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Contents

1. Introduction and overview

Property remains a target for consideration with the ATO, and there is increasing engagement of people from all walks of life in "property plays" that often involve some level of improvement, if not complete development.

With the real estate markets in Sydney and Melbourne experiencing sustained growth in residential property values, almost every owner has experienced the upswing in value, and many are considering how they might now realise this value. Some may simply look to downsize and cash up for retirement, while others may look to subdivide portions of large blocks, perhaps redevelop or build a duplex: selling one and keeping the other.

Perhaps since the introduction of Capital Gains Tax in 1985, industry and advisors seemed comfortable that the old revenue cases were easy to understand, with the CGT regime dealing with the rest; punishing those who sold within 12 months with no discount.

A continuing boom in property in Australia has resulted in both more focussed efforts to maximise value on any property investment, and existing property owners putting properties into ventures to develop them.

Increasingly, homeowners are being approached by developers either individually (or in a line with neighbours) to realise prices that many would not have anticipated. As a response to this, neighbours are starting to work together in key areas to realise the best value for themselves, either by obtaining the development approval (DA) and selling as a package, or even undertaking the development themselves – perhaps partnering with a builder.

The rewards are potentially large, but with all rewards comes risk. Those considering such an undertaking should tread carefully to avoid those risks, as well as a potential disaster.

1.1. What are the issues to be aware of?

The most common question raised is how much tax will we pay? Usually followed by "it's my home and that's exempt from tax isn't it?" Questions about GST, and whether or not a company or trust should be utilised are usually follow-up questions.

It is beyond the scope of this article to address the due diligence required in getting your building contract and pricing right, or testing your expected gross realisations on sale. We strongly recommend that you do your homework and do engage with experienced professionals to assist. From experience, cost savings here usually lead to difficulties later that well outweigh the costs. If you need help or introductions, please contact us.

What we can directly assist on are the key issues of structure and taxation. Taxation costs across income tax, GST, Duty and Land Tax can be significant if not managed properly. Similarly, your structure and the basis on which you may enter arrangements with other parties can severely impact your commercial exposure and put your valuable property at risk. This paper focusses on the income tax, CGT and GST issues.

2. Assumed knowledge

I have included detailed comments that I have drawn from my previous papers and presentations that focus on the technical issues. Below I focus on the more practical issues using a series of examples. We can delve into the technical issues as required – I am always happy to have a robust discussion on these issues.

2.1. Tax treatment of property realisations

Understanding of the Revenue v Capital distinction – see Chapter 6 generally - and the three main ways that the sale or realisation of property may be treated:

- On "capital account" where the sale will be treated as a capital gain as opposed to ordinary income. Assets held longer that 12 months will be eligible for the Capital Gains Tax (CGT) discount for eligible trusts and individuals.
- On "revenue account" but not trading stock. To be trading stock, you must be in business - this will arise where the property is not part of your business or indeed the core of a business in itself, yet:
  - The intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and
  - The transaction was entered into and the profit was made in the carrying out of a business operation or commercial transaction.

See comments below in regard to *TR 92/3, TD 92/161 and Myer Emporium* under Section 6.1.

Taxation is assessed on completion, sometimes with complex calculations to isolate the part that may be capital proceeds, which is of course assessable in the year that the contract was exchanged.

- Trading stock as part of your business. Normal trading stock valuation options apply and ultimately proceeds are assessable in the period received.

2.1.1. What happens when you lose money?

For a loss on capital account, this simply creates a capital loss which can only be used to offset current period capital gains or future period capital gains.

Where you have a revenue asset that is not part of a business or trading stock, losses made can be set off-set against other assessable income for revenue purposes. This is in accordance with TR 92/4. However, in practice you might find this more difficult and cases such as Hartley – in regard to speculative shares – demonstrate why. See more in Section 6.2.

Where the property is trading stock as part of a business, then it is much more straightforward, and all matters are on revenue account.

2.2. Some "givens" that need to be considered

2.2.1. Most property investments will be on capital account (or at least start that way)

The ATO accommodation on this is quite generous, notwithstanding unusual cases like *August v FCT* (see Section 6.4.2).

Where property is acquired with the main purpose of deriving income over time (and not for sale at a profit), then it will generally be accepted as being on capital account. This is the ATO's approach, notwithstanding the writers apparently controversial views on negative gearing and purpose (see Section 6.5).

2.2.2. Things can change

Property that is on "capital account" can move to "revenue account". This invariably depends on an objective assessment of purpose, and is usually supported with contemporary records and actions consistent with that purpose.

This may occur in one of two ways when ownership does not change:

- **On becoming trading stock in a business:** On a practical level, this triggers CGT event K4 and you may take up the value at market or cost. The trap here is that you will have a CGT liability before realisation, so care needs to be taken (see comments at Sections 3 and 6.7).
- **On being ventured into a profit-making undertaking or scheme as contemplated by TR 92/3:** The practicalities of this are somewhat more complex. If not trading stock as part of a business, there is no CGT event until the ultimate sale.

That ultimate sale will be both a CGT event at the time of contract, and income or loss for ordinary income purposes when completed. The complexity is dividing between those two treatments. In many respects it is a “valuation exercise”, and you can preserve your CGT and pre-CGT components, but care needs to be taken. You should carefully document and support your position.

The important thing to understand is that it is usually possible to isolate and preserve your capital gains status up to the point in time when profit-making intentions are commenced, but care must be taken.

The alternate is always actual transfer to a different entity, however this is a definite trigger point for CGT (except if exempt as pre-CGT or main residence) and Duty will apply – currently $40,490 for the first $million + 5.5% of the excess over that.

2.2.3. You will need to think about GST

If you are doing something that will turn a gain, you are likely to be an *enterprise* and will need to register for GST if your ultimate sale will exceed the registration threshold.

See Sections 3.2 and 7 below. There are however planning considerations around when registration is made, and it may be wise to align this with any change of intention.

2.3. Care with securing CGT status and concessions

Although with care you can ordinarily secure your CGT status and treatment up to a point in time, care needs to be taken where the main residence exemption is in play. This is demonstrated by practical examples below. In Section 3.1 below and elsewhere, the following will be problematic:

- Subdivision of the block on which the family home sits, and sale of the vacant lot.
- Grouping together with other property owners to consolidate develop into something else – say commercial/retail or commercial and residential.

It should also be clearly understood that concessions and exemptions to CGT for pre-CGT and main residence only apply to CGT – i.e. when they are capital assets. These exemptions have no application when they are a revenue asset and/or part of a business.

3. Comments

3.1. It's my home, I won't pay tax on that, will I?

If the property is your *main residence*[1] in Australia, and you simply sell it, whether to a developer or another person to live in, tax will not be paid. Unless there is 'something' or 'some period of time' that disqualifies you from the *principal residence* exemption, no Capital Gains Tax (CGT) will be payable on the sale. As *residential premises*, GST would also not be payable on an outright sale.

Anything outside a simple sale may however create issues. The exemption from CGT only applies to CGT and will not apply where you are considered to have:

- Entered that property into a business as *trading stock*[2], or
- Commenced a profit-making intention or scheme on that property

Both of those will cause the property to move from "capital" to "revenue" and become subject to income tax rather than concessional Capital Gains Tax (CGT) treatment. Consideration of this will be critical if you do anything more than just sell the entire property. There have been a number of recent cases where the ATO has been successful in having the sales subject to income tax.

These are covered in Section 2 below, however in a case handed down in 2015, *Rosgoe Pty Ltd v FC of T ('Rosgoe')*[3] is perhaps in stark contrast to some of those, and at this point, a win for the taxpayer.

In short, Rosgoe Pty Ltd (as trustee of a trust) acquired two adjacent properties with the intention of developing and selling these as part of a joint venture with a large property developer. They were however unable to secure funding and abandoned their intention to carry on a development business and develop the property.

At a later time, development approval (DA) was obtained for a 10-storey residential development on the property and then a contract was entered into for the sale of the property with the DA.

Ignoring some procedural/findings of fact issues, the Federal Court found that on the facts, this would be just the mere realisation of a capital asset and not on revenue account.

The other main trap to be aware of is subdivision of the large block on which the family home sits, and the selling off of the vacant block. Unless the block was acquired pre-September 1985 when CGT commenced, this will ordinarily have a difficult tax outcome. Once subdivided, the vacant part of the land is no longer a main residence and will be subject to CGT, based on gain from a portion of the original purchase price. There is no lock in or preservation of its previous use as part of the principal residence exemption.

1 Section 118-100 - Income Tax Assessment Act 1997 ('1997 Act')

2 Division 70 – 1997 Act

3 *Rosgoe Pty Ltd v FC of T* [2015] FCA 1231

Preserving Capital Status

While it is possible with careful planning to preserve "capital" status by walking the delicate line of undertaking only the steps required to improve the "mere realisation of a capital asset", there is no certainty here. From experience, anything beyond engaging an external professional for preliminary steps in approval for a different use will put you in deeper water.

If you intend to seek Development Approval and/or undertake some form of subdivision or building – either on your own or in an arrangement with a developer, the likelihood is that at the very least you have commenced a profit-making undertaking or scheme and will end up on revenue account and subject to income tax on some part of the profit. Subdivision for sale? It will almost certainly become trading stock and consequences flow from this.

However, every circumstance is different and there is no one rule that fits all. Seeking the right advice, paying attention to detail and remaining consistent with your stated intentions is key.

Locking in Capital Status and/or Concessions?

You have decided you want to see things through and participate in the upside of developing the block with the assistance of a friendly builder. Perhaps you and your neighbours have banded together to develop or resell with DA the larger block. At some point, unless you originally acquired the property to resell at a profit, it will move from "capital account" to "revenue account". Picking that time carefully, and determining how this occurs, is part of the careful planning you should undertake, as it is possible to lock in your capital gains concessions up to a point in time, then profits beyond that be subject to normal income tax.

There are three ways that this can normally be achieved. The first question we are usually asked is, should I transfer the property into another entity to lock in the concessional CGT treatment? The alternatives are:

a. Transfer to another entity. Yes, this will be a CGT event A1[4] and ordinarily your CGT concessions, including *main residence* exemption will be crystallised.

   On the negative side of this scenario, there will be *ad valorum* Duty costs which would dissuade you, other than where there are very strong commercial drivers to do so. Also it may provide a CGT cost, albeit at a discount, well ahead of when you might realise cash flow from external sale.

b. Commence to treat the property as *trading stock*. This is an election available to you provided you are in business and hold the property for resale at a profit. Note the requirement in the definition[5] that the property be held for *sale...in the ordinary course of a business*.

4 Section 104-10 – 1997 Act

5 Section 70-10 -1997 Act

The movement from capital account to trading stock triggers CGT event K4[6] and locks in your status just as effectively as transfer to another entity, without the Duty. In addition to this, you have a choice as to whether this occurs at cost or market value[7]. Clearly market value has some attraction, as it locks in your CGT concessions to date as for (a) above. The downside being a potential CGT cost well ahead of cash realisation. It is very rare, but not unheard of that "cost" is elected.

c. Commence a "profit-making undertaking or scheme". This is perhaps the most difficult to define as it requires a change of intention that should then be backed up by some objective evidence to support that change. Why? With careful planning there are clear benefits to getting the timing right. The property is likely to increase in value and accordingly provide more CGT concession benefits the longer you can validly delay this, but you must have a solid position.

   How is this dealt with on a practical level? The profit-making undertaking or scheme principal is no longer in the tax legislation and it is now simply a judicial concept that requires application. Essentially you do not have any taxing event at the time of the change and it all is dealt with on sale. With complications. Part of the gain will be on revenue account and part on capital and the timing may be different!

   The need to have your position documented and supported by your actions at the time is obvious. The need to have a valuation equally obvious, but there are issues to cover off and deal with that require some real thought, including precise timing and how you might account for all this.

How should I structure this and how can I minimise risk?

Option (a) above has the advantage perhaps of being able to isolate development risk in a separate entity. This advantage is moderated by the Duty and income tax costs together with the inability to draw any cash value away to a safer place without final realisation. It is not recommended for those reasons.

Assuming you go with (b) or (c), the question will be whether you do develop the property yourself, or engage in same arrangement with a developer. The former carries significant risk for the inexperienced and the only way to moderate that risk is to seek out good advice and listen to it. Check your feasibility and road test your assumptions rigorously – primarily your gross realisations (expected sales), building and other costs and taxation/duty. You will need a valuer, tax advisor, quantity surveyor, a construction lawyer and a project manager to keep your builder honest. Finance and the level of debt will also be critical – take the advice of your accountant and financier and do not overstretch. Then road test your feasibility again, and continue to do so as you progress.

If you enter into any arrangement with a developer, there is little attraction for them to acquire the property directly from you due to the Duty cost. You may end up in a development agreement, joint venture or even a partnership. We would ordinarily recommend against joint ventures or partnerships mainly due to the more complex tax issues and also managing risks of joint and several liabilities if the development goes bad.

Personally, I favour a development agreement, where you provide the property and the developer provides the construction. A well-designed agreement will provide you as much protection as may be possible subject to the factors below. Engage a good lawyer, who works with your accountant and is familiar with the issues and risks.

In any case, you will remain the vendor of the property when sold, and you should focus on the deal factors that minimise your risk – most commonly as a trade-off to profit and reward:

- Select a reputable and experienced developer. They may be more expensive/take a greater cut, but should provide you with a more certain outcome and product.
- Take some cash off the table up front. This provides buy in/commitment from the developer.
- Determine how much you want up-front v share of profit later. This is a risk vs reward discussion – be happy to take less up front to get certainty and seek more if you are taking your share at the end.
- Be aware that the market can change and may not always rise. It is smart to factor in at least 10% reduction in gross realisations to see if your feasibility still stacks up.
- Be very careful about whether the property itself is used as security for the construction. Ideally not, but the world is not ideal. If it is used as security, retain control of this and monitor it all the way through. Ensure the developer shares his feasibility and updates openly.
- Remain mindful of the other risk and the need to engage professional as noted above.

This will be a topic we will throw over to open discussion and practical considerations at the end of the main presentation. The variety of circumstances will no doubt be as wide as the variety of views.

6 Section 104-220 – 1997 Act
7 Sections 104-220(1) and 70-30(1)(a) – 1997 Act

3.2. Goods and Services Tax

Over the last six years, there has been a number of cases in the Federal Court of Australia and the Administrative Appeals Tribunal that have made interesting reading for anyone dealing with GST. In some cases, these decisions have clarified the law. In other cases, they have only served to highlight areas of uncertainty. The main purpose of this paper is to provide an update on the decisions that have mainly related to property, and canvass other developments as they relate to business and property.

The Decision of the Full Federal Court in *Brady King Pty Ltd v Commissioner of Taxation* [2008] FCAFC 118 made it clear, if there was any doubt, that for the purposes of the margin scheme, the land that was acquired did not have to be the same form of title as the property that was on-supplied. The time of acquisition of the land acquired was when the contract for its purchase was entered into, rather than when it was completed.

In *Gloxinia Pty Ltd v FC of T*[8] handed down on 24 May 2010, held that the assignment of long-term strata leases of residential property, where such leases were immediately granted after a surrender of development lease entitlements, were input taxed under section 40-70. The High Court of Australia refused to grant special leave to Commissioner of Taxation ("the Commissioner") to appeal against the decision on the basis that an appeal had insufficient prospects of success. This has now been addressed by amendments that in the writers view should not have been necessary.

The decision of the Full Federal Court in *South Steyne Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 155 is one of the more controversial decisions in the GST arena. It deals with suppliers of residential premises and commercial residential premises. It has implications for the drafting of GST causes in sale of land contracts and for the treatment and consequences of supplies of going concerns.

8 [2010] FCAFC 46, 2010 ATC 20-182

This decision kicked off a series of subsequent actions in regard to its sister entity MBI Properties Limited, which had now been heard all the way through to the High Court[9]. The outcome from the High Court provided some certainty sought by the ATO in regard to who is liable for GST when the reversion in lease is acquired by someone other than the original lessor. In doing so however, the High Court has run against traditional wisdom and understanding in property law that the "supply" under the lease can only be made by the original lessor. The High Court has also substantially widened the concept of "supply"[10] and what that means well beyond the context of a lease, as well as what this means for a landlord who has acquired property with an existing lease or reversion in place.

