The Tax Summit

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Session 11.2: Do you have a choice about whether the property deal is on revenue account or capital account?

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1. Introduction

Australians and real property have a very special relationship. Often entrepreneurial clients will come up with exciting 'property deals' and the tax aspects of a deal can be critical to project profitability. As as advisor you may be asked the question 'Can I choose to have my deal on capital account?' and you will know that the transaction values are likely large and that the revenue v capital question has perennially been a vexed and litigated issue.

This paper will consider the distinction between capital and revenue transactions in the modern risk context of big data and an ever-extending searchable history of taxpayers. Specifically, the ATO's recently commenced data matching project will be looked at and the key issue of 'intention' of structures will be considered.

The crucial point of having documentary evidence to support the facts of a purported intention will be examined. There are no doubt tough times ahead for some taxpayers and for their advisors who have not been provided all of the information from their clients that the ATO will now be able to obtain on their own.

2. Revenue v Capital

There are many entire papers dedicated to this topic, and real justice cannot be done to it in a quick timeframe. In this paper, an extremely brief overview of the topic is given, more to provide background as to the current state of risk that taxpayers face in navigating the issue.

2.1 The Consequences of Revenue v Capital

There are both income tax and GST consequences depending on whether a property transaction is on revenue account or capital account.

Very simply, if a transaction is on capital account, then it is not ordinary income and will be assessable under the capital gains tax provisions. If the asset is a pre-CGT asset, then it will not be subject to tax. If it is a post CGT asset, the entity may be entitled to the 50% CGT discount. Taxpayers are very often arguing that a transaction should be on capital account in order to receive this tax treatment. Additionally, if on capital account, it is likely that the transaction is not subject to GST (as there will be no need for the taxpayer to register for GST).

If a transaction is on revenue account, then profits will be taxed as regular income of the landowner. There is no 50% CGT discount, the pre-CGT status of the asset is not relevant, and there will likely be GST on the sale (unless it is subject to an exception such as being existing residential premises or sold as a going-concern).

There are two types of revenue transactions:

- A transaction where the entity conducts a business with the real property; and
- A project which is an isolated profit-making scheme or undertaking using the real property.

The timing of the income and deductions slightly differs between the two revenue options, but overall the taxable income is the same.

2.2 Rulings & Legislation

A transaction will be on revenue account and assessable as ordinary income under Section 6-5 of the Income Tax Assessment Act 1997 if a business is being carried on. If a business is not being carried on, then it will be considered ordinary income under Section 6-5 only if the income arises from an isolated profit-making undertaking.

Taxation Ruling 97/11 sets out factors which will be indicative of a business being carried on. Taxation Ruling 92/3 provides the ATO position on whether profits on isolated transactions are income.

If a transaction is neither a business nor an isolated profit-making scheme, it will be on capital account.

TR 97/11

Paragraph 13 of the Ruling sets out the following 8 factors to consider as relevant indicators of whether a business is being carried on. They are:

- Whether the activity has a significant commercial purpose or character; this indicator comprising many aspects of the other indicators;

- Whether the taxpayer has more than just an intention to engage in business;
- Whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity;
- Whether there is repetition and regularity of the activity;
- Whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;
- Whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
- The size, scale and permanency of the activity; and
- Whether the activity is better described as a hobby, a form of recreation or a sporting activity.

No indicator is decisive and there are some interesting cases in the area. The ATO gives a current example on their website of a taxpayer they consider to be in the business of property renovation and sale. In that example, a carpenter has purchased a property intending to renovate and sell for a profit which they do successfully. Following that, they cease their employment and purchase two more houses to conduct the same renovation and sale for profit activity. Whilst the example is not very clear on the point in time at which it commences to be considered a business, it appears as if it is the point where the taxpayer ceases employment and purchases the two next properties.

TR 92/3

Taxation Ruling TR 92/3 is the ATO view which must be applied in analysing whether transactions are from an isolated business operation or commercial transaction. The Ruling requires both of the following elements:

a. The intention or purpose of the taxpayer when entering into the transaction to make a profit or gain; and
b. The profit must be made in the course of carrying on a business or in carrying out a business operation or a commercial transaction.

The cases and rulings give good illustrations of both of these elements. It is important to note that Paragraph 7 of TR 92/3 states "The relevant intention or purpose of the taxpayer (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case." This makes clear why all cases are said to turn on their own facts.

2.3 Cases

There are many cases on the distinction between revenue and capital. A detailed analysis of the cases is beyond the scope of this paper, but a quick summary of the salient points of some often-referenced cases is below.

