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TAX TRAPS FOR SUBDIVISION OF LAND

As property prices go up across Australia, subdivision of land becomes a financially attractive undertaking for "mum-and-dad investors". Unfortunately, there are potentially complex tax issues involved that the taxpayers may not be aware of until the Australian Taxation Office (**ATO**) comes knocking.

It is not uncommon for taxpayers to assume that any profits they generate from the sale of subdivided blocks of land are either tax-free because they used the land (before the demolition of the old building) as main residence or taxed as capital gains. This is not necessarily the outcome for many cases. A case in point is the recent Administrative Appeals Tribunal (**AAT**) case, *McCarthy and FCT [2021] AATA 1511*.

The Background Facts

The taxpayer and her husband purchased a residential property in Western Australia at auction for $675,000 as joint tenants on 27 August 2016. The Taxpayer and her husband then lodged an application for approval of a plan for the subdivision of the Property into two lots to the local council on or about 10 November 2016 (less than 2 weeks after the settlement). The plan of the subdivision submitted for approval was dated 21 October 2016 (around 2 weeks before the settlement).

At the time of the property purchase, there was a long-term tenant in residence. The tenant vacated the property in May 2017 and the house was demolished in July 2017. The two lots were sold for $480,000 on 3 August 2017 and $490,000 on 2 January 2018 respectively.

The taxpayer and her husband then applied for a private ruling to the ATO through their tax agent on the income tax implications of the sale of the lots. The ATO ruled that the profits from the sale of the lots were assessable as ordinary income under section 6-5 of the *Income Tax Assessment Act 1997* (**ITAA97**), being an isolated transaction carried out for profit and commercial in nature. As such, the taxpayer and her husband had to pay tax on the full profit rather than 50% of the profit under the Capital Gain Tax (**CGT**) provisions.

The taxpayer then took the matter to the AAT after her objection to the assessment was disallowed by the ATO.

The Decision

The AAT upheld the ATO's assessment and held that the profits were ordinary income under section 6-5 of the ITAA9. The AAT found that, at the time of the purchase of the property, one of the taxpayer's purposes for the purchase was a potential profit by subdivision and sale and that it was not an insignificant purpose. In particular, it was significant that the subdivision activities were undertaken shortly after the auction.

Further, the AAT rejected the Taxpayer's submission that it was her intention to hold the property as a rental investment but decided to subdivide and sell the lots instead, as she could not afford to keep the Property as a rental investment property.

The Take Away

Ultimately, the Taxpayer failed to convince the AAT that it was her original intention to keep the property as a rental investment but had to sell, as she could no longer afford to keep the property. That is, the taxpayer was unable to provide any calculation, enquiry or action as a support to her intention.

The case demonstrates the importance of obtaining proper tax advice in advance, before the purchase, and certainly before any subdivision activities are undertaken to ensure that proper documentation of the facts supporting the intention of the taxpayer is in place. For example, the taxpayer and her husband could have demonstrated how much rental they could earn after renovations, how much such renovations would cost and other factors that may have influenced their decision to abandon that original intention and sell the property.

Generally speaking, the longer a taxpayer keeps the property, the better the argument that a property was held with the original intention as investment. However, this in itself would not guarantee that the ATO will always be satisfied with the taxpayer's intention.

If you have any queries about the income tax implications of subdividing a property, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

GST, Supply of Property & Requirement to Register

As housing prices across Australia accelerate through a combination of ultra-low interest rates, strong consumer confidence and low supply, so too does the increase in mums and dads looking to capitalise on this trend. Where these individuals are not registered for GST, the primary question is, will their proposed property transaction trigger a requirement for them to register?

As with most tax issues, the answer to this is that it depends on their circumstances. An entity is required to be registered for GST if it satisfies the 2 limbs of section 23-5 of the GST Act[1] :

[1] *A New Tax System (Goods & Services) Act 1999 Commonwealth (the GST Act).*

(1) the entity is carrying on an enterprise; and
(2) the entity's GST turnover is at or above the registration turnover threshold.

The term enterprise is defined for GST purposes in section 9-20 of the GST Act and includes, among other things, an activity or series of activities done:

- in the form of a business; or
- in the form of an adventure or concern in the nature of trade.

Miscellaneous Taxation Ruling MT 2006/1, *The A New Tax System: the meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number* provides the Tax Office view on the meaning of 'enterprise' for the purposes of entitlement to an ABN.

Of relevance is paragraph 245 of MT 2006/1 which refers to 'the badges of trade' that may be taken into account when determining whether assets have characteristics of 'trade' and are held for income producing purposes, or either as an investment asset or for personal enjoyment. Some of these include:

- intention of the taxpayer to engage in commercial activity;
- an intention to make a profit from the activity;
- the recurrent or regular nature of the activity;
- the activity is systematic, organised and carried on in a business-like manner;
- the activities are of a reasonable size and scale;
- a business of product; and

While an activity such as the selling of an asset may in itself amount to an enterprise, this needs to be viewed in the context of other activities leading up to the sale to determine if an enterprise is being carried on.