The decision of the Full Federal Court in *Sunchen Pty Ltd v FC of T*[11] handed down on 8 December 2010 was welcomed as ending some of the uncertainty that existed in relation to the GST treatment of sales of residential property. This decision denied that anything other than the physical characteristics of the property (e.g., the subjective or even objective intention of the purchaser) was relevant to the question of whether a supply of residential premises by sale is input taxed for the purposes of section 40-65 of the *GST Act*.

Vidler v Commissioner of Taxation [2009] FCA 1426 is a decision of Stone J concerns the question of whether a supply of vacant land is an input taxed supply of residential premises. Her Honour said it was not, but the taxpayer appealed the decision. The Full Court however dispensed with the appeal in economic fashion, seeing no error in the findings of Stone J in the decision reported at [2010] FCAFC 59.

9 Commissioner of Taxation v. MBI Properties Pty Ltd Case S90/2014

10 Section 9-10 – *A New Tax System (Goods and services Tax) Act 1999* ('GST Act')

11 [2010] FCAFC 138, 2010 ATC 20-229

On *GST-free going concern* matters *Aurora Developments Pty Ltd v Commissioner of Taxation* [2011] FCA 232 deals with the 'en globo' sale of land with associated contractual obligations to complete works as a pre-condition of settlement. As the contract did not refer to the supply of an enterprise as a GST-free going concern, it was therefore a taxable supply.

The supply of a project enterprise within the business enterprise together with all things necessary to continue the project enterprise, such as relevant contracts with buyers and plans, would be likely to satisfy a 'going concern'. However, a GST-free going concern is not satisfied by demonstrating that the recipient has been supplied with only those things that the recipient regards as necessary to enable it to undertake its enterprise.

By the date of contract, the seller was no longer engaged in the development of the land as characterised by all the 'Development Material' under the contract, i.e. an adult community development project. Rather, the sale of the land was an abandonment of that project enterprise in favour of an outright disposal of the land on particular terms.

This is perhaps a harsh lesson to us all to ensure that we attend to all the detail and give proper consideration to the application of the going concern provisions.

Developers should be aware of these matters, and where necessary seek quality advice or risk significant cost and/or disputes if something goes wrong.

For the accidental developer however it is principally a matter of:

a. Do I need to register for GST?

b. If so, when should that happen, and

c. What are the main considerations, and

d. Can I apply the margin scheme?

All of these issues are dealt with in more detail in Section 4 below.

4. Practical examples

To keep things simple, let's use a common fact pattern and apply it to a number of different situations:

Property acquired by Mum and Dad	1984 with alternate of 1990
Cost	$300,000
Size	1,000m2 or 1/4 acre
Value "last year"	$2,300,000
"Offer" – value – developer	$3,300,000
Blue Sky if you do it yourself...	$4,300,000

Property has been used as main residence all the time that it was held, and Mum and Dad are seriously contemplating getting out and have approached you to advise them on getting the best value.

Dad and Mum know a little about property and have done a duplex or two and also built their son's and daughter's house using their builder contacts. Dad knows the local council and feels pretty confident in the DA process.

We will go through each of these in more detail in the presentation.

4.1.1. Sell now for between $2.3m and $3.3m

Pretty straightforward. All proceeds CGT free, no income tax and Duty is the purchasers issue.

4.1.2. Sell 600m2 off the back yard and keep the house

Mum is attached to the house, but agrees to sell off the now unused back yard. The developer offers them $1m, which Dad thinks is plenty to retire on.

Vacant land is not a "residence" and cannot access the CGT exemption for main residence:

- Purchased 1984 and "pre-CGT" – no issue and no tax, $1m net.
- Purchased 1990 – CGT applies. Assume 50% allocation of cost base.

  Gain = $1m – (50% x $300,000) reduced by

  50% CGT discount

  = $850,000 x 50%

  = $425,000

Tax payable may be up to $425,000 x 49% or $208,250.

Net is now $791,750 and Dad is not happy.

Can be solved by selling the house with land and building a new house on remaining portion.

4.1.3. Mum and Dad decide to do it themselves...

Dad's mate the architect, says he can put a block of 8 units on the site:

Arch and DA Costs	$100,000
Council fees	$100,000
Building	$4,000,000
Gross realisation	$9,600,000

Issues to Consider

- Will this be an *enterprise*?
  - At some point almost certainly – now later than when the DA is approved?
- Will I need to register for GST? When?
  - Property will be *new residential premises* and *taxable* – Yes.
  - No later than 12 months before first settlement.
- Do not rush into registering! Consider carefully:
  - Benefit of claiming GST credits, vs benefit of increased "cost" value under the margin scheme – if Mum and Dad not previously registered = value at time of registration...
  - Beware ATO alert on abusing this.
- Will this be on revenue account for income tax?
  - Almost certainly at some point.
  - Where Dad engages early, and secures the DA – around that time?
  - May be able to delay until Dad and Mum decide to go all in, rather than sell with DA.
- How will that work?
  - Value of the interest at that time relevant – get a robust valuation.
  - Consider aligning the "intention decision" and GST registration as an *enterprise*.
  - Pre-CGT status – in theory preserved up to that point. Income from there on. Assume "value" of $3.3m – that amount of proceeds will be exempt and balance on revenue account.

- Post-CGT – will no longer be residence on sale – CGT treatment should be preserved to that point, but not main residence exemption (see s118-165 97 Act):

  Gain = ($3.3m - $300,000) x 50% CGT discount

  = $3,000,000 x 50%

  = $1,500,000

  Tax payable may be up to $1,500,000 x 49% or $735,000

  Balance of realisation will be on revenue account and income as above.

- What can we do about that?
  - Consider selling the property to another entity to crystallize the exempt main residence gain – save $735,000 in tax and pay Duty of $166,990.

    This tends to annoy people as the Duty is "dead money", however there may be other benefits where the family wish to keep some of the units.
  - Dad disengages completely from the process and we seek to have all or the majority of the proceeds treated on capital account. You would need to do the numbers to see if this gets a better outcome.

    You would need to consider engaging external parties to manage all aspects of the development, including sale etc. and be totally passive in this arrangement. The risks on a "development agreement" also arise as you place your fortune in the hands of other parties. Choose well!
  - We go the other way and approach it as a "business" venture. If we are a business, then the property may become *trading stock* being *anything...held for purposes of...sale or exchange in the ordinary course of a business*. (s70-1 ITAA97) CGT event K4 would apply to trigger a Capital Gain.

    If the residence still exists at that point do we get the exemption? It would appear so. This produces the best outcome, but care should be taken and proper advice obtained.

4.1.4. Mum and Dad decide to syndicate with surrounding properties to realise best value

Taxation and Duty issues are substantially the same as above, noting in particular that any CGT exemption for the main residence will almost certainly be lost, unless the property is entered in as trading stock while the residence still exists – but not after it is demolished. What is being sold is not a dwelling, s118-165 97 Act would appear to exclude it.

We will accordingly focus discussion on the structure alternatives and issues:

- Will there be a "partnership" between Dad, Mum and the other residents?
  - Yes, this is quite possible and there are consequences.
  - The Partnership would become the vendor for GST purposes.
  - Joint and several liability may apply in regard to GST and other costs incurred.
  - Partnerships are notoriously difficult to operate, control and get a decision from.
- Can this be drafted as a joint venture agreement, to limit this?
  - Yes you can draft as this, but it will be a question of fact whether a "partnership" still exists.
  - Registration as a JV for GST is almost impossible, where the lots are to be sold.
  - The vendor will still be "you" or the partnership (for tax and GST).
- Structure as Development Agreement with one party taking control:
  - Attractive as it solves the control/decision making issues.
  - Developer engages direct with each party and takes control of all aspects – no partnership and perhaps optimal tax treatment (extend capital >> revenue shift).
  - You don't have to do anything, but this should be balanced with development risk and the risk that the developer themselves my fail and/or act inappropriately.
- Sell all lots into a development entity:
  - Cleanest and most straightforward outcome.
  - CGT concessions/exemptions secured.
  - Duty costs, but weigh against tax savings – adjust price.
- Trade off of risk and $ - when you get paid:
  - More upfront – lower risk >> lower share of "profit".
  - Stay in for the journey – higher risk >> possible higher return.
  - Don't be greedy!

5. Revisit the lay of the land in the revenue vs capital distinction

5.1. The basics and history

The birth of modern income tax; in England in 1799 saw taxes levied on; income derived from property; on the annual value of property or from employment income. These were the types of income that were recognisable and well understood to the wealthy and property holding classes which were well-represented by Parliamentarians. The concept of income derived from trade however was far more remote, and as such was not included in early income tax. And indeed, as will be discussed further in this paper, to some extents there has remained significant difficulty in ascertaining the profits derived from trade and the tax to be levied upon these profits. Income from property (such as rent, dividends and interest) is generally easily recognisable and taxable, as is income from exertion. Income from trade is not always so clear.

One of the main complications which arise on income from trade is where there are different treatments of revenue and capital. Where revenue and capital gains are treated differently (and indeed revenue and capital losses) examinations of gains and losses which are mixed with trade necessarily involve considerations of whether disposals of assets constitute mere realisations of capital assets or some more conscious business like or profit-making undertaking.

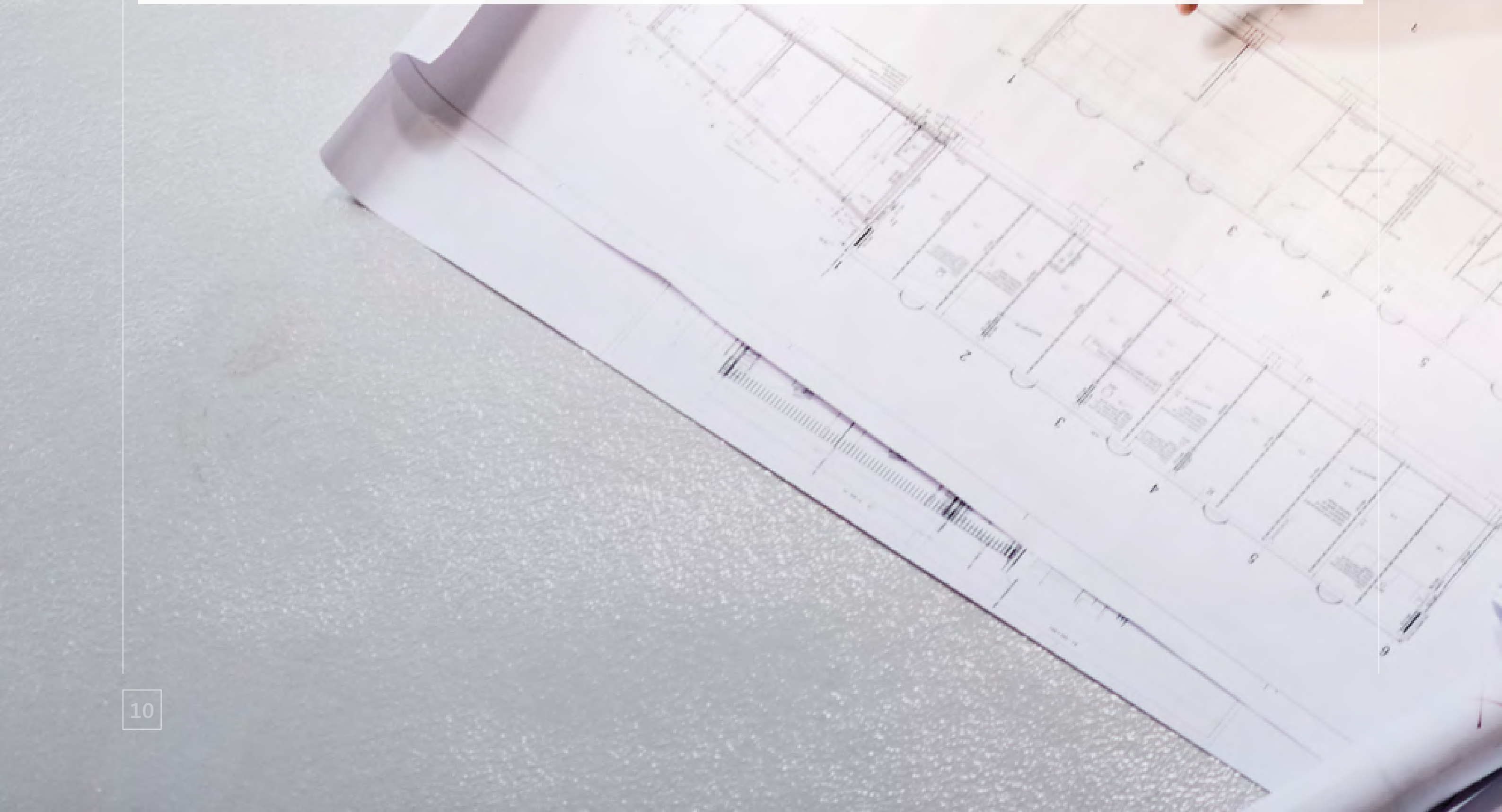
Provisions in place prior to September 1985

- Section 25A of the 1936 Act (which is referenced in s15-115 of the 1997 Act) which brought into income profits on disposal of assets, interests etc. where they were acquired with the purpose of profit-making by sale.
- Sister provision s52 allowed a corresponding deduction for loss, provided you were able to prove you had the requisite profit-making intention.
- Both shelved as of the introduction of CGT on 19 September 1985 in regard to assets acquired after that date.

One may be forgiven for assuming that the CGT provisions that distinguished between short term gains of less than 12 months which were fully taxable, and those in excess of 12 months that were discounted, were a direct substitution for this.

Not long after the parking of s25A and commencement of CGT, we ended up with cases such as *Myer Emporium*, and then Cooling's case, which brought lease incentives into income; then flipping on *Selleck* and reverting on *Montomery* in regard to those incentives.

The law continues to evolve, with periods of dormancy in between. Let's revisit the ATO and court views over this period.



6. The distinction between revenue and capital

6.1. The ATO View – TR 92/3 and TD 92/161

Taxation Ruling TR 92/3 – *Income tax: whether profits on isolated transactions are income* remains the leading exposition of the ATO view on the revenue v capital distinction.

This was issued following the decision in *FCT v Myer Emporium*[12] and specifically addresses the view of the ATO that profits arising from an isolated transaction will be assessed as ordinary income. In other words, when it is not part of your ordinary business activities.

The ATO is of the view that profits from isolated transactions of taxpayers not carrying on a business and that these will be income according to ordinary concepts where:

- The intention or purpose of the taxpayer in entering the transaction was to make a profit or gain; and
- The transaction was entered into and the profit was made in the carrying out of a business operation or commercial transaction.

The ruling states that it is usually, but not always, necessary that the taxpayer has a profit-making intention when the property is acquired. The ruling seeks to distinguish the *Westfield case*[13], where the Full Federal Court held that the gain from the sale of land was not derived in the ordinary course of the taxpayer's business. The court held that for a gain to be characterised as ordinary business income of *Westfield*, the gain derived must have a nexus with a profit-making intention of the company. As this was absent, the court found the gain was not derived from a profit-making scheme and accordingly held that it was on capital account.

Interestingly, TD 92/161 *Income tax: property development: if land originally acquired (before 20 September 1985) and used as a farm, is later ventured into a business of subdivision, development and sale, how are the proceeds on the sale of a block returned as assessable income?* (perhaps also vying for the distinction of having possibly the longest title of something that may be considered a public ruling) addresses specifically the later venturing of land into a *business* of subdivision etc. It specifically recognises that the land is not *trading stock* before being ventured, and that what may be recognised as income on disposal is reduced by the marker value of the land at that time. This recognises and reinforces the principles in *Whitfords Beach*[14]. It is noted that the issue is more prescriptively dealt with by the CGT and trading stack provisions as detail under the sub-heading *Land as Trading Stock* in this paper below.

For a transaction to be characterised as a business operation or a commercial transaction according to the ATO, it is sufficient that the transaction is business or commercial in character (*Whitfords Beach*). As the ATO acknowledges however, whether a particular transaction has a business or commercial character depends very much on the circumstances of each case.

