Law Council
OF AUSTRALIA

Business Law Section

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Dear Mr Warner

Tax consequences on sales of small scale land subdivisions

1. This submission to the Australian Taxation Office (**ATO**) is made by the Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**).

Key points

2. The Committee was asked to provide the ATO with additional examples to supplement the recently published webpage on the "Tax consequences on sale of small scale land subdivisions". We have not commented on the information nor on the examples published by the ATO on the webpage.

3. We have included three examples as part of this submission. Each example is attached to the submission and seeks to highlight the following issues:

   - **Example 1: Farmland and Pre-CGT land**

     Example 1 is a variation to the fact pattern of the current example shown on the website ("Example—residential block development"). As such, it endeavours to illustrate how the taxation treatment is affected when:

     - the land acquired is pre-CGT and therefore the existence of a pre-CGT capital gain forming part of the gain made on the sale of land ventured on revenue account (whether ventured into a profit-making undertaking or plan or in business becoming the trading stock of that business) and where the so-called revenue gain is taxable, and the capital gain, less the revenue gain, is tax-free;
     - there is a change of purpose in respect of the holding of the land and where that change of purpose is for:
       - long term investment and income production (through the derivation of rent);

- venturing into a profit-making undertaking or plan and the conversion of land previously held on capital account to being held on revenue account;
- venturing into a business of property development or land subdivision and the conversion of land previously held on capital account to being held as trading stock.

- **Example 2: Tax losses**

  This example seeks to highlight that a loss from an isolated transaction is deductible if:

  - in entering into the transaction, the taxpayer intended or expected to derive a profit which would have been assessable; and
  - the transaction was entered into, and the loss was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

- **Example 3: Suburban Duplex**

  The Suburban Duplex example considers the tax treatment of the subdivision and development of property originally held for domestic purposes as a main residence, where one subdivided lot starts to be held for a profit-making purpose, whilst the other subdivided lot continues to be held for domestic purposes. This illustrates how the CGT main residence exemption may be retained for the lot that is held as such throughout the ownership period.

4. We also suggest that the ATO considers the inclusion of Examples 5 and 12 from the Draft Property and Construction Website Guidance that has been withdrawn by the ATO. These examples should be updated to take into consideration any relevant comments received when the draft website was available for review. For convenience, the two examples are reproduced and attached to this submission.

Conclusion and further contact

5. The Committee would be pleased to discuss any aspect of this submission.
6. Please contact the chair of the Committee, Justin Byrne, (justin.byrne@qldbar.asn.au) if you would like to do so.

Yours faithfully

Philip Argy
Chairman
Business Law Section

Example 1: Farmland and Pre-CGT land

Peter and Joan purchased a small farming property situated outside the Central Coast in 1980 as joint tenants for private and recreational purposes.

Peter and Joan constructed a holiday house on the land in 1984 and until the early 1990s used all of the land for private and recreation purposes. Since the early 1990s and from time to time, Peter and Joan leased parts of the land to neighbouring dairy farmers who used the land to keep parts of their herd of cattle. The remainder of the land continued to be used for their private and recreational purposes.

In January 2023, Peter and Joan engaged a project manager to provide them with options as to the future development on the land in light of some recent re-zoning by the State Government. It was decided that the land in the first instance would be subdivided into three (3) parcels and in respect of:

- the first parcel, which included the holiday house, Peter and Joan would continue to use this parcel for their private and recreational purposes (**First Parcel**);
- the second parcel, residential houses and apartments would be constructed and retained as investment assets and for the purposes of deriving rent. As part of the construction finance, the bank would require Peter and Joan to sell four (4) of the residential houses to pay down some of the loan and then to refinance the remainder on a longer-term loan which is consistent with the holding of the assets for the long term (**Second Parcel**);
- the third parcel, and a short time later, this parcel would be further subdivided into fifty (50) residential lots and marketed for sale to third party purchasers. Infrastructure works (in the form of roads, sewerage, water, electricity and telecommunications connections would be constructed). Peter and Joan intend to engage a third-party property development company to provide the necessary town planning, project management and construction services for the project while at the same time being actively involved in the project. As part of this, they would prepare a business plan and obtain third party finance etc. (**Third Parcel**).

