

## CGT consequences of the sale or transfer of land

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### 1. Introduction

In broad terms, capital gains tax (**CGT**) is a tax payable by a seller of property where the property's value has increased since the seller acquired that property. However, the tax is a lot more complicated, and there are many exemptions and/or forms of roll-over relief available that mean that a sale of a property is not always subject to the CGT.

CGT is not a separate tax. Instead, it forms part of the income tax system and a "net capital gain" is included in a taxpayer's "assessable income" (section 102-5 of the *Income Tax Assessment Act 1997 (ITAA 1997)*).

A general overview of the CGT regime is found in Division 100 of the ITAA 1997.

#### 1.1 CGT assets

In general, CGT only applies in respect of CGT assets (section 100-25).

A "CGT asset" is defined as:

- any kind of property; or
- a legal or equitable right that is not property (section 108-5).

An example of a CGT asset is land (see note to section 108-5).

However, in the conveyancing context, buildings, life interests and remainder interests in land or buildings (whether legal or equitable) also constitute CGT assets.

### ***Exception for pre-CGT assets***

In general, however, assets acquired before 20 September 1985 (ie pre-CGT assets) are exempt from CGT (see for example section 104-10(5)).

All other assets are “post-CGT” (that is, assets acquired on or after 20 September 1985 or assets expressly deemed to be post-CGT assets).

### ***Land and buildings***

In the property law context, buildings erected on land are regarded as inseparable from land (*Ramsden v Dyson* (1866) LR 1 HL 129 at 140-141, 168).

However, for CGT purposes, in some circumstances, land *may* be considered separately from a building on it (section 108-55). Instances where land will be considered separate from a building include the following:

- if the land and building are post-CGT assets and the depreciation regime or the R&D regime apply to the building; or
- if a post-CGT building is constructed on pre-CGT land, and the construction contract is entered into post-CGT.

Further, a “capital improvement” to land will be considered separate to the land if a “balancing adjustment” is claimed (section 108-70).

Unrelated “capital improvements” (to a pre-CGT asset) are also considered separate CGT assets if those improvements exceed the improvement threshold and 5% of the proceeds from an event happening (section 108-70).

Part of a building may be separate for depreciation purposes (section 108-60). Land adjacent to pre-CGT land is separate even after it is amalgamated with that land into a single title (section 108-65).

## 1.2 CGT events

A “capital gain” or “capital loss” will only arise if a CGT event happens (section 100-20(1) of the ITAA 1997). A capital gain or loss will arise at the time of the relevant CGT event.

In the conveyancing context, occurrences such as the sale of property, the grant of a lease, the passing of property under a will, the subdivision of land, leaving Australia or a marriage breakdown may all result in a CGT event (see examples in section 100-10).

A table of CGT events and CGT computation rules is found in section 104-5. The time when a CGT event occurs is defined, as well as the “capital gain” and “capital loss” calculations.

If multiple CGT events apply to a given situation, the one to use is the one that corresponds most closely to the situation at hand (section 102-25).

A summary of CGT events follows with some realty-related examples.

