

# Local Tax Club – Geelong

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# CGT Main residence exemption

## Danger lurks beneath the surface

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# What we will cover

The CGT main residence exemption is a significant but deceptively complex concession, with many ways it can be gained, or inadvertently lost due to demolition, death, or absence. Against this background, and in the context of the main residence exemption, this session will address:

- Deriving income from a main residence
- Keeping the exemption when demolishing or subdividing
- Succession and deceased estate issues
- Absences, especially for foreign residents

# Key Concepts



# Core Criteria

- The sale or transfer needs to be on capital account!
  - Isolated profit-making transaction? Be cautious of property development!
- Generally only available to **Australian resident** individuals
  - 1 main residence between spouses (118-170)
  - Bare trust okay because of absolute entitlement
- “Main residence” and “Dwelling”
  - “The place of residence of an individual is determined, not by the situation of some business or property he is carrying on or owns, but by reference to where he eats and sleeps and has his settled or usual abode.” (Koitaki Para Rubber Estates Ltd)
  - Exhibit factors of residing/living in a residence, such as location of possessions, registered address under the electoral role, registered address for mailing purposes etc (TD 51 (withdrawn)).

# General

- Difficult to apply to everyday and common transactions
  - Renting out part of a dwelling
  - Subdividing the dwelling
  - Building a new dwelling
  - Using a dwelling during COVID
  - Cost base reset rules on first income producing use
  - Inheriting a dwelling from a deceased estate that was in turn inherited by the deceased from a previous deceased estate
  - Moving overseas

# Income producing use



# Income producing use: section 118-190

- What happens if you use part of the dwelling for income producing purposes?
  - Interest deductibility hypothetical - if you had incurred interest on money borrowed to acquire the whole dwelling, you could have deducted some or all of that interest.
  - The capital gain is increased by an amount that is reasonable having regard to the extent to which you would have been able to deduct that interest.

$$\text{Capital gain} \times \text{Percentage of floor area not used as main residence} \times \text{Percentage of period of ownership that that part of the home was not used as a main residence} = \text{Taxable portion}$$

- Floor space the default for apportionment (TD 1999/66)
- Only applies to “your assessable income.” If you let someone else use your main residence for their work, can still avail of full exemption (TD 1999/71)



# Income producing use: TD 1999/66

- John, a carpenter, has lived in his home for 10 years and he owns it. He has used the garage as a workshop for his carpentry business for the whole 10 years.
- Based on the area of the dwelling occupied by the garage, John estimates the workshop is 20% of the area of the whole dwelling. This is the basis on which John would have claimed an interest deduction if he had a mortgage on the property.
- John sells the home and makes a capital gain of \$25,000 from that CGT event.
- As the dwelling was John's main residence, he would have been able to disregard the whole capital gain of \$25,000. However, applying subsection 118-190(2), John has a capital gain of \$5,000 (20% of \$25,000) to be included in his assessable income.
- SB CGT concessions?!?!

# Income producing use: home office

- Home offices – have we lost a full main residence exemption?
- Unlikely per IT 2673 and what it means to have a “place of business.”
  - is set aside exclusively as a place of business;
  - is clearly identifiable as a place of business; and
  - is not readily suitable or adaptable for use for private or domestic purposes in association with the dwelling generally.
- TD 1999/66 (examples)

# Income producing use: side hustles

- Use of a residence for a 'side hustle'
- IT 2673 says what it means to have a "place of business."
- TR 93/30 says it is a balanced consideration of
  - the essential character of the area
  - the nature of the taxpayer's business
  - any other relevant factors
  - the area constitutes a "place of business" in the ordinary and common sense meaning of that term.
- TD 1999/66 (examples)

# Cost base reset – first income producing use (not a choice!)

- Cost base reset to market value when property used to produce assessable income **for the first time** – 118-192.
  - This resets acquisition dates for CGT purposes!
  - Note 12-month period for CGT discount!
- Can only apply if:
  - The Property was **first used** for producing assessable income **after 20 August 1996;**
  - The taxpayer is only eligible for a **partial exemption** in relation to the dwelling as it was used for the purpose of producing assessable income during the taxpayer's ownership period; and
  - The taxpayer would have been entitled to a full exemption if the CGT event had happened **just before the first time** it was used to produce assessable income.
- Interactions with the Absence Rule : ATOID 2003/1112 and ATOID 2003/1113 (Withdrawn).

