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Newsletter

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Taxing developments

In recent months I've had a number of conversations with clients who are building new residential properties, a couple intending to keep the property and rent it out and some intending to sell for a profit. When I informed these clients of the potential tax implications of selling, they were quite surprised that GST could apply and they wouldn't necessarily be eligible for CGT discounts.

By Pat Mannix

There has also been a couple of recent ATO cases where the tax office has determined property sales to be profit-making, rather than realisation of capital assets, so it's important to have all your ducks in a row.

How the sale of the new property is treated for tax purposes all comes down to your original "intention" at the initial time of purchase (and the ability to prove this intention to the ATO). Proof of your intention may include items like email correspondence with your accountant and minutes of meetings. There are three possible categories and subsequent tax implications:

Merely realising an asset: CGT
(sale of investment property)

Once-off profit making scheme: CGT, GST and income tax
(build a single property with intention to sell)

Serious development: CGT, GST and income tax
(multiple properties built and sold)

Capital Gains Tax **and** income tax can apply to situations where the property purpose has changed. For example, you purchase a property and rent it out for a few years, you then approach the council and are told you can build four townhouses on the land. It's at this point, when the "purpose" of the property changes, that the property changes from being a capital asset to being trading stock and a CGT event occurs. The value for CGT then becomes the cost for the land trading stock to ensure you aren't taxed twice.

CASE STUDY

Ross and Rachel own an investment property in the Melbourne suburb of Wantirna. They have been renting this property out for five years and are now trying to decide what to do with it. They have three options:

1. Sell as is. The sale of the property will be subject to Capital Gains Tax. As they have owned the property for more than 12 months they'll be entitled to the 50 per cent CGT discount.

2. Subdivide the backyard, build a new property and sell both with the intention of making a profit. As with option one, selling the existing home will be subject to CGT and the 50 per cent discount will be available. Selling the back house will most likely require registration for GST (as the new residential premises are being sold within the first five years of construction) and the profits will be subject to income tax. The margin scheme may also be able to be used to reduce the GST liability.

3. Submit plans to council, obtain permits and build five townhouses that they sell. Ross and Rachel are now in business as developers. At this time they have a CGT event when their land changes from being a capital asset to trading stock on hand. They'll also have to account for GST and income tax on the profits and again they may be able to use the margin scheme.

The margin scheme is applied to reduce the amount of GST payable on the sale and is based on the difference between the purchase price and the sale price. When using the margin scheme you're still entitled to claim the credits for any GST you have paid to your suppliers.

So you can see, there's a lot to consider. Whether you're planning on a large development or a one-off build, not understanding the tax implications could be very costly.

As always, speak to your accountant before going ahead to ensure you don't receive any nasty tax surprises.

Pat Mannix *has extensive experience dealing with tax and structuring advice for investors including structures in self managed superannuation and direct property. For more information, go to www.gatherumgoss.com*