The Tax Summit

Session 14.2: Examining less common CGT scenarios

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1. Overview

The ownership, development, investment and use of property can give rise to a number of significant tax issues, ranging from income tax, capital gains tax ("**CGT**"), GST and stamp duty. In the CGT arena, with the huge number of CGT events contained in the tax legislation, different transactions and use of property can give rise any number of different events. The CGT main residence exemption adds an extra layer of complexity.

While CGT event A1 is commonly known, there are a number of others that can arise in a number of situations. However, they are not common and can be missed.

The purpose of this paper is to consider five different scenarios that give rise to CGT implications that are not commonly known or understood. These are:

1. Compulsory acquisitions (this will include, for instance, land for road reservations in property developments);
2. Destruction/demolition of a dwelling on land (particularly the main residence);
3. Tips and traps about disposing of part of a site to downsize;
4. Other CGT events associated with property and property developments;
5. When an Australian tax resident disposes of a dwelling in another jurisdiction.

Unless otherwise specified, all legislative references in this paper are the *Income Tax Assessment Act 1997*.

2. Compulsory acquisitions

Compulsory acquisitions occur when the Government seizes land or property from individuals and/or entities for public purposes such as building infrastructure through a power conferred on them by law. Since there is a disposal of a CGT asset (generally, land or property) following a compulsory acquisition, this would constitute CGT event A1. However, special timing rules under sub-s 104-10(6) apply "*If the asset was *acquired from you by an entity under a power of compulsory acquisition conferred by an * Australian law or a * foreign law*". Under this sub-s, the timing of the event is the earliest of:

a) *when you received compensation from the entity; or*

b) *when the entity became the asset's owner; or*

c) *when the entity entered it under that power; or*

d) *when the entity took possession under that power."*

CGT is payable on the capital gain, which is the difference between the capital proceeds received and the cost base in the asset; the "capital proceeds" are broadly the consideration (that is, sale proceeds) that is received. The cost base is the costs in acquiring the CGT asset and certain costs in holding the asset. Where only part of an asset is disposed of, only part of the cost base is used to calculate the capital gain.

Ordinarily, the disposal of the CGT asset will result in CGT being payable. However, there are exemptions or concessions that may apply under certain circumstances. Where there is a CGT event involving a compulsory acquisition of the "adjacent land" of a main residence, a capital gain or capital loss incurred in relation to this CGT event is disregarded if the requirements under s 118-245 are met. Additionally, under s 118-147, where the taxpayer has an ownership interest in a substitute dwelling or land after their land or property is compulsorily acquired by the Government, then they may be able to elect to treat this substitute dwelling or land as their main residence such that the main residence exemptions apply to that substitute. Where neither of these exemptions or concessions apply, under Subdivision 124-B, a "roll-over" is available where assets are "compulsorily acquired, lost or destroyed". This subdivision applies where, *inter alia*, a CGT asset "*is compulsorily *acquired by an *Australian government agency*": para 124-70(1)(a).

2.1 Compulsory acquisition of the "adjacent land" of a main residence

Under s 118-245, where there is a compulsory acquisition of the "adjacent land" of a main residence, a capital gain or capital loss incurred from the CGT event relating to land ("**the exempt land**") may be fully or partially disregarded if:

a) you are an individual; and

*b) the exempt land is all or part of a * dwelling's * adjacent land at the time of the CGT event; and*

c) the CGT event does not happen in relation to the dwelling and does not happen in relation to your ownership interest in the dwelling; and

d) one of the following subparagraphs applies:

*i. the dwelling was your main residence throughout all or part of your * ownership period of the dwelling;*

*ii. your ownership interest in the dwelling * passed to you as a beneficiary in a deceased estate;*

iii. you own your ownership interest in the dwelling as the trustee of a deceased estate; and

iv. *section 118 - 250 (about compulsory acquisitions of adjacent land) applies to the CGT event and the exempt land; and*

e) *the sum of the following is 2 hectares or less (“**2 hectare rule**”):*

i. *the area of all of the dwelling's adjacent land at the time of the CGT event;*

ii. *the area of the land immediately under the dwelling;*

iii. *if this section applied to you for an earlier CGT event that involved reducing the area of the dwelling's adjacent land at the time of that earlier CGT event--that reduction in area.*

Therefore, according to s 118-245, there must be a CGT event involving a compulsory acquisition of an “adjacent land” or “adjacent structure” to a main resident, rather than the main resident dwelling itself. Note that land adjacent to dwelling is only adjacent land if it used primarily for private or domestic purposes: sub-s 118-120(2). Adjacent structures are defined as a garage, storeroom or other structure associated with a flat or home unit that are adjacent to the dwelling that are used primarily for private or domestic purposes: sub-s 118-120(6).

2.1.1 The 2-hectare rule

The maximum area of adjacent land is two hectares (or five acres): sub-s 118-120(3). However, this does not include land immediately under the dwelling. Full or partial exemptions can be applied when selling off these adjacent land or structures, where they are subject to compulsory acquisition by government bodies. In this regard, the maximum area that can include adjacent land would be reduced by the amount on which an exemption has already been claimed.