# Absences



# Partial exemption: section 118-185

- Likely to be relevant if:
  - There are overlapping ownership periods of dwellings.
  - Acquired a dwelling while there were tenants living there.
  - Didn't move into the dwelling as soon as practicable.
  - Rented the dwelling for more than 6 years.
  - Inherited the dwelling via a deceased estate and did not dispose of dwelling within 2 years of deceased's death.
- Note also 50% CGT discount

# Absence Rule (118-145)

- Individuals who **cease** to occupy a dwelling and commence using it to derive assessable income can continue to treat the dwelling as their main residence **for up to 6 years.**
- If not rented out, dwelling can be treated as main residence indefinitely (subject to whether taxpayer wants to treat another property as a main residence and foreign resident interactions)
- Still need to have occupied the dwelling at some stage. Can't commence using it for investment purposes and treat it as a main residence.
- If you make the choice, you cannot treat any other dwelling as your main residence while you apply this section, except if section 118-140 (about changing main residences) applies.
  - See ATO ID 2001/743 (Withdrawn)

# Absence Rule (118-145)

- What constitutes “assessable income”?
  - Ordinarily, where a taxpayer grants a lease or licence of property, whether wholly or in part, whether at arms length or otherwise, the amount received as rent or in respect of the licence is assessable income
  - What about board/lodgings under a domestic family relationship? See IT 2167
- Must the 6 years be continuous? No, the periods are aggregated
- Can you reset the 6-year period by moving back in and then vacating? Yes
- When does the 6-year period start? Presumably when rental income first received.



# Example 1

- You bought a house in July 2020 and moved in immediately. In July 2023, you moved out and began to rent it. You sold it in July 2030, making (apart from this Subdivision) a capital gain of \$10,000. At the time you sold the house, you were an Australian resident
  - You can choose to continue to treat the dwelling as your main residence under section 118-145 (about absences) for the first 6 of the 7 years during which you rented the house out.
  - You will be taken to have made a capital gain of: 
$$\$10,000 \times \frac{365}{3,650} = \$1,000$$
- Assume that, when you moved in, you used  $\frac{1}{4}$  of the house as a doctor's surgery. Under section 118-115, your capital gain was \$1,000.
  - Under section, it would be reasonable to add an amount of:
  - You have a total capital gain of \$3,250 on the sale of the house? 
$$\$10,000 \times \frac{9}{10} \times \frac{1}{4} = \$2,250$$
- **What's wrong with this example!?!**

# Demolition and subdivision



# Demolition rule: section 118-150

- Tax payers can continue to apply the main residence exemption to and if there is a dwelling on the land at the time it was acquired and the taxpayer demolishes and builds a new dwelling on the land.
- Generally 4 years in which to demolish dwelling and move in and continue to treat it as a main residence. If dwelling tenanted, 4-year period starts when tenant vacates.
- Can also apply if there is no dwelling on the land but you construct a dwelling within 4 years.
- Taxpayers must move into the newly constructed dwelling “as soon as practicable” after it is completed and must be lived in for at least 3 months.
  - Per TD 92/147, “as soon as practicable” is:
    - when the certificate of occupancy is issued;
    - the date final building inspection approval is provided;
    - the date the dwelling becomes structurally complete; and
    - the date when utility connections are finalised.

# Demolition and subdivision - Example

- Mum and dad own an investment property (Dwelling A), which they rent to third party tenants.
- They previously lived in dwelling A and have continued to treat the property as their main residence under the 6-year absence rule.
- They are now considering:
  - Subdividing the Land into two lots, Lot B and Lot C;
  - Demolishing Dwelling A;
  - Building 2 units (Dwelling B and Dwelling C) on the respective subdivided parcels of Land, being Lot B and Lot C;
  - After Dwelling B has been constructed, leasing Dwelling B to a third-party tenant
  - Moving into and living Dwelling C for at least a couple of years.