TR 92/3 states that in, general terms, a transaction or operation has the character of a business operation or commercial transaction if the transaction or operation would constitute the carrying on of a business in its own right. Some key indicators that may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are:

- The nature of the entity;
- The nature and scale of other activities undertaken by the taxpayer;
- The amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;
- The nature, scale and complexity of the operation or transaction;
- The manner in which the operation or transaction was entered into or carried out;
- The nature of any connection between the relevant taxpayer and any other party to the operation or transaction;
- If the transaction involves the acquisition and disposal of property, the nature of that property; and
- The timing of the transaction or the various steps in the transaction.

In short, under TR 92/3 a profit from the sale of property will be of a revenue nature if:

e. There was a profit-making intention on the part of the taxpayer when entering into the transaction; and

f. The transaction was entered into, and the profit made, in the course of either carrying on a business or in carrying out a business operation or commercial transaction.

Where a property transaction is neither:

a. Part of a taxpayer's normal business; nor

b. Commercial in nature,

Then unless the property was acquired with a view to a profit-making intention, any subsequent disposal of the property is likely to be a "mere realisation" of the asset, and as such, on capital account under TR 92/3.

12 FCT v The Myer Emporium Ltd [1987] ATC 4363

13 Westfield Ltd v FCT [1991] ATC 4234

14 FCT v Whitfords Beach Pty Ltd [1982] ATC 4031

6.2. TR 92/4 Income tax: whether losses on isolated transactions are deductible

TR 92/4 Income tax: whether losses on isolated transactions are deductible, deals with the opposite outcome to TR 92/3: it deals with determining whether a loss on an isolated transaction is deductible under general principles (section 8-1 or the old section 51(1)).

The language used in TR 92/4 mirrors that of TR 92/3 and specifically provides that a loss from an isolated transaction is generally deductible if:

- In entering into the transaction the taxpayer intended or expected to derive a profit which would have been assessable income; and
- The transaction was entered into, and the loss was made, in the carrying out of a business operation or commercial transaction.

Note the similarities: both rulings require an intention of expectation of profit or gain, and that the transaction is entered into in the carrying out of a business or commercial transaction.

As such, TR 92/4 stands for the proposition that if an isolated transaction would have been assessable as ordinary income pursuant to TR 92/3 if a profit had been made, any net loss from the same isolated transaction should be deductible.

TR 92/4 does not further define or seek to clarify how to determine whether a transaction was entered into in carrying out a business operation or commercial transaction, and rests on the discussion provided in TR 92/3.

There is some precedence as to determining whether a loss from an isolated transaction is deductible. Specifically, some share traders have come before the Administrative Appeals Tribunal (**AAT**), with the AAT having to decide whether the losses incurred by these traders were deductible.

These cases largely revolve around whether the specific taxpayer is a "share-trader" i.e. is actively carrying on a business being the trading of shares, or is a speculator i.e. someone that places speculative bets on the market.

The distinction is often a difficult one that has required a careful consideration of factors. In Case W8[15], the taxpayer purchased and sold a number of shares for the purpose of realising short term gains (i.e. all were sold within a year of their purchase). The taxpayer derived a net gain, and disclosed the net gain in their return. The Commissioner sought to disallow the losses incurred, and assess the taxpayer on the gains. The AAT found that the taxpayer's practices did constitute share-trading and as such that the net gains were assessable (i.e. that the losses were allowable deductions). Specifically the AAT found that the taxpayer acquired the shares as trading stock. Interestingly, this matter arose before the Commissioner released TR 92/4, and provided the view that if gains from an isolated transaction were assessable, similar losses should be deductible. The AAT's findings support the Commissioner's later view.

In both *Hartley* [16]and *Case 6*[17] the AAT found on the contrary, that the taxpayers in question were mere speculators and not share-traders. What follows from this finding is that the taxpayers thereby cannot be carrying on a business, as they are not share-traders. The implications which arose in both of these matters were that losses which were incurred by the taxpayers in buying and selling shares were not deductible.

In both of these cases the losses were found to not be deductible due to not satisfying the second limb[18] i.e. *"being necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income"*. It is interesting that neither of these matters address whether the loss is deductible under the first limb[19], i.e. *"incurred in gaining or producing your assessable income"*.

It appears that the argument that a speculator can still be on revenue account due to the desire to make a profit was not raised. If a speculator was looking to make a profit which was not of a capital nature, then under the first limb, any associated losses or outgoings should be allowable deductions. Arguably an argument of this nature could have resulted in the deductions being allowable despite there being no carrying on of a business.

The *August* case which is discussed later on in this paper provides the precedence for the Commissioner treating a speculator on revenue and not capital account, thereby providing the precedence to allow this type of argument to stand.

6.3. Does *enterprise* matter?

Taxation Ruling TR 92/3 – whether profits on isolated transactions are income (refer below), is still the leading ruling issued by the ATO on the income tax capital/revenue distinction that is relevant to the broader discussion in this paper. The more specific and Taxation Determination TD 92/161 with the lengthy title *Income tax: property development: if land originally acquired (before 20 September 1985) and used as a farm, is later ventured into a business of subdivision, development and sale, how are the proceeds on the sale of a block returned as assessable income?* is also relevant.

It is worth starting with the relatively more recent view on *enterprise* in an ABN (and GST) context expressed by the ATO provide a more practical insight on current thinking. Issued initially as draft Miscellaneous Taxation Ruling MT 2004/D3 and in final form as MT 2006/1 - on whether profits from an isolated transaction involving land will be profits from an enterprise carried on by the taxpayer (i.e. from an

15 Case W8 89 ATC 171

16 Hartley and Commissioner of Taxation [2013] AATA 601 (26 August 2013)

17 AAT Case 6, 297 [1990] 21 ATR 3747

18 s. 8-1 or s. 51

19 *Ibid*

adventure or concern in the nature of trade) and thus of a revenue nature.

Although specifically in respect of ABN entitlements, the GST focussed MT 2006/1 is nonetheless useful as an opening point for our revenue vs capital analysis for the particular issues for SMEs that this paper seeks to address.

The draft ruling was particularly interesting because it stated that "[if] there is a subdivision of land which is not substantial (as a rule of thumb say less than 10 blocks) and has only required minimal activities to meet council requirements and to sell the subdivided land, we will accept that these activities may not be in the form of an adventure or concern in the nature of trade": paragraph 215.

MT 2004/D3 was then replaced by draft Miscellaneous Taxation Ruling MT 2005/D1 and the 10 block 'rule of thumb' disappeared. Now in final format as MT 2006/1 it does have an expanded series of very useful examples and improved cross referencing to established case law, and as such is worth considering for its general discussion.

Although specifically in regard to the issue of *enterprise*[20] and *adventure or concern in the nature of trade*[21], rather than *business*[22] per say, one wonders where the line may be drawn between the two. It is accepted that *enterprise* is a lower threshold than *business*, however at least in the ATO view the lines are beginning to blur.

Certainly you may observe that in practice the existence of an *enterprise* drives the ATO view toward transactions or arrangements being on revenue account. Although on a formal basis the ATO indicates there is a distinction, the writer is aware that they tend to take the view that anything that returns a profit is on revenue account and anything that results in a loss would be on capital account.

The relevant extracts from the final ruling MT 2006/1 are accordingly, set out below:

> *Isolated transactions and sales of real property*
>
> 262. The question of whether an entity is carrying on an enterprise often arises where there are "one-offs" or isolated real property transactions.
>
> 263. The issue to be decided is whether the activities are an enterprise in that they are of a revenue nature as they are considered to be activities of carrying on a business or an adventure or concern in the nature of trade (profit-making undertaking or scheme) as opposed to the mere realisation of a capital asset. (In an income tax context a number of public rulings have issued outlining relevant factors and principles from judicial decisions. See, for example, TR 92/3, TD 92/124, TD 92/125, TD 92/126, TD 92/127 and TD 92/128.)

20 Section 9-20 – A New Tax System (Goods and Services Tax) Act 1999 ('GST Act')

21 Section 9-20(1)(b) – GST Act

22 Section 995-1 – 1997 Act

264. The cases of *Statham and Anor v. Federal Commissioner of Taxation (Statham)* and *Casimaty v. FC of T (Casimaty)* provide some guidance on when activities to subdivide land amount to a business or a profit-making undertaking or scheme. In these cases, farm land was subdivided and sold. Minimal development work was undertaken to meet council requirements and to improve the presentation of certain allotments. On the particular facts of these cases the courts held that the sales were a mere realisation of a capital asset.

265. From the *Statham* and *Casimaty* cases a list of factors can be ascertained that provide assistance in determining whether activities are a business or an adventure or concern in the nature of trade (a profit-making undertaking or scheme being the Australian equivalent, see paragraphs 233 to 242 of this Ruling). If several of these factors are present it may be an indication that a business or an adventure or concern in the nature of trade is being carried on. These factors are as follows:107

- There is a change of purpose for which the land is held;
- Additional land is acquired to be added to the original parcel of land;
- The parcel of land is brought into account as a business asset;
- There is a coherent plan for the subdivision of the land;
- There is a business organisation — for example a manager, office and letterhead;
- Borrowed funds financed the acquisition or subdivision;
- Interest on money borrowed to defray subdivisional costs was claimed as a business expense;
- There is a level of development of the land beyond that necessary to secure council approval for the subdivision; and
- Buildings have been erected on the land.

266. In determining whether activities relating to isolated transactions are an enterprise or are the mere realisation of a capital asset, it is necessary to examine the facts and circumstances of each particular case. This may require a consideration of the factors outlined above, however there may also be other relevant factors that need to be weighed up as part of the process of reaching an overall conclusion. No single factor will be determinative rather it will be a combination of factors that will lead to a conclusion as to the character of the activities.

267. No two cases are likely to be exactly the same. For instance, while the conclusions reached in the *Statham* and *Casimaty* cases were similar, different facts and factors were considered to reach the

respective conclusions.

268. The case of *Marson (H M Inspector of Taxes) v. Morton and Others* describes the process of reaching a conclusion in cases involving isolated transactions. After listing the factors that have been taken into account by courts in other cases, including the badges of trade, Sir Nicolas Browne-Wilkinson V-C stated:109

I emphasise again that the matters I have mentioned are not a comprehensive list and no single item is in any way decisive. I believe that in order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question — and for this purpose it is no bad thing to go back to the words of the statute — was this an adventure in the nature of trade?

Similarly, Foster J in *AB* v. *FC of T* observed:110

It is clear in my view, that before the label "adventure in the nature of trade" can be applied it is necessary to isolate with clarity the particular matters which are the subject of its application...Accepting as I do, that the phrase means "an isolated business venture" questions must be asked as to what was the venture and what gave it its commercial character.

269. The Commissioner recognises that in some cases practical difficulties may arise in deciding whether the activities involved in a particular subdivision amount to an enterprise. The question is necessarily one of fact and degree. As outlined above, it requires a careful weighing of the various factors and exercising judgment in the light of decided case law and commercial experience. If an entity is experiencing practical difficulty reaching a decision they can seek guidance from the Tax Office.

Land bought with the intention of resale

270. In isolated transactions, where land is sold that was purchased with the intention of resale at a profit (which would be ordinary income) the Commissioner considers these activities to be an enterprise. This would be so whether the land was sold as it was when it was purchased or whether it was subdivided before sale. An enterprise would be carried on in this situation because the activities are business activities or activities in the conduct of a profit-making undertaking or scheme and therefore an adventure or concern in the nature of trade.

Examples of subdivisions of land that are enterprises

Example 28

271. Stefan and Krysia discover that the local council has recently changed its by-laws to allow for smaller lots in the area. They decide to take advantage of the by-law change. They purchase a block of land with the intention to subdivide it into two lots and to sell the lots at a profit. They carry out their plan and sell both lots of land at a profit.

272. Stefan and Krysia are entitled to an ABN in respect of the subdivision on the basis that their activities are an enterprise being an adventure or concern in the nature of trade. Their activities are planned and carried out in a businesslike manner.

Example 29

273. Tobias finds an ocean front block of land for sale in a popular beachside town. He devises a plan to enable him to afford to live there. He decides to purchase the land and to build a duplex. He plans to sell one of the units and retain and live in the other. The object of his plan is to enable him to obtain private residential premises in an area that would otherwise be unaffordable for him.

274. Tobias carries out his plan. He purchases the land, and lodges the necessary development application with the local council. The development application is approved by the council, Tobias engages a builder and has the duplex built. He sells one unit, and lives in the other.

275. Tobias is entitled to an ABN. His intentions and activities have the appearance of a business deal. They are an enterprise.

276. Further, there is a reasonable expectation of profit or gain (see paragraphs 378 to 405 of this Ruling) as his plan has enabled him to be able to keep and live in one of the units.

Example 30

277. Steven buys a 100 hectare property. He believes that the property may be suitable to be developed as a resort. After investigation he decides that it would be more profitable to subdivide and sell the property. He decides to subdivide the property into one hectare lots and sell these.

278. He engages a town planner and a surveyor to survey the 100 hectare property and to establish how many hectare lots it can be subdivided into. Steven then approaches the local shire council and is advised that he may subdivide his property into 65 one hectare lots.

279. However, Steven must satisfy various shire council conditions if he wishes to obtain development approval. They are:

- *The making of new sealed roads with kerbing and channelling within the subdivision;*
- *The provision of water, electricity and telephone services to the new lots;*
- *The provision of culverts and other storm water drainage works; and*
- *The transfer of certain areas of land to the shire council for parks, environmental and other public purposes.*

280. Steven consults his accountant and legal advisers. Together they prepare a comprehensive business plan *for the project. They approach a commercial lender to arrange a substantial loan, secured by the property, to cover all development costs and related expenses.*

281. After gaining development approval from the council, Steven then engages a project manager who arranges for all the survey and subdivisional works to be carried out. Contractors are engaged to put in the roads, complete all the necessary drainage works and install the water, electricity and telephone services.

282. Steven also investigates a marketing strategy that will provide the best return for his project. Sales agents are retained to carry out the marketing program which involves a comprehensive advertising campaign using a promotional estate name, "Bush Turkey Hill".

283. Steven is entitled to an ABN on the basis that the subdivision is an enterprise and it is more than a mere realisation of a capital asset. Significant factors that are relevant which lead to this conclusion are as follows:

- *There is a change of purpose for which the whole property is held;*
- *There is a comprehensive plan for the development of the property;*
- *The subdivision is developed in a businesslike manner for example there is a project manager, significant development costs, a comprehensive marketing campaign including an estate name for the land; and*
- *A substantial loan has been taken out to finance the development.*

Example 31

284. Prakash and Indira have lived in the same house on a large block of land for a number of years. They decide that they would like to move from the area and develop a plan to maximise the sale proceeds from their land.

285. They consider their best course of action is to demolish their house, subdivide their land into two blocks and to build a new house on each block.

286. Prakash and Indira lodge the necessary development application with the local council and receive approval for their plan. They arrange for:

- *Their house to be demolished;*
- *The land to be subdivided;*
- *A builder to be engaged;*
- *Two houses to be built;*
- *Water meters, telephone and electricity to be supplied to the new houses; and*
- *A real estate agent to market and sell the houses.*

287. Prakash and Indira carry out their plan and make a profit. They are entitled to an ABN in respect of the subdivision on the basis that their activities go beyond the minimal activities needed to sell the subdivided land. The activities are an enterprise as a number of activities have been undertaken which involved the demolition of their house, subdivision of the land and the building of new houses.

Examples of subdivisions of land that are not enterprises

Example 32

288. Astrid and Bruno live on a large suburban block. The council has recently changed their by-laws to allow for smaller lots in their area. They decide to subdivide their land to allow their only child, Greta, to build a house in which to live.

289. They arrange for the approval of the subdivision through the council, for the land to be surveyed and for the title of the new block to be transferred to Greta. She pays for all the costs of the subdivision and the cost of her new house.

290. Astrid and Bruno have not carried on an enterprise and are not entitled to an ABN in respect of the subdivision. It is a subdivision without any commercial aspects and is part of a private or domestic arrangement to provide a house for their daughter.

Example 33

291. Ursula and Gerald live on a 2.5 hectare lot that they have owned for 30 years.

292. They decide to sell part of the land and apply to subdivide the land into two 1.25 hectare lots. The survey and subdivision are approved. They retain the subdivided lot containing their house and the other is sold.

