Property and Income Tax

Carlo Di Loreto

Tuesday 9 April 2024

Wolters Kluwer

Crowe

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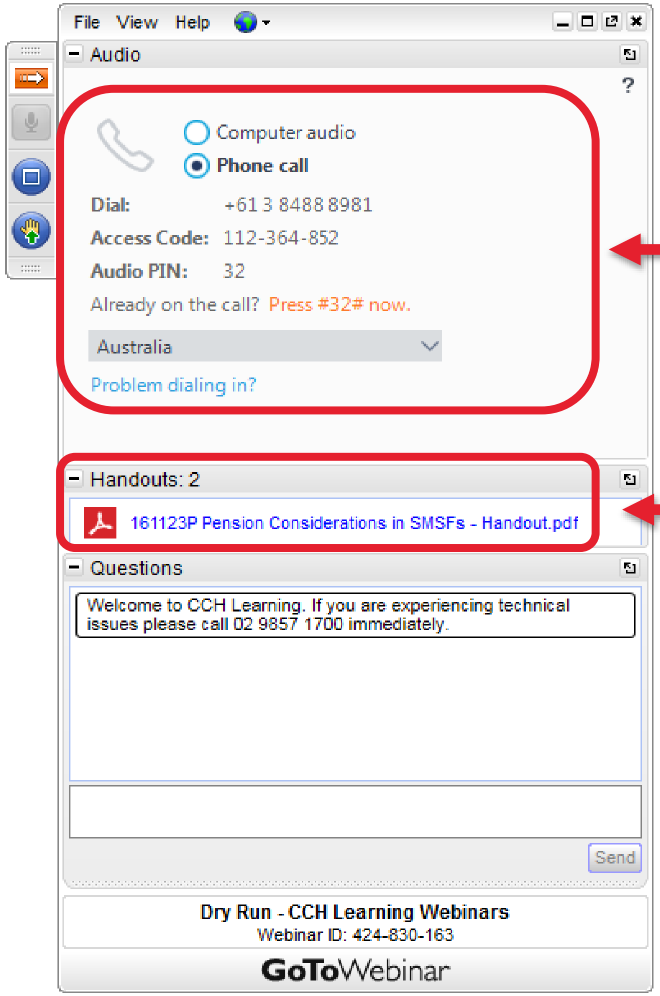

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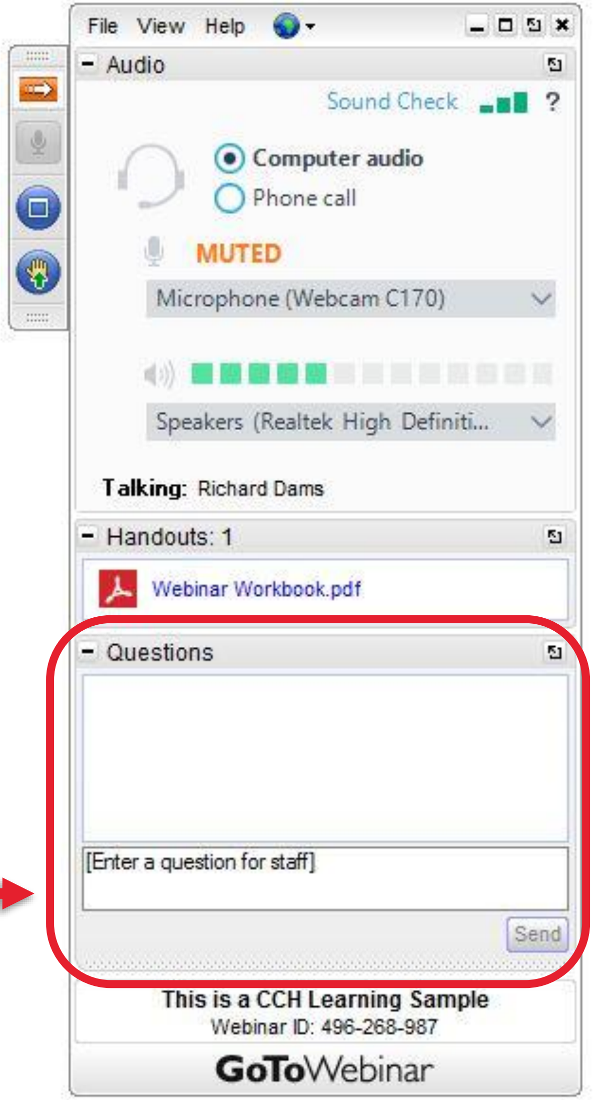

