

## Income Tax Issues in Property Investment and Property Development

The following article highlights some of the more common tax issues affecting property investors and developers. Given the large monetary outlay associated with property transactions, it is critical to have all tax considerations attended to in order to progress correctly and in accordance with the respective strategy of the investor and/or developer.

### Property Investment

Some of the key taxation issues affecting a **property investor** are detailed below. Although not an exhaustive list, these are the more critical issues that need greater attention.

#### Capital Gains Tax

In simple terms, Capital Gains Tax (CGT) applies when you sell real estate not classified as your main residence. This can be an investment property or a holiday house.

There is a main residence exemption from CGT which only applies to individuals. To get the exemption, the property must have a dwelling on it and you must have lived in the dwelling. Any property held in a company or trust will be subject to CGT upon sale.

Land adjacent to a dwelling may also qualify for the main residence exemption if it and the dwelling are sold together, the land was used mainly for private and domestic purposes and the total area of the adjacent land is not greater than two hectares (4.94 acres). Rural and semi-rural properties are examples where this will apply. Adjacent land greater than two hectares may be subject to CGT.

When selling your family home, CGT can apply to the extent that it was used in carrying on a business, for example when part of the house is used as a doctor's surgery.

The small business CGT concessions may reduce the CGT payable on certain transactions, where applicable.

When you sell or otherwise dispose of real estate, the time of the CGT event is generally when you enter into the contract, not when you settle. If there's no contract, the CGT event is when the change of ownership occurs.

You must keep records of every act, transaction, event or circumstance that may be relevant to working out whether you have made a capital gain or capital loss from a CGT event. Your records will help you work out your capital gain or capital loss correctly and ensure you don't pay more CGT than necessary. Critically, this is very important after 20 August 1991, whereby non-deductible expenses may be added to the CGT cost base of a property purchase. This may include things such as rates, land tax, loan interest and repairs. None of these items should have been claimed as a tax deduction in the years prior to the sale.

#### Decline in value of depreciating assets and Capital works deductions

Claiming depreciation deductions over the useful life of a depreciating asset (Div 40) and claiming capital works deductions (Div 43) at 2.5% per annum should be distinguished. As the ATO has taken a keen interest over recent years in this particular area, care should be taken to ensure correct classification.

To work out the decline in value of a depreciating asset, you need to know its effective life. Generally, the effective life of a depreciating asset is how long (in whole years) you can use it for a taxable purpose. For most depreciating assets you can choose to work out the effective life yourself or use an effective life determined by the ATO.

You work out your deduction for the decline in value of a depreciating asset using either the:

**prime cost method** - this means the value of the depreciating asset decreases uniformly over its effective life, or

**diminishing cost method** - this means the decline in value each year is a constant proportion of the remaining value and produces a progressively smaller decline over time.

When purchasing a property, enquiries should be made to ascertain whether there is an existing schedule showing the Div 43 deductions available for the construction costs of the building, as the vendor is required to provide this information to you. In many cases, this information is often not available so the law allows you to obtain a report from a quantity surveyor estimating the construction costs.

Distinctions should also be made when major renovations are undertaken as an analysis will be required to determine costs that are deductible repairs and costs that are depreciating assets. Costs that must be included in the capital works deductions will also be determined.

### **Expense deductibility**

You can claim a deduction for certain expenses you incur for the period your property is rented or is available for rent.

A vacant or partially vacant property will be treated as available for rental if a genuine attempt has been made to source tenants at an appropriate rental, for example engaging a real estate agent or advertising the rental property.