Income Tax Outcome

- The land is a CGT asset and Peter and Joan will be taken to hold the land on capital account.
- The subdivision of the land should not result in a CGT event where Peter and Joan remain the owners of the land after the subdivision occurs.
- Each parcel of land created after the subdivision will be taken to have been acquired in 1980 and will therefore be a pre-CGT asset of Peter and Joan.
- The cost base of each parcel of land will be worked out by a reasonable apportionment of the cost base of the original land.
- Where Peter and Joan retained the First Parcel for private and recreational purposes, this would continue to be held on capital account. If they later moved in and made the holiday house their main residence, any later sale may be exempt from CGT noting that land containing a main residence of up to two hectares of land used as part of the main residence would attract the CGT main residence exemption.

- Where Peter and Joan retain the residential houses and apartments constructed on the Second Parcel, each should remain a CGT asset they each hold on capital account.

- The residential homes and apartments, each being an improvement constructed after 19 September 1985, will constitute a separate CGT asset from the land and taken to be acquired after 19 September 1985 (provided their cost exceeds the relevant threshold for the year in which they were constructed). Any later sale will be taxable on capital account and any capital gain would be subject to tax under the CGT provisions. The capital gain referable to the sale of the pre-CGT land would be disregarded.

- Whereas part of the project Peter and Joan construct some of the residential homes and apartments for the purposes of sale (**Sale Lots**), there will be a change of intention in respect of the land and the following taxation treatment will apply:

  - Peter and Joan will be taken to venture the Sale Lots into a profit-making undertaking or scheme and the sale proceeds net of costs attributable to this profit-making undertaking or scheme will be included in their assessable income as ordinary income;

  - Peter and Joan should obtain a cost for the Sale Lots equal to the sum of:

    - the market value of the Sale Lots as at the date that they decided to venture the Sale Lots into the profit-making undertaking or scheme (in this case, being January 2023); and

    - the costs incurred in constructing the townhouse,

    (together, the **Cost**);

  - the profit (representing ordinary income) derived from the profit-making undertaking or scheme will be the difference between the sale proceeds received and the Cost;

  - CGT event A1 will also happen when Peter and Joan sell the Sale Lots. They will make a capital gain where the capital proceeds received are greater than Peter and Joan's cost base in the Land. The capital gain will be reduced by the amount included in their assessable income as ordinary income;

  - the capital gain should be disregarded as the Sale Lots will be taken to have been acquired in 1980, that is, prior to 20 September 1985. Accordingly, the capital gain less the amount included in their assessable income will be disregarded.

- Where Peter and Joan execute their business plan including entering into arrangements with a third-party property development company for the development of the Third Parcel, they will be taken to venture the Third Parcel in to a land subdivision business at that time. Accordingly, and at this time:

  - the Third Parcel will become the trading stock of the business that Peter and Joan will be conducting;

  - as the land was previously held on capital account, Peter and Joan will need to make a trading stock election. They will elect market value;

  - as Peter and Joan have elected market value under the trading stock election, CGT event K4 will happen, and a capital gain or capital loss will arise depending on whether the market value of the Third Parcel is greater (for a capital gain) or less than (for a capital loss) its cost base. However, as the Third Parcel will be taken to be acquired pre-CGT, any capital gain or capital loss will be disregarded.

GST Treatment

- Peter and Joan will be taken to be conducting an enterprise in respect of:
  - the Second Parcel, and the enterprise being conducted is both a leasing enterprise (in respect of the leasing of the investment assets) and a development enterprise (in respect of the sales to fund construction costs);
  - the Third Parcel, and the enterprise conducted is the business of land subdivision.
- Peter and Joan will be required to register for GST as a partnership as they will meet the turnover test because the value of taxable supplies to be made from the sale of residential houses and apartments comprising part of the Second Parcel and the sale of the residential lots comprising the Third Parcel is expected to exceed $75,000 per annum.
- The supplies of long-term residential leases as part of the carrying on of the enterprise will be an input taxed supply.