293. Ursula and Gerald are not carrying on an enterprise and are not entitled to an ABN in respect of the subdivision as the subdivision and sale are a way of disposing of some of the land on which their home is situated. It is the mere realisation of a capital asset.

Example 34

294. A number of years ago Elsie and Karin purchased some acreage on which to keep their horses, which they rode on weekends. Karin now accepts a job overseas and they decide to sell the land.

295. They put the land on the market with little success. The local real estate agent then advises that it would be easier to sell the land if it was subdivided into smaller lots. They arrange for a development application to be lodged with the local council and obtain approval to subdivide the land into nine lots. Elsie and Karin arrange for the land to be surveyed. The land has a road running along its boundary and has some existing services such as electricity. Only minimal activity is required to subdivide the land.

296. Elsie and Karin are not entitled to an ABN. The sale is not considered to be an enterprise and is the mere realisation of a capital asset.

Example 35

297. Oliver and Eloise have lived on a rural property, Flat Out for the last 30 years. They live a self-sufficient lifestyle. As a result of a number of circumstances including their advancing years, Oliver's deteriorating health, growing debt and drought conditions they decide to sell.

298. Oliver and Eloise put Flat Out on the market and are unable to find any buyers. They then receive advice from the real estate agent that they may be able to sell smaller portions of it. They initially arrange for council approval to subdivide part of Flat Out into 13 lots. They undertake the minimal amount of work necessary and sell the lots. They continue to live on the remaining part of their property.

299. A few years later Oliver and Eloise decide to sell some more land to meet their increasing debt obligations. They arrange for council approval to subdivide another part of Flat Out into four lots. Again they undertake the minimal amount of work necessary to enable the lots to be subdivided and arrange for the real estate agent to sell these lots.

300. Three years later Oliver's and Eloise's personal and financial circumstances are such that they again decide to sell some more land. They arrange for further council approval to subdivide part of their remaining property into three lots. Again they undertake the minimal amount of work necessary to enable the lots to be sold and arrange for the real estate agent to sell the lots.

301. Over the years involved Oliver and Eloise have subdivided 30% of Flat Out. They continue to live on the remaining part of their property.

302. Oliver and Eloise are not entitled to an ABN as they are not carrying on an enterprise. They are merely realising a capital asset. In this example the following factors are relevant:

- *There is no change of purpose or object with which the land is held — it has remained their home.*
- *There is no coherent plan for the subdivision of the land — the subdivision has been undertaken in a piecemeal fashion as circumstances change.*
- *A minimal amount of work has been undertaken in order to prepare the land for sale. There has been no building on the subdivided land. The only work undertaken was that necessary to secure approval by the council for the subdivision.*

As noted above, although on a formal basis the ATO indicates there is a distinction, the writer is aware that they tend to take the view that anything that returns a profit is on revenue account, and anything that results in a loss would be on capital account.

This leads to a bigger question that I highlight under the discussion on *trading stock*[23], as to whether land on revenue account can be something other than trading stock, the differing requirement being only the words "in the ordinary course of a business".

6.4. The view of the Courts

6.4.1. The established position

In looking at the capital versus income distinction, the question often considered by the courts is whether or not the sale of property constitutes either:

- A mere realisation of a capital asset and is therefore on capital account; or
- Whether the taxpayer was either carrying on a business of property development or was carrying out a business or commercial transaction with the intention to make a profit or gain, in which case any gain would be on revenue account.

It is appropriate to review some of the leading judicial decisions in order to understand what the courts have considered to be the key factors in determining whether the sale of property is on revenue or capital account.

Sale of property on capital account

The following discussion outlines what the courts have considered to be a mere realisation of a capital asset.

In *Californian Copper Syndicate v Harris*[24] Lord Justice Clerk said:

> *"It is a quite well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit ... assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme of profit-making?"*

23 Section 70-10 – 1997 Act

24 California Copper Syndicate v Harris [1905] 5TC 159 at

In *Scottish Australian Mining Co Ltd v FC of T*[25], the taxpayer purchased land for the purposes of carrying on a business of coal mining. Once the mine was exhausted, the taxpayer then subdivided the land. The taxpayer incurred substantial expenditure in sub-dividing the land. Roads were built and part of the land was set aside for parkland and other amenities.

The High Court held that the sale of the land was a mere realisation of an asset as the company had not purchased the land for the purpose of profit-making by sale and had merely taken the necessary steps to realise the land to its best advantage.

In *Statham v FCT*[26], it was decided that the property in question was to be subdivided and sold after a business of raising cattle had failed. The taxpayer relied on the local council to carry out the subdivision work (i.e. the required infrastructure facilities) and the local real estate agents handled the advertising and sale of the lots. The Full Federal Court held that what occurred was "the mere realisation, by the most advantageous means, of the asset which the owners had on their hands when they abandoned the intention of farming the subject property".

In *Casimaty v FCT*[27], the taxpayer conducted a primary production business on land in the early 1950s. Due to the growing debt and ill health of the taxpayer, the land was progressively subdivided and sold off over a period of 18 years. Most of the subdivisions required certain infrastructure costs to be incurred such as the construction of roads, connection to facilities and the fencing of boundaries.

In his judgment, Ryan J in the Federal Court held that the profits resulted from the mere realisation of a capital asset and as such the profits were not assessable as ordinary income. Ryan J stated that:

> *"I have been influenced primarily by the indisputable fact that he acquired and continued to hold "Acton View" for use as a residence and the conduct of the business of a primary producer. Apart from the activities necessarily undertaken to obtain approval from time to time for subdivision of parts of the property, there is nothing to suggest a change in the purpose or object with which "Acton View" was held".*
>
> *"A related consideration is the fact that the development and subdivision ... was undertaken piecemeal in response to the exigencies of increasing debt and deteriorating health. No coherent plan was conceived at the outset for the subdivision of the whole property, even in stages, to maximise the return from the aggregate of the individual lots. Even at the date of the last of the assessments to which these proceedings are related, an area considerably over one-third of the whole of the original property had not been subdivided.*
>
> *"Nor did the taxpayer undertake any works on, or development of, beyond what was necessary to secure the approval by the municipal authorities of the successive plans of subdivision and enhance the presentation of individual lots for sale as vacant blocks".*

Sale of property on revenue account

Where the transaction goes beyond the mere realisation of an asset, the gross proceeds or the net profit as the case may be will be treated as assessable income under ordinary concepts.

In *Whitfords* Beach the taxpayer company acquired 1,584 acres of land in 1954 so that the shareholders in the company could continue to have access to their beachfront fishing shacks.

In 1967 the shares in the taxpayer company were sold to three companies. The new shareholders acquired the shares with the intention of developing, subdividing and selling the land at a profit.

Two of the new shareholders were appointed to manage the development, subdivision and ultimate sale of the allotments. It was proposed to subdivide the land into some 2,200 residential lots.

During the period between 1970 and 1975 a substantial number of lots were sold resulting in a significant profit.

The High Court held that the taxpayer's actions amounted to more than a mere realisation of a capital asset and as such constituted the carrying on of a business of land development.

In particular, Mason J noted that:

> *"In this respect I do not agree with the proposition which appears to be founded on remarks in some of the judgments that sale of land which has been subdivided is necessarily no more than the realisation of an asset merely because it is an enterprising way of realising the asset to the best advantage. That may be so in the case where an area of land is merely divided into several allotments. But it is not so in a case such as the present where the planned subdivision takes place on a massive scale, involving the laying out and construction of roads, the provision of parklands, services and other improvements. All this amounts to development and improvement of the land to such a marked degree that it is impossible to say that it is a mere realisation of an asset...."*

While it would be fair to say that each case must depend on its own particular facts and circumstances, it would appear that the *Whitfords Beach* decision and the subsequent decision in *Stevenson v FCT*[28] limit the application of the decision *in Scottish Australian Mining Co Ltd*.

In *Stevenson*, land originally acquired for farming activities was subsequently subdivided and sold for a profit. The

25 Scottish Australian Mining Co Ltd v FC of T (1950) 81 CLR 188

26 Statham v FCT [1989] ATC 4070

27 Casimaty v FCT [1997] ATC 5135

28 Stevenson v FCT [1991] ATC 4476

taxpayer obtained finance and personally arranged for the construction of the infrastructure, including the construction of roadworks and water facilities. Throughout the process, the taxpayer personally dealt with councils, engineers and relevant authorities. He also handled the advertising and was the main point of contact for sales enquiries.

A total of 220 blocks were sub divided, of which, 180 were sold between 1980 and 1986.

The court held that the taxpayer was carrying on a business, as the scale of the subdivision and the taxpayer's involvement in the systematic organisation, planning, management and repetition of a purposeful profit-making activity extended beyond those activities that could be accepted as being directed to the mere realisation of a capital asset.

In determining whether a taxpayer is engaged in business or a commercial operation of property development, the various court decisions have placed particular emphasis on the intention of the taxpayer, the frequency of the transactions and whether the transactions are carried out in a business-like manner.

However, it is considered that while the frequency of such transactions and the business-like manner are indeed important factors, undoubtedly the key factor in determining whether a profit is assessable as ordinary income or more correctly reflects a capital gain, is the intention or purpose of the taxpayer.

Profit from an isolated transaction may be ordinary income

The profit or gain from a single transaction may also be treated as ordinary income, if it arises as a result of a transaction that was entered into for the purpose or intention of making a profit. This was considered in *Myer Emporium*[29].

The case involved an extraordinary transaction that was not part of the taxpayer's ordinary business. The High Court held that as the intention or purpose existing at the time of acquisition was for the purpose of generating a profit by sale, the profit on ultimate sale was considered to be ordinary income.

Specifically, the High Court stated that:

> *"But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may very well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intentions or purpose in entering the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being property characterised as income…**The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit."** (emphasis added)*

The *Myer Emporium* decision confirmed previous authorities that even a single transaction could be treated as taxable under the ordinary income provisions of section 6-5 if:

1. It arose in the ordinary course of carrying on a business; and
2. That particular transaction was entered into for the purpose of making a profit.

6.4.2. More recent cases

Rosgoe Pty Ltd v FC of T – revenue v capital and GST thrown in

Rosgoe Pty Ltd v FC of T ('Rosgoe')[30] is perhaps in stark contrast to the decision in *August* from 2012 – which suffered credibility issues to their detriment – on which I comment below.

In short, Rosgoe Pty Ltd (as trustee of a trust) acquired two adjacent properties with the intention of developing and selling these as part of a joint venture with a large property developer. They were however unable to secure funding and abandoned their intention to carry on a development business and develop the property.

At a later time development approval (DA) was obtained for a 10-storey residential development on the property and then a contract was entered into for the sale of the property with the DA. For certainty prior to completion, application was made to the Commissioner for a private ruling in relation to the tax treatment of the sale of the property. That ruling indicated the Commissioner considered the proposed sale of the property was not a mere realisation of a capital asset. The Commissioner stated that the property had been acquired with the intention that it be developed and sold at a profit and that, even though the profit "was not obtained via the original means envisaged" it was nonetheless sold at a profit. It was also indicated that he considered that an isolated transaction had been entered into and the profit was made in carrying out a commercial transaction.

The taxpayer objected to the ruling and sought review of the Commissioner's decision after its objection was disallowed.

The AAT affirmed the objection decision. This was

29 Myer, supra, at 4366-67

30 *Rosgoe Pty Ltd v FC of T* [2015] FCA 1231

problematical as the AAT sought to make alternative findings of fact when it is not really in a position to do so in respect of an Appeal from a private ruling. The AAT nonetheless found Rosgoe had a profit-making purpose from the outset – which should be distinguished from the business of property development.

The Federal Court held that the finding by the AAT that Rosgoe was at all times carrying on a business was not open to it from the facts, and was accordingly to be disregarded.

Ignoring the procedural issues the Federal Court nonetheless held that the profit was not ordinary income. On the basis of the description in the arrangement, what occurred was the mere realisation of a capital asset, taxable under the capital gains tax regime.

The second question dealt with the issue of GST, and the court remitted the matter to the AAT for that second question to be addressed and ruled upon. Given the decision of the Federal Court that the receipt would be of capital, its seems almost certain for the AAT to determine that the amount may be excluded from the GST turnover threshold, notwithstanding the sale may have been otherwise subject to GST. If Rosgoe is accordingly not required to be registered, then it need not charge GST on that sale.

August v C of T - land that is a revenue asset but not trading stock

Unless land is held for the purpose of sale in the 'ordinary course of a business' it will not be considered to be trading stock - even if its sale is part of a business or commercial transaction with a profit-making intent.

The recent decision in *August v Commissioner of Taxation* ('August')[31] is a timely reminder to property investors to not only seek good advice at the time of acquiring a property, but also to be clear about their intentions and keep their house in order if they wish to stay on 'capital account' and within the CGT regime.

This was an interlocutory application to adduce further evidence prior to hearing of a further Appeal to the Full Federal Court following the single judge decision of Nicholas J[32]. In rejecting the application Siopis, Besanko and Mckerracher JJ have set out in detail the Nicholas J findings and firmly rejected the challenge to the conclusions "of the trial judge" on evidentiary issues.

The Full Court also addressed the substantive issue in confirming the earlier decision and the ATO view that the sale of the relevant properties were not on capital account and formed part of ordinary income under Section 6-5[33]. At stake was the 50% discount that would have been available if it fell under the CGT provisions.

A further step perhaps along the line of what was held by Finn J in *R & D Holdings* where the relevant property was found to be trading stock that was held *"at the relevant time for the dual profit making purposes of sale or lease of subdivided lots."*

Since this paper was originally published we have also had the AAT decision in *Re WWXY and FCT [2015] AATA 130*, where land was originally acquired to enter into a joint venture for profit-making, but then retained and leased for many years when this was found to be uneconomic. An apparent change of intention that would normally be accepted and falls under the Commissioners guidance. At a later point the taxpayer obtained a DA and sold the property - something you may ordinarily consider a simple realisation of capital for best value. The AAT found that this was on revenue account, and although likely to be appealed, it will be interesting to see what the Federal Court has to say.

Also subsequent to the publication of this paper Mr AH Slater QC made some observations in his address at The Tax Institute 2014 Tax Intensive in November 2014 on this topic and I would recommend obtaining and absorbing his paper from that event. Those comments were in regard to negative gearing and the sale of an income producing property that loses money year on year where the only prospect of recovering the resultant loss is from sale of the property – that receipt arguably being on revenue account. A point many will take issue with no doubt, but it would be unwise to ignore the observations of Tony Slater.

Why is this of concern?

Although lengthy, the August judgment makes interesting reading. On the face of it, the facts as set out and the statements of the Applicant/s seem reasonable, and the "capital account" argument perhaps not too far-fetched. The properties were generally rented, if after making significant improvements to improve value or constructed anew on the same site and the Applicant stated that sales only occurred when the price was too good to refuse. All reasonable contentions ordinarily.

Where the arguments seem to have failed is in the detail – detail of original intention, support to that not only in documents and corroborating witnesses, but in the Applicants actions. Also key was the view that the evidence of the Applicant and corroborating witnesses just was not reliable, and evidence sought to be later introduced was not in existence at the relevant time. Serious stuff and an indication of a view not only adopted by the Judge/s but possibly also by the ATO officers involved. Also apparent was a level of "guilt by association" with parties who had a track record of property development.

These issues aside, the facts are perhaps not dissimilar to many investors who may acquire property with the dual intention to lease, perhaps improve and ultimately make a gain. The tricky question along the continuum between "revenue" and "capital" is exactly how far you sit toward one or the other. Who for example buys a residential investment property without some thought of sale for a gain?

Perhaps of more concern would be Property Trusts that have a clear modus operandi of acquisition of commercial buildings, some improvements and/or refit, increases in

31 *August v Commissioner of Taxation* [2013] FCAFC 85
32 *August v Commissioner of Taxation* [2012] FCA 682
33 Section 6-5 – 1997 Act

rent and then sale based on the improved cap rate (in particular, where the property trust does not (or is unable to) make a MIT capital account election). Is that so dissimilar to the circumstances in August? Taking the apparent personalities out of it, this is perhaps just another step along the continuum.