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Your Presenter

Carlo Di Loreto

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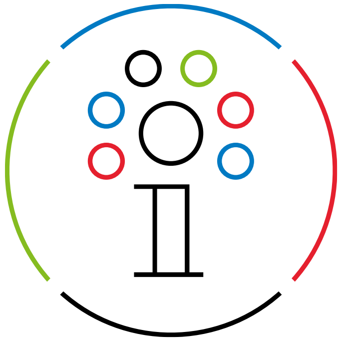
Today's session will cover

The principles distinguishing gains on capital account & revenue account:

- case law history
- timing of taxing point
- calculating profits & gains
- case studies



Case history: income v capital

Relevance of income & capital

- land acquired before 20 September 1985 - exempt from CGT
- sale of land which is capital – access to 50% discount & small business relief
- capital losses are quarantined against capital gains
- land held for profit making purposes:
  - taxed at marginal rates of tax
  - no tax concessions can be applied

Income vs capital | case history overview

- significant body of case law has developed over time & many of the key principles are relevant in day-to-day practice (see list of some of these at the end of this presentation)

- a broad understanding of the fundamental concepts contained in the common law decisions

- the following common law decisions are intended to provide a ‘snapshot’ of the key principles & how they have been established

- a number of additional common law decisions covered in the download – webinar will cover main cases of interest

Income vs capital | case history

California Copper Syndicate v Harris (1904) - United Kingdom

- Principle
  - enhanced price of an ordinary investment is not profit;
  - where not mere realisation, but truly carrying on a business, may be assessable
- Facts
  - mining property acquired for resale at a profit, not to derive mining income
- Decision
  - held to be income

Income vs capital | case history

Scottish Australian Mining Co Ltd v FCT (1950)

- Principle
  - merely realising land in the most advantageous way is capital
- Facts
  - land used for coal mining for 60 years, until exhausted
  - land was sub-divided, roads & a railway station were built, part of land set aside for parks, schools & churches
  - considerable expenditure incurred in making land attractive to purchasers
  - land had not been acquired for a profit-making purpose

Income vs capital | case history

FCT v Whitfords Beach Pty Ltd (1982)

- Principle
  - more than mere realisation such that carrying on a business of property development is revenue account
- Facts
  - company was formed to acquire land so as to ensure shareholders continued to have access to their fishing shacks
  - land was not acquired for development, sub-division or profit making
  - shares in the company were sold to property developers
  - adopted an entirely new set of Articles more appropriate for the intention of the new shareholders
  - new owners embarked on substantial activity of rezoning, development, sub-division & sale

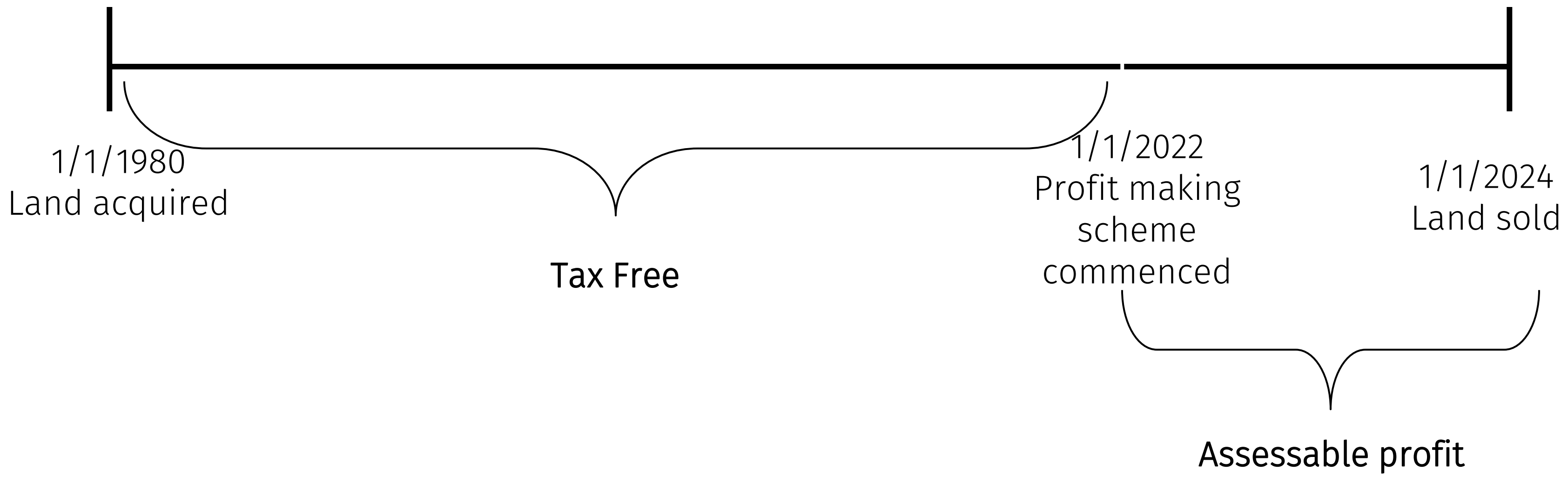
Income vs capital | case history

FCT v Whitfords Beach Pty Ltd (1982)