### Summary of CGT events with some realty-related examples

	Event Description	Realty (conveyance)-related example
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A1	Disposal	Sale of land
B1	Use and enjoyment before title passes	If a person moves into a property before a disposal
C1	Loss or destruction	House burns down
C2	Cancellation, surrender that ends asset	Revoke a covenant, easement, profit a prendre, licence, lease or option over land
C3	End of option to acquire shares	Not applicable
D1	Creating contractual or other rights	Grant restrictive covenant, easement, profit a prendre, licence, or lease
D2	Granting an option	Grant option over land
D3	Granting right to income from mining	Not applicable
D4	Entering a conservation covenant	Where a conservation covenant is granted
E1	Creating trust over CGT asset	Creating a trust over land
E2	Transferring CGT asset to trust	Transfer land to a trust
E3	Convert trust to unit trust	Not applicable
E4	Capital payment for trust interest	Remainder interest to land under testamentary trust
E5	Beneficiary becomes absolutely entitled to trust asset	Remainder interest to land under testamentary trust.
E6	Disposal to beneficiary to end income right	Life interest to rented land under testamentary trust
E7	Disposal to beneficiary to end capital interest	Life interest to land under testamentary trust
E8	Disposal by beneficiary of capital interest	Life interest to land under testamentary trust
E9	Create a trust over future property	Not applicable
F1	Grant a lease	Grant a lease
F2	Grant a long-term lease	Grant of a long term lease
F3	Lessor pays lessee to get lease changed	Lessor pays lessee to get lease changed
F4	Lessee paid to change lease	Lessee paid to change lease
F5	Lessor paid to change lease	Lessor paid to change lease
G1	Capital payment for shares	Not applicable
G3	Liquidator declares shares worthless	Not applicable
H1	Forfeiture of deposit	Rescission of realty contract
H2	Receipt for event relating to CGT asset	Not applicable
I1	Individual or company stops being Australian resident	Individual or company (owns Australian land) stops being resident
I2	Trust stops being a resident trust	Trust (owns Australian land) stops being resident

J1	Company stops being member of wholly owned group	Not applicable
J2	<b>Change of status of replacement CGT asset (small business roll-over)</b>	<b>Small business rolls-over land that it owns</b>
J3	Change of status of replacement CGT asset (being company shares or trust units) in small business roll-over	Not applicable
J4	<b>Disposal of trust assets to company</b>	<b>Trust asset includes land</b>
K2	<b>Bankruptcy</b>	<b>Bankrupt pays off debt by transferring land</b>
K3	Asset passes to tax-advantaged entity	Land transferred to exempt charity trust
K4	CGT assets becomes trading stock	Land owner starts realty business
K5	Capital loss for collectable	Not applicable
K6	Pre-CGT shares or trust interest	Not applicable
K7	Balancing adjustment occurs for depreciating asset (really CGT asset)	Plant building that was not used as plant
K8	Direct value shift (in debt or equity in company or trust)	Not applicable
K9	Entitlement to payment of carried interest	Not applicable
K10	Forex realization gain	Not applicable
K11	Forex realization loss	Not applicable
L1	Entity joins consolidated group	Not applicable
L2	Entity joins consolidated group (loss)	Not applicable
L3	Entity joins consolidated group (gain)	Not applicable
L4	Entity joins consolidated group (no reset assets to apply gain against)	Not applicable
L5	Entity leaves consolidated group	Not applicable
L6	Computing mistake when entity joins consolidated group	Not applicable
L7	Discharged liability amount differs from allocable cost	Not applicable
L8	Entity joins consolidated group (loss cannot be allocated)	Not applicable

The mortgaging of land does not result in the happening of a CGT event (section 104-10(7)). Further, if a mortgagee exercises their power of sale, the

disposal is deemed to be the mortgagor's act (section 106-60). Therefore, in such a case it will be the mortgagor that will need to pay any CGT on the sale.

### 1.3 Calculation of CGT

Ordinarily, a capital gain is calculated as the difference between an asset's **cost base** and the **capital proceeds** received from the happening of the relevant CGT event (see, for example, section 104-10(4)). Whereas, a capital loss arises where the capital proceeds are lower than the asset's **reduced cost base**.

Cost base indexation may apply to assets acquired before 21 September 1999 (section 114-1). If assets are held for over a year, the cost base is increased for inflation (according to a published indexation factor) (Division 114). The third-element of the cost base (ie the non-capital costs) cannot be indexed.

Instead, certain taxpayers (that is, individuals, complying superannuation funds, trusts, and listed investment companies) can elect to apply the 50% CGT discount (instead of indexation) (section 114-5).

The "reduced cost base" of an asset has all the elements of the "cost base" of an asset, except for the third element (ie non-capital costs).

