GST, TAX & PROPERTY

Disclaimer

This document has been prepared as an introductory guide does not have any regard to any particular person's investment objectives, financial situation and needs. Accordingly, no recommendation (express or implied) should be acted upon without first obtaining specific advice from your adviser.

Ellco Group
Accountants | Advisors
186 Margaret Street
Toowoomba Qld 4350

March 2014

GST, Tax and Property - An Introductory Guide

CONTENTS

GST, Tax and Property

An Introductory Guide

GST and Sale of Property

GST does apply to sale of all property, if:-

- the sale is for consideration
- the sale is made in the course or furtherance of an enterprise that the taxpayer carries on
- the sale is connected with Australia
- the taxpayer is registered or required to be registered for GST
- the sale of the property is not GST-free or input taxed

An example of when the sale of a property is not subject to GST is the sale of residential premises (other than new residential premises).

Example 1

John is a member of the defence force, is not registered for GST and sells his home.

The sale of his home is not subject to GST because the sale has not been made in the course or furtherance of any enterprises. John is also not required to be registered for GST.

Example 2

Jack who is a consultant to the defence force and is registered for GST sells his home.

The sale of his home is not subject to GST because the sale has not been made in the course or furtherance of any enterprises. The fact that Jack is registered for GST is not important because the sale of his home is not made in the course or furtherance of his enterprise.

In the Course or Furtherance of an Enterprise

The sale of property will be subject to GST when it is made in the course or furtherance of an enterprise that is carried on. For example:-

- A property developer selling property; or
- A business taxpayer selling their business premises; or
- A builder selling a property that was bought then renovated for sale.

Tax Trap

The definition of enterprise is so broad that it includes isolated profit making ventures – that is, a "one off" development can also be caught.

Example

Ben is a teacher at the local high school. Ben is not registered for GST.

Ben purchases a vacant block of land with the intention of building a house and selling it to make a profit.

The sale of house and land will be subject to GST as Ben's turnover from the activity will be more than $75,000.

Therefore, Ben must be registered for GST prior to undertaking any works so that he may claim the input tax credits in relation to the development costs. Even though the house is residential premises the sale will be subject to GST because it is new residential premises.

Alternative

If Ben had also purchased a house and land and then undertook "substantial renovations" the sale would also be subject to GST.

It Is All a Matter of Intention

If a property developer or builder builds a house with the intention of living in it then its sale would not be in the course or furtherance of enterprise, and therefore, it would not be subject to GST.

However, if a property developer or builder lives in new residential premises it does not automatically mean the sale of those premises will not be subject to GST.

Whether or not the sale is in the course or furtherance of the property developer's or builder's enterprise will depend on the particular circumstances. Other important factors include:-

- The period the house is lived in
- How many times a similar transaction has been undertaken

Example

Joe is a police officer and a small time developer – he builds approximately two houses per year – he is registered for GST.

During the last four years Joe has built six new homes for himself each time selling the home for a profit.

The ATO may easily argue that Joe's real intention is not building a home for himself but his real intention is to sell the property for a profit. If this opinion is formed the ATO would treat the sale as a taxable supply.

How Much Profit

GST is ignored when calculating the profit from a transaction

Example

Jill works for Centrelink in their call centre.

Jill purchases a vacant block of land with the intention of building a house and selling it for a profit. This isolated transaction will be subject to GST.

Details

- Land Cost $170,000 (not a taxable supply ie no input tax credits available)
- Construction Costs $220,000 (including GST)
- Sale Price $500,000

Jill elects to apply the margin scheme to the sale of the property.

Sale Proceeds		$500,000
Margin = $330,000 (ie. $500,000 Sale Proceeds - $170,000 land cost)		
GST on Margin *(ie. $330,000 x $1/11^{th}$)*		($30,000)
Net Sale Proceeds		$470,000
Less		
Cost of Land *(no GST included in cost)*	170,000	
Construction Costs *($220,000 – $1/11^{th}$)*	200,000	370,000
Assessable Net Profit		**$100,000**

The GST position is as follows:-

GST collected *($500,000 - $170,000 = $330,000 x $1/11^{th}$)*		$30,000
Less GST paid		
Cost of Land *(no GST included in cost)*	0	
Construction Costs *($220,000 x $1/11^{th}$)*	20,000	20,000
Net GST owing to the ATO		**$10,000**

If we assumed that Jill paid tax at the top marginal rate her cash flow position would be as follows:-

CASH IN	
Proceeds from Sale *(includes $30,000 GST)*	500,000
CASH OUT	
Cost of Land	170,000
Construction Costs *(includes $20,000 GST)*	220,000
Net GST owing to the ATO *(calculated above)*	10,000
Income Tax	46,500
	446,500
CASH SURPLUS	**$53,500**

What is the Margin Scheme

The margin scheme can be applied in the following circumstances, if the property was acquired as follows:-

- Pre GST (ie before 1 July 2000); or
- Post GST from someone who calculated their GST liability using the margin scheme; or
- Post GST from someone who did not have a GST liability (eg the vendor was not registered for GST).

An example of how the Margin Scheme is applied is given above. Please also note any costs of purchase (eg legal fees, stamp duty etc) are ignored when establishing the margin.

For pre GST property the margin is determined by reference to the valuation of the property at 1 July 2000 – this valuation **must** be prepared by a properly registered valuer using the strict guidelines provided by the ATO.