- Decision
  - held to be more than mere realisation & was assessable as income
  - Judges' critical distinction from Scottish Australian Mining Co Ltd in that change in shareholding & change in Articles "transformed" the company to having a purpose of "commercial venture with a view to profit"
  - activities were to such an extent that constituted carrying on a business of property development

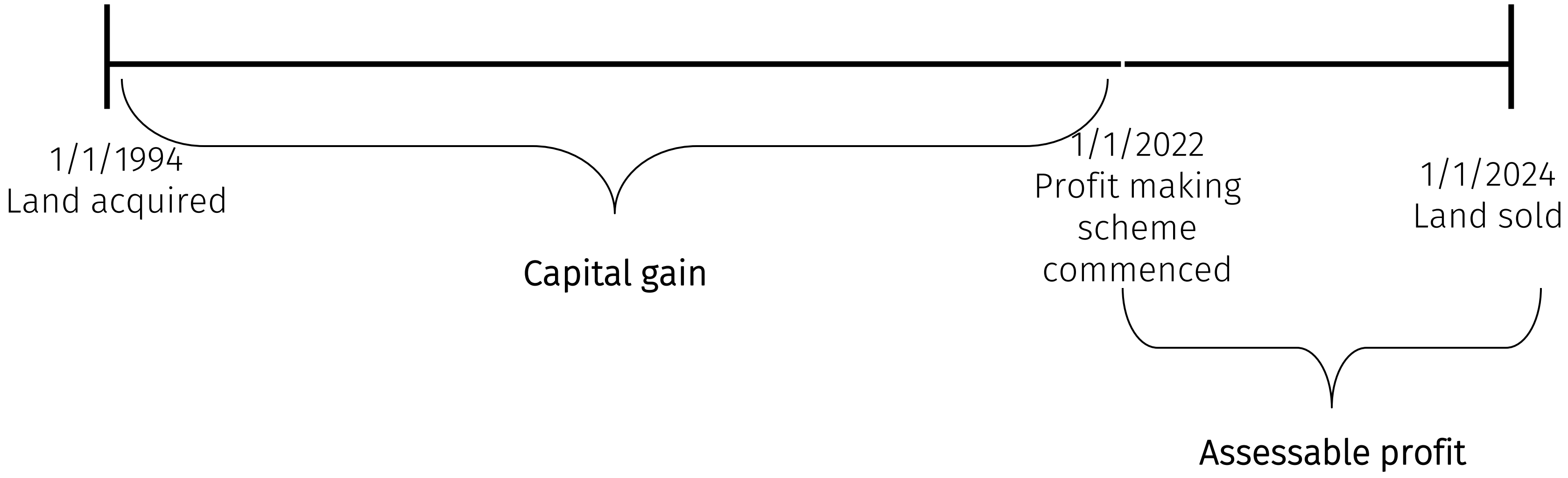
Income vs capital | determining cost for profit making scheme

- cost of the land is MV at time of entering into the profit-making scheme
- pre 20/9/1985 land:



Income vs capital | determining cost for profit making scheme

- post 20 September 1985 land:



Income vs capital | case history

FCT v Myer Emporium (1987)

- Principle
  - profit from an isolated transaction will be assessable if:
    - profit making intention
    - entered into:
      - in the course of carrying on a business; or
      - in carrying out a business operation or commercial transaction
- Facts
  - $80 m lent to a subsidiary at commercial rate
  - few days later, right to receive interest assigned for $45 m

Income vs capital | Taxation Ruling TR 92/3

- TR 92/3 – factors for isolated transactions
  - Nature of the entity undertaking the operation or transaction
  - Nature and scale of other activities undertaken by the taxpayer
  - Amount of money involved in the operation or transaction
  - Magnitude of the profit sought or obtained
  - Nature, scale & complexity of the operation or transaction
  - Manner in which the operation or transaction was carried out

Income vs capital | Taxation Ruling TR 92/3

- TR 92/3 – factors for isolated transactions
  - Nature of any connection between relevant taxpayer & any other party to operation of transaction
  - Nature of the property sold
  - Timing of transaction or the various steps in the transaction
  - Motive upon acquisition of the land
  - Motive upon disposal of the land
  - Personal involvement in the project