Scottish Australian Mining Co Ltd v FC of T[1]

The company purchased land in order to carry on its business of coal mining. After the mine had served its purpose as a mine, the taxpayer subdivided and sold the land. There were substantial costs necessary to subdivide (roads, parks etc). The transaction was held to be on capital account as a mere realisation of the

[1] *Scottish Australian Mining Co Ltd v FC of T* (1950) 81 CLR 188

asset. The intention on purchase had not been to make a profit by subdivision and sale, and the court held that the taxpayer had only taken the steps necessary to realise its capital asset to its best advantage.

Whitford's Beach[2]

The company acquired over 1,500 acres of land and allowed the shareholders of the company access to their beachfront fishing shacks. 13 years after acquiring the land, the shares in the company were sold, and the new shareholders intended to subdivide and sell the land at a profit. The taxpayer argued the gain was on capital account as the original intention of the company when it purchased the land was for private recreational purposes. There were approximately 2,200 residential lots developed. The court found that this transaction was on revenue account as the land had been ventured into a business. The massive scale of the transaction and the business-like way in which the development proceeded prevented it from being a mere realisation.

Myer Emporium[3]

The taxpayer conducted its business of operating retail shopping, but entered into a loan agreement with a subsidiary and then assigned the right to interest under the loan to another party. It was intended, from the start that the taxpayer would make a profit on the interrelated transactions, although the taxpayer was not normally in the business of entering such agreements. Due to this intention at the time of acquisition, the income was held to be on revenue account.

Statham v FCT[4]

Land was acquired by the taxpayer in order to conduct a business of cattle farming. The business failed and the taxpayer subdivided and sold the property. This was held to be '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'. The land was not acquired with the intention to profit from its sale.

Stevenson[5]

Land was acquired by the taxpayer in order to conduct a farming business. The land was ultimately subdivided and sold. The scale of the project was large; with 220 blocks being subdivided in total. The taxpayer was heavily personally involved in the subdivision activity having dealt with councils, engineers, infrastructure construction and roadwork construction himself. In this case, the transaction was held to be on revenue account with the court finding the taxpayer was carrying on a business. The main factors in coming to this decision were the large scale and the taxpayer's personal involvement in the subdivision process.

Casimaty[6]

Land was acquired by the taxpayer on which a primary production business was operated and the taxpayer resided. The taxpayer had debts and worsening health and subdivided and sold off blocks of land in stages over a period of 18 years. The court held the proceeds on capital account as the original purpose of acquisition had no revenue intention. Whilst the subdivision was regular and over a long period of time, it was found that there was no coherent plan for the subdivision to maximise the return, and only the activities that were necessary to obtain approval for the subdivided lots were carried out.

August[7]

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[2] *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd* (1982) 150 CLR 355
[3] *FC of T v The Myer Emporium Ltd* (1987) 163 CLR 199
[4] *Statham & Anon v FC of T* [1989] ATC 4070
[5] *Stevenson v FC of T* [1991] ATC 4476
[6] *Casimaty v FC of T* [1997] ATC 5135
[7] *August v Commissioner of Taxation* [2013] FCAFC 85

The taxpayers, through a unit trust, purchased properties in 1997 and 2000, which were renovated / developed as a shopping centre. They were rented and then ultimately sold in 2007. A rental period of between 7 and 10 years is, on the face of it, a substantial time and might have been expected to be found on capital account.

The key finding of the court is that the taxpayer always had an intention to profit from the sale of the property, and that the taxpayer operated in a commercial way in order to achieve that intention. The evidence the taxpayer presented was also found to be unreliable and evidence attempted to be introduced on appeal had been backdated. The decision does stand out, but the key principle of first establishing taxpayer intention is not a change to any other position.

Greig[8]

The taxpayer acquired shares in a company on 64 occasions at a significant sum (over $11.8 million). Ultimately the value of the shares was lost and the taxpayer sought to claim the loss on revenue account. In the end, the taxpayer was successful as the transactions were found to be entered into with a profit-making intention and carried out as an isolated business operation or commercial transaction. The taxpayer was found to have an overall profit target strategy and the taxpayer had regularly reviewed research, attended meetings with the target-company CEO, negotiated ASIC rules to exert influence over the company and applied his professional skills as a managing director of a worldwide company.

2.4 Past Draft ATO Guidance

In July 2018, the ATO published some Draft Property and Construction Website Guidance. Part of the website gave a list of 21 factors which it said the ATO would take into account in determining if a transaction was a ‘mere realisation’ or a disposal in the course of a business or as part of a profit-making undertaking. The ATO sought consultation on the guidance, and feedback closed 17 August 2018. Following the feedback, the guidance was removed.