***Is the CGT Main Residence exemption available for Dwelling C?***

# Demolition and subdivision - Example

- Dwelling C can continue to qualify as a main residence for an unbroken period. provided that:
  - The taxpayers move into Dwelling C as soon as practicable after construction has finished.
  - The taxpayers have made the Absence Choice (in accordance with section 118-145) in relation to the land from the time that Dwelling A has been rented
  - The taxpayers have made the Building Choice by continuing to treat Dwelling C as their main residence
  - The time from when the tenants vacate Dwelling A to when the taxpayers move into Dwelling C is less than 4 years; and
  - The taxpayers continue to treat Dwelling C as their main residence following construction (meaning that the ultimate disposal of Dwelling C will be completely exempt from CGT);
- Remember subdivision doesn't trigger a CGT Event – but requires an apportionment exercise regarding cost base – see TD 97/3
- What about dwelling B?

# Deceased estates



# Dwellings acquired from a deceased estate (118-195)

## Dwelling acquired from a deceased estate

- (1) A \* [capital gain](#) or \* [capital loss](#) you [make](#) from a \* [CGT event](#) that happens in relation to a \* [dwelling](#) or your \* [ownership interest](#) in it is disregarded if:
- (a) you are an [individual](#) and the [interest](#) \* passed to you as a beneficiary in a deceased estate, or you owned it as the [trustee](#) of a deceased estate; and
  - (b) at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied; and
  - (c) the deceased was not an \* [excluded foreign resident](#) just before the deceased's death.

Beneficiary or <a href="#">trustee</a> of deceased estate acquiring <a href="#">interest</a>		
Item	One of these items is satisfied	And also one of these items
1	the deceased * <a href="#">acquired</a> the * <a href="#">ownership interest</a> <i>on or after</i> 20 September 1985 and the * <a href="#">dwelling</a> was the deceased's main residence just before the deceased's death and was not then being <a href="#">used</a> for the * <a href="#">purpose of producing assessable income</a>	your * <a href="#">ownership interest ends</a> within 2 <a href="#">years</a> of the deceased's death, or within a longer period allowed by the <a href="#">Commissioner</a>
2	the deceased * <a href="#">acquired</a> the * <a href="#">ownership interest</a> before 20 September 1985	<p>the * <a href="#">dwelling</a> was, from the deceased's death until your * <a href="#">ownership interest ends</a>, the main residence of one or more of:</p> <ul style="list-style-type: none"><li>(a) the <a href="#">spouse</a> of the deceased immediately before the death (except a <a href="#">spouse</a> who was living permanently separately and apart from the deceased); or</li><li>(b) an <a href="#">individual</a> who had a right to occupy the <a href="#">dwelling under</a> the deceased's will; or</li><li>(c) if the * <a href="#">CGT event</a> was brought about by the <a href="#">individual</a> to whom the * <a href="#">ownership interest</a> * passed as a beneficiary--that <a href="#">individual</a></li></ul>

# Dwellings acquired from a deceased estate

- If taxpayer an individual, and he/she acquires a main residence from a deceased estate, then full CGT exemption on disposal of that property can be obtained by that individual.
- Depends on a range of factors including:
  - Whether the property was acquired by the deceased pre or post 20 September 1985
  - Whether, just before death, the deceased was using the property to produce assessable income
  - Whether the individual who inherits the main residence is a spouse or is a person with a right to occupy the main residence under the deceased's will
- Whether the deceased is an “excluded foreign resident” just before their date of death (discussed later) 2 years generally to sell the property and avail of full CGT exemption. Can be extended by the Commissioner – guidance under PCG 2019/5 – discussed later
- Extends to testamentary trusts – ATO ID 2004/882 and ATO ID 2006/34



# Dwellings acquired from a deceased estate

- If full exemption not available, then partial exemption is available. (118-200)
- The quantum of the capital gain is measured by comparing “non main residence days” to the number of “total days.”
- Non-main residence days =  $CG \text{ or } CL \text{ amount} \times \frac{\text{Nominal residence days}}{\text{Total days}}$ 
  - if the deceased acquired the ownership interest on or **after** 20 September 1985 - the number of days in the deceased's ownership period when the dwelling was not the deceased's main residence; plus
  - the number of days in the period from the death until your ownership interest ends when the dwelling was not the main residence of, broadly, you as beneficiary, the deceased's spouse or a person with a right to occupy under the will
- Total days =
  - if the deceased acquired the ownership interest before 20 September 1985 - the number of days in the period from the death until your ownership interest ends; or
  - If the deceased acquired the ownership interest on or **after** that day – the number of days in the period from the **acquisition of the dwelling by the deceased until your ownership interest ends.**
- Additional modifications if deceased acquired ownership interest from a deceased estate after September 1985 (section 118-205)