Income vs capital | case history

McCurry v FC of T (1998)

- Principle
  - will be income where main purpose is profit making, despite existence of other purposes
- Facts
  - 1986
    - purchased land with an old house of no value
    - half of purchase price funded by finance
    - house was removed
    - obtained additional finance to construct three units

Income vs capital | case history

McCurry v FC of T (1998)

- Facts
  - May 1987
    - units advertised for sale (before completion), but none sold
  - Jun/Aug 1987
    - units completed
  - Jun 1987
    - taxpayer's family moved into units 2 & 3
    - unit 1 used for business storage & visitors

Income vs capital | case history

McCurry v FC of T (1998)

- Facts
    - Dec 1988
        - units sold
    - no attempt made to rent out units
    - taxpayer had in mind the possibility of, for a time at least, renting out

Income vs capital | case history

McCurry v FC of T (1998)

- Decision
  - held to be profit making scheme & not inconsistent that two possible ends were in mind
    - deriving profit & deriving regular income
  - possibility of reselling at a profit was the dominant factor
    - units put onto market prior to completion
    - intention was to realise a foreseen profit
    - no attempt to secure tenants
  - scheme not abandoned & units not irrevocably committed to another activity
  - profit making always remained an option, despite for a period when convenient, units used for another purpose

Income or capital | indicators

Factor	Capital	Revenue
Intention is to realise/maximise inherent value	✓	
Capital use of land exhausted, no intention of creating profit	✓	
Owned for a long time	✓	
Land was used to generate rental income	✓	
Little knowledge or experience of property industry	✓	
Acquired ordinary course of business		✓
Large scale activity		✓

Income or capital | indicators

Factor	Capital	Revenue
Intention is to create value		✓
Large amount of construction & development		✓
Taxpayer extensively involved		✓
History of property development		✓
Extensive borrowings		✓
Undertaken risk		

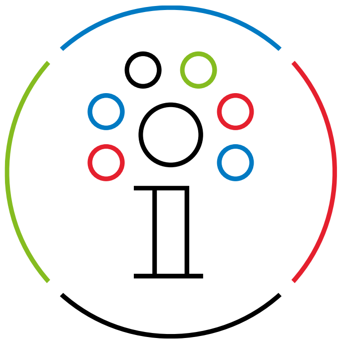
Income vs capital | capital : revenue spectrum

Activity	Tax position
Single sale of land, little or no activity	Capital
Obtaining development approval and selling sub-divided blocks	Capital
Selling subdivided blocks with sewerage, gas, electricity, water, etc	Probably capital
Selling subdivided blocks with services, roads and actively involved in the development and marketing	Probably revenue
Selling subdivided blocks with a house	Almost certainly revenue

Income vs capital | property development business

- Key factors in determining whether a property development business is being carried on include:
  - the purpose in acquiring land & carrying out the development
  - property development history
  - extent to which taxpayer is personally involved
  - profitability & profit motive, including reasonable prospects of profit
  - overall nature, scale & complexity of the development
  - the way lots are released to the market, including staged developments
  - manner in which lots are listed for sale e.g. multiple agents, concerted advertising campaign
  - extent of construction work undertaken

Poll Question 1. How were the land sales in the Whitfords Beach case taxed?



a) Trading Stock
b) Profit making scheme
c) Capital
d) A and B
e) B and C

Timing of taxing point

Timing of taxing point

- The timing of the taxing point is relevant under the three broad scenarios of:
  - CGT provisions
  - profit making scheme
  - carrying on a business

- Practically, there may be opportunities to defer the timing of a CGT event and/or defer the recognition of income under the other scenarios.

Timing of taxing point | CGT provisions

- time of CGT event is when enter into contract for the disposal
- for land, generally when offer is accepted by the owner
- if no contract, when stop being owner of land

Timing of taxing point | effect of conditions

- two main types of condition in a contract:
  - condition precedent to performance (“condition subsequent”)
  - condition precedent to formation of contract (“condition precedent”)

- typical examples is “subject to finance” & “subject to approval”

- contract exists from the date it is accepted

Timing of taxing point | condition precedent

- contract does not exist, or not entered into, until conditions fulfilled
- this must be clear in offer/contract
- Courts interpret most conditions as subsequent

Timing of taxing point | amended agreements

- contract entered into, but subsequently amended

- where a contract is amended, need to determine whether the sale takes place under the original agreement or the amended agreement