Despite its removal, the list of factors is below and is interesting to see what factors were / are considered relevant by the ATO in its decision making. It is also an interesting exercise to consider whether the factors would have been considered relevant in terms of either:

a. Is a business being conducted (TR 97/11); or

b. An isolated profit-making transaction:
   - Intention on acquisition (TR 92/3); or
   - Business operation / commercial transaction (TR 92/3 and MT 2006/1)

Particularly they may have been intended as a way to construe the taxpayer’s intention. As mentioned earlier Paragraph 7 of TR 92/3 states “The relevant intention or purpose of the taxpayer (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case.” So there must be some facts that are taken into account to infer this objective intention and the below is an itemised list.

	Factor
1	Landowner period of ownership prior to development and sale
2	Farming or other non-development activities prior to development

[8] *Greig v FC of T* [2020] FCAFC 25

3	Acquired as private residence or for recreation
4	Original acquisition intention as an investment (rental income, long-term capital growth)
5	Land near urban fringe at the time it was acquired
6	If recently re-zoned, did taxpayer actively seek rezoning
7	Did landowner have an offer to sell prior to entering development
8	Was the landowner unable to find a buyer for land
9	Did landowner apply for rezoning around time of acquiring property
10	Did the landowner register for GST
11	Did the landowner set up a related entity to conduct development
12	Landowner history of buying and selling developed land for profit
13	Development operations carried out in a business-like manner
14	Landowner changed use from one use to another (eg. farm to development)
15	Scale, scope, duration and complexity of the development
16	Who initiated the proposal to develop the land for resale
17	Sophistication of development or pre-sale arrangements
18	Involvement level of landowner in development activities
19	Legal or financial control landowner maintained
20	Risk level of landowner in acquiring, holding and/or developing the land
21	Value of the development or other costs relative to the value of the undeveloped land

Some of these, for example the length of time land has been owned before it was subdivided for sale are clearly relevant and have been important in many case decisions. The assumption being that if someone intends to subdivide and profit from acquiring a piece of land that they will do so fairly quickly after acquiring it. However, if they have owned it for a very long time (eg. 30 years) that is taken as evidence they did not have this intention and just fail to act on it for the last 30 years.

Some of these factors however are much more dubious. Land being located near the urban fringe at the time of acquisition stands out as a potentially huge leap to construe an intention to profit on sale of the land. But it does show that there are many facts that contribute to the overall assessment of intention.

2.5 Recent Private Binding Rulings

Taxpayers often seek private binding rulings on whether their transaction should be treated on a revenue or capital basis. Some recent rulings are summarised below, but the reasoning process and decisions in these matters is not always clear or correct.

<u>1051757260120 (7 October 2020)</u>

The taxpayer acquired land and built their main residence several years after acquisition. They resided, and still reside in the residence. The taxpayer has health issues and is unable to maintain the entire property, but wishes to continue residing in the residence. Neighbouring properties have since been subdivided and the taxpayer seeks to subdivide and sell the vacant land to reduce property maintenance requirements and to fund their retirement.

The ruling finds the sales are on capital account, but is very confusing. It ignores the taxpayer's intention on entering the transaction completely, and then does not explain why the profit was found not to be made in the course of carrying out a business operation or commercial transaction. It merely states:

> Making an overall assessment on the factors set out in TR 92/3, it is the Commissioner's view that the subdivision of the Property and sale of the Sale subdivided lots will not be considered commercial in nature, but will be a realisation of a capital asset, being a long-held privately owned property.

<u>1051683921023 (29 May 2020)</u>

There is no reasoning for this decision. The facts are presented and an answer given that the transaction is on capital account.

<u>1051639184074 (5 March 2020)</u>

The taxpayer purchased a property with funds borrowed from family members and was renovating it. The taxpayer had previously purchased properties with bank loans, renovated the properties and rented them out. The taxpayer was under financial pressure and before renting this property was disposing of it to repay debt, although stated their original intention was to derive rental income.

This ruling forms the view that the transaction is on revenue account as a result of the commercial exploitation of an asset acquired for a profit-making purpose.

Taxation Ruling TR 97/11 is identified as relevant to first assess whether a property development business is being carried on. It is concluded there is no business.

Taxation Ruling 92/3 is then identified as requiring an assessment of intention on acquisition of the asset. The ruling states that:

> While it is acknowledged that you purchased and rented out the other properties following renovations, and it was your stated intention to do the same with the property, the available evidence indicates that you purchased the property to renovate and sell it at a profit.

