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Tax implications of renovating for profit

We're regularly asked about the tax consequences of renovating to sell for a profit and the answers and issues that may arise often surprise clients. Here's some information on renovating for profit and the significance of substantial renovations.

By Pat Mannix and Bec Mackie

A few weeks ago, a client came to see me and one of the things we discussed was the fact that they'd just moved house. They'd purchased an old property in a good inner-Melbourne suburb. While they lived there they'd renovated the house, including a new kitchen, new bathroom and removing a wall to open up the living area. They had also repainted the entire house, inside and out, and polished the floors. This house was sold a couple of months ago and they'd recently moved into their new home – and next project, another rundown house in the same suburb.

The first thing we look at is whether this now means they're in the business of renovating for profit, or have entered into a one-off profit-making activity, or have just sold their family home. In this first instance, in most cases it would be likely they were just selling their family home after realising the profit they could make, and that they could do this again and potentially make even more profit if their purchase and renovations are well planned and costed. It's at this point that their intention has changed from renovating the family home to renovating to make a profit so it's this new property that will have tax consequences on the sale. Whether they're in business, or this is a one-off profit-making activity, depends on whether or not they plan on doing it again.

Either way, the profit from the sale needs to be included in their tax return and no capital gains concessions will apply, as the sale isn't on capital account. As the income from the sale has been classed as profit, we also need to look at potential GST issues.

GST doesn't apply to the sale of residential premises unless they're new residential premises. The definition of new residential premises includes those properties that have "been created through substantial renovations of a building". This could pose some problems for those renovating to sell, as GST on the sale price could really eat into the profits. For renovations to be "substantial" they need to affect the building as a whole and result in the removal or replacement of a substantial amount of the building. If the client above completed a similar renovation as their first home, with new kitchen, bathroom and painting, this wouldn't constitute substantial renovations. If, however, they removed a wall to convert a bedroom to an ensuite and walk-in robe, and added an extension with an extra living room, then it's much more likely the renovations would be considered substantial. More information about this can be found in the ATO's ruling GSTR *2003/3.*

If the renovations are considered substantial, such that the house is now treated as new residential premises, then GST would apply to the sale. However, they may be able to apply the margin scheme to reduce the GST and they'd be able to claim the GST credits on all the renovation costs.

This is another case where it's important to do your research, speak to your experienced property accountant to ensure you know exactly how your activities will be taxed, and don't get any nasty surprises.

Pat Mannix and Bec Mackie *have 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*