- the time of the sale is taken to be the original agreement

Timing of taxing point | deferring the time of sale

- by entering into a Heads of Agreement (HoA)
  - can lock in a purchaser today by agreeing principal conditions in advance
  - defer the timing of the sale to a later date

- HoA should clearly specify that it requires entering into formal contract for disposal

- the sale takes place when the formal contract is entered into

- useful if a buyer is present but the sale needs to go through in the following year

Heads of Agreement – Case Law

- There are several common law decisions in the context of contractual arrangements for the sale of CGT assets (including HoA's).
- In Elmslie & Ors v FC of T 93 ATC 4964, the Federal Court held that when there is more than one contract (HoA & sale contract) the relevant contract (the sale contract in Elmslie) is the one that was the immediate means by which the asset was acquired.
- In FC of T v Sara Lee Housing & Body Care (Australia) Pty Ltd (2000) ATC 4378, the High Court held it is the contract which is the source of the obligation for disposal that is relevant where two or more contracts affect the rights & obligations of the parties.
- Whilst HoA's may be used to defer the time of sale, care must be taken in the drafting the HoA, as well as the sale contract itself.

Timing of taxing point | profit making scheme

- when the profit is ‘derived’
- normally derived when:
  - ‘earned’
  - there is an enforceable right to receive

Timing of taxing point | carrying on a business – trading stock

- when land ceases to be trading stock of the developer’s

- usually at settlement & not when contract becomes unconditional

Gasparin v FC of T (1994)

- Principle
  - income derived when debt arises
  - allotments of land remain trading stock on hand until settlement, when vendor loses dispositive power
- Facts
  - property developer entered into sale contracts for land
  - contracts become unconditional upon certain events
    - 9 contracts settled before 30/6/1985
    - 64 contracts settled after 30/6/1985

Calculating profits & gains

Calculating profits & gains | CGT

- capital proceeds:
  - money received/entitled to receive
  - market value of property received/entitled to receive

Less:

- cost base:
  - money paid to acquire
  - costs of acquisition
  - non-capital costs of ownership

Calculating profits & gains | CGT

- if pre-CGT disregard any gains
- potential for 50% discount
- potential for small business relief

Land held on capital account becomes trading stock

- have now embarked upon carrying on a business where the land held for resale
- land deemed to have been disposed & immediately reacquired
- can choose whether deemed disposal/re-acquisition at MV or cost (choose MV)
- CGT event K4 is triggered
- capital gain arises if MV exceeds cost base
- cost of trading stock is MV - based on highest and best use (TD 97/1)

Land held on capital account becomes trading stock

Example

• 2016	Land held on capital account acquired for $1,800,000
• 2022	Land becomes trading stock. MV of $3.0 million
• 2022 - 23	Land subdivided & developed into residential units. Development costs of $3.0 million
• 2023	All residential units sold for $8 million

Land held on capital account becomes trading stock

Result

- 2022 | CGT event K4 triggered. Capital gain arises

Market value	$3,000,000
Cost base	(1,800,000)
Capital gain	1,200,000
Less: 50% discount	(600,000)
Net capital gain	$600,000

Cost of trading stock: $3,000,000

Land held on capital account becomes trading stock

Result

- 2023

Assessable income			$8,000,000
Cost of goods sold			
Land		3,000,000	
Development costs		3,000,000	($6,000,000)
Taxable amount			$2,000,000
Total amount subject to tax			
2022	Net capital gain		600,000
2023	Taxable income		2,000,000
			$2,600,000

Land held on capital account becomes trading stock

- Alternative – choose deemed disposal/re-acquisition at cost
  - if no cash is available to pay the CGT in 2022, can elect for the cost of the trading stock to be its original cost (s 70-30) ie. $1,800,000
  - election must be made by lodgement of return for year in which started to hold as trading stock
  - if election made, the K4 capital gain is disregarded (s 118-25(2))

Land held on capital account becomes trading stock

Result

2022	K4 capital gain disregarded		
	Cost of trading stock:		$1,800,000
2023	Assessable income		$8,000,000
	Cost of goods sold		
	- land	1,800,000	
	- development costs	3,000,000	(4,800,000)
	Taxable amount		$3,200,000

Land held on capital account becomes trading stock

- Whilst making the election defers the taxing point from 2022, the result is losing the benefit of the CGT 50% discount

Result

Total amount subject to tax:	
2022 net capital gain – disregarded	Nil
2023 taxable income	3,200,000
Total	$3,200,000
Difference (equal to CGT 50% Discount)	$600,000

Calculating profits & gains | profit making scheme

- Profit making scheme
  - sale proceeds
- Less:
  - all costs in respect of the land, development costs, engineers, consultants, selling costs, etc
  - not deductible until land has been sold ie profit has been derived