For example, where an individual subdivided property, part of which formed their primary residential premises and the sale of the subdivided portion of the property was not conducted in a business-like manner; the property was not brought to account as a 'business' asset and expenses relating to the subdivision of the property were not claimed as a business expense, it is unlikely that the individual is conducting an enterprise and therefore they will not be required to register.

As the individual is not required to be registered for GST, the sale of the property would not meet the definition of a 'taxable supply' and they would not be liable for GST on the sale in accordance with section 9-40 of the GST Act.

It is important that there is supporting evidence to substantiate this position as the risk of getting this issue incorrect can be costly. We recommend this issue be considered as part of the cost analysis of any property project as the GST component can make a sizeable difference in profitability.

If you would like to discuss any of the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Mussalli v FCT – Another Capital vs Revenue Decision

The recent Full Federal Court case *Mussalli v FCT* [2021] FCAFC 71 decided that upfront payments to secure a rent reduction were on capital account and not deductible under section 8-1.

The facts of the case are briefly summarised below.

Mr. Mussali was the controlling mind of the Mussali Family Trust (**the MFT**) that operated 7 McDonald's restaurants on the NSW Central Coast. The rent for each restaurant comprised of a base amount and an additional amount based on a percentage of gross monthly sales.

MFT had the option to pay a reduced rent amount for the restaurant by paying an upfront payment. The upfront payment for each franchise was calculated based on the "agreed price of the restaurant" less the value of the equipment of the restaurant. The "agreed price of the restaurant" was based on a multiple of anticipated profit of that restaurant in a single year.

The MFT exercised this option in each case and paid approximately $10.5 million in upfront payments.

The ATO issued amended assessments for the relevant income years disallowing the upfront payments as deductions under section 8-1. An objection was made by the taxpayer, which was subsequently disallowed by the Commissioner.

The case was initially decided at the Federal Court where the MFT's appeal against the ATO's decision was dismissed. The taxpayer ultimately lodged an appeal at the Full Federal Court.

The Full Federal Court made the following key findings in relation to the upfront payments:

- The payments were not made to secure the right to occupy the premises and they had no relationship with the period over which any benefit associated with them was enjoyed.
- The purpose of the payments was to obtain a more profitable business structure rather than to pay rent upfront.
- Upon renewal or extension of the leases, no further prepayments would be payable. Further, on termination or surrender of the lease, there would be no pro-rata repayment of the prepayments.
- The prepayments would not necessarily lead to any reduction in expenditure on revenue account. The rent payable was based on a set base rent and a percentage of turnover. If the turnover of the relevant restaurants did not exceed certain amounts, the prepayments would not achieve a reduction in rent.

Based on these key findings, the Full Federal Court unanimously dismissed the taxpayer's appeal and disallowed a deduction under section 8-1 for the upfront payments.

If you would like to discuss any of the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Changes for Expats Selling Their Former Homes Apply for 2021 and Later Years

After the expiry of the transitional period on 30 June 2020, the main residence exemption is no longer available for "excluded foreign residents" and foreign residents who do not satisfy the "life events test". If an individual falls into any of these categories, the exemption is not available notwithstanding of the history of the dwelling as a main residence.

An individual is an ***excluded foreign resident*** if they are:

- A foreign resident at that time; and
- Have been a foreign resident for a continuous period of more than six years.

For a foreign resident who satisfies the above conditions, the main residence exemption is not available. The fact that their dwelling may have been their main residence while they were a resident is not relevant. That is, no partial exemption would be available to take into account the Australian residency period. If a capital loss is triggered upon the sale of the dwelling, the full capital loss should also be available (i.e. the loss would not be disregarded under the main residence exemption).

If a foreign resident has been a foreign resident for a continuous period of six years or less, the main residence exemption will only be available where they satisfy certain "life event tests" that lead to the sale of their former home.

These tests are as follows:

- The individual or their spouse had a "terminal medical condition" at any time during the foreign residency;
- A child under the age of 18 had a terminal medical condition at any time during the foreign residency;
- The individual's spouse or child under the age of 18 died during the foreign residency period; or
- The sale of the dwelling involves a marriage or relationship breakdown pursuant to section 126-5(1) of the ITAA 1997.

In summary, if a person is a foreign resident at the time they dispose of a property and they have been a foreign resident a continuous period six years or less, they can only access the main residence exemption if they satisfy any of the life events outlined above.

If they have been a foreign resident for a continuous period of more than six years, the main residence exemption would not be available ***even if*** these life events are satisfied.

Whilst COVID-19 may have forced many expats back to Australia and back to their former homes, those who have remained overseas should carefully consider the application of these new rules before they list their former Australian home for sale. The harsh reality of these rules will first be felt in the 2021 financial year and will effectively require expats to defer selling their former home until they return to Australia and resume their Australian tax residency.

If you have any questions on how these new rules might apply to your clients please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.