New Residential Premises and the Five Year Rule

Residential Premises remain new residential premises unless they have been continuously rented out for a period of at least 5 years from when they were built or substantially renovated.

Example

Bob is a chef and small time developer. He is registered for GST. He buys two vacant blocks and decides to build houses on each. Due to the prevailing market conditions Bob decides rather than selling the houses he will rent the first house for a period of three years and then sell it and he will rent the second house for a period of seven years and then sell it.

The sale of the first house is the sale of new residential premises and therefore a taxable supply subject to GST.

The sale of the second house will not be a sale of new residential premises because it has been rented out continuously for more than five years. As the sale of the house is not the sale of new residential premises it should be treated as being input taxed.

Tax Trap

The renting out of the premises causes a change to the creditable purpose of the acquisition – that is, if the houses were built as part of the taxpayers enterprise's the GST on the constructions costs would be normally be claimed back during construction. However, by changing the decision to rent out the houses will result in an increasing adjustment for the GST previously claimed back (ie repaying the GST claimed back from the ATO).

Substantial Renovations

Residential premises are also new residential premises if they have been created through substantial renovations of the building.

Factors that indicate substantial renovation include:-

- The increase in market value of the building after the renovations;
- The amount spent on the renovations;
- The requirement to obtain building alteration approvals;
- The requirement to obtain rezoning approvals;
- A change in council rate classification.

Income Tax and Capital Gains Tax Issues

When real property is sold there are three tax scenarios that are possible (excluding GST).

1. The property is trading stock, therefore the sale proceeds are assessable as ordinary income; or
2. The property is not trading stock but the profit from the sale is assessable as ordinary income; or
3. A capital gain arises on the sale.

Trading Stock

It is not necessary that the acquisition of land to be repetitive to constitute trading stock. A single acquisition of land for the purpose of development, subdivision and sale by a business commenced for that purpose would lead to the land being treated as trading stock.

Example

Kev purchases 50 acres of land for the purpose of subdividing it into 155 lots for sale at a profit.

The development requires him to build roads, parks, footpaths, kerbing and channeling etc. He is also required to ensure each lot is connected to sewerage, power and water.

Although Kev engages professionals to undertake the various stages of work, he has significant involvement in the subdivision, development and sale of the lots.

Although this is the only development Kev intends to undertake, and even if he does not undertake any other developments again, the land will be trading stock because the size, scale and nature of the development is such that he is carrying on a business. As the ATO states Kev has embarked on a definite and continuous cycle of operations designed to lead to the sale of the land it constitutes a business and therefore the land is treated as trading stock.

Income Tax or Capital Gains Tax

The sale of property purchased after 19 September 1985 will either be subject to Income Tax or Capital Gains Tax. The issue is determined as a matter of fact.

A profit from an isolated transaction is generally income when both of the following elements are present:-

(1) the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and

(2) the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

For a transaction to be simply treated as income it is not necessary that the intention or purpose of profit-making be the sole or dominant reason for entering into the transaction. It is sufficient if profit-making is a significant purpose.

Example

Craig is an employee fireman. He not registered for GST.

Craig purchases a house with the purpose of doing some minor cosmetic renovations and then immediately re-selling the property for a profit.

Any income made as a result of the transaction will simply be treated as income.

How Long Must A House Be Held To Be Treated As A Capital Gain

There is no set minimum time. However the longer the house is held the less likely the ATO is able to argue that the transaction was undertaken with a view to make a profit on sale.

Why Is Capital Gains Tax Better Than Income Tax

If the transaction is treated as income the entire amount of profit is simply added to your taxable income whereas if the profit is treated as capital profit certain Capital Gains Tax concessions may be available. For example, if a property is held by individuals for longer than 12 months - when sold, the capital gain is immediately reduced by one-half being the CGT discount allowed by the ATO.

Example

Joan is a school teacher and is not registered for GST. Joan is not a property developer or builder.

Joan purchased a block of land on 1 May 2001 for $100,000 in order to construct a house on the land and earn future rent. Joan spent $220,000 in construction costs including GST during 2001.

As soon as the house construction was complete it was immediately rented.

The house was continuously rented until Joan sold the property on 1 June 2006 for $400,000.

Joan will not claim the GST back in relation to the construction costs due to her intention of merely renting the property. GST is not applicable to the sale proceeds because of the operation of the five year rule deeming the sale not to be the sale of new residential premises.

The Capital Gain is calculated as follows:-

Sale Proceeds	$400,000
Less	
Land Costs	100,000
Construction Costs	220,000
	320,000
Capital Gain	80,000
Less CGT Discount	40,000
Net Taxable Capital Gain	$40,000

Therefore, $40,000 needs to be added to Joan's income for the year ended 30 June 2006.

Capital Gains Tax and the Home

No capital gains tax applies to the sale of a taxpayer's main residence.

Further the main residence exemption can be also applied to two houses to cater for the situation where a taxpayer buys a new house before selling the old one. However, certain time limits and restrictions apply.

The Main Residence Exemption and the Six Year Rule

The main residence can still be applied to a dwelling regardless that the owners no longer use the dwelling as their home.

If the property is not rented out, the main residence exemption can be claimed indefinitely (ie if the home is simply left vacant).

If the property is rented out the main residence exemption can be claimed for period up to six years.

It should be remembered that the exemption can only be claimed on one main residence.