Note:

- there is no bringing to account gross assessable income & claiming deductions
- the assessable amount is the net profit

Calculating profits & gains | trading stock

Carrying on a business

- land is trading stock
- trading stock rules apply
- taxable income is calculated as:
  - sale proceeds

  Less:
  - cost of goods sold

Calculating profits & gains | trading stock

Carrying on a business

- valuation of trading stock required at year end
  - cost
  - market selling value
  - replacement value

- IT 2350
  - full absorption costing method must be used if valuing closing stock at cost
  - excludes holding costs such as interest, rates & taxes

Calculating profits & gains | trading stock

Example

- Land acquired for $2,000,000 - 2022
  - development costs of $600,000 incurred
  - interest of $50,000 incurred

- Development costs of $1,000,000 incurred 2023
  - interest of $110,000 incurred
  - land sold as individual residential units for $5,000,000

Calculating profits & gains | trading stock

Result

2022	Assessable income				Nil
	Cost of goods sold				
		- opening stock	-		
		- land	2,000,000		
		- development costs	600,000	2,600,000	
	Less:	Closing stock		(2,600,000)	-
	Gross profit				Nil
	Expenses - Interest				(50,000)
	Taxable income/(loss)				$(50,000)

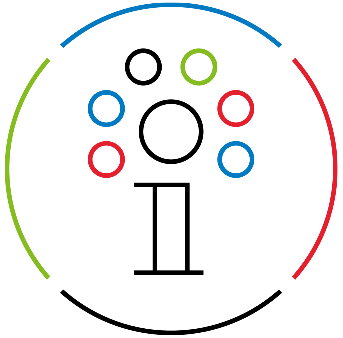
Calculating profits & gains | trading stock

2023	Assessable income				5,000,000
	Cost of goods sold				
		- opening stock	2,600,000		
		- development costs	1,000,000	3,600,000	
	Less:	Closing stock		-	3,600,000
	Gross profit				1,400,000
	Expenses	- Interest			(110,000)
	Taxable income/(loss)				$1,290,000

Long term construction contracts

- IT 2450 sets out two alternative methods acceptable to the ATO for bringing to account assessable income for construction or building services
  - including all progress & final payments received in a year in assessable income & subtracting all allowable deductions
  - spreading of the ultimate profit or loss over the life of the project
- IT 2450 applies to providers of construction or building services
- IT 2450 does not apply to land held as trading stock or for a profit-making scheme

Poll Question 2. When does a CGT event happen under a standard land sale contract with a finance clause?



a) On settlement
b) When finance approval is received
c) When it is entered into
d) Some other time

Income vs Capital
Case studies

Case study 1 | rental property

Facts

- Jane's main source of income is her salaried job
- she purchased a house in 2019 as a rental investment for $1,700,000
- she has continuously rented it out
- occasionally vacant while in between tenants
- decides to sell & engages real estate agent to market & handle the process
- the house sells for $2,200,000

Case study 1 | rental property

Solution

- Jane has not embarked upon a business venture nor profit making scheme
- she is merely realising a capital asset
- disposal is capital & subject to CGT provisions only

Case study 2 | rental property with improvements

Facts

- same as Case Study 1, except Jane feels the property looks run down
- she thinks she could get more for house if it is improved & does the following:
  - engages landscaper to replace existing garden with colourful flowers, shrubs & mulch
  - the interior and exterior of the house are repainted
  - the hot water system is replaced
  - Jane paints the fence herself (never been painted) over several weekends
  - some rooms have worn out carpet replaced
  - the flaking guttering is replaced and she has the roof sealed
- the above costs $160,000, which Jane has borrowed
- Jane then engages a real estate agent and the house is sold for $2.5 m

Case study 2 | rental property with improvements

Solution

- Jane has sought to maximise the value obtainable from the house
- she engaged external professionals to undertake the work
- she personally did some of the work herself
- presumably, Jane has no history of property development
- the improvements have been funded by debt
- if the house did not sell, could it command a higher rent?
- selling agent engaged
- continued with her usual main source of income

Conclusion:

- Mere realisation of a capital asset - extracting maximum value inherent in the property - CGT provisions apply.

Case study 3 | sell backyard

Facts

- Julia has resided in her home since 2006
- the land area is 1,200m2
- she has no desire for a large backyard anymore & decides to sub-divide the backyard & sell it
- capital or revenue?