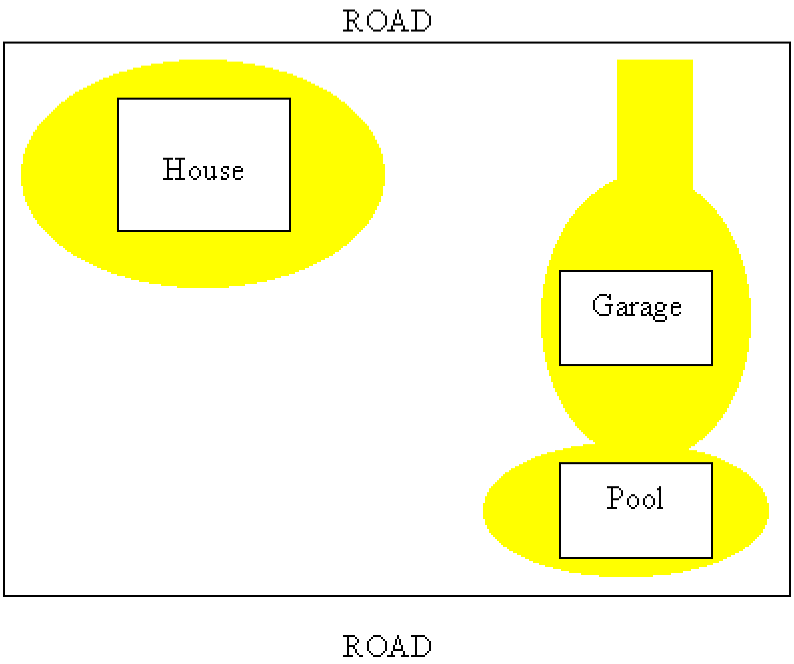
When adjacent land is more than two hectares, it is possible for the taxpayer to elect which portion of the land represents the “adjacent land”: Taxation Determination TD 1999/67. In this regard, the Commissioner makes the following points:

- If your selected area of land can be separately valued, you calculate your capital gain or capital loss on the remainder of your land by apportioning the capital proceeds and the cost base or reduced cost base (if applicable) on the basis of the valuation. This is relevant if the value of the remainder of the land is of a greater or lesser value than your selected area of land.
- If your selected area of land cannot be separately valued, your capital gain or loss on the remainder of your land may be calculated by apportioning the capital proceeds and the cost base or reduced cost base (if applicable) on an area basis.
- The amount of the capital gain or capital loss attributable to the remainder of your land must be reasonable in the circumstances.

The Commissioner provides the below example which is telling, as it indicates that the portion chosen does not need to be contiguous:

ATO Example 1, TD 1999/67

Alistair owns a 10 hectare property - see the diagram below. He has selected the shaded area as the part of the land on which he wishes to claim the main residence exemption. This area does not exceed 2 hectares and is used primarily for private or domestic purposes in association with Alistair's dwelling. He sells the property for $500,000. He obtains an opinion from an expert valuer that the value of the 2 hectares of land and the house is $300,000. The cost base attributable to this part of the property (taking into account improvements since *purchase) is $180,000 and the remainder is $120,000. The capital gain on the total property is $200,000. Alistair disregards $120,000 of the capital gain because it is attributable to his main residence.*



2.2 Treating a substitute dwelling or land as main residence

Section 118-147 permits taxpayers to transfer the main residence status to a replacement dwelling, even if they have never resided in it, under the following conditions:

a. the original dwelling ("**old dwelling**") is considered the taxpayer's main residence due to an election made under s 118-145 (para 118-147(1)(a));

a. the old dwelling must be, as defined in sub-s 124-70(1) compulsorily acquired by an Australian government agency or an entity with compulsory acquisition authority or totally or partially lost or destroyed (**"the key event"**) (para 118-147(1)(b)); and

b. as a result of the acquisition, loss, or destruction, the taxpayer ceases to have any ownership interest in the old dwelling (para 118-147(1)(c)).

Following the key event, the taxpayer acquires an ownership interest in a replacement property ("**the substitute property interest**"), which can be either a dwelling ("**the substitute dwelling**") or land ("**the substitute land**"). The substitute property interest must be acquired within one year after the end of the income year in which the old dwelling was compulsorily acquired or destroyed. This timeframe may be extended by the Commissioner in certain circumstances: para 118-147(1)(d)).

Taxpayers can elect to treat the substitute dwelling, or a dwelling constructed on the substitute land, as their main residence from the later of:

a. The date of acquisition of the substitute property interest; or

b. One year before the key event occurred.

2.3 Subdivision 124-B CGT roll-over

As previously discussed, since there is a disposal of a CGT asset following a compulsory acquisition, this will result in CGT being payable on any capital gain, which is the difference between the capital proceeds received and the cost base in the asset. However, where the CGT exemptions or concessions under s 118-245 or s 118-147 are not applicable, there is a "roll-over" available under Subdivision 124-B, where assets are "compulsorily acquired, lost or destroyed". This subdivision applies where, *inter alia,* a CGT asset "*is compulsorily *acquired by an *Australian government agency":* para 124-70(1)(a).

2.3.1 Where money is received as compensation

Key Conditions

Where money is received as compensation for the key event, the conditions to satisfy the roll-over are contained in s 124-75. In particular, and amongst other things:

a. *"You must…incur expenditure in *acquiring another *CGT asset (except a *depreciating asset whose decline in value is worked out under Division 40 or deductions for which are calculated under Division 328"* (para 124-75(2)(a));

b. *"At least some of the expenditure must be incurred…no later than one year, or within such further time as the Commissioner allows in special circumstances, after the end of the income year in which the event happens"* (para 124-75(2)(b)); and

c. Either:

    a. if the original asset is an active asset of a business, the replacement asset must be an active asset of the business (sub-s 124-75(4)); or

    b. the replacement asset must be used for the same or similar purpose for which the original asset was used just before the key event (sub-s 124-75(4)).

With respect to (b), the time limit runs from the end of the income year in which the key event incurred. Where the expenditure is not incurred within one year from the end of the income year in which the key event incurred, then an application can be made to the Commissioner of Taxation requesting for an extension, demonstrating special circumstances.

With respect to (c), the replacement asset must be used for a reasonable time as an active asset of the business, or for the same or similar purpose for which the original asset was used. Whether the replacement asset is used for the same or similar purpose for which the original asset was used is a question of fact and degree. Taxation Determination TD 2000/42 provides some examples:

ATO Example 1, TD 2000/42

"Steve owned machinery for use in his manufacturing business. The machinery is destroyed by a fire. He replaces the machinery with a rental property. The rental property is not used for the same or a similar purpose to the purpose for which the machinery was used."