Essentially the Commissioner has formed a view of the taxpayer's intention on acquisition, contrary to what the taxpayer advised their intention was. The evidence relied on to form this opinion was a declaration from a family member who loaned the money to finance the property purchase that 'the money is to be repaid on the sale of this property once the renovations are completed'. Additionally, the property was financed with a private loan from a family member whereas the taxpayer's other rental properties were financed with bank funding.

The only facts mentioned in forming the opinion that the transaction had the characteristics of a commercial transaction are that the taxpayer was a professional builder and renovated the property themselves.

<u>1051622204070 (14 January 2020)</u>

The taxpayers purchased land in 2012 and then built their main residence where they still reside. In 2015 the local council changed the land zoning which allowed the land to be subdivided. The taxpayer's received some offers from developers to acquire the land, but did not want to sell the entire parcel as they wanted to remain living there. They did investigate subdividing themselves and selling some vacant lots in order to reduce debt. Over a period of 6 years they achieved the DA (into 7 lots). A project manager has been appointed to conduct all activities of development as the taxpayers do not have these skills and have never been involved in any development before. Bank funds are being borrowed to fund the required development necessary to obtain the approvals (tree removal, road construction, bushfire plan etc).

The ruling concludes that the transaction is on revenue account. It first accepts the taxpayers are not conducting a business of developing land as their activities lack repetition, scale and volume and are not of the nature of a developer carrying on a business.

The taxpayer's intention on acquisition of the property is not discussed and no conclusion as to intention is expressed. The ruling does then decide that 'the development is planned, organised and carried on in a businesslike manner in order to make a profit; showing that the subdivision has a significant commercial purpose'. This is despite it taking 6 years to achieve a very simple subdivision and no facts being referred to which support this conclusion.

<u>1052075522848 (9 March 2023)</u>

Spouses own a number of rental properties and purchased a house and land package (HP1) to add to their portfolio. They hired a real estate agent to lease the property after construction was completed and it was leased for 12 months. They also purchased a second house and land package (HP2) but shortly after purchase one spouse lost their job. They found a new job but their income was drastically reduced. The other spouse was diagnosed with an ongoing medical condition. The tenant of HP1 significantly damaged the property and refused to pay rent. The taxpayers decided to sell HP2 to raise funds to repair HP1 and reduce other financial obligations and it was sold a few months after completion of the house on HP2. There is no history of property development.

The ruling decision is that the transaction is on capital account. It states a business is not being carried on in accordance with TR 97/11 and neither is it a profit-making or commercial transaction in accordance with TR 92/3. There is no other reasoning other than to describe the facts.

<u>1052129844808 (28 Jun 2023)</u>

A trust was operated by a corporate trustee with a single director. The trust purchased a property with an existing dwelling and the taxpayer's stated intention was that they intended to rent that property, subdivide the property into 6 lots and to build 5 houses on the 5 vacant lots to rent out and provide income to the director and his spouse in later life. The director received verbal advice about the renting viability / demand, property market values and estimated subdivision costs before purchase. There is no history of property development.

The subdivision occurred but took longer than expected and was over budget. To fund the subdivision the director sold their house to loan funds to the trust as other finance was sought and not approved. To provide funds to continue the subdivision Lot 4 was sold to the director's son at below market value. To enable a reduction in borrowings and pay back the director, Lot 1 was sold to an unrelated party. The director decided to build a house on Lot 5 since he had been renting for several years and sold lot 5 from the trust to themselves.

The Lot 4 contract stated it included GST. The Lot 1 contract stated it did not include GST but the purchaser was given a GST Withholding notice advising the amount of GST to withhold. On purchase of Lot 5 the director paid the GST withholding amount. No GST was claimed and no GST on sales were reported on any BASs.

The two vacant lots and the house lot have been retained. The stated intention is to continue to rent the house lot and to build houses on the 2 vacant lots to derive rental income.

The sales of the 3 lots were determined to be on capital account. The ruling identifies the process to follow of following TR 97/11 to decide if a business is being operated and then considering TR 92/3 to decide if the transaction is an isolated profit-making undertaking. An analysis of factors is given but key appears to be that the process was extremely disorganised and therefore concluded there was no profit-making motive and that also the prospect of profit is minimal. Had a significant profit been made on the sale of the earlier lots potentially a different conclusion would have been reached.

<u>Conclusion</u>

Whilst private binding rulings are helpful much of the time, when it comes to the revenue v capital distinction it is not clear that the correct process is always used, or which facts of each case are crucial in forming the decision.

2.6 How to Assess A Taxpayer’s Intention

Unfortunately the correct answer is not simply to ask them what their intention was. The cases all come down to the same point every time; each case turns on its own facts. I am yet to see a judgment that said the case turned on the taxpayer’s stated intention. However asking their intention is still a good place to start.