Case study 3 | sell backyard

Solution

- profit on sale is not income if it is the mere realisation of a capital asset
- in this case, Julia is selling off part of the land on which her home is located therefore sale of capital asset
- the profit on sale can be assessed as income if Julia has entered into a profit-making scheme
- simply sub-dividing & selling land should not amount to a scheme meaning sale is a capital account

Case study 4 | build on backyard and sell

Facts

- Pete has lived in his home since 2009 & his suburb has experienced increased demand & growth
- he sees an opportunity & sub-divides his backyard from his home
- he obtains finance & has a new house built on the backyard (costing $800,000)
- he then sells the backyard property for $1,600,000
- is the resulting gain capital or revenue?

Case study 4 | build on backyard and sell

Solution

- the sale will be capital if it is a mere realisation, or a realisation is an advantageous manner
- the sale will give rise to assessable income if it is more than a mere realisation, but is a profit-making scheme

Case study 4 | build on backyard and sell

Solution

- need to consider the manner in which the development was undertaken
  - if Pete used a builder & did not actively participate in the construction, possible sale may be mere realisation
  - if Pete undertook the project himself, became the owner/builder, organised tradesmen directly, could be profit making scheme
- given that Pete is doing more than merely realising the increase in value of the land, sale is likely to be revenue in nature & the profit assessable

Case study 5 | partition of property

Facts

- Phil & Don own a single parcel of vacant land equally:

Land

Phil: 50% Don: 50%

- they no longer intend to carry out their joint plans for the property
- instead, they decide to sub-divide the property evenly with each taking half the land:

Land

Title A	Title B
Phil: 100%	Don: 100%

Case study 5 | partition of property

Issue

- clients sometimes have a misconception that no consequences arise from doing the above
- this usually arises from considering the final outcome i.e. “owned half the land & still own half the land”

Case study 5 | partition of property

Tax consequences

- The tax consequences become clear when we consider each step of the partition process:

Land

Phil: 50%
Don: 50%

- Step 1: Divide into 2 titles
  - Phil & Don have each taken their 50% interest and split it into 2 separate assets. No tax consequences arise from doing this

Land

Title A	Title B
Phil: 50%	Phil: 50%
Don: 50%	Don: 50%

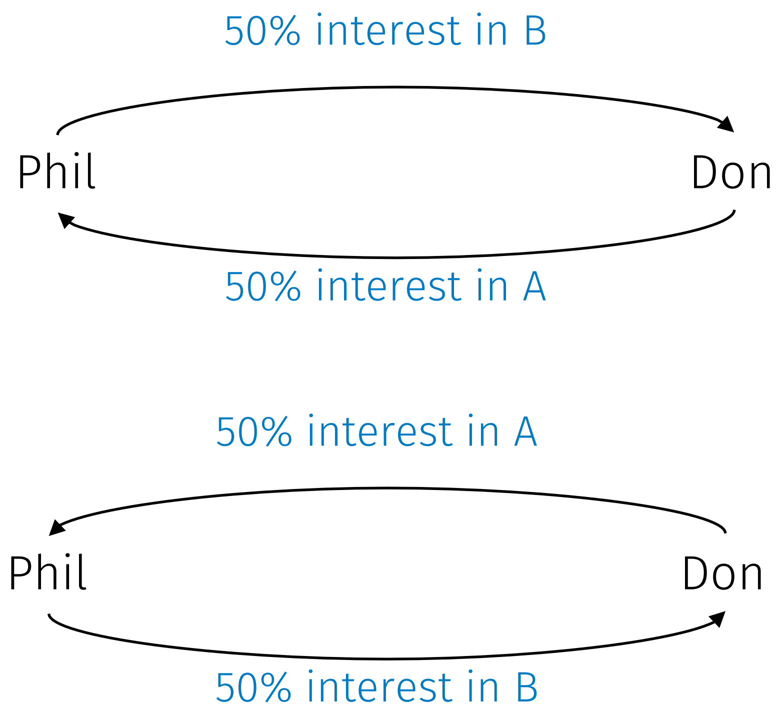
Case study 5 | partition of property

Tax consequences

- Step 2: Phil & Don exchange a half interest in each title:
  - Phil
    - disposes of his 50% interest in Title B (to Don); and
    - acquires Don's 50% interest in Title A (Phil's 50% interest in B is the consideration)
  - Don
    - disposes of his 50% interest in Title A (to Phil); and
    - acquires Phil's 50% interest in Title B (Don's 50% interest in A is the consideration)

Case study 5 | partition of property

Tax consequences - title transfers



Case study 5 | partition of property

Tax consequences – end result

Land

Title A	Title B
Phil: 100%	Don: 100%

- Phil will have tax consequences in respect of his 50% interest in Title B disposed
- Don will have tax consequences in respect of his 50% interest in Title A disposed