A further, perhaps more concerning impact could be in respect of retirement villages. This is an industry that does not need another complexity in the already complex myriad of State and Commonwealth regulation and particularly complex GST and Income Tax issues. It has become common practice over the last 10 years for new retirement villages to be constructed, leased to multiple residents and then sold as a whole. Primarily driven by valuation, cash flow and GST issues, this type of arrangement is detailed in GSTR 2011/1.

Traditionally the sale of the whole would be taken on "capital" account, and certainly not treated as trading stock. Given the intention to sell once fully tenanted, this must now be seriously questioned. Of course there is the requirement that there must be an intention of a gain, which is not always certain in those arrangements, and that raises the issue as to what may be the appropriate treatment in the event of a loss? Logically it would also be on revenue account provided the requisite intention existed.

The critical issue to consider here is that, unlike R & D Holdings where the property was held to be *trading stock*, the properties in August were otherwise ostensibly "investments" that were not trading stock.

A brief note on history

The capital vs revenue argument is older than our income tax legislation in Australia, with a history from deep within English law and cases. Many of our cases on property predate the introduction of Capital Gains Tax in 1985 or relate to that earlier period, but the issue has been quietly proceding and now seems to be gaining some momentum with the ATO.

On the introduction of CGT the legislated provisions regarding a "profit-making undertaking or plan"[34] ceased to have operation, and were replaced by the much less prescriptive Section 15-15[35]. In practice many, including the ATO, took the view that the 12-month rule in CGT took care of most gains that would otherwise be "revenue" and the availability of discount CGT provisions (initially indexation, followed by the 50% discount) for gains outside one year, implied that application would be limited to such "short term" gains unless clearly "trading stock".

Whilst R & D Holdings tested that view on "investment" properties, the ATO position has clearly evolved and their sights are firmly set on capturing a wider range of properties on revenue account.

Practice notes

The importance of being clear on intent at the time of purchase cannot be understated. This cannot be simply what you may say later when questioned, but be supported by actions both at the time of purchase and later while you hold the property.

There are a number of factors that the ATO and the courts look to when determining intent and purpose, including what evidence may be available as to intent, how you initially finance the property, the viability if not sold, any level of involvement in improvement/development for sale as well as the extent of that improvement/development.

While there is no reason why you cannot later change your mind and intention, if you intend to hold initially as an investment you should be crystal clear on that and have your advisors assist you in that assessment and perhaps to document this. Behavior and actions should remain consistent with that intention.

R & D Holdings and trading stock - can property be held for dual purposes?

In the single judge decision of the Federal Court in R & D Holdings[36], Finn J states that he can see no reason why property cannot be regarded as trading stock even though the dominant purpose of holding the property may be as a long term investment. This issue was not addressed in the appeal to the full court[37] and the decision remains undisturbed on the issue of trading stock.

The single judge decision has raised a number of issues relevant to the holding of property and other assets and seemingly closes the gap between what might be considered to be on capital account and what might be trading stock. In addition to this the existence of a property asset that may be on revenue account, but not trading stock may appear to some as a beast approaching extinction – see 3.6.1 below.

It is this issue of dual purpose that is raised at this point. Following review of the judgment and the precedent that Finn J draws upon it may be observed how the dual purposes intention has been the ATO view for a number of years.

There are two key issues to address:

- Is the ATO/Finn J view in accordance with the Supplementary Explanatory Memorandum ("EM") to the Tax Law Improvement Bill 1997 ("the Bill")?
- Has the ATO always adopted a dual purposes approach to trading stock?

We would suggest a practical approach across the board to all assets is the answer.

34 Section 25A – Income Tax Assessment Act 1936
35 Section 15-15 – 1997 Act
36 *R & D Holdings Pty Ltd v FCT* [2006] FCA 981
37 FC of T v R & D holdings Pty Ltd 2007 ATC 4731

The judgment

The relevant part of his judgment is paragraph 50 – which is set out in full below:

> *While I do not consider the quoted observations from John as being of relevance in this proceeding, there is one aspect of John which is of present assistance. It was indicated in the joint judgment (at 430) that the s 6(1) definition of "trading stock was predicated on the prescribed purpose (i.e. of manufacture, sale or exchange) attending the acquisition of the item in question". However, it was indicated that the definition did not require that the relevant purpose be the sole or dominant purpose". I can see no reason why a like view should not be taken to the like purpose requirement for which the relevant property is held in the s 70-10 definition of the 1997 Act. The significance of this for present purposes is that I have found below that R & D Holdings held the Bulletin Place property at the relevant time for the dual profit-making purposes of sale or lease of subdivided lots. These two purposes clearly are not "contrary or inconsistent": John at 430.*

The reference above to John is to the High Court decision in *John v FCT* (1989) 166 CLR 417 and the relevant part of that judgment is as follows:

> *The definition of "trading stock", in speaking of the "purposes of manufacture, sale or exchange", clearly predicates that one such purpose shall attend the acquisition of the item in question. The definition does not require that the relevant purpose be the sole or even the dominant purpose.*

In *John* bonus shares were acquired for the dual purposes of profit-making by sale and obtaining a tax advantage. The High Court held that the latter purpose did not prevent the bonus shares from being trading stock:

> *In the present case the acquisition of the bonus shares was attended with the purpose, evident from the prearrangements made, that the shares should later be sold. That purpose having been present, the bonus shares were trading stock as defined in the Act, notwithstanding that the transaction may have been attended by another purpose. As such, by force of sec. 51(2) of the Act, the loss or outgoing incurred in relation to the shares cannot be characterised as an outgoing of capital or of a capital nature and hence non-deductible on that account.*
>
> *Our view that the purpose of obtaining a private tax advantage does not take the bonus shares issued outside the description of trading stock is consistent with the approach adopted by this Court in Investment and Merchant Finance ; F.C. of T. v. Patcorp Investments Ltd. 76 ATC 4225; (1976) 140 C.L.R. 247 and F.C. of T. v. Westraders Pty. Limited 80 ATC 4357; (1980) 144 C.L.R. 55. None of those cases involved bonus shares. However, all three cases concerned the acquisition of shares for the purpose of obtaining distribution of dividends and subsequent sale in circumstances attracting a taxation advantage. In none of those cases did the purpose of obtaining a taxation advantage serve to set the shares apart from other shares which were trading stock, or to characterise the taxpayer as other than a trader in relation to the shares so acquired.*

The dual purposes interpretation of section 70-10 has been the ATO view for a number of years

Given that the ATO has been advocating a dual purposes interpretation of section 70-10 for a number of years (refer below), the approach taken by Finn J in R & D Holdings seems to be in response to an argument advanced by the ATO in that case.

That is, in TR 98/7 – Income tax: whether packaging items (i.e. containers, labels etc.) held by a manufacturer, wholesaler or retailer are trading stock, the ATO (obliquely) refers to a dual purposes interpretation of section 70-10 by including John as a case to consider when looking at the ordinary meaning of trading stock.

A more direct reference to this dual purposes interpretation by the ATO of section 70-10 can be found in Private Ruling 34502 (which issued in 2002) and in ATO ID 2004/25 – where the ATO specifically refers to John, when stating that property does not need to be held for the dominant purpose of sale in order to be trading stock.

The relevant parts of the above Private Ruling are as follows:

> "In *John v. Federal Commissioner of Taxation* (1989) 166 CLR 417 at 429; (1989) 20 ATR 1 at 8; 89 ATC 4101 at 4107 the majority of the High Court stated:
>
> > *The relevant issue is not the nature of the business carried on, but rather whether the person is a trader in the goods claimed to be trading stock. ...*
> >
> > *Whether or not a person is a trader seems to us to be a question of fact, albeit that in some cases the determination of that fact may depend on questions of impression and degree. If trading has not commenced or if there is no discernible trading pattern, the question of intention or purpose may be relevant in the sense that if there is an absence of intention or purpose to engage in trade regularly, routinely or systematically then the person may well not be a trader. ...*
> >
> > *The definition of 'trading stock', in speaking of the 'purposes of manufacture, sale or exchange' clearly predicates that one such purpose shall attend the acquisition of the item in question. The definition does not require the relevant purpose to be the sole or even the dominant purpose.*
>
> "You are engaged in a business activity that consists of acquiring shares in companies with the view to selling off those shares for a profit. You have outlined in your facts that you conduct your business in a way that involves a system of regular monitoring

> and reviewing your existing investments and future prospects."
>
> "You also derive income through the redemption of convertible notes and ancillary activities from some of the companies you invest in. Whilst you may have held the shares in order to derive other income, the dominant purpose for holding the shares is for the purpose of sale. The primary source of income for your company in future years is anticipated to come from sell down/exit proceeds from the sale of shares in the companies."
>
> "In addition, the shares were held for the purpose of sale in the ordinary course of your business of buying and selling shares."
>
> "Accordingly the shares held by you in companies are 'trading stock' for the purposes of section 70-10 of the ITAA 1997."

The relevant parts of ATO ID 2004/25 are set out below:

> "In *John v. Federal Commissioner of Taxation* (1989) 166 CLR 417 at 429; (1989) 20 ATR 1 at 8; 89 ATC 4101 at 4107 (the *John Case*) the majority of the High Court held that an item will be trading stock if 'the person is a trader in the goods which are claimed to be trading stock.' In addition, in the *John Case* the High Court stated that the relevant purpose did not need to be a dominant purpose."
>
> "The taxpayer is engaged in a business activity that consists of selling residential properties under instalment contracts. In selling the properties under an instalment contract, the taxpayer also derived interest income over the period of the sale contracts. Whilst the taxpayer may have held the property in order to derive this interest income, the property was also held for the purpose of sale."
>
> "In addition, the properties were held for the purpose of sale in the ordinary course of the taxpayer's business of selling residential properties under instalment contracts."
>
> "Accordingly, the residential properties held by the taxpayer and sold under instalment sales contracts are 'trading stock' for the purposes of section 70-10 of the ITAA 1997."

Is the ATO/Finn J view in accordance with the Supplementary Explanatory Memorandum ("EM") to the Tax Law Improvement Bill 1997 ("the Bill")?

The definition of trading stock was altered by the Bill to allow the insertion of specific rules to deal with the situation where a taxpayer changed the use of an asset (for example, to deal with the case where an asset held for investment purposes was converted into trading stock).

The EM is quite specific that:

- "Changes of use will be treated according to commercial reality" (paragraph 1.12); and
- The "proposed rules will only apply to *genuine* changes in an asset's use. Whether there is a genuine change is determined objectively" (paragraph 1.17).

We would argue that the commercial reality, at least in the case of a business taxpayer who prepares financial statements, is that an asset is usually held predominantly for one purpose - as per the balance sheet of the taxpayer - rarely equally for dual purposes.

In this regard, the whole basis of the revised definition of trading stock in the Bill would seem to be that an asset is only held for one (predominant) purpose at a time - which is determined on objective grounds. If an asset can (as per the ATO/Finn J view) be held for dual/multiple purposes its use may never change; which would defeat the reason for altering the definition of trading stock in the first place.

From both a practical and a technical basis therefore, we would argue that a dominant/main/primary purpose test is required to be used to determine whether an asset is being held as trading stock. (Interestingly, Finn J himself also seems to use a dominant purpose test in paragraph 75 of his judgement in R & D Holdings when he concludes that he is "satisfied that the sale of strata lots was Mr Richardson's dominant purpose.")

Has the ATO always adopted a dual purposes approach to trading stock?

The short answer to the above question is 'No'. In TR 93/26 – Income tax: issues relating to the horse industry, the ATO advocates (in successive paragraphs) a:

- Sole or main purpose test (paragraph 17);
- Dominant intention test (paragraph 18); and
- Primary purpose test (paragraph 19),

to determine if a horse should be depreciated as plant or included in the livestock accounts of a taxpayer.

More recently, in Miscellaneous Taxation Ruling MT 2006/1 - The New Tax System: the meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number, the ATO states (at paragraph 260) that *assets can change their character but cannot have a dual character at the same time* referring to *Simmons*[38] in doing so.

While the ATO will no doubt seek to distinguish this statement on the basis that it relates to a discussion in the draft ruling on UK cases which have considered the meaning of the phrase 'in the form of an adventure or concern in the nature of trade' – which is relevant in the context of section 38 of the *A New Tax System (Australian Business Number) Act 1999* – it does reflect the commercial reality we referred to above.

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38 *Simmons (as liquidator of Lionel Simmons Properties) v. Inland Revenue Commissioners* [1980] 2 All ER 798

In my view, the practical/pragmatic approach taken by the ATO in TR 93/26 should be adopted 'across the board' – it should not matter whether the asset in question is a building or something else completely different, but of the same character for taxation purposes, such as a horse.

6.5. The "negative gearing" conundrum and s51AAA

Much has been in the press over the last year in respect to negative gearing – primarily focussed on residential property – and what might or might not be done in legislation to address perceived unfairness and anomalies.

Politically, one party has made restricting negative gearing on residential property part of its key platform – but new property, shares and other investments are not in the firing line. A fair question that comes out of this however, is whether it really should be a policy issue for the parliament of the day, or is it really an issue for the Australian Taxation Office (ATO) to take a stronger approach under current legislation?

A recent article by Dale Boccabella[39] provides an excellent analysis noting the precedent that we are stuck with on apportionment of interest. Whilst I agree with Dale's view that the Courts could have arrived at a different conclusion, however without the ATO willing to take this on and/or a case decided in the alterative this is unlikely to change. As Dale notes, the issue of apportionment between revenue and capital purposes would be complex and I feel the ATO just do not want to take it on. They are focussing their attentions on private use and market rent issues, but could they enliven again the sleeping s51AAA[40]? Written in old drafting style, it takes a little thinking to understand, but in all its glory:

> ***Deductions not allowable in certain circumstances***
>
> *7. Where:*
>
> *a. An amount is included in the assessable income of a taxpayer of a year of income by section 102-5 of the Income Tax Assessment Act 1997 (about net capital gains) or subsection 124ZZB(1) of this Act (about notional capital gains of PDFs);*
>
> *b. A deduction would, but for this section, be allowable under a provision listed in the table in subsection (2) to the taxpayer; and*
>
> *c. If the amount had not been included in the assessable income the deduction would not be allowable;*
>
> *the deduction is not allowable.*

Simply put, the provision indicates that to the extent the cost is incurred in deriving a capital gain, there cannot be a deduction on revenue account. There is limited testing on this point as Dale's article notes, and it is a matter of whether the ATO would or should consider biting it off.

Whilst *Janmor Nominees*[41] from 1987 would seem to be the leading case in regard to negative gearing, what it perhaps stands for is the principle that ordinarily the amount of income derived on a commercial best endeavours basis does not impact the deductibility of underlying costs incurred on a *bona fide* basis, including interest.

Whilst there is discussion of another purpose, it does not really take on the issue of the alternate purpose of capital gain with any vigour and certainly does not address s51AAA. Clearly it would not, as the years in question were prior to the introduction of CGT and s51AAA had no application.

Whilst the Commissioner addresses s51AAA in a number of product rulings the context of certain financial products (where there is both income and capital gains), the general conclusion is that it will have no application on the basis that the interest would otherwise be deductible against the income. The position taken on hybrid trust and borrowings to acquire capital units is distinctly different for good reason and requires no further discussion.

There is also little in the way of case law on s51AAA, although it gets a short airing by the AAT in 1996[42]. It should be noted that this was from a time where holding costs such as interest could not be added to cost base for CGT, so hence the argument that it ought to be deductible – even on vacant land. The claim of course failed.

It would seem to the writers that time and context has moved on and the field is wide open for the ATO to weigh in with a considered approach on apportionment of interest and s51AAA.

Politics, policy and a better approach?

Placing the political focus and policy on residential property that is not "new" is indicative of the problems we have in the Australian tax landscape. Australia leads the world in levels of political policy "fixes", complex taxes and "also taxes" such as Medicare, private health insurance, levies and startling array of State taxes and charges than underpin the Commonwealth minefield. Although this keeps me and other advisors in a healthy living, it once again eats into some fundamental principles of tax law. I would suggest it is a political "knee jerk" reaction that is unnecessary.

It also seems ill thought out to consider action after a period of sustained growth in property values, exacerbating the perceived mischief, where a decline in values remains a real possibility.