#### ***Cost base and reduced cost base***

An asset's cost base and reduced cost base includes what the taxpayer pays to acquire the asset (sections 110-25 and 110-55). More specifically, it consists of 5 elements:

- money paid plus the market value of property given (by the purchaser) for the purchase (section 110-25(2));

- incidental acquisition costs (like legal fees, stamp duty, advertising, valuation costs transfer costs, selling expenses) (section 110-35). Selling expenses are thus not deducted from the capital proceeds;
- non-capital costs of ownership (like interest payments, refinancing cost, insurance, rates, land tax, strata levies and minor repairs). These costs cannot be included if they are deductible (like interest, insurance, levies and rates) (section 110-45);
- capital expenditure that increases the value of the CGT asset (like major repairs). Note that not all capital expenditure is included; and
- capital expenditure to establish, preserve or defend title to the asset.

Where a CGT asset is split (as occurs in a subdivision), the original cost base should be reasonably apportioned between the separate parts of the assets (section 112-25). If the event occurs to part of the asset, the cost base is partially allocated (section 112-30).

### ***Capital proceeds***

In general, the capital proceeds from a CGT event are the total of the money the taxpayer receives plus the market value of any property received (section 116-20).

### ***Modifications***

The general position relating to both the cost base and the capital proceeds for a CGT event may be modified in, for example, the following instances:

- “market value substitution”: if the transaction is a non-arms’ length transaction, then a market value substitution rule may apply (sections 112-20 and 116-30). In such a case, it is recommended that an independent, competent valuation be made contemporaneously with the happening of the CGT event. The valuation should include a full description of the property.

- “apportionment”: an amount should be apportioned where it relates to multiple CGT events (sections 112-20 and 116-40).
- “assumption of liability”: an amount will need to be increased to the extent of any liability associated with an asset (sections 112-35 and 116-55).

## **2. Life and remainder interests**

The ATO has released a draft ruling, *Taxation Ruling* TR 2005/D14 on the complex subject of life and remainder interests. Life and remainder interests arise in respect of land. There are two possible types of life and remainder interests that may arise: legal and equitable. Equitable interests are more common than legal interests. In all cases, care should be taken in ascertaining the precise nature of the interest (that is, equitable or legal) before examining the CGT consequences of the interest.

### ***Grant of an interest***

If land starts to be held for the benefit of life and remainder owners, on trust (ie an **equitable** life and remainder interest is created), the original owner may make a capital gain or loss from either of CGT events E1 or E2 (sections 104-55 and 104-60).

For inter vivos trusts, the trustee acquires the asset for its market value when the trust is created or when the asset is transferred (sections 109-5). For testamentary trusts, capital gains and losses may be disregarded (section 128-10).

### ***Legal and equitable life tenants***

A legal life tenant is entitled to possession: an equitable life tenant may (or may not) be. If the trustees have active duties (maintain property, collect

rent), the equitable life tenant has no right to possession unless a term of the trust gives him/her this right. However, the equitable life tenant can usually persuade the Court to give him/her this right if he/she gives security and an undertaking to maintain the property. The life interest is not part of the life interest owner's estate.

Also, legal and equitable interests should be distinguished from a mere right of occupancy. A right of occupancy is simply a personal right to occupy the property for life. A right of occupancy does not carry with it a right to any income from the property (TR 2005/D14 paragraph 114).