A helpful way to progress the point beyond this, when approaching the question of intention can be to describe the facts that occurred. The presumption behind this starting point being that what actually happened is what you intended to happen and that if something different to what you intended to happen did in fact occur, there will be additional facts which explain the reason for that.

For example, the fact that I am attending and speaking at the Tax Summit right now suggests that I intended to attend and speak at the Tax Summit. If I did not intend this then something very peculiar must have happened such that I actually am (maybe I was attending a difference conference at the centre, wandered into the room, saw the presenter with an identical name to me had not appeared and decided to leap on stage and present the topic anyway). Whilst facetious, it does illustrate the point that it is hard to argue against that intention given the actual occurrence of a positive fact.

In contrast, a non-occurrence is much easier to present additional facts to explain why something against your intention happened. For example, I am sure there are quite a few people who intended to attend Tax Summit but who are not here. There will be additional facts that explain why this did not occur (for example, they broke their leg the day before their flight or they were invited to a wedding on the same day and had to cancel their conference place).

So, one approach that could be used for assessing intention can be:

1. Ask the taxpayer their intention at the time of acquisition for the property deal;
2. Describe the facts of what occurred;
3. Compare whether the facts are consistent with the stated intention;
4. Where the facts are inconsistent with what occurred, seek additional facts which explain the discrepancy; and
5. Once all the possible facts have been obtained, assess from an objective point of view what the actual intention was.

Keep in mind that when performing the analysis for profit-making undertakings under TR 92/3, the time of assessing the intention is the time of acquiring the asset, but many of the facts which may be used to evidence such intention may occur a long time after this.

EXAMPLE 1

Alexis is a 30 year old data analyst with a young family. She purchases a large block on the outskirts of Brisbane which has a huge yard her kids can play in and that will suit their family lifestyle. However, her real plan of purchasing was that she suspected this fringe suburb would be rezoned and she would be able to subdivide and sell the block at some stage in future for a large profit based on current prices. Whilst her family would live there for a while, it was not intended to be long-term as they would be moving interstate for her work after 12 months and renting the property out until the subdivision project was possible due to the zoning.

Next door to Alexis lives Mimi. Mimi is a carpenter and purchased the large block at the same time as Alexis did to live in long-term as it gave her space to keep her horse and play with her motorcycles.

On the basis of the facts above, Alexis holds the property on revenue account and Mimi holds the property on capital account. However consider the following facts.

Mimi and Alexis talk during the year that Alexis lives there and tells Mimi of her plan which gets Mimi thinking that if the rezoning does happen, maybe she could also make some money and set herself up financially. After a year Alexis moves interstate and rents her property. Eighteen months later, the properties are rezoned and subdivision is possible.

Whilst Alexis had intended to subdivide and sell as soon as it was possible she is too busy with life to do much about it. Being interstate means the idea is put on the backburner and she continues to rent the property for 9 more years. Mimi on the other hand jumps into action as soon as she finds out about the rezoning. She contacts professionals to assist her to manage the process and after 12 months her block is now 4 separate titles which she sells. Alexis does the subdivision on returning the Brisbane and sells her 4 blocks approximately 9 years after Mimi did.

How would we describe the facts for each of Alexis and Mimi, to compare to their stated intentions:

Alexis:

- Purchased a property in 2023 and moved in immediately
- Lived in the property for approximately 12 months
- Moved out of the property and rented it for 10.5 years
- Ceased renting the property and Subdivided it into 4 over approximately 12 months (9 years after it was possible to do so)
- Sold the 4 blocks after owing the land for 12.5 years

Mimi

- Purchased a property in 2023 and moved in immediately
- Lived in the property for approximately 2.5 years then commenced subdividing into 4 lots (immediately this became possible)
- Sold the 4 blocks after owning the land for 3.5 years

Based on the facts described above, it appears that Mimi quite possibly holds on revenue account and that Alexis likely holds on capital account; the actual facts presented are contrary to their stated intentions. Other than Alexis' subjective intention to make a profit, there is not documentary evidence of this intention at the time. Mimi also likely does not have documentary evidence of her intention at the time of acquisition and then due to the very short timeframe involved she may end up with a disastrous tax result (no CGT main residence exemption, no discount gain and potentially GST on the sale of the vacant blocks).

Because the facts are different to the stated intention, seek additional facts which explain the difference. It may be virtually impossible for Mimi to obtain evidence that Alexis alerted her to the possibility of subdivision after she had acquired the property, especially in any documentary form. A potential documentary source of intention that could be requested could be a client's written financial plan. For example, does Mimi have a financial planner who documented her intention to purchase a main residence with more space for her lifestyle hobbies both before and at the time she acquired the property? And has that financial planner documented the reasons for doing the subdivision (it landing in her lap despite not intending it to happen) in their regular planning meetings throughout that time. If no actual facts like this can be obtained then Mimi faces an uphill battle to prove her original intention when it is assessed objectively.