Expenses for which you may be entitled to an immediate deduction in the income year you incur the expense include:

- ❖ advertising for tenants
- ❖ body corporate fees and charges
- ❖ cleaning
- ❖ council rates
- ❖ gardening and lawn mowing
- ❖ insurance (building, contents, public liability)
- ❖ interest expenses
- ❖ land tax
- ❖ pest control
- ❖ property agent's fees and commission
- ❖ repairs and maintenance
- ❖ travel undertaken to inspect the property or to collect the rent
- ❖ water charges

A very important distinction should always be made when classifying "repairs and maintenance" as either expense or capital. Costs will be deductible if they restore a property to its original condition and can reasonably be seen to relate to damage or wear and tear over time. Costs will not be deductible where they represent an improvement (eg replacing tin roof with tiled roof), a depreciable asset (eg a new kitchen) or an initial repair (eg repairs due to damage that existed at the time of purchase).

## **Property Development**

A selection of income tax specific issues that can arise as a result of **property development** will be highlighted below.

### **Revenue or Capital**

The revenue versus capital distinction is still very important especially since the introduction of the CGT discount. This distinction will lead a developer to determine the appropriate tax treatment of a particular transaction.

The revenue versus capital question will be decided by pre-determined tax legislation and legal precedent. The correct tax treatment is then determined by interpreting these important aspects:

- ❖ The 'mere realisation' of a capital asset will be treated on capital account.
- ❖ Carrying out an undertaking or scheme that has a profit making purpose, will be treated on revenue account.
- ❖ Carrying out a property development business will be treated on revenue account.

Unfortunately, the above three scenarios are not always easily determined and subtle differences in client cases will lead to treating each case on its merits and assessing each with a question of fact.

An obvious starting point in determining whether a property development venture is on revenue or capital is to determine the original purpose of the entity in acquiring the relevant property. Was the property originally acquired for private, investment or commercial purposes?

Once the original purpose has been determined, an analysis will conclude whether the subsequent profit will constitute a mere realisation of a capital asset, a profit making undertaking/scheme or that a business of property development is being carried on.

Subtle differences in each case may lead to varying outcomes, as illustrated by the number of legal cases that have impacted property owners on whether profits are on revenue or capital account.

### **Capital Gains Tax & Trading Stock**

When it is apparent that an entity is carrying on a business of property development, the proceeds received will be assessable as ordinary income. The property developer is entitled to a deduction for the costs of acquiring the property (eg land) to be held as trading stock subject to the operation of the legislative trading stock provisions.

The CGT rules do not apply to property held as trading stock as part of a property development business, however the CGT rules may be utilized if property which was initially acquired and held on capital account is used in a property development business and proceeds are held to be revenue.

When property (eg land) is acquired as a capital asset that is subsequently held as trading stock, a property developer is taken to have disposed of the land at its cost or its market value. If the developer elects to dispose of the land at its market value, a CGT event will occur, while a disposal at cost will ensure CGT is disregarded.

There may be significant benefits in electing to dispose of land at its market value if the taxpayer is eligible to access the 50% CGT discount and small business CGT concessions.

### **The Main Residence Exemption (MRE) & Property Development**

The MRE is a well known attribute of our tax law that applies to individual taxpayers, but there are subtle distinctions that can complicate matters.

The type of transaction that usually complicates matters is when a taxpayer subdivides part of the land which comprises their main residence and goes about trying to sell it on a commercial basis.

Normally, the subdivision of a property will not constitute a CGT event in itself. However, the subdivided area will constitute a separate CGT asset where the original cost base must be apportioned across. As the MRE can apply to a CGT asset that is your "dwelling" and on the basis that the subdivided property is a separate CGT asset that is not the taxpayers "dwelling", the MRE cannot apply to the subsequent sale of the subdivided property.

This aspect may take taxpayers and budding property developers a little by surprise, as tax will now be paid on what was considered the main residence.

### **Conclusion**

Property investors and developers face a wide range of tax issues. Due to the size and monetary outlay associated with property investment and development, the consequences of not being aware of tax issues can have a significant effect. With careful planning and the right advice, the correct strategy can be implemented to reduce and minimise tax on specific projects and investments.

**For more information, please contact Sash Nikolovski on 9018 4666 or call your Client Partner.**



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