ANGST UPDATE

MORE COMPLICATIONS WITH SMALL PROPERTY DEVELOPMENTS

With the recent property boom, taxpayers without experience are conducting small property developments. Unfortunately many have run into significant problems in dealing with income tax and GST issues due to the complexity of our taxation system. The following case study demonstrates some additional issues to be kept in mind before proceeding with these developments. The message from this case study is to plan carefully and consider all of the taxation angles!

Please note that this case study is not a hypothetically contrived situation that would never occur. This case study is based on a situation brought to our attention in providing specialist taxation consulting advice.

Case study

Harpo, Groucho and Zippo were brothers who conducted a farm business together as partners and were registered for GST, but not on an individual basis. The profits from the farm were strong and they decided to conduct a small property development together. They bought some land under the margin method for $600,000, and intended to sub-divide the land into six blocks and build houses on each. All of the houses were to be sold upon completion.

They spent $330,000 for each house in the development and recovered 100% of the GST in relation to the houses as the costs were incurred. Three houses were sold for $650,000 each. Allocating $100,000 of the cost of the land to each sub-divided block, the margin for each sale was $550,000 and the GST paid was $50,000. They ended up making a profit of $200,000 on each of the three houses after payment of GST.

Due to difficulties in selling the three remaining houses they decided to move into one house each and treat it as their main residence for CGT purposes. After two years of living in the houses, they move out and rent the houses. Four years later each of the houses were sold for $980,000.

In theory the income tax and GST consequences in relation to the retained houses should be resolved easily. However the tax consequences are enormously complex and significant liabilities will arise as is explained next.

EDITOR – TONY EVANS

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GuSTAX Consulting Pty Ltd
ABN 16 097 171 509
(Just Tax Consulting)
PO Box 5200, Studfield Post Office,
Wantirna Vic. 3152
Email: tony@justtax.com.au

About the Editor

Tony Evans is a Chartered Accountant who has extensive tax consulting experience over 20 years working in the profession including overseas experience working with VAT in the UK. The founder and Managing Director of GuSTAX Consulting Pty Ltd, he was previously a partner with a boutique tax division in one of the mid-tier accounting firms in Melbourne. Tony's diverse tax specialisation's include: -

- GST
- Employment taxes
- Corporate Taxes
- CGT
- PAYG
- Expatriate Taxation

He is also recognised as an excellent communicator and trainer and has conducted numerous technical sessions for the ICAA and members of the profession. ♦

Sale of original three houses

The first point to note is that the position in relation to the three houses sold upfront is reasonably clear. As long as the brothers elected to apply the margin scheme to their sale prior to or on the day these houses were supplied, the margin method could be used. Furthermore, as long as the allocation of $100,000 to each of the sub-divided blocks was reasonable (as it would appear to be), the basis of calculating the margin was reasonable. We will assume these sales have been dealt with correctly.

GST Adjustments for remaining houses

Under GST legislation, two possible adjustments can arise when the decision to hold the remaining three houses was made. The most common is under Division 129 in relation to changes in creditable purpose. The second is under Division 130 where an acquisition is applied solely for private and domestic purposes and there is no previous adjustment under Division 129. Normally Division 129 applies in relation to houses as they are rented rather than sold and therefore not applied to 100% private and domestic purpose. However in this case, as the remaining houses were used as personal residences, Division 130 will apply as there has been no other change in creditable purpose, and the residences are first used for private and domestic purposes.

Position under Division 130

Division 130 has no thresholds and basically requires all of the input tax credits to be given back to the ATO on acquisitions applied solely for private and domestic purpose. Therefore, as the brothers recovered $90,000 in GST (3 x $30,000), they will be required to repay the $90,000 to the ATO at the end of the tax period in which they moved into the houses.

Once an adjustment arises under Division 130, it is impossible to have any subsequent adjustments under Division 129 as the law specifically excludes this. Thus if the houses should subsequently be applied to a creditable purpose like being sold as new residential premises, there is no possible clawback of any of the GST on the inputs at that time.

Position under Division 129

If Division 129 had applied, a portion of the GST recovery could have been kept as the change in creditable purpose rules only apply to acquisitions that exceed $1,000 in value excluding GST. So where GST had initially been recovered on acquisitions less than $1,000, it would not have been required to be refunded. However, the accounting becomes a bit more complicated from then on as the taxpayer would be required to continue monitoring the application of various acquisitions to determine if further GST adjustments were required. Acquisitions between $1,000 and $5,000 would need to be monitored over 2 adjustment periods or approximately 3 years depending on the date of each acquisition. Acquisitions between $5,000 and $499,999 would need to be monitored over 5 adjustment periods or approximately 6 years. Although there were no such acquisitions in this case, acquisitions of $500,000 or more must be monitored over 10 adjustment periods or approximately 11 years.

Each individual acquisition in constructing these houses must be separately monitored and may require a different adjustment at a different time depending on when each acquisition was incurred.

It should also be noted that had the brothers rented the property first and then moved in, Division 129 would have applied. The only reason that Division 130 applied was because the very first application of the acquisitions was for 100% private and domestic purpose. The choice to use the houses as personal residences rather than rent them has a significant GST consequence in this case!

What happens when the properties are rented?

Initially the brothers were conducting an enterprise of property development. That enterprise ceased when they occupied the houses. However the brothers were still conducting a separate enterprise in relation to the farm and could not therefore cease their GST registration. It is worth reminding everyone at this time that each of the retained houses was owned one third each by each of the brothers as the brothers were initially in partnership and acquired the property jointly.