EXAMPLE 2

Financial plans are a written plan of a taxpayer's intentions at the time which are updated over time. The review of these could reveal much and potentially alter the tax treatment of some assets.

Consider a financial plan for Sharon and Bob which recommends the purchase of a rental property with the following reasons stated as to why it is appropriate:

- A negatively geared rental property will offset your high salaries
- A rental property will increase your total funds invested (leverage) due to being able to borrow to fund this asset
- The rental property is expected to have high capital growth which will accumulate over the years you are working
- The rental property will not provide a sufficient cash stream to fund your retirement and will be sold at the point of retirement
- By selling the property after you retire, you will obtain favourable tax treatment of the increase in value (50% capital gains tax discount and also your starting taxable income will be very low because you have ceased employment)

The plan includes a graph of the net rental income not reaching a positive figure until 15 years of ownership and at that point being a very minimal amount, due to the loan being interest only for many of the early years. It also includes a retirement point and a sale shortly after for a large gain due to the projected capital growth.

In this case, there is an argument that the property should be treated on revenue account, despite that it may be held and rented for 20 years before sale. The intention on acquisition was to sell it for a profit, and it is explicitly recognised that the rental stream is never a reason for holding the property. Whilst there would be very few taxpayers in the circumstances above who have ever reported such a gain on revenue account, if challenged with this documentary evidence from the time of acquisition, they may face an uphill battle to have the transactions treated on capital account. Bob and Sharon's saving grace may be the second limb of TR 92/3 being that the transaction needs to occur as part of a business operation or commercial transaction. There is a strong argument that simply purchasing and holding a property for a lengthy period before sale is not a commercial transaction.

2.6.1 History as a relevant fact

A taxpayer's history is a relevant fact (repetition and regularity of activity being one of the factors to assess whether a business is being carried on per Taxation 97/11). It can also be a factor in assessing a profit-making intention if the same conduct has occurred previously leading to profits being made that it can be inferred the taxpayer intended the same conduct to make further profits.

Take as an example a taxpayer who has purchased a run-down property and moved in and renovated the property themselves over the next 2 years. They have then sold the property for a much larger gain than would have been expected from normal market movement in the area.

With the proceeds they purchase another run-down property and again renovate it over 2 years before selling for a large gain. They do this a third time and a fourth-time and a fifth time such that over 10 years they have held 5 properties which have all been renovated and sold for large profits. It is very unlikely that the taxpayer would ever succeed in a capital account argument on the sale of the fifth property. However, they would have a much better chance on the first sale where there is no history of having done such a transaction before. The chance of a successful capital argument reduce with each future sale where the history of the repeated activity is stronger and stronger.

Taxpayer history is mentioned as a fact in nearly every case and every private ruling decision.

3. ATO Data Matching Project

In April 2023 the ATO announced their Residential Investment Property Loan data matching project. This project will collect data relating to the 2021/22 to 2025/26 income tax years.

It is expected that data on approximately 1.7million individuals will be collected each of these years. The intent of the program is stated to aim at ensuring taxpayers with rental properties correctly report and lodge returns for their rental properties and also correctly report and lodge capital gains tax events on sale of these rental properties. However, the data collected could potentially be relevant in decision-making as to whether a property deal is on capital or revenue account.

The data providers are assessed based on principles, but the current listed financial institutions expected to provide data are:

- Adelaide Bank
- ANZ
- Bank of Queensland
- Bendigo Bank
- Commonwealth Bank
- Bankwest
- ING
- Macquarie Bank
- National Australia Bank
- Suncorp
- Westpac
- RAMS
- Ubank
- St George
- Bank of South Australia
- Bank of Melbourne
- ME Bank

Given this list covers all of the largest financial institutions in Australia, it will cover the majority of individual taxpayers with residential investment property loans.