# Dwellings acquired from a deceased estate

- Tension between Subdivision 118-B and Division 128.
- What if deceased was renting out post-CGT dwelling at the time of death but availing of the 6-year absence rule under 118-45
  - Is a full CGT main residence exemption available? Not clear.
    - But relief still afforded under 118-200(3) and (4) if dwelling sold within 2 years of deceased's death.
  - Is the cost base reset to market value at the time of deceased's death? Not clear.
- What about adjacent land to the dwelling? Does that get a cost base reset?
- Issues identified by Treasury in 2011, but no further action.  
<https://treasury.gov.au/consultation/minor-amendments-to-the-capital-gains-tax-law>
- Perhaps merit in obtaining certainty from the ATO...

# Practical example: facts

- On 1 January 1975, W acquired a Property as joint tenant with H (her husband).
- W and H have always treated the Property as their main residence and never used it to derive assessable income.
- On 1 January 2005, H passed away and his 50% transferred to W (as per the rule of survivorship for joint tenants).
- On 1 January 2015, W passed away and transferred to her child, C , 100% of her interest in the Property.
- C has never lived in the Property and does not move into the Property.
- On 1 January 2016, C rents out the Property.
- On 1 January 2019, C sells the Property (settlement date)

## Questions

- What is the cost base of the dwelling in C's hands?
- Can C avail of the CGT main residence exemption?

# Practical example: cost base

- Are there two ownership interests? Do we have two separate cost bases? Are the interests amalgamated in some way?
  - 50% interest acquired when Property transferred to W upon death of H in 2005 (**Post CGT interest**) – surviving joint tenant rule s 128-50
  - 50% interest acquired when W first bought the Property in 1975 (**Pre CGT interest**)
- S 128-50(4) - Cost base reset to market value on date of death of deceased for pre-CGT assets (see TD 1999/72)
- BUT, then Property first used to produce assessable income on 1 January 2016
  - Is cost base reset to market value at this date? No! 118-192(3) deeming rule (via 118-197)
  - Property never main residence of C.

# Practical example: application to C

- Full CGT main residence exemption not available because Property not sold within 2 years or used as a main residence by a spouse or other beneficiary.
- Need to refer to 118-200 and 118-205 ITAA 97. Comparison between “non-main residence days” and “total days.” Modified if dwelling first inherited from a deceased.

# Practical example: application to C

## Post CGT 50% interest

- Non main residence days = 1462
  - Days from when W passed away (1/1/15) until time when Property settles (1/1/19)
- Total days – 12,518 (5114 + 7044)
  - Days between acquisition of interest by W (1/1/05) to when Property settles (1/1/19); AND
  - Days between 20 September 1985 to when W acquired H's interest (1/1/05) – extended rule per 118-205 as the interest was acquired by W from H.
- Capital gain = Capital gain amount x 1462/12,158
- Note: Total days formula modified by 118-205 – W is deemed to have acquired her interest from H via a deceased estate (despite being a joint tenant – see section 118-197)

# Practical example: application to C

## Pre CGT 50% interest

- Non main residence days = 1462
  - Days from when W passed away (1/1/15) until time when Property settles (1/1/19)
- Total days = 1462
  - Days from when W passed away (1/1/15) until time when Property sold (1/1/19)
- Capital gain = Capital gain amount x 1462/1462
- Fully taxable! A worse outcome despite being a pre-CGT interest!