When they decided to rent the houses, the brothers recommenced an enterprise of renting the properties. Although the income was clearly input taxed, the brothers had recommenced an enterprise and were now in a tax partnership together. They were in the joint receipt of income.

It was not possible to recover GST on the acquisition of this property at this time as Division 130 does not allow any further adjustments. As stated earlier, Division 129 cannot apply where Division 130 applies first.

Subsequent sale of the houses

Although the houses were rented for four years and lived in as residences for two years, they were still new residential premises. To be excluded from the definition of new residential premises, they must be applied to make input taxed supplies for a period of at least 5 years. The period they were personally lived in by the brothers does not count as they were not used to make any supplies.

As the partners were registered for GST and were conducting an enterprise in relation to the houses, they would need to charge GST on their sale. They meet the basic requirements of Section 9-5 in that they have made a supply for consideration in the course or furtherance of their enterprise and the supply was connected with Australia. Remember, they were already registered for GST due to their farming interests. They could and should have used the margin method on the sale and the GST payable per house should have been $80,000 [one eleventh of ($980,000 less the cost of $100,000)]. The profit on the sale of each house was therefore $470,000. However, the problems for the brothers do not end here.

CGT Implications

Although the original intention in acquiring the land was for a profit making purpose, we are making the bold assumption that the brothers can claim a main residence exemption for their ownership interests in the houses they occupied as residences. We are also assuming that the portion of the residences not subject to the main residence exemption would still be subject to CGT and the 50% discount for holding the assets over twelve months would be available. However this result is not certain. The ATO may seek to tax the gain of the sale of the 3 houses or a portion of this gain on revenue account. The ATO may argue that the period from acquisition until occupancy was on revenue account even if the remaining holding period is not.

Assuming CGT applies, the main residence exemption can only apply to the ownership interest of the house occupied by the taxpayer as his main residence. As all of the houses were owned jointly, two thirds of the gain on each house would be subject to tax no matter what. Only one third would be eligible for CGT exemption.

In relation to the one third potentially eligible for exemption, it may be exempt for the whole holding period provided the individual partner making the claim did not have an alternative main residence at any time during the holding period. In addition, to get the main residence exemption for the period from acquisition of the land until moving in, the property must be on capital account and the taxpayer must have moved in as soon as possible after completion of the house. It is debatable whether it is on capital account and it will be a question of fact whether the partner moved in at the first possible time.

To get the exemption for the period the house was rented, it must be rented for a period of less than six years and, as stated earlier, there cannot be another main residence in this period. Again this will be a question of fact.

Planning considerations.

Whilst there is no perfect way to conduct a small property development, there are some basic planning points to assist in minimising the GST and income tax consequences. These include:-

- For residential developments, try and ensure that the enterprise is conducted by persons or entities that are not required or will be unlikely to be required in the future to be registered as an enterprise for any other enterprise other than the development.

- Segregate residential developments from commercial developments wherever possible. Commercial rent may require GST registration whereas residential rent will not. Residential properties held on capital account as part of an enterprise of property rental can be sold free of GST where GST registration is not required. They will potentially be taxable as sales of new residential premises where GST registration is required.

- Where a change in usage of an asset occurs consider whether it is possible to use the asset for non-creditable purpose thus triggering adjustments under Division 129 rather than Division 130. This will provide more flexibility in the future. More importantly, you need to fully understand how these adjustment rules work and retain sufficient records to apply these rules.

- Always clearly document your intentions upfront and support those intentions with hard physical evidence wherever possible. Obtain and keep all documentation along the way as well.
- Consider joint ventures rather than partnerships where assets like land are not to be held jointly. Apart from potentially obtaining 100% main residence exemption in the case study, there may also be stamp duty savings. These alternatives may mean that each person owns a 100% interest in their own land.
- Where some houses in a property development are to be used as a main residence, consider upfront "off the plan" sales of these assets for consideration equal to the land cost plus share of the development cost. These have worked effectively in the past for other taxpayers. Court cases support this approach.
- When moving into the rental stage of a property development for rental purposes, consider the possibility of ceasing your GST registration.
- It is almost certain that when developers have combined intentions in relation to land at the time of purchase, the land is on revenue account and CGT cannot apply. This applies to scenarios where they will sell if they can, but otherwise rent. Intentions can subsequently change and may also change the subsequent tax consequences.
- Never forget that all taxes like GST, income tax, CGT, land tax and stamp duty all need to be considered.

The most important point to realise is that each development stands on its own and the taxation consequences need to be determined on a development by development basis. Significant care is required in making sure that all of the facts are known before providing advice. There is a far greater chance of planning and dealing with the taxation issues efficiently and cost effectively if advice is obtained before the development commences rather than after it has commenced.

GST AND TAX PARTNERSHIPS

The ATO has recently finalised its ruling in relation to the treatment of tax partnerships for GST purposes. The ruling is quite controversial in that it recognises in some cases that the individual partners are carrying on separate enterprises and require separate GST registration in relation to partnership assets. This will tend to occur where the income is not banked to joint accounts, the borrowings to buy assets are not made jointly, expenses are incurred separately and the partners are acting independently of each other. In these cases, the partnership should not be the GST registered enterprise. Taxpayers in tax partnerships and advisors to these partnerships should review the status of these partnerships and alter their registrations accordingly.

The ruling also takes the approach that the partnership can be deemed to be selling interests in partnership assets when a partner is selling their partnership interest. This will potentially allow the partner to charge GST on the sale or to treat the sale as being a sale of a going concern should the going concern rules be otherwise met. This will overcome problems arising from adjustment events upon the cessation of a tax partnership. However, partners will need to keep their wits about them and still take considerable care in selling interests in tax partnerships.