ATO Example 2, TD 2000/42

"Geoff owned a printing press which he used in his business. The printing press is entirely destroyed by a fire and Geoff decides to close down his printing business and to open a pet shop. He uses the insurance proceeds from the destruction of the printing press to acquire shop fittings he needs for his new pet shop. For the

purposes of Subdivision 124-B, these replacement assets do not satisfy the business asset test in subsection 124-75(4) because they are not used in the printing business. Additionally, the shop fittings do not satisfy the same or similar purpose test in the subsection. This is so because, although both the printing press and the shop fittings are assets used in a business, they are not used for the same or a similar purpose in the respective businesses."

ATO Example 3, TD 2000/42

"Marina owns a house near the sea which she has always rented out. The house has, for capital gains purposes, been treated as an asset separate from the land on which it is situated — the land having been acquired in 1980 — because of the operation of Subdivision 108-D. The house is destroyed by a cyclone and she has the choice of either:

d. *acquiring a city unit for rental purposes; or*

e. *rebuilding the house to use as her main residence.*

For the purposes of Subdivision 124-B, the use of the city unit will fall within the scope of the same or similar purpose test. The use of the new building as a main residence will not."

In accordance with Taxation Determination TD 2000/41, there is no restriction on the number of CGT assets which may be treated as replacement assets for an original CGT asset under Subdivision 124-B. However, if more than one CGT asset is acquired as a replacement asset for the original CGT asset, each separate CGT asset must satisfy the relevant conditions of the subdivision.

Consequences of a roll-over being available

The consequences of a roll-over being available under subdiv 124-B differ depending on whether the original asset was acquired before 20 September 1985, or on or after that date. If the original asset was acquired on or after 20 September 1985, the following CGT consequences apply:

a. If the money received is in excess of the expenditure incurred to acquire the replacement asset, and the gain is greater than this excess, then the gain is reduced to match the excess, and the expenditure is reduced by the amount by which the original gain is greater than the excess;

b. If the money received is in excess of the expenditure and the gain is less than or equal to the excess, the gain remains unchanged; or

c. If the money received does not exceed the expenditure, the gain is disregarded, but the expenditure is reduced by the amount of the gain.

2.3.2 Where an asset is received as compensation

Key Conditions

Where an asset is received as compensation for the key event, the conditions to satisfy the roll-over are contained in s 124-80. In particular, and amongst other things:

a. the replacement asset must not be included in the taxpayer's trading stock;

b. the replacement asset must not be a depreciating asset; and

c. the market value of the replacement asset must be greater than the cost base of the original asset just before the key event.

Consequences of a roll-over being available

Where an asset is received as compensation, any capital gain made from the original asset is disregarded.

3. Destruction of a dwelling on land

Destruction of a dwelling is not a straight-forward case of CGT event C1 occurring, subject to exceptions such as the main residence exception. This is, of course, a relevant consideration. However, there are a number of other tax implications to be considered.

In this paper, we have considered the following situations:

- The CGT outcome for involuntary and voluntary destruction of dwelling.
- Division 43 balancing adjustments where the dwelling is destroyed before deductions have been claimed in full.
- Building/repairing/renovating a main residence that is damaged or destroyed.
- Destruction of the dwelling where it is considered a separate asset from the land.

3.1 The CGT outcome for involuntary and voluntary destruction of dwelling

Where a dwelling is destroyed, CGT event C1 may be triggered: s 104-20. Destruction includes both voluntary and involuntary destruction (e.g. by way of demolition). However, CGT event C1 only applies if you own the dwelling (e.g. you are the registered proprietor of the dwelling).

If CGT event C1 applies, it happens when:

- a taxpayer first receives compensation for the destruction, such as amounts received under an insurance policy; or

- if no compensation is received - the destruction occurred.

If nothing is received for the demolition of a dwelling, there should be no capital gain. This is because the market value substitution rules for capital proceeds do not apply to CGT event C1: s 116-25.

3.2 Division 43 balancing adjustments where the dwelling is destroyed before deductions have been claimed in full

Broadly, taxpayers may deduct amounts for capital expenditure on the construction of capital works (i.e. “construction expenditure”) under Division 43: ss 43-10 and 43-15. Construction expenditure include buildings, structural improvements and environment protection earthworks (or extensions, alterations or improvements to the same): s 43-20. These deductions are claimed at 2.5% over a period of 40 years (or 4% over a period of 25 years in certain limited cases), and cannot be deducted before construction is complete: ss 43-25 and 43-30. However, the construction expenditure must have been incurred for the purpose of producing assessable income or conducting R&D activities (additional requirements apply in the case of the 4% rate of deduction): ss 43-140 and 43-145.

However, a question arises as to what happens to the remainder of unclaimed deductions if the dwelling is destroyed before deductions have been claimed in full. Broadly, the taxpayer will be able to deduct any excess of undeducted construction expenditure with respect to the capital works that have been destroyed over the amounts that the taxpayer has received or has a right to receive for the destruction: s 43-250. For example, this could be an amount received under an insurance payout: s 43-255.

A word of caution is that the deductions can only be deducted by a taxpayer if that taxpayer:

- owns, leases or holds part of a construction expenditure area of capital works (“your area”);
- incurred the construction expenditure or is an assignee of the lessee or holder who incurred the expense; and
- uses “your area” to produce assessable income or in some cases for carrying on R&D activities.

3.3 Building/repairing/renovating a dwelling that is damaged or destroyed

Where a taxpayer builds a dwelling on the land or repairs/renovates the dwelling (i.e. the “replacement dwelling”) where their main residence was damaged or destroyed, the taxpayer may be entitled to choose to apply an exemption under section 118-150. This exemption treats the replacement dwelling as if it were the taxpayer’s main residence from the beginning of the period in which they acquired the land.

However, this only applies if:

- the taxpayer moves into the dwelling “as soon as practicable after the work is finished”; and
- the dwelling continues to be the taxpayer’s dwelling for at least three months.