# What could have been done differently?

- Sell the property within 2 years (based on settlement times!)
  - Even while generating assessable income? Would appear to be okay – TD 1999/70
  - Example:
    - You acquire a house as a beneficiary in a deceased estate, rent it out for 12 months and sell it within 2 years of the deceased's death. You can ignore the rental because the exemption does not require the house to be your main residence during the 2 years after the death. (118-190)
- Move into the Property and treat it as a main residence.
- Use a testamentary trust and give multiple beneficiaries a right to occupy the dwelling.
- Consider Commissioner's discretion to extend 2-year period – next slide



# Extending the 2-year period: PCG 2019/5

## Safe Harbour Guidelines:

- During the first two years after the deceased's death, **more than 12 months** was spent addressing one or more of the circumstances described in paragraph 12
- the dwelling was listed for sale as soon as practically possible after those circumstances were resolved (and the sale was actively managed to completion)
- the sale completed (settled) within 12 months of the dwelling being listed for sale
- if any of the circumstances described in paragraph 13 were applicable, they were **immaterial** to the delay in disposing of your interest, and
- the longer period for which you would otherwise need the discretion to be exercised is **no more than 18 months**.

## Paragraph 12 circumstances:

- the ownership of the dwelling, or the will, is challenged
- a life or other equitable interest given in the will delays the disposal of the dwelling
- the complexity of the deceased estate delays the completion of administration of the estate, or
- settlement of the contract of sale of the dwelling is delayed or falls through for reasons outside of your control.

## Paragraph 13 circumstances:

- waiting for the property market to pick up before selling the dwelling
- delay due to refurbishment of the dwelling to improve the sale price
- inconvenience on the part of the trustee or beneficiary to organise the sale of the house, or
- unexplained periods of inactivity by the executor in attending to the administration of the estate.

# Foreign residents



# Foreign residents | Key points

- Rules changed to deny main residence exemption to:
  - Excluded foreign residents
  - Foreign residents who do not satisfy the life events test
- Most individuals who are foreign residents at the time of signing the contract to sell their family home will be ineligible for the full (or even partial) main residence exemption
- Irrelevant that the individual may have been living in the family home as an Australian resident at any time since 1985
- Based on the time of the CGT event, even though the taxpayer's ownership interest continues until settlement (section 118-130)

# Basic case: section 118-110

- (1) A \* capital gain or \* capital loss you make from a \* CGT event that happens in relation to a \* CGT asset that is a \* dwelling or your \* ownership interest in it is disregarded if:
  - (a) you are an individual; and
  - (b) the dwelling was your main residence throughout your \* ownership period; and
  - (c) the interest did not \* pass to you as a beneficiary in, and you did not \* acquire it as a trustee of, the estate of a deceased person.
- (3) However, **this section does not apply if**, at the time the \* CGT event happens, you:
  - (a) are an \* **excluded foreign resident**; or
  - (b) are a **foreign resident who does not satisfy the \* life events test**.