### ***Who owns what?***

The entitlements to the property during the life of a "life tenant" are as follows:

- if the interest of the life tenant is a **legal** life interest:
  - the trustee has nothing since at the time of the creation of the interest they are taken to have disposed of their entire interest in the property (TR 2005/D14 paragraphs 23 to 27)
  - the life tenant holds the entire fee simple in the property for the term of their life only (TR 2005/D14 paragraph 41)
  - the remainder beneficiary has nothing. Until such time as the life tenant passes away, the remainder beneficiary does not have any interest in the property (TR 2005/D14 paragraph 34).
- if the interest of the life tenant is an **equitable** life interest:
  - the trustee holds the property on trust for both the life tenant and the remainder beneficiary (TR 2005/D14 paragraph 36)
  - the life tenant has an interest in the trust during their life (TR 2005/D14 paragraph 37)

- the remainder beneficiary will have a capital interest in the trust, which vests in possession only when the life interest ends (TR 2005/D14 paragraph 34).
- the trustee “owns” the equitable life and remainder interests for CGT purposes; the beneficiaries own only a trust interest. Accordingly, the most relevant CGT events for the beneficiaries are CGT events E5 to E8 (sections 104-75 to 104-100). However, they contain an exception for trusts ‘to which Division 128 applies’ (that is, passing of asset from deceased estate’s legal personal representative to a beneficiary).

### ***Death of life tenant***

The death of the person by whose life the life interest is measured will cause the life interest to end. This may have consequences for the life interest owner, trustee and remainder owner.

In particular, CGT event C2 (section 104-25) may happen when the life interest ends (by death or contract or asset ends). If no capital proceeds are received, the market value substitution will apply (section 116-30).

### ***Other occurrences***

If the remainder owner becomes absolutely entitled to the asset, CGT event E5 occurs (section 104-75). If the remainder owner paid nothing nor was it assigned to him/her, capital gain or loss is ignored. If both the trustee and remainder owner make a capital gain, the anti-overlap rule will reduce the remainder owner’s capital gain by the trustee’s capital gain amount (section 118-20).

If a trustee disposes of a trust asset to a beneficiary to satisfy their right to income, CGT event E6 occurs (section 104-80). If a trustee disposes of a trust asset to a beneficiary to satisfy their right to capital, CGT event E7 occurs (section 104-85).

### **3. Exemptions and roll-over relief**

Pre-CGT assets are exempt from CGT. As are assets used solely to produce exempt income or non-assessable non-exempt income (section 118-12). Also, anti-overlap provisions prevent double taxation, including:

- certain plant disposals (section 118-24);
- land as trading stock (section 118-22);
- a capital gain previously included in the taxpayer's ordinary income (section 118-20).

“Rollovers” differ from “exemptions” in that “rollovers” allow a capital gain or loss to be deferred or disregarded until a later time. For example, an asset transferred due to a marriage breakdown is rolled-over (see Subdivision 126-A).

In broad terms, there are two main types of roll-overs:

- replacement asset: where a CGT asset is replaced with another one (section 112-115). Examples include: land compulsorily acquired or lost or destroyed (Subdivision 124-B), strata title conversion (Subdivision 124-CD) and small business replacement rollover (Subdivision 152-E).
- same asset: where a transferee obtains the characteristics of an asset of the transferor and no CGT implications result to the transferor. Examples are: transfer of land due to marriage breakdown (Subdivision 126-A), transfer of land to a wholly owned company (Subdivision 122-A).

In addition, there are a number of CGT exemptions that should be borne in mind in the conveyancing context, as discussed below.

### 3.1 Main residence exemption

This is probably the exemption most likely to arise in the conveyancing context (section 118-110).

The sale of a property is exempt from CGT if the property is the owner's main residence throughout the ownership period and the owner did not inherit it. It is available only to individuals (unless he/she holds it as trustee: *ATO Interpretative Decision* ID 2003/467). Grants of easements, however, are not exempt (*Taxation Determination* TD 93/236).

“Dwelling” means accommodation in a building, caravan, houseboat, or mobile home and any land immediately underneath it (section 118-115). The term dwelling may include multiple accommodations if used together as one residence (*Taxation Determination* TD 1999/69).

In addition, land adjacent to a main residence is exempt if used for domestic or private purposes (section 118-120). The maximum area exempt (including the dwelling), however, is 2 hectares. This does not apply to land sold separately from the main residence (section 118-165).