39 Thomson Reuters Weekly Tax Bulletin – Issue 26, 27 June 2016

40 Section 51AAA – Income Tax Assessment Act 1936

41 *C of T v Janmor Nominees Pty Ltd* [1987] FCA 317

42 The Taxpayer and Deputy Commissioner of Taxation [1996] AATA 427

There is surprisingly little discussion on what impact the generous capital allowances for buildings has on the perceived mischief, and why they remain. There is also no mention of the revenue capital question on the sale side of the equation.

It is clearly a political policy issue for the government of the day to determine whether the generous capital allowances for buildings continue in all property classes. I will however go out on a limb here and suggest that whether that remains or not, the fundamentals of tax law should not be tinkered with and the ATO can and perhaps should address the issue more rigorously.

How?

If we were to accept that s51AAA may have application and/or the suggestion detailed below that geared rental properties may properly be on revenue account in circumstances where the objective intention to sell at a profit exists, how might the ATO address this, given that it may be as equally complex and difficult as apportioning interest?

While it is not for me to tell the Commissioner how to suck eggs, in the context of the recent favour of setting "Safe Harbour" positions and "circumstances less likely to lead to audit" the following (summarised) position would not in my view be unreasonable:

The ATO is reviewing the treatment of rental properties held where year-on-year a shortfall of income over interest is incurred through the period held, and later sale occurs which is claimed as a discount capital gain:

- You will be considered less likely or at low risk of review if you choose to not claim more interest than rent received, and you later treat the gain on sale as a discount capital gain, which unclaimed interest will reduce.
- If you year-on-year claim more interest than rent received, then you will be considered to have circumstances more likely to lead to an audit or review when you sell, with a focus on whether that the sale will be on revenue account, or ordinary income without any discount.

A strong position perhaps, but these would only be guidelines and people could take their own advice and position/s. You would however need to be careful on both record keeping and noting your intention. Any evidence that you always intended to "sell for a profit" would be a problem. But who did not buy a rental property to later sell at a profit over the past decades?

It's a question for another day what might happen in a falling market.

Why is this an issue and what is the mischief?

A core principle: where you incur operating costs in order to derive income such as rent, you may claim and offset those costs against the income in your tax return. Those costs may include interest on loans to acquire the underlying property, and to the extent that interest exceeds rental received you are considered "negative geared". But this is a real cost, so it's fair to get a tax deduction? To change this on one class of assets upends the integrity of the tax system for political purposes.

On top of this however you will likely get a depreciation tax deduction for furniture, fittings and most importantly building costs, which were included in your purchase price and you are not out of pocket for. This supercharges your tax loss and creates tax relief and/or refunds that substantially alleviate any net cash shortfall. In fact it is possible to have a breakeven or cash surplus while still showing a loss for tax purposes – and the benefit is at full tax rates and offset.

Some see this as overly generous and although any claimed building depreciation adds back and increases your capital gain when you sell, under law and accepted practice, this gain is discounted by 50% and there is a clear overall tax benefit.

The Revenue v Capital Issue

I have for some time been of the view that interest on loans to fund a property acquisition should be apportioned between the purpose of income and making capital gain – The part you don't claim just goes to the cost base for capital gains purposes. Buts it's perhaps all too difficult.

In November 2014, I put the question of negative gearing at a Tax Institute event to Mr AH Slater QC who responded verbally, but not his paper, to the following effect: "If a property is acquired to rent, and year-on-year that property makes a shortfall, and the only way that shortfall might be recovered is by sale at a profit, then arguably that sale is on revenue account".

Simple, considered and someone's views who ought not to be ignored. Anyone who considers that leased property cannot be on revenue account or even trading stock need only refer to August v Commissioner of Taxation [2013] FCAFC 85 and R & D Holdings Pty Ltd v FCT [2006] FCA 981.

It is however a question of intention – at the time of purchase or later – to sell for a profit. But who honestly buys a rental property without the intention to sell later for a profit? It is a question of degree, but an issue the ATO could pursue more vigorously. Large property funds may remain insulated from this on their MIT election. What about shares and other growth investments? A consistent approach on core principles could be applied.

Where to from here?

The ATO has been making inroads on excessive claims for properties not fully leased – although "available" – such as holiday houses and similar used by owners with some success. Perhaps the next step is targeting more closely regular property turnover and/or short ownership, where tax deductions have been claimed. Some genuinely do buy to hold forever or until a surplus is achieved, and would have a strong position, but the risk for others is there.

Whatever the political outcome, it is fair to expect that negative gearing will remain on the agenda for property owners. Personally I would like to see the integrity of the tax system preserved and the perceived mischief or anomaly dealt with in political sense only via contraction of existing concessions such as capital allowances. That seems to make more sense, but we will see.

6.6. Income tax implications where the sale of property is on revenue account

Income from the sale of property is usually treated as ordinary income where the taxpayer develops and enhances a property with a view to generating a profit from the development activity – see wider comments above. Taxpayers engaged in this type of activity are usually referred to as "property developers".

Where property is disposed of as part of the ordinary course of a business, any proceeds from the disposal of such property will be returned as assessable income on a gross proceeds basis under Section 6-5.

Gross proceeds basis

Under the gross proceeds basis, the income derived from the sale of property may arise sometime after the expenditure has been incurred in carrying on a business of property development.

This 'time lag' occurs because income derived from the sale of property is recognised for income tax purposes at the time of settlement of the contract, and not when the contract is signed or becomes unconditional[43]. On the other hand, the cost of purchasing the land, subsequent development costs and expenses relating to any development of the land will generally be deductible when incurred.

However, while the cost of purchasing the land and development/administration costs are deductible outgoings, some of these costs will form part of the cost of the land for trading stock purposes.

Effectively, the inclusion of such development and infrastructure costs as part of trading stock has the result of deferring a deduction until such time as the land is sold and the land ceases to be trading stock.

6.6.1. Land as trading stock

Given that a profit arising from the disposal of property may be held to be on revenue account, in many cases that property will constitute trading stock of the taxpayer.

In *FC of T v St.Huberts Island Pty Ltd*[44], the Full High Court confirmed that land could be so characterised as trading stock as the taxpayer was considered to be carrying on a business in the course of which the land had been acquired for development and sale.

In TD 92/124, the ATO stated that land will be treated as trading stock for income tax purposes where:

- It is acquired for the purposes of resale; and
- A business activity which involves dealing in land has commenced.

That is, both the required purpose and the business activity must be present before the land is treated as trading stock.

The ATO considers that a business activity is taken to have commenced when a taxpayer embarks on a definite and continuous cycle of operations designed to lead to the sale of the land.

The ATO also stated in TD 92/124 that it is not necessary for the acquisition of land to be repetitive. A single acquisition of land for the purpose of development, subdivision and sale by a business commenced for that purpose would lead to the land being treated as trading stock.

Trading stock will be on hand if a taxpayer is in a position to dispose of the stock[45].

Land remains trading stock until settlement, being the time at which the vendor loses all dispositive power and the sale becomes final. This follows the decision in *Gasparin v FCT*[46].

In *Gasparin*, the taxpayer was a property developer and the ultimate beneficiary in a series of three trusts, the main one of which had (as a participant in a joint venture) joined in a subdivision of a parcel of land into a number of allotments.

Contracts for the sale of 73 of the allotments were executed in the 1984/85 year. All of these contracts were expressed to be conditional upon the acceptance, deposit and registration of the plan of subdivision by the Land Titles Office on or before 30 July 1985. Each contract also provided that settlement was to be effected within 14 days of the issue of a Certificate of Title for the relevant allotment.

The Certificates of Title were issued on 27 June 1985. Nine of the contracts were settled on or before 30 June 1985. The contracts in respect of the remaining 64 allotments were

43 Gasparin v FCT [1994] ATC 4260

44 FCT v St. Hubert's Pty. Ltd. [1978] ATC 4104

45 All States Frozen Foods v FCT 1990 21 FCR 457

46 Gasparin, supra

settled in the following financial year. The joint venturers treated these 64 allotments in their books of account for the 1985 financial year as "closing stock on hand" for both accounting and taxation purposes.

The ATO took the view that because the contracts in respect of these allotments had become unconditional before 30 June 1985 they had ceased to be trading stock on hand and had become "sales". That is, the ATO maintained that the joint venturers had derived income from those sales in the 1985 financial year.

The issue before the Full Federal Court was whether the profits from the proceeds of sale of each of the 64 allotments were assessable income derived:

1. In which each of the contracts of sale became unconditional; or
2. In the year in which settlement took place.

It was held that each allotment remained trading stock on hand until settlement, that being the point of time in a sale transaction when the vendor finally loses all dispositive power – the contingency that the sale will not proceed to completion disappears.

Re-characterisation of land as trading stock

Under the current trading stock provisions, an asset no longer has to be acquired for the purpose of sale for it to be trading stock. It only has to be held for the purpose of manufacture or sale or exchange in the ordinary course of a business[47]. This means that land that was a capital asset can convert into trading stock where the land is later ventured into a business of development, subdivision and sale.

Where a capital asset is converted into trading stock, section 70-30 of the 1997 Act allows a taxpayer to elect to bring in the trading stock at either its cost or market value. Where market value is elected, it is determined by having regard to the "highest and best use" that can be made of the land and to the probability of consent being given for such potential use[48].

It is important to note that where land that was originally acquired as a capital asset is subsequently held as trading stock, a notional sale will be deemed to have occurred. This notional sale may result in a capital gain if the market value of the property exceeds its cost base and an election is not made to use the cost method for valuing trading stock[49].

Whether a capital gains liability actually arises for land that was originally acquired post September 1985 will depend on whether the taxpayer is able to access any of the CGT concessions (e.g. 50% CGT discount for individuals and/or small business CGT concessions) or has unutilised capital losses.

47 Section 70-10(a) -1997 Act (See also R & D Holdings Pty Ltd v FCT [2006] FCA 981 for confirmation of this point)

48 TR 97/1

49 Section 70-30(1)(a) of the ITAA 1997

Where the land in question is a pre-CGT asset, the best tax outcome will be achieved by maximising the trading stock value (i.e. using market value) which will lower the future revenue profit on sale and will not result in a capital gains tax exposure.

Valuation of land as trading stock

Under section 70-45 of the 1997 Act land may be valued as trading stock on hand at the end of an income year at its:

- Cost;
- Market selling value; or
- Replacement value.

The choice as to which valuation method to use is important as the value of closing trading stock directly effects the calculation of a property developer's assessable income. That is, any difference in the value of trading stock between the start and the end of the income year will be brought to account as either assessable income or an allowable deduction[50].

This is because where the value of trading stock at year-end exceeds its value at the start of that year the difference will be included in assessable income. On the other hand, where the value of trading stock at the beginning of a tax year exceeds its value at year-end the difference will be an allowable deduction.

Cost method used to value land as trading stock

Where cost is used to value land as trading stock an absorption-costing basis would seem appropriate following the Full Federal Court decision in *Kurts Development*[51].

In *Kurts Development* the taxpayer carried on the business of developing and subdividing undeveloped land ("broadacres"). It did so by buying broadacres, obtaining appropriate approvals, carrying out various construction works on the broadacres, subdividing the broadacres and selling the subdivided lots. It was accepted that the broadacres and the individual subdivided lots were trading stock of the taxpayer.

As a condition of obtaining approval from the local authority for the subdivision, it was usually necessary for the taxpayer to undertake, on certain parts of the broadacre land ("the Infrastructure Land"), work comprising the provision of services and facilities - such as roads, parks, sewerage, drainage, electricity and telephone ("Infrastructure Works"). It was also a requirement for approval that the Infrastructure Land be dedicated to the Crown or a public authority. That dedication was effected upon and by the registration of a plan of subdivision.

At issue was the application of the trading stock provisions of the Income Tax Assessment Act 1936 ("the 1936 Act") to the business activities of the taxpayer. In particular, the

50 Section 70-5(3) of the ITAA 1997

51 FCT v Kurts Development Ltd 39 ATR 493

extent to which certain costs incurred by the taxpayer in the development process should have been treated as part of the cost price of the individual subdivided lots resulting from the development process.

The costs in question fell into two categories, namely:

- Costs incurred in carrying out the Infrastructure Works ("Infrastructure Costs"); and
- Costs incurred as a condition of the taxpayer obtaining approval from a local authority to a proposed subdivision, being payments made to local authorities for "headworks" and other works which were physically external to the land of the taxpayer ("External Costs").

The taxpayer contended that when parcels of Infrastructure Land vested in a local council, by reason of the registration of a plan of subdivision, the value of the taxpayer's trading stock (determined by reference to its cost price) was reduced by the cost of:

a. The Infrastructure Land; and

b. The services and facilities constructed thereon which vested in the local council.

That is, the taxpayer argued that the value of its trading stock at the end of the year of income was the cost of the individual subdivided lots on hand less:

a. The cost of the Infrastructure Land; and

b. The Infrastructure Costs relating to the Infrastructure Land.

In other words, the taxpayer contended that these costs were allowable deductions that did not become part of the cost price of the taxpayer's trading stock.

The Full Federal Court held that:

3. The Infrastructure Land was never a separate article of trading stock. The taxpayer's business involved converting one form of trading stock (broadacre land) into a different form of trading stock (subdivided lots). One cost of so doing was the Infrastructure Costs. Another cost was the cost of the Infrastructure Land. Those costs were properly to be characterised as part of the cost price of the resultant individual subdivided lots;
4. The individual subdivided lots that were created upon registration of the plan of subdivision were part of the trading stock of the taxpayer. All of the costs incurred by the taxpayer in creating those individual lots were regarded as part of their cost price. There was no justification for drawing a distinction between the direct costs of the lots on the one hand and the general costs of the development on the other hand; and
5. The External Costs were also part of the cost price of the individual subdivided lots. They were all expenses that had to be incurred in order to create the individual subdivided lots.

Emmett J stated that:

> *"The individual subdivided lots which are created upon registration of the plan of subdivision are part of the trading stock of the Taxpayer. All of the costs incurred by the Taxpayer in creating those individual lots must be regarded as part of their cost price. There is no justification for drawing a distinction between direct costs of the lots on the one hand and general costs of the development on the other hand. Equally, there is no justification for treating the Infrastructure Costs as "wasted" or treating the Infrastructure Land as a "waste product" . All of those costs are necessarily incurred in order to bring into existence the individual subdivided lots. They are all properly to be regarded as part of the cost price of the individual subdivided lots."*

Until a local authority/council has formerly approved the subdivision and the taxpayer has separate title to each individual subdivided block, it follows from the above decision (and the decision in *Barina Corporation Ltd v FCT*[52]) that the cost of broadacre land and any associated internal and external infrastructure costs are valued as a single item of trading stock.

Only when broadacre land is converted into individual subdivided allotments do the allotments become individual items of trading stock that can be valued at either cost, market selling price or replacement value.

In addition, it is only when broadacre land has been subdivided into individual allotments that the internal and external development costs can be apportioned to each allotment. (In this regard, as a number of methods may be used to apportion cost the ATO will usually accept any 'reasonable' method).

The fact that land is trading stock however does not mean that all expenses in relation to that land are considered by the ATO to form part of the cost of that land for trading stock valuation purposes. For example, in TD 92/132 holding costs such as interest, council rates and taxes were not regarded as related to the conversion or development of land into trading stock.

6.6.2. Land on revenue account – not trading stock

How is this treated?

The important point to note from this characterisation is that any profit from the transaction will be assessed on a "net profits" basis.

Under the net profit approach the development expenses of a transaction are not deductible as they are incurred. This is because the transaction amounts to a profit-making activity rather than an ordinary course of business activity. Instead,

52 Barina Corporation Ltd v FCT [1985] ATC 4847 (See also the R & D Holdings case, supra, where Barina was distinguished on its facts)

the development expenses are offset against the proceeds from the sale of the land - with the resultant net profit/loss being assessable/deductible at settlement.

Holding costs such as rates, taxes and interest should however, be deductible when incurred.

Wider questions and risks

While just a few years ago the writer was questioning the narrowing circumstances where property could be classified as such, *August* provide a clear example of where it does. However perhaps the judges found it unnecessary to put their minds to that question.