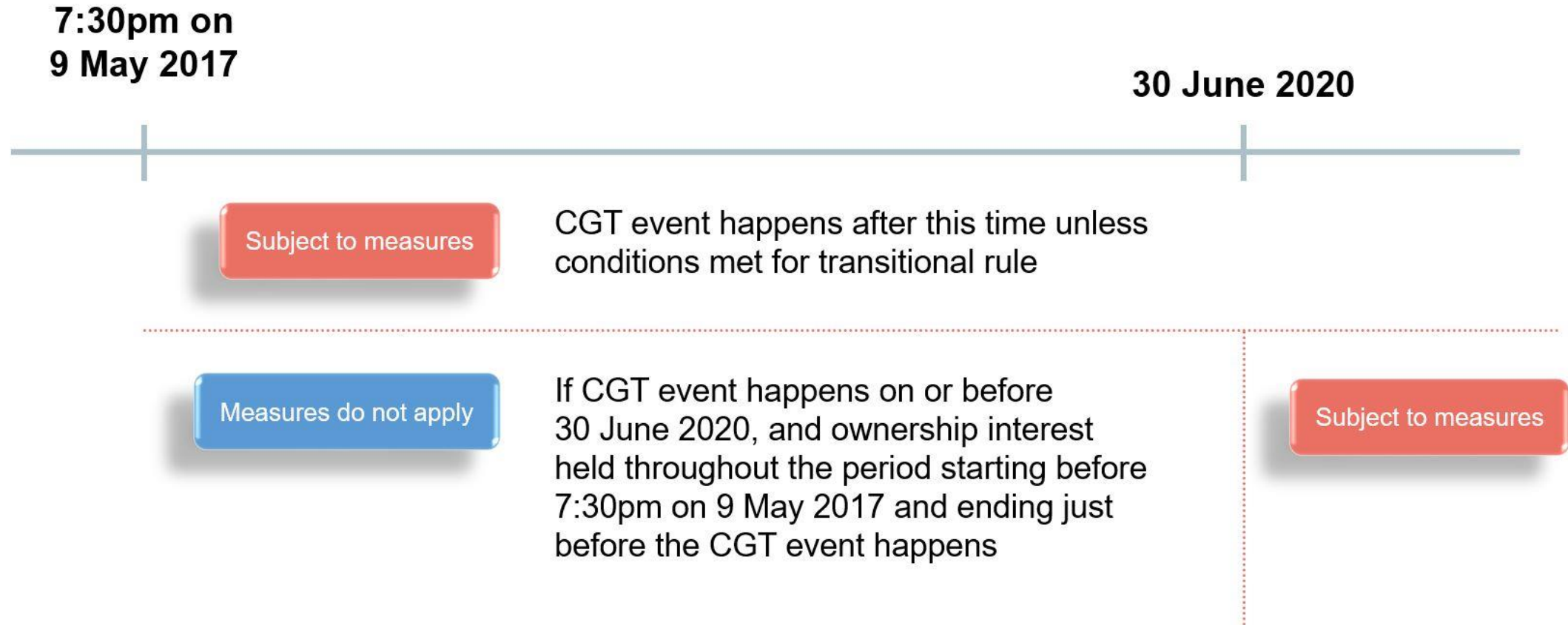
# Deceased estates: section 118-195

(1) A \* capital gain or \* capital loss you make from a \* CGT event that happens in relation to a \* dwelling or your \* ownership interest in it is disregarded if:

- (a) you are an individual and the interest \* passed to you as a beneficiary in a deceased estate, or you owned it as the trustee of a deceased estate; and
- (b) at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied; and
- (c) the deceased was not an \***excluded foreign resident** just before the deceased's death

Where the deceased is an “excluded foreign resident”, the cost base uplift to the market value on the date of death also does not apply.

# When do the measures apply?



# The core provisions

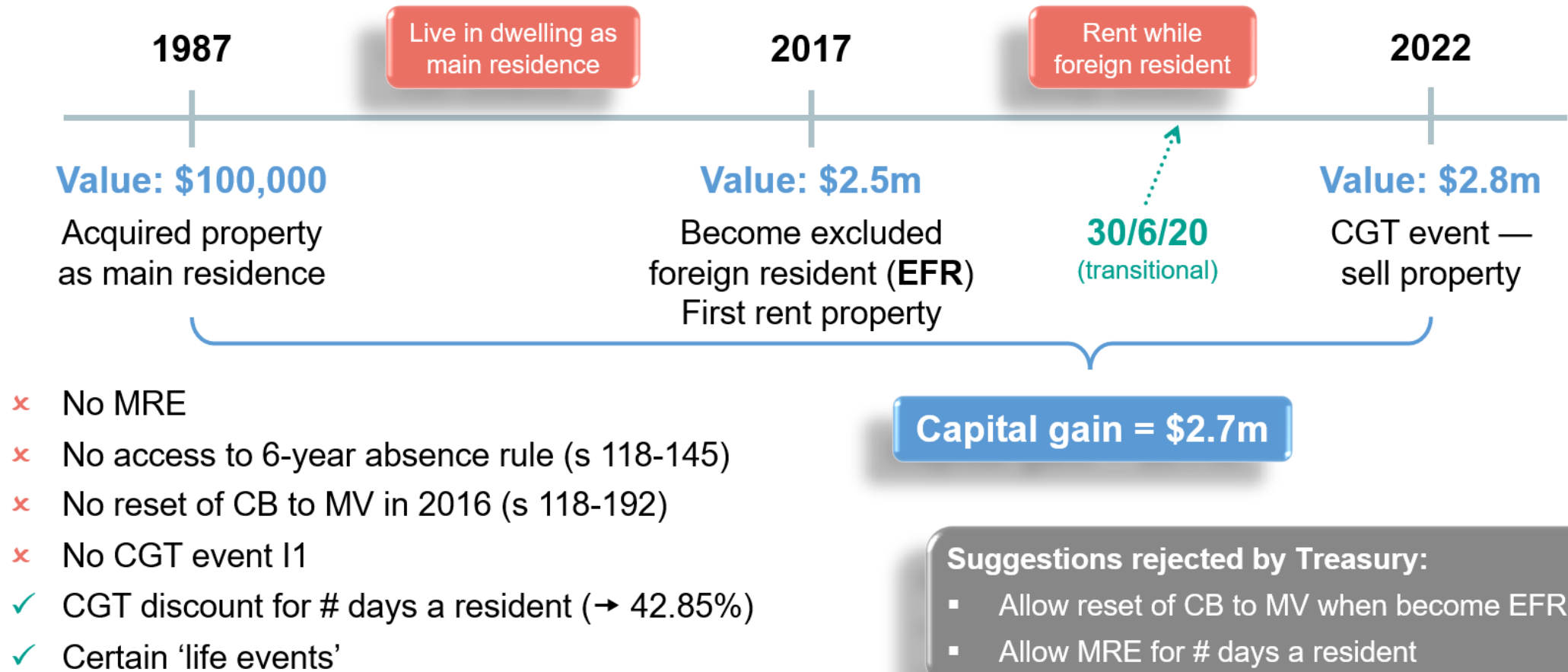
- CGT main residence exemption will no longer apply when, **at the time of the CGT Event**:
  - You are an “excluded foreign resident”: or
  - You are a foreign resident who does not satisfy the “life events test”.
- “Excluded foreign resident:”
  - A foreign resident at the time; and
  - the continuous period ending at that time for which you have been a foreign resident is ***more than*** 6 years.