In understanding how the data collected could be relevant, it is important to understand exactly what is being collected. The list of information that will be required by the institutions to provide is as follows:

Loan account holder details

- Unique client ID
- First name, middle and surname(s)
- Addresses (residential, postal)
- Australian business number (if applicable)
- Email address
- Contact phone numbers
- Date of birth

Loan account details

- Unique account ID
- Account number
- BSB
- Account name
- Loan type
- Loan commencement date
- Expected loan end date
- Term of the loan
- Opening balance (start of loan)
- Opening balance (start of financial year)
- Closing balance (end of financial year)
- Borrowing expenses

Property details

- Unique property ID
- Property address

Loan account transactions

- Unique account ID
- Transaction date
- Transaction type
- Transaction description
- Transaction amount
- Credit or debit

As can be seen, the ATO will have details of every loan transaction that occurs through any of these accounts. The data is going to be retained for 7 years after receipt of the data file from the last provider of the information. The timeframe for keeping the data may be extended based on rolling reviews for intervals up to periods not exceeding 7 years. There is a possibility this data will be retained for a very long time. One of the stated reasons the data is required to be kept is that *the data is used in multiple risk models, including models that establish retrospective profiles over multiple years aligned with the period of review*.

4. Data Matching Implications for Assessing a Taxpayer's Intention

Whilst it is not part of the current program's stated purpose or a way in which the data will be used, it is not hard to imagine that some of the information collected would be useful in forming an objective view as to a taxpayer's intention in regards to a certain property. For example, if the following data was collected:

- Property purchase date is 6 September 2023 (collected from other sources)
- loan commencement date is 6 September 2023
- expected loan end date is 6 September 2025
- four transaction payments of $25,000 are recorded 30 November 2023, 28 February 2024, 30 April 2024 and 31 July 2024 with the description (reno payments)
- there is a transaction payment of $2,000 on 2 August 2023 with the description (agent advertising)
- property sale date is 15 September 2024 (collected from other sources)

The actual circumstances that have occurred are:

1. the taxpayer has purchased a property
2. the taxpayer has organised a 2 year loan for this property
3. the taxpayer has commenced renovations on the property very quickly after purchasing it
4. the renovations appear to have completed 31 July 2023
5. the taxpayer has engaged a sale agent 2 August 2023
6. the taxpayer has entered a contract for sale 9 days after their 12 month holding period

Given these actual facts, and no other facts, the intention that would be inferred would almost certainly be that the taxpayer carried out a profit-making project that should be taxed on revenue account. Prior to this data matching project the only information the ATO would have had would be the purchase and sale dates and prices. Both prior and subsequent to the data matching project the only information the accountant or tax advisor would usually have is still those items along with what the taxpayer tells them occurred and what their intention was.

Consider the additional facts of the taxpayer explaining that the house on purchase was in complete disrepair and required to be extensively renovated before it was able to be rented long-term. Their long-term ability to service the loan was in question and so the bank was only willing to offer a short-term loan with the understanding it would be able to be refinanced to a 30 year loan after the renovation was complete and the rental income yield would support such a loan. However, halfway through the renovation the taxpayer and their spouse divorced meaning the property was sold quickly upon completion of the renovations before being rented. In those full circumstances, the taxpayer did have a genuine intention to rent the property long-term on acquisition and the transaction should be on capital account. However, they would need to provide the evidence of the bank negotiation showing the short-term timeframe reasons and that the divorce had occurred as a reason for the quick sale. Without that evidence, a taxpayer's stated intention to hold for long-term rental which is in completion opposition to the actual facts that occur will not likely succeed.

5. Entity (virgin) Intention

How to assess the intention of a newly established entity is an interesting question to think about. Whilst many continuing entities are assumed to have the same intention as prior transactions they have been involved in, a brand new entity has no history to rely on. What it will have is controllers, shareholders or parties with an interest in the entity.

I would suggest identifying those parties and then applying their history as one relevant fact in coming to a decision on the intention of this new entity is a something that may occur. Whether this is a correct approach is debateable.

For example, a new trust is established and has a single controller (director of the corporate trustee is also the appointor and primary beneficiary of the trust). This trust then purchases a run-down property which is renovated, rented for a few years and then sold. Arguably the transaction could be on either capital or revenue account.

The relevant intention to look into will be the intention of the trust's controller on acquisition of the property. If this controller has a history of doing this exact type of transaction many times and always in a separate entity, that history may lead to a conclusion this was the intention again this time and that the transaction should be on revenue account. However, if the controller has a history of doing revenue account transactions all through the same entity, but for some reason this transaction was separated and the taxpayer states their intention in separating was to earn a long-term rental stream quarantined from the trading risk there is a good chance the transaction is on capital account. However, you would also be looking for further documentation showing the reason for separating on acquisition that demonstrated this intention and for facts that explain why the property was sold only a short time after it was rented.

A good source of documentation is likely to be the notes of advisors who have helped establish the entity and advise on the transaction. It is therefore important that as advisors we take and keep proper notes that may be needed as evidence of intention at a later time.