This raises a very interesting issue in the context of the single judge decision in *R & D Holdings* (as detailed above) when viewed in conjunction with a general broadening of what may be considered *business*[53] noting that the definition of *trading stock*[54] includes:

> "a. anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a *business;"

Where business is in turn defined as:

> *"**Business** includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee."*

Beyond this, all we have to rely on is the rafts of precedent on what is a "business", that could in itself be a topic for a separate paper. As noted, with the advent of ABNs, GST and the concept of *enterprise* the existence of property on revenue account – particularly where you may also register for GST – that is not part of your *enterprise* simply does not exist.

Certainly an isolated transaction in property may be considered a business and I note again my comment above that the ATO states in TD 92/124 that it is not necessary for the acquisition of land to be repetitive. A single acquisition of land for the purpose of development, subdivision and sale by a business commenced for that purpose would lead to the land being treated as trading stock.

Traditional thinking on this has perhaps been asleep since the introduction of CGT and the simplistic approach of gains under 12 months being fully assessable. Many practitioners may have assumed that the old *profit-making undertaking or scheme* provisions which were s26(a)/25A under the 1936 Act, were perhaps enlivened by Section 15-15 in the 1997 Act.

It is worth noting that *this section does not apply to a profit that*[55]:

*a. Is assessable as *ordinary income under section 6-5; or*

b. Arises in respect of the sale of property acquired on or after 20 September 1985.

This clearly leave property acquired after 20 September in the general law context of profit-making undertaking or scheme, which *August* has reinforced.

Perhaps this is of little consequence? The end result on disposal is fundamentally the same and the only major difference in treatment on this method rather than inclusion in a trading account, would be the ability to adopt cost, market or replacement value during the course of the development.

The more thorny issue may be on the ultimate result where you have a project that is not a *business* per se, and not eligible to be trading stock, yet is on revenue account. Relatively clear outcome if you have a surplus, however is that position as clear if that project results in a loss.

Certainly the ATO may pay more attention. Given that the loss must fall to Section 8-1[56] one wonders if anything positive comes of that provision:

> 1. You can ***deduct*** from your assessable income any loss or outgoing to the extent that:
>
>   a. It is incurred in gaining or producing your assessable income; or
>
>   b. It is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.

Noting the requirement under (b) to have a business. It would seem that a remote expectation of assessable may cause difficulties with nexus under (a) if there is none and the path to a tax loss created by a profit-making undertaking or scheme would require some element of assessable income? Perhaps not. Greater minds will no doubt apply themselves to this question eventually.

6.7. Income tax implications where the sale of land is on Capital Account

Where land is not held on revenue account, its disposal may be subject to tax under the capital gains provisions unless specifically excluded (for example, where the land is a pre-CGT asset).

It is important to note that the mere subdivision of land does not give rise to a CGT event. While each of the subdivided blocks of land will be considered to be a new asset for CGT purposes, the splitting or change from the original asset to the new assets is not considered to be a CGT event: section 112-25 of the 1997 Act.

Instead, the cost base of the original undivided block of land is required to be apportioned across the new subdivided blocks. Such an apportionment must be based

53 Section 995-1 – 1997 Act

54 Section 70-10 – 1997 Act

55 Section 15-15 – 1997 Act

56 Section 8-1 – 1997 Act

on a reasonable method under subsection 112-25(3) of the 1997 Act.

While the subdivision of land itself does not give rise to a CGT event, a CGT event may arise where undivided land is held jointly by taxpayers as joint tenants or as tenants in common, the undivided land is subsequently subdivided into two or more lots and each party agrees to own outright one of the subdivided lots.

In this case, each party will be deemed to have disposed of a 50% interest in one lot and to have acquired a 50% interest in the lot that they now own outright. As a consequence, a capital gain or loss will arise.

6.7.1. Timing of sale transaction under CGT event A1 where sale is on capital account

Where property is disposed of on revenue account, the proceeds are generally assessable at the time of settlement of the property. However, this is not the case where the sale proceeds are treated as being on capital account.

Where the sale of property represents "a mere realisation of a capital asset" (and accordingly is on capital account), for capital gains purposes the taxpayer is considered to have derived a gain/loss at the time the sale contract is entered into, or if no contract, at the time of the ownership change: section 104-10 of the 1997 Act.

The date of contract is not only important in the context of a disposal of property, but is equally important to the question of acquisition.

For CGT purposes, the date of contract will determine:

- Whether the gain is subject to capital gains tax. Where the property has been acquired pre-20 September 1985 the gain will be treated as a pre-CGT asset and will not be subject to CGT (unless Division 149 applies due to a greater than 50% ownership change having occurred);
- The year of income in which a capital gain (or loss) arises;
- Whether the taxpayer has held the asset for a period greater than 12 months (excluding the day of acquisition and day of disposal), in which case the taxpayer may be eligible for the CGT discount; and
- Whether indexation may apply to increase the cost base of the disposed asset where that asset has been acquired prior to 21 September 1999.

If a contract is subject to a condition, it does not affect the time of the making of the contract unless it is a condition precedent to the formation or existence of the contract.

In the case of a condition precedent to the formation, the non-fulfilment of the condition prevents a binding contract from coming into existence. No contractual rights enforceable by the parties are created unless and until the condition is fulfilled.

Practical problems can arise under the capital gains rules when the date of contract and the date of settlement occur in different financial years. That is, although the date of disposal for CGT purposes is the date of making the contract, a disposal does not actually occur until there has been a change in beneficial ownership.

TD 94/89 outlines the ATO view where a contract is entered into in one year and, at the time of lodging the tax return for that year, the taxpayer is unsure whether settlement will occur. The determination states that there is no requirement for the taxpayer to include the capital gain or capital loss prior to settlement occurring. The taxpayer may however choose to do so.

If a taxpayer chooses not to include the relevant gain or loss in the tax return for the year the contract is made, the determination requires the taxpayer to take steps within a reasonable period after settlement to lodge a request for amendment for that year.

Where a contract for the sale of property falls through prior to settlement and the taxpayer has previously included the gain or loss in their return, the determination states that the taxpayer would need to lodge an amended return.

6.8. Optimising the interaction of CGT and revenue treatment

If we have a contemplated future project using land already held on capital account the core questions will invariably be:

- How do I preserve my pre CGT/CGT status on that asset?
- If it is going to be on revenue account, will that be everything?
- Should I sell it now to another entity to protect my CGT position?

The answer these questions is that you can preserve your CGT status up to a point in time and you ordinarily do not need to incur unnecessary Stamp Duty on transfer of property interest to another entity.

It is clear from the trading stock and CGT provisions detailed above, capital assets moving to trading stock will trigger a CGT event at either cost or market value at your choice and is taken up in trading stock at that value. The future profits (or loses) are then on revenue account.

The attraction of market value is strong, and a clear and supportable professional valuation should be obtained at the selected time to establish that. This however is not perhaps always the right answer and you should always consider all circumstances.

The transition to trading stock at market value where there is a capital gain will result in a CGT liability attributable to that year, notwithstanding that completion and ultimate realisation may be some years away. It will very much depend on the entity type, tax/loss position and ultimately cash flow.

It is clear however that CGT asset will crystallise a capital gain/loss and a pre-CGT asset will crystallise that pre-CGT gain at the time that it becomes trading stock. The most important planning assistance you can provide is around the timing of that.

There is an obvious attraction to improving the property by (for example) securing the DA or demolishing the existing structure etc, and if the transition to trading stock can be deferred until that higher value is achieved there may be a significant benefit.

Extreme care needs to be taken however, as the more the value is improved, the higher the probability that the ATO may select an earlier time as the commencement of your business or profit-making undertaking or scheme.

Similar advantages apply to assets that move to revenue account, but are not trading stock. Although there is no specific provisions as there is for trading stock, this principle is well supported at law in cases such as *Whitfords Beach* etc. Again, care should be taken on any advice and the actual circumstances assessed fully before setting the valuation point.

Is there a CGT event? If not trading stock, this is not clear and seems unlikely that the events on creation of rights etc would have application. In this regard the timing issue on tax liabilities would appear to be relieved and all would appear to be settled up on disposal – noting that this would be an apportionment exercise and the CGT component would be assessable on contract and revenue component on settlement.

This provides less certainty and precision around the issue, which leads some to the attraction of triggering a CGT event to be certain and suffering the Stamp Duty. In the writers view this is no necessary and properly detailed, supported and documented approach will provide an equivalent level of certainty, without the Stamp Duty cost.

This should however be done in any case to ensure that in the event of ATO enquiry, all is in order and the process can be handled with minimal disruption.

6.9. Quick summary – Investors vs Developers

6.9.1. Property developers

A property developer typically carries on the business of acquiring, subdividing and selling the subdivided land or acquiring and renovating property with the intention of profit.

Factors suggesting a property developer

- Land is acquired with the purpose of making a gain on resale, or in the course of carrying on a business.
- Taxpayer or the taxpayer group has a history of developing land.
- Extensive subdivision of land going beyond the establishment of sewerage and drainage, with the provision of park areas, lakes, golf courses, etc.
- Taxpayer has a history of acquiring and renovating for a profit-making purpose.
- High degree of personal involvement – the taxpayer makes decisions on many aspects of the development.
- Transactions are carried out in a business-like manner, e.g. taxpayer has a letterhead, advertising and marketing activities are undertaken, formal records are kept.

Is the land or property held on revenue or capital account?

- On revenue account.

Treatment of proceeds

- Proceeds received on the sale of land are assessable in the income year in which settlement of a sale contract occurs, i.e. when the vendor loses dispositive power.

Treatment of expenses and outgoings

- If carrying on a business of property development, outgoings incurred in relation to acquiring land and associated with the sale of the land are deductible in the year they are incurred.
- If not carrying on a business of property development but the transaction is undertaken with a profit-making intent or is a commercial transaction, outgoings are offset against the sale proceeds and the net profit or loss is returned in the year that settlement of the sale contract occurs.

Valuation of trading stock

- Land can be valued at the end of each income year at: (a) its cost; (b) its market selling value; or (c) its replacement value.
- If trading stock is valued using the cost price method the costs of converting the land into a condition in which it is to be sold represent the cost price of the trading stock.

Such costs would normally include internal and external infrastructure costs. Administration and holding expenses not directly associated with converting the land into marketable lots will not be included in the cost price of the land.

Accounting for trading stock

- If the value of trading stock at the year-end is greater than the value at the beginning of the year, the difference is assessable.
- If the value of trading stock at year end is less than the value at the beginning of the year, the difference is deductible.

6.9.2. Property investors

Property investors generally acquire land as an investment with the intention of using it to earn assessable income (e.g. rent). Property investors may develop the land but, rather than disposing of it soon after the completion of the project, they are likely hold on to the property for a longer period of time.

Factors suggesting a property investor

- Property acquired for investment and not for resale at a profit.
- Lengthy period of ownership. The longer the period of time that an asset is held, the less likely the gain will be on revenue account.

Is the land held on revenue or capital account?

- The land will be held as a capital asset provided that the requisite of intention of investment is satisfied.

Treatment of proceeds

- The time of acquisition or disposal is “the time of the making of the contract”.
- A capital gain is made where the proceeds received on the sale of land exceed the cost base of the property.
- A capital loss is made where the proceeds received on the sale of land are less than the cost base of the property.
- Note that certain discounts (eg 50% general discount and small business CGT concessions) may be available to reduce the gain.
- Where land and/or buildings are Pre-CGT assets any capital gain is exempt; subject to the application of Division 149.
- Where the land is pre-CGT and any buildings or improvements to land are post-CGT assets, then any capital gain on sale of the property is to be apportioned.

Treatment of expenses and outgoing

- **Land:** The amount paid to acquire the land forms the cost base of the property. Other costs such as construction and subdivision costs, legal costs etc may form part of the cost base of the property.
- **Building:** Capital expenditure to improve assets value forms part of the cost base of the asset (provided it is reflected in the state or nature of the asset at the time it is sold).
- Where the property is not used for income producing purposes (and was acquired after August 1991) any interest on borrowed funds, costs of repairing or insuring property, rates and taxes etc form part of the cost base of the asset.
- Where the property is used for income producing purposes any interest on borrowed funds, costs of repairing or insuring property, rates and taxes etc will be deductible against income derived from rent of the property.
- Initial repairs to building – form part of cost base.
- Where a building is constructed on the land, a deduction for a % of the construction costs is allowed but only when the construction of capital works is completed.

7. Specific GST issues

As noted above, the following comments represent a high level view of common issues and problems encountered in respect of GST and property transactions. It should not be treated as comprehensive technical analysis of the issues.

7.1. The GST basics

It may seem trite, but one may ask any budding GST advisor "how much is the GST – is it 10% or is it 1/11th?" Typically in any room, including seasoned practitioners, you would get a 50/50 split and some who hedge their bets and say "both".

The reality and perhaps the source of much confusion and contractual issues is that the rate is in fact 10% as defined[57], however this is calculated on ***value*** which is defined as 10/11th of ***price***[58].

Almost invariably in business to business (**B2B**) transactions involving taxable property, discussions and negotiations revolve around *value*, as it is presumed that GST will be charged on top or if *GST-free* as a going concern or farmland, then this has no impact – as it is the net proceeds and net cost that is relevant for the parties.

In business to consumer (**B2C**) or transactions between unregistered parties, the convention is mostly different and typically about *price*. This is of course how the government of the day wanted it, and how the ACCC would like us to behave. The trouble is that it is not always that simple, as we have the paths of business, both registered and unregistered, investors, service providers and consumers crossing paths on property that may be fully taxable, taxable under the margin scheme, input taxed or GST-free.

This leads to different views, advice or just plain ignorance of the GST treatment on a transaction between the vendor, the purchaser and indeed the ATO.

The problems that arise are apparent in the large amount of GST cases that have come to light, the ATO have recently advised that their case load in GST has reduced slightly to about 130 cases on the go at any one time. A good proportion of these cases deal with property, which would represent the tip of the iceberg for those cases that are not heard in court – we would guess about 90/10 in proportion, if that. Interestingly the proportion of cases direct between the parties in a transaction disputing the GST treatment constitutes almost half of the GST property cases that see the light of day – action that the ATO may in any case seek to join if there is a critical issue involved. Again, there would be many more that are settled between the parties before getting to court.

57 s9-70 of *A New Tax System (Goods and Services Tax) Act 1999* ('the GST Act')

58 s975 of the GST Act

7.2. What property is subject to GST?

If we start from the basics in GST, a *supply* for *consideration*, in the *course or furtherance of an enterprise* will be *taxable* where the vendor is required to be registered[59].

From that point – the same provision – we carve out that a *supply is not taxable to the extent that it is **GST-free** or **input taxed*** (highlight for emphasis). Property may fall into either of these categories:

- *GST-free* as *farmland*[60] or as part of a sale of a *going concern*[61].
- *Input taxed* as *residential rent*[62] or *residential premises*[63].

Leaving aside the complexities of sales of GST-free farmland and going concerns, we are left with the rent, lease or licence of *residential premises*[64] and the sale of residential premises (except *new residential premises*) being *input taxed* and consequently not subject to GST.

The exclusion to both these types of supply is *commercial residential premises*[65] which are *taxable* and on the face of it a simple distinction, but in itself is capable of a full technical paper in itself. A number of court cases demonstrate how this simple issue can be quite complex – see Marana Holdings[66] and South Steyne[67].

The consequences to being *input taxed* are the denial of GST input tax credits in respect of the *supply* of those premises either by way of sale or lease on the basis of *creditable purpose*[68].

59 Section 9-5 – *A New Tax System (Good and Services Tax) Act 1999* ('GST Act')

60 Section 38-475 – GST Act

61 Section 38-325 – GST Act

62 Section 40-35 – GST Act

63 Subdivision 40-C – GST Act

64 Section 195-1 – GST Act

65 Section 195-1 – GST Act

66 Marana Holdings Pty Ltd and Anor v FC of T [2004] FCAFC 307

67 South Steyne Hotel Pty Ltd and Ors v FC of T [2009] FCAFC 155

68 Division 11 – GST Act

In summary the following is generally applicable:

Type of Property	GST Treatment
Commercial	Taxable
Industrial	Taxable
Vacant land	Taxable
Farmland	Taxable
Residential (not new)	Input Taxed
Residential rent	Input Taxed
New Residential	Taxable
Commercial Residential	Taxable
Long Term Commercial Residential	Taxable/Option to be Input Taxed

7.3. Get your contract right!

A large source of disputes both between the parties to a property transaction and the ATO is the characterisation of the property and the (mis)understanding of what is the GST position. This happens at even the highest level – see *Toyama*[69] and *Sunchen*[70] decisions and even the decision in *South Steyne* (supra) had some contractual issues/ disagreement.