# Life events test: subsection 118-110(5)

- Continuously been a foreign resident for no more than 6 years (this 6-year rule is **not** the same as the 6-year absence rule in section 118-145)
- You or your spouse had a **terminal medical condition** that existed at any time during that period of foreign residency
- Child had a terminal medical condition at any time during that period of foreign residency, and the child was under 18 years at that time
- Spouse or child under 18 years (at death) died during that period of foreign residency
- CGT event happens because of family law matter



# Case study | Impact on expatriates



# Beneficiaries of deceased estates

- Difficult to apply to everyday and common transactions

## Full CGT main residence exemption (section 118-195)

- The full CGT main residence exemption is **not** available if the deceased is an “excluded foreign resident” just before death
- The full CGT main residence exemption may be available where:
  - the deceased was a resident or foreign resident (but not excluded foreign resident) just before death; **and**
  - the dwelling is sold within two years of death; **or**
  - the dwelling is sold during the period when the dwelling was the main residence of the deceased’s spouse, a person with right to occupy under the deceased’s will, or the beneficiary (provided the beneficiary is not an excluded foreign resident)

# Beneficiaries of deceased estates

## Partial CGT main residence exemption (section 118-200)

- A partial CGT MRE may be available if the deceased was a **resident** or **foreign resident (but not an excluded foreign resident)** at death and the beneficiary a **foreign resident** at the time of the CGT event, the main residence exemption will apply to:
  - the days the dwelling was the main residence of the deceased; plus
  - the days the dwelling post-death was the main residence of a person with right to occupy under the deceased's will, or the beneficiary (provided the beneficiary is not an excluded foreign resident)
- A partial CGT MRE may be available if the deceased was an **excluded foreign resident**, the main residence exemption will only apply to:
  - the days the dwelling post death was the main residence of a person with right to occupy under the deceased's will, or the beneficiary (provided the beneficiary is not an excluded foreign resident)

# Foreign residents | Issues

- Lack of apportionment or step up in cost base for taxpayers who were previously residents and treated the dwelling as their main residence
- Determining the cost base of the property when records were most likely not retained (purchase price + all the elements of cost base)
- Deceased estates — if individual was an excluded foreign resident when they died, and beneficiary was an excluded foreign resident when they sold, no main residence exemption, regardless of actual use of dwelling as main residence

# Thank you

Please complete your evaluation form

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