The sale of the residential houses and apartments forming part of the Second Parcel will be the sale of new residential premises and a taxable supply on which GST will be charged. The same treatment applies for the sale of residential lots forming part of the Third Parcel.

- They are entitled to claim input tax credits on the construction of these residential houses and apartments which they intended for sale and which they in fact sell. The same treatment applies for the input tax credits on the construction and development costs incurred with the Third Parcel. They will not be entitled to claim input tax credits on the construction costs of residential houses and apartments as part of the Second Parcel on the basis that they will be subject to residential leases and therefore will be input taxed supplies.

Any subsequent sale of residential houses and apartments which are not new residential premises will be input taxed.

Example 2: Use of tax losses

Helen decided to commence a small property development business. In preparation for this Helen completed a real estate course at a local college whilst still employed at her current job. At night she researched potential properties to acquire, and over weekends she visited sites and spoke to real estate agents. When she was able to during the work week, she interviewed project home builders and property developers with a view to identifying someone she could enter into a joint venture with or who she could engage to do a land development. She held meetings with financiers, architects and consultants that could help her realise her vision of owning a property development business.

Once the real estate course was done, she found land that met all her requirements. She immediately put her plan into action, obtained finance and purchased the land. Helen had to continue working a full-time job to make the repayments on the mortgage. Helen soon realised that working full time would hamper her ability to progress rapidly with the development of the land. She would not be able to drive the subdivision of the land, nor would she have time to meet with architects and other consultants. To ensure that she could make a profit on the project and realise her ultimate goal of having a property development business she decided to engage project home builders.

She did not check with the local council or other statutory authorities whether the land was subject to development conditions or restrictions that could affect the viability of the proposed project. She did not prepare a project plan. She left this to the project home builders to prepare for her. When this information was provided to her, she met with her accountant who prepared a project feasibility analysis and reviewed the financial viability of the project. Her accountant's analysis concluded that the project was not going to be profitable.

Following this result and after pursuing several options to save the project, Helen decided to sell the land without making any improvements. The sale did not realise as much as Helen wanted, and she made a loss on the sale. She also had to settle the costs incurred by the project home builders and her accountant. As a result of these significant losses, she did not undertake any similar projects.

Helen wanted to start her property development business and undertook significant steps towards realizing this goal. Importantly she bought land with the intention of realizing it at a profit. However, when the feasibility study and her other efforts could not find a way make project profitable, she cut her losses and sold the property. Although this was an isolated transaction and Helen decided that she will not be pursuing her dream of owning a property development business, it was part of business operation or commercial transaction undertaken by Helen with the purpose of realizing a profit. The costs incurred and the loss from the sale of the property should be treated as a revenue loss and set off against her ordinary income.

Example 3: Suburban Duplex

In 2000 Mr and Mrs Day purchased a house to live in, which was situated on an 850 m^2 block of land, for $400,000. They purchased the property as joint tenants. In 2017, the local council changed the minimum lot size from 500 m^2 to 400 m^2, making their block of land eligible for subdivision.

In 2018, Mr and Mrs Day settled on a plan to demolish the original house, build an attached dual occupancy dwelling (a duplex), and subdivide the lot. They intended to retain one half of the duplex for themselves to live in and to sell the other half to pay for the construction. The combined effect of general increases in property values in the area and the change to development controls meant that the property was valued at $1.5m at this time.

They hired an architect to design the duplex and a builder to obtain the development approval and subdivide the land and also to undertake the construction. They funded the redevelopment using a bank loan, with the property as security. They rented an apartment in a nearby suburb during the one-year construction period. The total construction and associated development expenses were $1 million.

The duplex was completed in late 2020 and Mr and Mrs Day moved into their side of the duplex in time for the summer holidays. They entered into a contract to sell the other half of the duplex on 1 April 2021 for $2 million.

The Days commenced a profit-making commercial transaction in 2018 with respect to the newly created lot that they intended to ultimately sell. They retained a domestic purpose in relation to the other lot that they intended to retain as their main residence.