Practically, this raises certain issues. In particular, what does the phrase “as soon as practicable after the work is finished” actually mean. Taxation Determination TD 92/147 has a few examples dealing with the “as soon as practicable” condition. These are:

- Where a Certificate of Occupancy issues but it is not possible to move furniture and belongings into the dwelling because of severe flooding, the taxpayer can satisfy the condition if they move in as soon as possible after the flooding subsides;
- The taxpayer travels overseas while a dwelling is constructed, and does not move in until after her return to Australia. However, in the this time was four-to-five months after the dwelling was completed. She does not satisfy the condition.
- The taxpayer travels overseas for work while a dwelling is constructed, and does not move in until after his return to Australia, as he was not able to return earlier. The time of moving in was three-to-four months after the dwelling was completed. He does satisfy the condition.

3.4 Destruction of the dwelling where it is considered a separate asset from the land

Usually, a dwelling would be considered a single asset together with the land it is located on. However, in some instances, it may be considered a separate CGT asset from the land. This can occur in two situations:

- Where the underlying land was purchased before 20 September 1985. However, the contract for construction or the construction work of the dwelling commenced on or after 20 September 1985: sub-s 108-55(2). For example, settlement for your purchase of the land completed before 20 September 1985. However, you begin construction of the dwelling on the land three months later.
- If the underlying land was purchased on or after 20 September 1985, the dwelling may be considered a separate asset if the balancing adjustments under Subdivision 40-D, s 355-315 or s 355-525 apply to the dwelling: sub-s 108-55(1). For example, the dwelling might not be a building. Instead, it may be a portable dwelling that can easily be removed from the land.

If the dwelling is considered a separate asset from the land, then the CGT rules will apply to that dwelling (even though it is on “pre-CGT” land).

4. Tips and traps about disposing of part of a site to downsize

There are various options available to taxpayers when downsizing. In this paper, we have considered the following scenarios:

- a taxpayer subdivides the site on which their main residence is situated and sells the vacant subdivided lot;
- a taxpayer subdivides the site on which their main residence is situated, builds a house on the newly subdivided lot, and sells the subdivided lot with the newly built house;
- a taxpayer subdivides the site on which their main residence is situated, builds a house on the newly subdivided lot, sells the subdivided lot with the original house and keeps the subdivided lot with the newly built house;
- a taxpayer knocks down their main residence and build a duplex in its place. Immediately after construction, one side of the duplex is sold to a third party and the other is maintained as a main residence of the taxpayer; and
- a taxpayer converts their multi-storey house into separate apartments under strata title and then sells those apartments.

As a starting point, we note that when a CGT asset is split into two or more new assets, there is ordinarily no CGT event. Instead, the cost base (and reduced cost base) is apportioned between the two assets on a reasonable basis: s 112-25. Therefore, the act of subdividing (and constructing, if relevant) should not be a CGT event. However, a taxing event may be triggered on a subsequent sale.

4.1 A taxpayer subdivides the site on which their main residence is situated and sells the vacant subdivided lot

If the taxpayer subdivides the property, keeps the lot on which the main residence is located and sells the vacant subdivided lot, the main residence exemption should not extend to the sale of the vacant subdivided lot: s 118-165. Instead, the sale of the vacant subdivided lot should be subject to capital gains tax (with the relevant discount to the capital gain if the rules are satisfied). If the sale of the vacant subdivided lot is on revenue account (e.g. there was a profit-making intention in the subdivision and sale of that lot), the amount received would be treated as income and included in the calculation of the assessable income of the taxpayer.

4.2 A taxpayer subdivides the site on which their main residence is situated, builds a house on the newly subdivided lot, and sells the subdivided lot with the newly built house

Similarly, the main residence exemption should not extend to the sale of the subdivided lot with the newly built house.

In any event, the amount received would likely be considered income under ordinary concepts or income made from a disposal with a profit-making intention (to which the main residence exemption has no application). The amount received would therefore be included in the calculation of the taxpayer's assessable income.

4.3 A taxpayer subdivides the site on which their main residence is situated, builds a house on the newly subdivided lot, sells the subdivided lot with the original house and keeps the subdivided lot with the newly built house

Where the new house is kept and the original house is sold, we would ordinarily expect the main residence exemption to apply.

When the taxpayer then moves into the newly built house on the subdivided lot, that new house may become the new "main residence" of the taxpayer. However, the taxpayer is likely only able to obtain a partial exemption for the new house as it would not have been the main residence of the taxpayer for the entire period in which the taxpayer owned the land. Under s 118-185, the relevant formula for apportionment is as follows:

CG or CL amount x (Non-main residence days / Days in your ownership period)

In this regard:

- "CG or CL amount" is the capital gain or loss the taxpayer would have made apart from the exemption.
- "Non-main residence days" is the number of days in the taxpayer's ownership period when the newly built dwelling was not the main residence.

4.4 A taxpayer knocks down their main residence and build a duplex in its place. Immediately after construction, one side of the duplex is sold to a third party and the other is maintained as a main residence of the taxpayer

Even if the main residence exemption were available for CGT purposes, the sold portion of the duplex may be taxed on revenue account on the basis that it was sold with the intention of making a profit. The amount received would therefore be included in the calculation of the taxpayer's assessable income.

4.5 A taxpayer converts their multi-storey house into separate apartments under strata title and then sells those apartments

This situation involves stratifying an existing residence and selling the different strata title units. This has some very difficult consequences to fathom, leading to questions as to which of the two units was the main residence for the purposes of the exemption. This situation is rare in Australia and the tax position remains unsettled.

Different situations that may arise could include:

- Where one unit is kept (the "**lived unit"**) and the other is rented out (the "**other unit"**). Assuming the other unit is now on a separate title, the other unit should no longer be a "main residence" of the taxpayer and, therefore, CGT should arise on a subsequent sale.
- However, where the lived unit and the other unit are not on separate titles, and the other unit is rented, then a partial main residence may be available: s 118-190.

5. Other CGT events associated with property and property developments

The most common CGT event associated with property and property developments is CGT event A1, which involves the disposal of a CGT asset. However, there are various less common CGT events associated with property and property developments, which are detailed below.

