APIN** offer ?

Seminars & Workshops

Why is that most people aren't taught how to be rich or happy? We are trained to do most things in our lives, in order to do them well enough to get by. We are taught how to read and write, how to cook, how to drive. We are taught how to do incredibly complex and challenging tasks like designing and building bridges over wide spaces, how to cure diseases, to fly airplanes, yet when it comes to creating personal wealth and happiness, we're left to find out for ourselves.

There's another, more subtle reason why most people don't achieve wealth and happiness. Deep down they don't believe that there is a choice to be made between being rich and being happy. They believe that somehow you can't have both, which is why in the end they don't get either.

The money that slips through your fingers could make you wealthy if spent more wisely.

Our free seminars and information evenings will provide you with leading edge valuable and up to date information. As a bonus you will be able to meet other like minded people who are either starting out on the road to success or are avid investors sharpening their investment knowledge. As a further advantage we encourage you to meet and freely talk with our alliance partners. These hand picked people both male and female are leaders in their own right, they are also licensed, qualified and independent.

These evenings are fun and informative plus you will have access to lots of support material in the form of e-books, books and cd's on a wide range of topics. Come and learn the many strategies used by successful investors NO SECRETS just sensible plain English techniques that really work in any market at any time.

Education

It's true what they say "*the difference between the rich and poor is what they know and what they do*". Property is more than houses and unit investing. Do you know how to buy a property using an option, how about knowing all the ins and outs of being your own "DIY Developer"?

There are many ways to make money in real estate and with the correct tools and strategies you too can play with the best.

TIME x INTENSITY = SUCCESS.

You can't expect to get results in life if you have all the information but fail to apply the principles needed to succeed.

Our programs, e-book, books and home study kits will give you the ability to learn and gather what you need at your own pace in your own time. We encourage you to learn from our expert alliance partners all that you can, so when you are ready to act you will have the education to get into your first investment or do your own JV building renovation makeover.

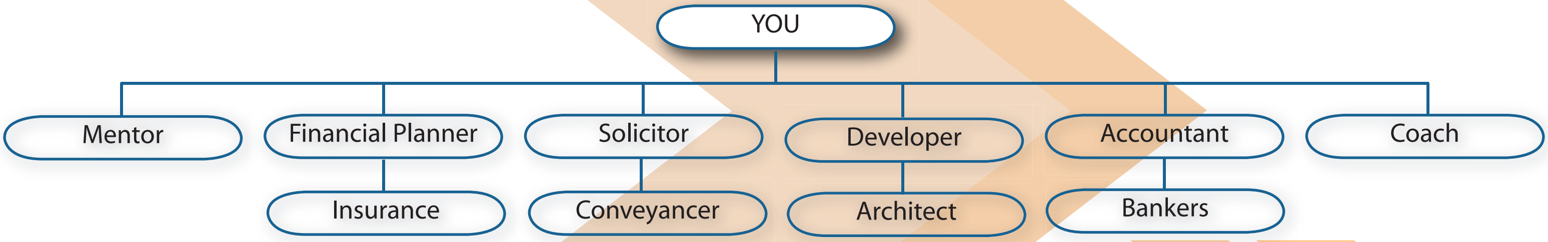
On going Support

Through APIN's Alliance Partners and Discussion Forums you can fortify your ideas and gain strength by exchanging information. Creating alliances generates business opportunities increasing your network and of course - your cashflow.

We have a mentoring service for those that are not quite ready to take those steps without guidance, extra information and some affirmation. Helping you to create a "*safe*" environment for your first steps.

Who is on your team?

When looking at people who are successful, you will notice they have a hand selected group of people to support and advise throughtout the journey to success.



Property Opportunities

Through our Australia wide network we select opportunities that "stack up". We use an independent Research company (Guardian) who are licensed financial planners and real estate agents to use our pre selection due diligence program. From investment properties, development sites, future land subdivisions, building makeovers to even golf course resort projects.

APIN also align ourselves with a select group of builders and developers where we negotiate wholesale purchasing, saving you 10% off the retail price. These opportunities are not available to the public but only members of the APIN site. We can introduce you to the key people who are experts in their fields, saving you thousands of hours of frustration and heartache. Very shortly APIN will also be offering FREE property advertising on our site through resisearch.com who are one of our alliance companies. APIN is fast becoming the most exciting site in Australia.