5.1 Data matching as it relates to Virgin Entities

Whilst the current data matching program as discussed earlier is aimed at collecting data on individuals it could still be relevant if those individuals are identified as controllers or interested parties for transactions of other entities and where their history is considered a relevant fact. For someone starting to do property transactions just now, eventually there will be a long history of all transactions in a profile for that taxpayer. So potentially whilst the matching program may not be used to construe intention due to only a very short history of data being available, the longer the program goes and the more history there is, the greater the potential for the data matching to be considered relevant or used in assessing whether a transaction should be on revenue or capital account.

Additionally, if further data matching programs which extend beyond individuals are initiated then the identification of the relevant individuals involved will be a key part of the exercise.

6. Can a Minority Interest Holder Control an Entity?

In examining the intention of an entity in a property transaction, we are usually looking at the intention of the controlling mind of the entity. But it is not quite as simple as asking what the legal ownership interest is in order to assess control.

There are various ways to determine who controls an entity, but one of the most widely used is Section 50AA in the Corporations Act 2001. That section states:

(1) For the purposes of this Act, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies.

(2) In determining whether the first entity has this capacity:
   - (a) The practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and
   - (b) Any practice or pattern of behaviour affecting the second entity's financial or operating policies is to be taken into account (even if it involves a breach of an agreement or breach of trust)…..

So the key point for control of the entity under this section is the *practical influence* that someone can exert.

<u>Example</u>

George is in the business of property renovation and sale for profit; a business he has conducted for 20 years and he has done approximately 40 successful projects. George has three children. None of those children have anything to do with property development and their occupations are teacher, nurse and personal trainer respectively.

George wants to assist his children to get on the property ladder. He establishes a company of which his three children are the directors and they each hold 33% of the shares with George holding the remaining 1%. George pays the deposit for a property which the company buys and organises the bank finance for the remaining purchase price. George organises the renovation of the property and also funds the renovation. On completion of the renovation the property is rented, but is then sold after 2 years for a large profit.

Should this transaction be on capital account or revenue account? On first glance, the company is 99% owned and directed by individuals with no previous property ownership history who in their subjective minds likely had no intention to be conducting a property renovation business. However, the practical influence that George was exerting indicates that he was controlling the company and given his history this entity is likely in the business of property renovation.

7. Are Cash Transactions Beyond Data Matching?

Cash transactions are not a part of the Residential Investment Property Loan data matching program, but this does not mean they are beyond the data matching capabilities of the ATO. There are many other data matching sources including:

- Landlord insurance data matching program (also running from 2021/22 to 2025/26). This should identify rental properties held even where there is no loan on a property. There are nearly 50 insurance providers listed who information will be collected from
- Property management data matching program (running from 2018/19 to 2022/23) collects data from property management software providers
- Rental bond data matching program (running from 1985 to 2022/23 years) collects data from the state authorities responsible for holding residential bonds
- Real property data matching which obtains transfer records from state and territory title offices and revenue agencies.

So even if a property is not caught by the new program discussed, either because cash transactions occur or a lender is not required to provide data on the loan, it is still extremely likely the data is captured in relation to property ownership.

However, what about if cash is used to fund a renovation or a build of a house on a block of land rather than a borrowing. Will those transactions be beyond data matching? It seems likely they would still be caught by either:

i. Analytical processes showing the gain on a particular property is outside of the normal range of price movements for a given area over the given time; and
ii. Online evidence of the state of the property.

For example, a dilapidated property is purchased for $800,000 in 2023 and the RP Data listing of this shows the state of the property. It is renovated, although all with cash payments of $100,000 and then sold after 13 months for $1,350,000. The gain of $550,000 will not be within range of normal gains over that period and a look at the photos from the final sale listing will show the significant renovation that has occurred. Therefore, whilst the fact of renovation is not immediately identifiable through a data match, the evidence of this can be obtained independently by anyone.

8. Conclusion

The perennial issue of whether a transaction should be treated on revenue or capital account will continue and each case will continue to turn on its own facts. However, the data matching programs of the ATO are continuing to become more sophisticated and are gathering more and more facts about property transactions to be used in their risk models.

Whilst taxpayer intention is key to the treatment of transactions and no doubt a taxpayer chooses their own intention, if there are facts which indicate a contrary intention they will need evidence to explain this. A taxpayer's history is one such relevant fact and the longer the data matching processes continue and the longer the history of facts the ATO has, the more potential there is for that history to be considered relevant. Documentary evidence of a taxpayer's intention on entering transactions is crucial; as is evidence to explain why any actual occurrence of facts that run contrary to that stated intention.

The net is closing in and practitioners need to advise their clients of these developments. Advisors need to probe deeper to discover the facts that may not be being told to them, as the ATO will have them already.