5.1 CGT event B1

Under sub-s 104-15(1), CGT event B1 occurs if you enter into an agreement with another entity and under that agreement:

a. *"The right to the use and enjoyment of a CGT asset you own passes to the other entity; and*

b. *Title in the asset will or may pass to the other entity at or before the end of the agreement."*

The time of the event is the first point at which the other entity is entitled to use and enjoy the asset: sub-s 104-15(2).

If title in the asset does not pass during or at the end of the agreement, any capital gain or loss made is disregarded: sub-s 104-15(4).

If there is a "terms contract" with respect to a sale and purchase of land agreement whereby the purchaser is entitled to possession of the land, or to the receipt of rents and profits prior to the transfer of the land, then CGT event B1 occurs.

Taxation Determination TD 1999/78 provides examples of when CGT event B1 does not occur:

ATO Example 1, TD 1999/78

Perry allows his son use and enjoyment of the family holiday house as and when his son wishes with an expectation that some time in the future, when his son can afford to buy it, the title of the house will pass to him. This type of loose family arrangement does not fall within CGT event B1 because there is no agreement under which title will or may pass and because there is no specific point of time or particular occurrence when the arrangement will end.

ATO Example 2, TD 1999/78

Bill leases a parcel of land, giving him use and enjoyment of the land. As part of the agreement with the lessor, Bill is granted a right of first refusal for the acquisition of the land, so that if the lessor decides to sell the property, he has to offer it to Bill first. This situation is not covered by CGT event B1 because the agreement is not one under which title will or may pass at the end of the agreement.

5.2 CGT event D1

Under sub-s 104-35(1), CGT event D1 occurs if a contractual, or other legal or equitable right in another entity is created. Examples include where there is an easement over land or where the owner of a property grants certain management rights over their property.

The time of the event is when the contract is entered into or when the other right is created: sub-s 104-35(2).

Sub-s 104-35(5) specifies that CGT event D1 does not occur when:

a. *"You created the right by borrowing money or obtaining credit from another entity; or*

b. *The right requires you to do something that is another CGT event that happens to you; or*

…

g. *You created the right by creating in another entity a right to receive an *exploration benefit under a *farm-in farm-out arrangement."*

5.3 CGT event D2

CGT event D2 occurs when an option is granted to an entity, or an option that is granted is renewed or extended: sub-s 104-40(1).

The time of the event is when the option is granted, renewed or extended: sub-s 104-40(2).

If the option is exercised, any capital gain or loss made from the grant, renewal or extension of the option is disregarded: sub-s 104-40(5).

5.4 CGT event D4

CGT event D4 occurs when a conservation covenant is entered into over land that you own: sub-s 104-47(1).

"Conservation covenant" is defined in sub-s 31-5(5) as a covenant meeting the three below conditions:

a. "*Restricts or prohibits certain activities on the land that could degrade the environmental value of the land; and*

b. *Is permanent and registered on the title to the land (if registration is possible); and*

c. *Is approved in writing by, or is entered into under a program approved in writing by, the *Environment Minister."*

The time of the event is when the covenant is entered into: sub-s 104-47(2).

A capital gain occurs where the capital proceeds from entering into the conservation covenant is greater than the part of the cost base of the land that is apportioned to the covenant, and a capital loss occurs if the capital proceeds are less than the part of the cost base of the land that is apportioned to the covenant: sub-s 104-47(3).

The formula to calculate the part of the cost base of the land that is apportioned to the covenant is provided under sub-s 104-47(4):

**Cost base of land x (*Capital proceeds from entering into the covenant/those capital proceeds plus the *market value of the land just after you enter into the covenant)*

CCH iKnow provides examples (adapted from the Supplementary Explanatory Memorandum to the *Taxation Laws Amendment Bill (No. 2) 2001*) of the calculation of the cost base of the covenant and the net capital gain.

CCH iKnow Example 1[1]

Jane enters into a conservation covenant with a deductible gift recipient for no consideration. The covenant covers 20% of the land she owns. Jane acquired the land on 19 May 1995 and uses it in her farming business. For the purposes of the CGT small business concession, the net value of the CGT asset is less than $5m and the land is an active asset (s 152-40).

The cost base of Jane's land is $600,000. The market value of the land before entering the covenant is $1m. The market value of the land after entering the covenant is $800,000.

The deduction under Div 31 (s 31-5) is $200,000 ($1m − $800,000).

As no consideration is received for entering into the covenant, the capital proceeds from the CGT event are taken to be the amount of the deduction (ie $200,000). This amount is relevant to the calculation of the capital gain and of the cost base of the land attributable to the covenant under s 104-47(4).

The cost base of the land attributable to the covenant is $120,000, calculated as follows:

$600,000 × $200,000 ÷ ($200,000 + $800,000)

The capital gain is $80,000 (ie $200,000 − $120,000).

If the CGT discount under Div 115 applies, the capital gain is reduced by 50% to $40,000.

If the small business concession under Div 152 applies, the capital gain is further reduced by 50% to $20,000.

The net result of entering into the conservation covenant is a deduction under Div 31 of $200,000 and a capital gain of $20,000. For the purposes of calculating any capital gains on the subsequent disposal of the land, the cost base of the land is reduced to $480,000 (ie $600,000 − $120,000).

CCH iKnow Example 2[2]

The cost base of land owned by Bruce is $200,000. Bruce receives $10,000 for entering into a conservation covenant covering 15% of the land. The market value of the land before entering into the covenant is $300,000 and after entering into the covenant is $285,000. In this case, the deduction to Bruce for entering into the covenant is $15,000 (ie $300,000 − $285,000). The cost base of the land that is apportioned to the covenant is calculated as follows:

$200,000 × 10,000 ÷ (10,000 + 285,000) = $6,780

As the proceeds from entering into the covenant ($10,000) exceed the part of the cost base attributable to the covenant, the excess ($3,220) is a capital gain. If the land is subsequently disposed of, any capital gain or loss is calculated on the basis of a cost base of $193,220 (ie $200,000 − $6,780).