- The increase in the value of the newly created lot from when it was originally acquired (in 2000) up to when the profit-making activities began (in 2018) should be treated as a capital gain.

- The original cost ($400,000) will be attributed equally to each of the newly created subdivided lots, $200,000 each.

- The value of each of the newly created subdivided lots at the time Mr and Mrs Day began to undertake profit-making activities in 2018 is also based on an equal attribution of the value at that time: 50 per cent of $1.5 million = $750,000 for each lot. The increase in the value from 2000 until 2018 is therefore $550,000 ($750,000 − $200,000). This is a capital gain realised when the lot is sold in 2021. As Mr and Mrs Day held the subdivided lot for more than 12 months, they are entitled to a 50 per cent CGT discount, hence there is a discounted capital gain of $225,000.

- The increase in the value of the newly created subdivided lot from when the profit-making activities began up to the time of sale should be treated as ordinary income.

- The net profit will be based on the GST exclusive sale proceeds ($2,000,000) minus half of the GST exclusive development expenses ($500,000) and the value of the subdivided lot at the time that the profit-making activities commence in 2018 ($750,000): $2,000,000 − $500,000 − $750,000 = $750,000.

Mr and Mrs Day will have a discounted capital gain of $225,000 and an ordinary income amount of $750,000 as a result of the sale of the half of the duplex. As joint tenants, they each must include half of these amounts in their tax return for the 2020/21 income tax year.

They will preserve the main residence exemption on relation to the other half of the duplex provided it remains their main residence until the time of sale.

Examples from Draft Property and Construction Website Guidance

Example 5—Sale of property to developer

181. The owners acquired a 40-hectare property in 1993, which they used for non-commercial purposes over time, such as keeping horses and some family activities.

182. The owners decided to subdivide the property in 2015 to take advantage of the property being rezoned as residential in 2013.

183. They were not active in seeking that region to be rezoned.

184. The owners alone or together with their close relatives have on occasions undertaken other property developments via entities they control.

185. Here, they entered into an agreement with a relative to subdivide land, where the relative carried on a business of property development.

186. The owners and the developer established a company to subdivide and develop the property and sell the residences.

187. The owners sold the property to the company at market value and brought the profit to account as a capital gain.

Our position

Prima facie, this is a straightforward CGT Event A1 at the time the owners sold the property to the company. However, it may become apparent that the owners are members of a wider group that has done this same thing several times before. Taking the wider group's activities into consideration, the repetitive actions of the group could mean the sale forms part of a business, and hence the sale proceeds could be on revenue account. Thus, in isolation, the transaction is likely to be on capital account, but further investigation may identify related activities that may bring the arrangement into a revenue focus.

Example 12—Cul-de-sac

249. A residential cul-de-sac in suburban western-Sydney had several properties, all owned by independent individuals.

250. All residents held each of their residential properties as main residences, with the notion that the main residence exemption would be claimed if and when they sold their properties.

251. Two of the homeowners received an expression of interest from a developer to purchase and subdivide both of their homes (two adjoined lots subdivided into 10).

252. The homeowners were not in the market for selling their properties.

253. After additional research, the two homeowners resolved that selling all of the houses in the cul-de-sac in one transaction would result in significant profits (in comparison to selling just the two).

254. They then encouraged their neighbours to sell, claiming that the 'main-residence exemption' would apply and that the profits would be tax-free.

255. They asked the developer to conduct surveys and test the market, and to present them with the findings.

256. The developer acquired all the properties for an immediate payment and a commitment to pay substantially more subject to certain Council approvals - these were successful.

257. Only one of the residents involved had a rental property located elsewhere, and none had entered into a development agreement in the past or intended to do so into the future.

258. To reduce costs, the group entered into an arrangement with a single solicitor to review and process the property sales.

Our position

259. In this case, by taking all of the facts into consideration, it is arguable that while the owners engaged in some organising and discussions to facilitate the arrangement, the low level of sophistication, the limited activities (such as meetings with the neighbours) and agreeing to let the developer undertake surveys and testing would not constitute a change of intention to that of a business or profit-making undertaking.