If a dwelling stops being a person's main residence, he/she can continue to treat it as such if no other dwelling is the person's main residence (section 118-145). If the dwelling is rented out, however, then the maximum period it can be treated as a main residence is 6 years. If it is not rented out, it can be treated as a main residence indefinitely.

If a person is changing their main residence, the person may treat both a new and a previous dwelling as their main residence for a period of up to 6 months after the change (or earlier sale or disposal) (section 118-140). This is possible

even if one dwelling was merely treated as a main residence (sections 118-145, 118-150).

A partial exemption is available if a property is a main residence for only part of the taxpayer's ownership period (see sections 118-185 and 118-190).

If a dwelling is being built, repaired or renovated (so is uninhabitable), the main residence exemption can still be claimed (section 118-150). To be claimed, however:

- it must be the individual's main residence once work is completed; and
- it must be the individual's main residence for a continuous 3-month period.

If spouses live in different main residences, they may (section 118-170):

- choose one of the dwellings as their main residence; or
- split the exemption between both properties.

If a dependent child (who is less than 18 years old and economically dependent) lives separately from his/her parents in a dwelling that he/she owns, the main residence exemption can be claimed either for the parents' dwelling or for the child's (but not for both) (section 118-175).

### **3.2 Position upon death**

An exemption from CGT *may* apply if an individual inherits a property as a beneficiary or trustee of a deceased estate (section 118-195). However, certain conditions need to be met for an exemption to be available in such circumstances.

The exemption applies if the dwelling is a **pre-CGT** asset in the hands of the deceased and:

- the beneficiary or trustee disposed of the dwelling within 2 years of the deceased's death; or
- the deceased's spouse or an individual having a right of occupancy under the will continued to use the dwelling as his or her main residence from the time of the deceased's death until the taxpayer disposed of it.

The same conditions need to exist for the exemption to apply if the dwelling was a **post-CGT** asset of the deceased. However, in such a case the dwelling must have been the main residence of the deceased just before death and not being used for income producing purposes.

### **3.3 Small business concessions and exemptions**

A small business may enjoy certain CGT concessions and exemptions under the provisions in Division 152.

For land to be eligible for these small business concessions and exemptions, the following basic conditions need to be met:

- the land must be an “active asset” (section 152-40); and
- an asset threshold test must not be exceeded - ie the “maximum net value” must be under \$5 million (section 152-15).

Four CGT concessions are available (section 152-1), as follows:

- the 15-year exemption: the land must be owned continuously for 15 years (sections 152-105 and 152-110).
- the 50% reduction: capital gain (section 102-5) is reduced by 50% (section 152-205). An individual may access this discount. After this reduction, the “retirement concession” or “small business rollover” or both may apply to any remaining capital gain (section 152-210).
- the retirement exemption: if the individual is at least 55, a capital gain may be disregarded (section 152-305). Otherwise, proceeds must be

contributed to superannuation for the exemption to be available. However, a life-time limit of \$500,000 applies (section 152-320). This can be used before or after the small business rollover.

- rollover: provides for the deferring of capital gains if a replacement asset is acquired between 1 to 2 years of rollover (section 152-410). The capital gain is disregarded to the extent that it does not exceed the replacement asset's cost base. The replacement asset must be an active asset within 2 years of rollover (section 152-425).

#### **4. Choice of purchasing entity**

**Individual:** Where possible, individuals must delay selling an asset until 12 months have passed since acquisition (to obtain a 50% discount on any capital gain that they make). If the individual runs a small business, and the business is structured as a family trust or a family company then he/she will need to be the "controlling individual".

**Trusts:** The general 50% discount is available to trusts. However, complications arise in seeking to rely on the small business concessions where the land is held on trust.

**Companies:** The 50% discount is not available to companies. However, in some circumstances, capital gains may be deferred by rolling over assets to a wholly owned company.

As with trusts, complications arise where assets are held in a company and reliance needs to be placed on the small business CGT concessions and exemptions.