5.5 CGT event E1

CGT event E1 occurs when a trust is created over a CGT asset either by declaration or settlement: sub-s 104-55(1). However, under sub-s 104-55(5), it does not occur if you are an absolute beneficiary of the trust and:

a. "*You are absolutely entitled to the asset as against the trustee (disregarding any legal disability); and*

[1] CCH iKnow, *CGT event D4 – conservation covenants* (Web Page) <[CGT event D4 — conservation covenants - CCH iKnow | Australian Tax & Accounting]()>.
[2] Ibid.

b. *The trust is not a unit trust."*

The time of the event is when the trust over the CGT asset is created: sub-s 104-55(2).

In *Taras Nominees Pty Ltd as Trustee for the Burnley Street Trust v FC of T* 2015 ATC, the taxpayer was the owner of a land ("**Tara's Land**") and entered into a joint venture agreement ("**JVA**"). As part of this JVA, the taxpayer executed an instrument of transfer of Tara's Land to a "Land Trustee" whereby the Land Trustee was to hold Tara's Land in accordance with a trust deed that included the JVA terms.

The Federal Court held that the taxpayer created a trust over Tara's Land by settlement, as the transfer of Tara's Land to a "Land Trustee" changed the taxpayer's rights over the land in manner that was similar to a settlement on trust. Moreover, the exemptions under sub-s 104-55(5) were held not to apply. This is because the taxpayer merely had a right to be paid a price from the development profits, which constituted a "pecuniary interest" such that the taxpayer was not the sole beneficiary, nor were they absolutely entitled to the asset as against the trustee. Therefore, CGT event E1 had occurred in this case.

5.6 CGT event E2

CGT event E2 occurs when a CGT asset is transferred to an existing trust: sub-s 104-60(1).

The time of the event is when the asset is transferred: sub-s 104-60(2).

With respect to the *Taras Nominees Pty Ltd as Trustee for the Burnley Street Trust v FC of T* 2015 ATC example provided in relation to CGT event E1, the Federal Court held that CGT event E2 did not occur, since the trust was not completed until the executed instrument of transfer was provided to the trustee. On that basis, there was no existing trust at the time that the taxpayer executed the instrument of transfer.

5.7 CGT event E5

CGT event E5 occurs if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust where Division 128 would apply) as against the trustee. In Draft Taxation Ruling TR 2004/D25, the Commissioner of Taxation stated that generally, if a beneficiary who has a vested and indefeasible interest in the whole trust asset is able to call for the asset to be transferred to them and in a way that is directed by them, this should constitute absolute entitlement to a CGT asset of a trust.

Under s 106-50, once a beneficiary becomes absolutely entitled to a CGT asset as against the trustee of a trust, any act done in relation to the asset by the trustee is treated as if they were acts of the beneficiary. Therefore, in this instance, if the trustee sells the asset, then the capital gain or loss from the sale is made by the beneficiary rather than the trustee: ATO Interpretative Decision ATO ID 2013/33.

5.8 CGT event E6

CGT event E6 occurs if the trustee of a trust (other than a unit trust or a trust where Division 128 would apply) disposes of a CGT asset of the trust to a beneficiary in order to satisfy their right to receive ordinary or statutory income from the trust: sub-s 104-80(1).

The time of the event is when the disposal happens: sub-s 104-80(1).

A capital gain or loss can arise for the trustee of a trust or a beneficiary of the trust. The trustee of the trust makes a capital gain where the asset's market value at the time of disposal is greater than its cost base, and a capital loss if it is less than its cost base: sub-s 104-80(3). The beneficiary of the trust makes a capital gain where the asset's market value (at the time of the disposal) is greater than the cost base of the right, and a capital loss where the market value is less than the reduced cost base of the right: sub-s 104-85(5).

5.9 CGT event E7

CGT event E7 occurs if the trustee of a trust (other than a unit trust or a trust where Division 128 would apply) disposes of a CGT asset of the trust to a beneficiary in order to satisfy their interest in the trust capital: sub-s 104-85(1).

The time of the event is when the disposal happens: sub-s 104-85(2).

Similar to CGT event E6, a capital gain or loss can arise for the trustee of a trust or a beneficiary of the trust. The trustee of the trust makes a capital gain where the asset's market value at the time of disposal is greater than its cost base, and a capital loss if it is less than its cost base: sub-s 104-85(3). The beneficiary of the trust makes a capital gain where the asset's market value (at the time of the disposal) is greater than the cost base of the interest, and a capital loss where the market value is less than the reduced cost base of the interest: sub-s 104-85(5).

5.10 CGT event E8

CGT event E8 occurs if a beneficiary under a trust (other than a unit trust or a trust to which Division 128 applies) disposes of all or part of their interest in the trust to someone who is not a trustee of the trust, and they also did not give any money or property to acquire the interest or acquire the interest by assignment: sub-s 104-90(1).

The time of the event is either when the contract for the disposal is entered into, or if there is no contract entered into, it is when you stop owning the interest or part: sub-s 104-90(2).

In Taxation Determination TD 2009/19, it was stated that a taker in default could not have an interest in the trust capital such that CGT event E8 would apply. This is because takers in default have defeasible interests.

5.11 CGT event E9

CGT event E9 occurs if you agree for consideration to hold property on trust when the property is created, and there is not a beneficiary at the time of the agreement who had a beneficial interest in the rights created by the agreement: sub-s 104-105(1).

The time of the event is when the agreement is made: sub-s 104-105(2).

CGT event E9 occurs, for instance, where a pre-admission *Everett* assignment occurs (this is when a prospective partner to a partnership agrees that, on becoming partner, they will hold a share of the partnership on trust for another person, or will assign that share to them. On becoming partner, the new partner becomes a trustee of the partnership interest (or the part assigned) (*Norman* (1963) 109 CLR 9; 13 ATD 13).

This is similar to CGT event D1, which occurs where the assignment is made to a particular person. CGT event E9 occurs when the partner holds the partnership share as trustee for a discretionary trust and it is not vested in another person.