Summary

- numerous factors to consider in distinguishing revenue from capital
- intention is turning factor in many cases
- evidencing and documenting intention becomes critical
- a number of additional case studies covered in the download

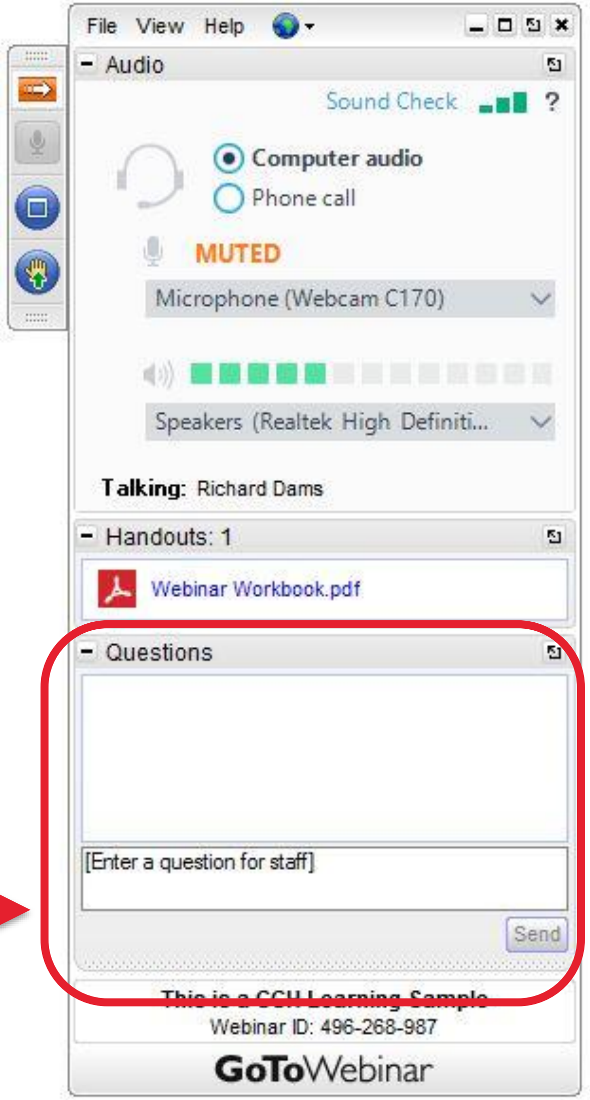
Case List

California Copper Syndicate v Harris (1904)	Stevenson v FCT (1991)
Scottish Australian Mining Co Ltd v FCT (1950)	Casimaty v FCT (1997)
FCT v Whitfords Beach Pty Ltd (1982)	McCorkell v FCT (1998)
FCT v Myer Emporium (1987)	Kraztmann v FC of T (1970)
Westfield Ltd v FCT (1991)	McCurry v FCT (1998)
Starco v FC of T (2002)	August v FC of T (2013)
Case 2/2013 AATA	Case R85 1984
Pastoral & Development Pty Ltd v FC of T (1971)	FC of T v NF Williams 127 CLR 226
McClelland v FC of T (1970)	Stratham & Anor v FC of T (1989)
Allied Pastoral Holdings Pty Ltd v FC of T (1983)	Numerous private rulings
Bowerman v FC of T (2023)	

Questions?

Alison Wood
CCH Learning Moderator

Type your question and hit **Send**



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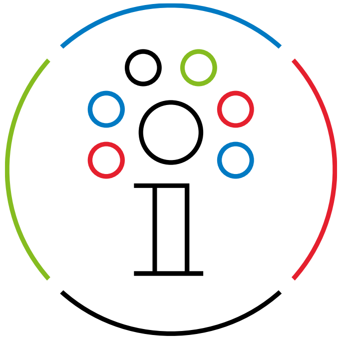

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- 11 April – End of Financial Year Tax Planning
- 18 April – ATO Tax Crime – Client Suspected – What to Do?
- 23 April – Tax Technical Update – April 2024
- 30 April – Understanding the Downsizing Decisions your older clients need to make
- 30 April – Business Real Property – The SMSF client issues just waiting to explode
- 2 May – Latest Developments around Revenue Recognition (IFRS 15)

Questions?

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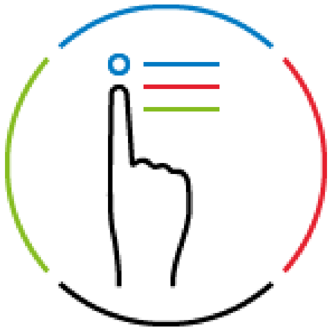

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