Whereas *Toyama* firmly placed the future intended use of the subject property as important in determining what was being sold and its GST status, *Sunchen* essentially curtailed this and brought us back to "it is what it is" and this is regardless of what the parties wanted it to be.

Sunchen involved the sale of a property which had a dwelling erected upon it (not new), which had a tenant at the time of sale. Normally this would be a simple *input taxed supply*. It was stated however to be the purchasers intention to develop the property and the parties agreed that it was a *taxable supply* on which GST was payable and for which the purchaser may receive a GST credit.

Ultimately it was held that the sale was of *residential premises* that was consequently *input taxed*. Accordingly the purchaser was denied GST input credits. You would assume that the vendor may now recover the GST he paid on sale and it will be a matter of how the contract was constructed as to whether they can retain that as a windfall gain or whether they must return it to the vendor.

The other matter that confuses accountants, lawyers and clients is what exactly the sale value is and does it include GST or not. This is dealt with to some degree in the legislation[71] where it is specifically prescribed that the *value* on which GST is charged is 1/11th of *price*. 10% is then calculated on that value, which of course equates to 1/11th of price.

69 Toyama Pty Ltd v Landmark Building Developments Pty Ltd [2006] NSWSC 83

70 Sunchen Pty Ltd v FC of T and Anor [2010] FCA 21

71 Section 9-75 – GST Act

Complex and confusing or just trite? The key is that if one party agrees the price to be X + GST this is quite incorrect. You can agree the "price", but in the absence of any provisions to the contrary this **will** include GST. You can also define it as X + GST to give the same outcome, but this must be clear.

The key is for you, and your client to be absolutely clear on:

- Whether the sale is subject to GST at all, if so
- Whether or not the margin scheme applies,
- What the GST inclusive *price* is, and
- Whether your client has a liability or a credit entitlement

If you have any doubt about this – seek advice!

Margin scheme issues? In its simplest form this allows the vendor of a property to calculate the GST liability by reference to 1/11th of the *margin*[72] rather than 1/11th of the sale value as noted above.

There are complications to this but *margin* is essentially the difference between the tax inclusive selling price (*consideration for the* supply) and the cost of the property interest acquired that was not fully taxable (*consideration for your acquisition*) and excludes any improvements[73]. In certain circumstances it can be the value of the property when it enters/ed the GST system. Most commonly this is the 1 July 2000 value, but can be at another time – for example for vendors not previously registered for GST, the valuation date is the date of registration (or the requirement to register).

This compensates the developer for not getting any GST credits on the acquisition of land or buildings for development, but has no overall advantage unless the *price* paid for the *acquisition* is lower than the fully taxable price.

Purchasers of property under the margin scheme cannot in any circumstances claim a GST credit in respect of this acquisition.

7.4. GST registration requirements

Assuming you have identified an *enterprise* – see MT 2006/1 and comment in 2.1 above – the issue is whether and when you must register for GST.

Clearly one motivation for registration is to enable recovery of GST input tax credits on building/contraction to ameliorate cash-flow.

You must however register where you are making or will make taxable supplies in excess of $75,000 per annum[74]. In most instances supplies of property will exceed this threshold, and is simple terms the cumulative effect of this

72 Division 75 – GST Act

73 Sections 75-10 and 75-14 – GST Act

74 Division 23 – GST Act

provision and the turnover calculation provisions[75] is that you must register if you are within 12 months of sales (generally settlement) in excess of $75,000.

There are some additional aspects however that you do need to be aware of. The principal "out" that many people may not be aware of is the exclusion from the turnover calculation of supplies that are the *transfer of capital assets* or in respect of *termination of an enterprise*[76]. This potentially allows quite large property to be sold without triggering the requirement to register.

This will not however help you if you are already registered (unless you can deregister without consequence) or where the sale is part of your *enterprise* such as the development and sale of property.

Once registered, you may elect to be quarterly or monthly depending again on turnover. Most developers would register monthly so as to assist cash flow with upfront GST credit claims.

7.5. Beware – Adjustment events

7.5.1. DIVISION 129 – Where your application of the *thing* ends up being different

- Initial GST claims based on intention – Division 11.
- Adjustments follow based on actual application – Division 129 – issue is meaning of "apply".
- Main example - developers who rented unsold stock due to lack of sales.
- Initial ATO view - required to repay 100% GST credits...
- ATO changed its view on GST adjustments for residential premises:
  - ATO ID 2008/114 - *GST and change in extent of creditable purpose where new residential premises are constructed for sale but subsequently rented* followed by GSTR 2009/4.
  - Draft legislation now tabled to make more certain.
- N.B. Division 129 also applies to "private or domestic use" such as a unit retained by an (individual) developer to live in.
- Former ATO view:
  - Strict interpretation of the term "apply".
  - Leasing seen as full application of the property for *input taxed* purposes.
  - Significant cash flow issues (increasing adjustments) for developers already under pressure.
  - Many anomalous results – seemingly quite unfair and unintended.
  - Often a sympathetic ear from the ATO "but policy states..."
- Revised ATO view:
  - Can claim credits on creditable purpose of taxable sale.
  - Leasing (input taxed) results in progressive repayment of credits <u>provided</u> continued intention/attempts to sell exist.
  - Dual "application" does not satisfy 5 year rule.
- Methodology - ATO ID 2008/14 / GSTR 2009/4:
  - Annual adjustments as required - "fair and reasonable basis" may be:

$$\textbf{Extent of creditable purpose} = \frac{\textbf{Estimated consideration for the taxable supply of the new residential premises when sold}}{\textbf{Estimated consideration for the taxable supply of the new residential premises when sold + consideration for the input taxed supplied of residential rent}}$$

- Also be aware of adjustment periods (common to other adj. provisions)

GST exclusive value of acquisition	Adjustment periods
$5,000 or less	Two
$5,001 to $499,999	Five
$500,000 or more	Ten

7.5.2. DIVISION 135 – Adjustment after acquisition of a *GST-free going concern*

- *GST-free going concern* concession is NOT restricted to taxable supplies.
- You may buy a residential rental property as a *going concern* but there are consequences! Problem more likely when status unclear.
- To the extent you intend to make *input taxed supplies* with what you have acquired you have an *adjustment event.*
- ***This is 10% of the acquisition price <u>in the period that you acquired it.</u>***
- Also claws back subsequent use – similar to Div 129.

75 Division 188 – GST Act

76 Section 188-25 – GST Act

- Clearly this does not apply on a vanilla transaction involving property that is always taxable – such as commercial or industrial property.
- Problems arise in the areas of *commercial residential* property and *new residential* developments that are then leased.

Where things have gone haywire – Division 135 and *supply*

It is perhaps beyond the scope of this paper to cover in detail, however the Full Federal Court decision in *South Steyne*[77] kicked off a series of decisions in regard to its sister entity MBI Properties Limited, which has now been heard all the way through to the High Court. In short, the purchasers of the investment units in the South Steyne development were held – erroneously in the writers view – to have acquired the hotel style apartments as a *GST-free going concern*. It was then held that the supply of these premises to the operator of the hotel under lease was an *input taxed supply* of *residential premises*.

On the face of it, this would appear to be a breach of Division 135, however the reasoning in the *South Steyne* decision gives rise to the view that no supply is being made by the purchaser (of the lease reversion) and accordingly Division 135 should not apply.

This is perhaps the right outcome, but for all the wrong reasons, and while the battle rages, has perhaps rendered Division 135 perhaps unworkable in these narrow circumstances. Some have sought to take advantage of that but may well come unstuck.

As noted in the introduction, since this paper was published, the case has now been heard all the way through to the High Court[78]. The outcome from the High Court has provided some certainty sought by the ATO in regard to who is liable for GST when the reversion in lease is acquired by someone other than the original lessor. In doing so however, the High Court has run against traditional wisdom and understanding in property law that the "supply" under the lease can only be made by the original lessor and have substantially widened the concept of "supply"[79] and what that means well beyond the context of a lease, and for a landlord who has acquired property with an existing lease or reversion in place.

It seems quite clear now that it is inappropriate to attempt to characterise a single transaction as representing a single supply. Equally clear is that Federal Court decisions in cases such as AP Group in respect of rebates and incentives to motor dealers are all open for re-examination.

77 South Steyne Hotel Pty Ltd v Federal Commissioner of Taxation (2009) 180 FCR 409

78 Commissioner of Taxation v. MBI Properties Pty Ltd Case S90/2014

79 Section 9-10 – A New Tax System (Goods and Services Tax) Act 1999 ('GST Act')

For property, within the boundaries now set, matters are perhaps a little more defined for run of the mill transactions, however outside that, it would be wise to obtain quality advice.

7.5.3. DIVISION 138 – Adjustments on cessation of registration

- You can cease GST registration at any time provided you no longer will make taxable supplies that exceed the threshold - $75,000.
- There are however consequences to this that must be considered where:
  - You still hold assets that you claimed GST input credits on.
  - Those assets have a market value.
  - The adjustment periods have not expired.
- The *increasing adjustment* is calculated as:
  - 1/11th x GST inclusive market value (adjusted for actual creditable use if required).
  - There is no *decreasing adjustment* under this provision.

7.6. ATO query / review / audit

The most common first encounter with the ATO for those dealing in property is when "compliance checking" calls. This typically occurs when there is a large or abnormal GST credit claim with little or no liability for sales.

You will be required to provide details of the top 10 tax invoices claimed and this is generally a simple process. If there are any issues with these invoices, it is best to disclose this upfront and work out a solution with the ATO officer. This will invariably be treated as a (pre-audit) voluntary disclosure and receive appropriate concessional treatment in respect of any penalties – typically nil.

The next level of enquiry from the ATO will be termed a "GST Review" and the approach will be very friendly with overtures of "assistance" for your business etc. Typically it will be focussed on a specific issue/line of enquiry or seek to review your systems and/or record keeping.

Be very clear (particularly if the ATO are not) that this most definitely is an "audit" and you should review your affairs with the view of making a voluntary disclosure before this commences, otherwise you will be in "post audit" area for penalties, which are statutorily defined as different in respect of voluntary disclosures – 20% discount as opposed to 80% for pre-audit disclosures.

The final level of ATO enquiry is audit, which may flow from the step above or may generate separately. This is definitively an "audit" and again, it pays to review your position in respect to GST and make any voluntary disclosures that may be necessary to afford the lowest penalty treatment in the event of adjustment.

The typical issues examined by the ATO are as follows:

- Tax invoices in respect of GST credits claimed for correct features including identified taxpayer, description, GST charged etc to ensure they are a valid tax invoice.
- Review of dates of tax invoices and attribution to the correct BAS period. This is normally straightforward for most tax invoices, but is often confusing for progress claims, particularly with retention provisions.
- Incorrect or unusual claims or transactions.
- Correct calculation and attribution of GST liability on sale, including review of margin scheme valuations, contract details.

As noted above, progress claims are often cause for confusion in any property development. The reason for this that the progress claim documentation is typically issued at the end of the month, then reviewed and bounced back and forth between the builder and your quantity surveyor/ project manager. Once it is agreed, it may then be issued in final form as a *Tax Invoice*.

Given that builders and quantity surveyors are not tax advisors, this is often unclear and subject to some variability. On top of this there may be some agreed retention from the progress claim of 5 – 10%.

The key questions are:

- When can I claim the credits for the developer?
- When should the builder include the GST liability in their BAS?
- What is the correct treatment in respect of retention?

The latter question can perhaps be dealt with first. Assuming all other matters, including issuing/holding of valid tax invoices, it is clear that the ATO view[80] is that retention amounts adjust both the GST input tax entitlement and GST liability on the basis of uncertainty, noting that the has made a legislative determination to this effect under Section 29-25 of the GST Act.

The issue as to questions 1 and 2 hinge largely on the issue and retention of a valid *Tax Invoice*. Excluding the adjustment for retention as noted above the normal rules will apply. In simple terms:

- Developers cannot claim a GST credit unless they hold a valid tax invoice attributable to a BAS period at the time of lodging that BAS. For monthly lodgers this is 21 days after the month end and for quarterly lodgers 28 days after quarter end.
- Equivalently, builders are not liable to account for GST until they have issued a valid tax invoice attributable to the relevance BAS period.
- In both cases, timing/attribution will be impacted by whether they are on *cash* or *accruals* basis for GST.

By way of simple example a progress claim for April 2010 may be issued on 1 May 2010 and bounce back and forth between the QS and the builder until 29 May 2010, when it is issued at $220,000 including GST as a *Tax Invoice*. An agreed retention of $11,000 is noted and the developer then pays 30 June 2010.

- The developer on accruals cannot claim GST in the April 2010 BAS as they did not hold a valid tax invoice at the time of lodging their BAS. This will now go into May.
- If the developer is quarterly, it will remain in the June BAS provided they are on accruals.
- Equivalently the builder will return the GST in their June 2010 BAS.

7.6.1. Retention payments

The retention of amounts is very common practice in the building and construction industry.

The provision for retention amounts is a contractual arrangement whereby the recipient of the construction services withholds an amount from the total amount payable in order to provide the recipient with some assurance that the builder will perform its obligations under the contract.

The common practice within the building and construction industry is for 5% retention pending satisfactory completion of the contract or until the end of the defects liability period.

The attribution rules in Division 29 of the GST Act allows the Commissioner to apply discretion when the application of the basic attribution rules involving a supply or acquisition made under a contract that provides for retention of some of the consideration, until the completion or performance of an obligation provides an inconsistent or unfair outcome to the parties involved in the transaction.

Due to the delay in receiving or paying retention amounts, the Commissioner is satisfied that this application of the basic attribution rules produces an inappropriate result. Accordingly, the Commissioner has made a determination under section 29-25 to defer attribution of GST payable and GST credits that relates to the retention amount.

80 GSTR 2000/35 paras 121-123; GSTR 2000/29 paras 172-189

The Commissioner's determination overrides subsection 29-5(1) to the extent that it would otherwise operate to attribute the GST payable in relation to the retention amount to an earlier tax period. Similarly, the Commissioner's determination overrides subsection 29-10(1) to the extent that it would otherwise operate to attribute the GST credit in relation to the retention amount to an earlier tax period[81].

For example:

Facts -

- A Co. is a developer.
- B Co. is a builder / construction company.
- A Co. enters into a contract with B Co. for the provision of construction services.
- The contract provides for 5% retention until satisfactory completion of the project.
- The March progress claim was issued by B Co. on 31 March 2010.
- The tax invoice for construction services (relating to the month of March) was finalised and issued on 25 April 2010.
- The tax invoice was for the amount of $110,000 (inclusive of GST) less a 5% amount of $5,500 (inclusive of GST).
- Therefore, net amount payable was $104,500 (inclusive of GST).

Attribution of supplies and acquisitions –

- **Cash reporting taxpayer**

  If reporting on a cash basis the amounts are reported in the activity statement in the tax period when amounts are received or paid.

- **Monthly accruals reporting taxpayer**

  The GST payable will be reported in the April tax period.

  The GST credit can be claimed in the April tax period.

  The recipient cannot claim the GST credit in the March tax period (when the progress claim was issued) because the recipient did not hold a valid tax invoice at date of lodgement of the activity statement being 21 April 2010.

- **Quarterly accruals reporting taxpayer**

  The GST payable will be reported in the June tax period.

  The GST credit can be claimed in the June tax period.

  The recipient could potentially claim a GST credit in the March tax period if payment was made on the date the progress claim was received (being 31 March 2010). This is due to the fact that the tax invoice was received prior to lodgement of the March activity statement being 28 April 2010.

81 GSTR 2000/29: Goods and services tax: attributing GST payable, input tax credits and adjustments and particular attribution rules made under section 29-25. para. 172 – 189 and GSTR 2000/35: Goods and services tax: Division 156 - supplies and acquisitions made on a progressive or periodic basis. para. 121 – 123.

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