5.12 CGT event H1

CGT event H1 occurs if a deposit that is paid is forfeited due to a prospective sale or other transaction not proceeding: sub-s 104-150(1).

The deposit amount is reduced by any part of the deposit that is repaid or the amount of compensation that constitutes a repayment of part or all of the deposit: sub-s 104-150(1A). However, the deposit amount is not reduced by any payment amount that could be deducted: sub-s 104-150(1B).

It was decided by the Federal Court in *Brooks v FC of T* 2000 ATC 4632 that there is a “prospective purchase” both prior to a contract being entered into and at any point between the contract being entered into and completion. In this case, the trustees of two family trusts owned a property as joint tenants. They entered into a contract of sale of the property where the purchasers paid a $31,500 deposit. However, the purchasers failed to complete the purchase and the contract was terminated. As a result, the deposit was forfeited. The trustees had incurred $888 of joint costs on the making and termination of the contract. The Federal Court held that each trustee had incurred a capital gain of $15,306.

The Commissioner explains the concept of a “continuum of events” in Taxation Ruling TR 1999/19. A “continuum of events” exists where there is a series of continuous and unbroken attempts to resell the property after the forfeiture of the deposit. However, a delay in putting the property back on the market for reasons such as time taken to consultant a legal adviser does not necessarily break the “continuum of events”. The deposit is not assessable where it is forfeited under a contract of sale of a pre-CGT asset and the forfeiture occurs within a continuum of events. Where there is a forfeiture under a contract of sale of a post-CGT asset, and it occurs within a continuum of events, the deposit then forms part of the capital proceeds from CGT event A1 when it is sold. Taxation Ruling TR 1999/19 provides examples of this:

ATO Example 3, TR 1999/19

Olivia purchased a vacant block of land in August 1988. In April 1989 she entered into a contract to sell the land for $460,000. A deposit of $46,000 was paid under the contract, settlement being due in April 1990. The purchaser later defaulted and in May 1990 Olivia terminated the contract and the deposit was forfeited to her. In June 1990 the land was resold for $320,000.

As the forfeited deposit was received as part of a 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit forms part of the capital proceeds from the disposal of the land under subsection 116-20(1). As the land was acquired after 19 September 1985, the forfeited deposit is, in effect, assessable as it adds to a capital gain or reduces a capital loss made on the disposal of the land.

Total capital proceeds from the disposal of the land is $366,000.

ATO Example 6, TR 1999/19

Jordan acquired a rental property in 1980. In March 1991 he entered into a contract to sell the property for $2.1m. A deposit of $210,000 was paid under the contract, with settlement due in March 1993. However, the purchaser defaulted and the deposit was forfeited to Jordan in April 1993. The property was then withdrawn from sale and not placed back on the market until March 1995. In July 1995 the property was resold.

As the 'continuum of events' was broken, the forfeited deposit can not be taken to be part of the capital proceeds from the disposal of the underlying (exempt) asset. Rather, the vendor makes a capital gain in the 1992-93 year as there has been an acquisition and an ending of ownership of the vendor's contractual rights, the contractual rights being the most relevant asset.

5.13 CGT event K4

CGT event K4 occurs if a taxpayer starts holding a CGT asset that they already own as trading stock and they elect to treat the CGT asset as having been sold for its market value: sub-s 104-220(1). The election must be made by the taxpayer under sub-s 70-30(1)(a).

The time of the event is when the taxpayer starts holding the CGT asset as trading stock: sub-s 104-220(2).

A capital gain is made if the asset's market value at the point just before it became trading stock is greater than its cost base, and a capital loss is made if the asset's market value is less than its cost base: sub-s 104-220(3).

An example of CGT event K4 is provided below:

Jenny acquires land in 2005 for the purposes of farming. During the income year ended 30 June 2007 ("FY07"), Jenny decides convert it into a business such that she began holding the land as trading stock. She elects under sub-s 70-30(1)(a) to treat the land as having been sold for its market value, which was $900,000. Its cost base at that time was $850,000.

Jenny has made a capital gain of $50,000 due to CGT event K4 occurring during FY07.

5.13.1 Where a CGT event K4 election is not made

If a taxpayer does not elect to treat the CGT asset as having been sold for its market value, then any capital gain or loss made is disregarded under s 118-25. The asset will be treated as having been sold for its cost, which is worked out under sub-s 70-30(3)-(4), and then instantly reacquired as an item of trading stock at that cost value.

5.13.2 Advantages and disadvantages of making a CGT event K4 election

By making a CGT event K4 election, a taxpayer can access the concessions available under the CGT regime to reduce their capital gain or disregarded, such as the 50% discount and the small business CGT concessions. Similar concessions do not exist under the trading stock rules. Therefore, a taxpayer that does not make a CGT event K4 election is generally subject to a greater amount of tax.

Where the market value of the land at the time that the taxpayer starts holding the CGT asset as trading stock is less than its cost base, there will be a capital loss made if there was a CGT event K4 election. If an election had not been made, any capital loss made would have been disregarded. However, the taxpayer will not be able to utilise this capital loss to offset against other capital gains made during the present income year or future income years.

6. When an Australian tax resident disposes of a dwelling in another jurisdiction

We would normally expect an Australian tax resident to be subject to Australian tax on disposals of assets, wherever located. However, the situation is far more complex than that. Depending on whether the taxpayer was an Australian resident, temporary resident or non-resident for tax purposes at any time prior to disposal, the outcome may be different.

In this paper, we have considered the following scenarios:

- A taxpayer who purchases an overseas dwelling while they are an Australian tax resident and subsequently disposes of that dwelling while still an Australian tax resident, having been an Australian tax resident throughout the entire time.
- A taxpayer who purchases an overseas dwelling when they were not an Australian tax resident and who, at a later stage, becomes an Australian tax resident and subsequently disposes of that dwelling while being an Australian tax resident.
- A taxpayer who is a temporary resident for tax purposes when they dispose of their overseas dwelling.

For these purposes, we have assumed that the overseas dwelling is held on purely capital account (not as trading stock or otherwise on revenue account) by a taxpayer who is an individual.

6.1 A taxpayer who purchases an overseas dwelling while they are an Australian tax resident and subsequently disposes of that dwelling while still an Australian tax resident, having been an Australian tax resident throughout the entire time

As an Australian tax resident, CGT event A1 would ordinarily triggered on the disposal of overseas dwelling: s 104-10. Broadly, the capital gain will be the extent to which the capital proceeds (e.g. consideration) exceed the taxpayer's cost base in the asset. The capital gain or loss (as relevant) will need to be included in the income tax return in the income year in which the taxpayer enters into the contract for sale (or, if there is no contract, when the change of ownership occurs).

As an Australian tax resident throughout the entirety of the period of ownership of that dwelling, it is unlikely that the main residence exemption would be available. This is because an Australian resident taxpayer is unlikely to have lived in that dwelling, being resident in a different jurisdiction: s 118-10.

6.2 A taxpayer who purchases an overseas dwelling when they were not an Australian tax resident and who, at a later stage, becomes an Australian tax resident and subsequently disposes of that dwelling while being an Australian tax resident

If the taxpayer was a non-resident at the time of purchase of the overseas dwelling, that dwelling will be brought into the Australian tax net when the taxpayer becomes an Australian tax resident. In this case, the taxpayer is deemed to have acquired the overseas dwelling for its market value on the day they become an Australian tax resident: sub-s 855-45(2). Accordingly, CGT event A1 should apply on a disposal of that overseas dwelling while the taxpayer is an Australian tax resident. The capital gain, if any, should be calculated on the difference between capital proceeds (usually, consideration received for the disposal) and the cost base (i.e., the market value of the dwelling on the day the taxpayer became an Australian tax resident).

In certain circumstances, a taxpayer may be able to claim the main residence exemption in relation to an overseas dwelling.[3] In particular, if the taxpayer has lived in a property prior to entering Australia, the taxpayer may make a choice under s 118-145 to treat that overseas dwelling as having continued to be their main residence in their absence for up to 6 years (unlimited if it is not used to earn assessable income), subject to the requirements of that section being satisfied. However, the taxpayer cannot treat any other dwelling as their main residence while this choice is in effect (subject to the rules about changing main residences in section 118-140): sub-s 118-145(4).

6.3 A taxpayer who is a temporary resident for tax purposes when they dispose of their overseas dwelling

If the taxpayer is a temporary resident for tax purposes when, or immediately before, the disposal of their overseas dwelling, any capital gain or loss made on the disposal will be disregarded: sub-s 768-915(1).

For these purposes, a taxpayer is a "temporary resident" if:

- the taxpayer holds a temporary visa granted under the *Migration Act 1958*; and
- the taxpayer is not an Australian resident within the meaning of the *Social Security Act 1991*; and
- The taxpayer's spouse is not an Australian resident within the meaning of the *Social Security Act 1991*.

However, at a high level, the taxpayer ceases to be a temporary resident if they are an Australian resident for tax purposes and any of the paragraphs above no longer are satisfied.

6.4 Can the 50% CGT discount apply?

Provided the regular conditions are satisfied (e.g. held for at least 12 months before disposal), the 50% CGT discount may apply in the case of a disposal of the overseas dwelling: ss 115-5 and 115-25. However, the CGT discount is generally not available to taxpayers who are temporary residents or non-residents for tax purposes. Accordingly, the discount percentage will be adjusted downwards to the extent that the taxpayer was not an Australian tax resident during the period of ownership of the overseas dwelling. The formula relevant to calculating this downward adjustment for periods starting after 8 May 2012 is expressed in sub-s 115-115(2) as follows:

[Number of days during discount testing period[4] that you were an Australian resident (but not a temporary resident)] / [2 x Number of days in discount testing period]

Where the discount testing period commenced on or before 8 May 2012, there are different approaches depending on whether the taxpayer was an Australian resident (and not a temporary resident) on 8 May 2012. If the taxpayer was an Australian resident (and not a temporary resident), the apportionment formula is:

[3] See, eg, *Taxation Determination TD 95/7 Income tax: capital gains: does subsection 855-45(3) of the Income Tax Assessment Act 1997 prevent a taxpayer from making a choice that section 118-145 of that Act apply to an overseas dwelling that the taxpayer owned before becoming a resident of Australia?*.

[4] Broadly, the "discount testing period" in relation to taxpayers who have direct gains (i.e. the dwelling is held in their name) is the period starting on the day the taxpayer acquired the CGT asset and ending on the day the CGT event happens.

$$\frac{\text{Number of days in discount testing period} - \text{Number of apportionable days that you were a foreign resident or } ^{*}\text{temporary resident}}{2 \times \text{Number of days in discount testing period}}$$

Where “apportionable days” is the number of days after 8 May 2012 in the testing period.

If the taxpayer was not an Australian resident (or was a temporary resident) on 8 May 2012, the taxpayer has a choice of applying sub-s 115-115(4). It can only do so if the asset’s market value on 8 May 2012 exceeded its cost base. In this regard, the discount percentage will either be:

- 50%, if the amount by which the market value on 8 May 2012 exceeded the cost base (“**Excess**”) is higher than the discount capital gain; or
- otherwise, an amount worked out by the following formula:

$$\frac{\text{Excess} + \left(\dfrac{\text{Shortfall} \times \text{Number of apportionable days that you were an eligible resident}}{\text{Number of apportionable days}}\right)}{2 \times \text{Amount of the } ^{*}\text{discount capital gain}}$$

Where the “shortfall” is the amount by which the excess is less than the discount capital gain.

If the taxpayer chooses to not apply sub-s 115-115(4), the amount of the discount is:

$$\frac{\text{Number of apportionable days that you were an Australian resident (but not a } ^{*}\text{temporary resident)}}{2 \times \text{Number of days in discount testing period}}$$