Tax implications for property developers and investors

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1. **The income tax regimes applicable to property transactions**

1.1 The income tax consequences surrounding dealings with property may be subject to assessment under a number of different parts of the tax law. The result is that dealings in property may have a number of different taxation consequences flowing to vendors of real property.

1.2 Identifying the taxing regime is mostly dependent on the determination of two issues, being:

1.2.1 the characterisation of the transaction; and

1.2.2 the profile of the taxpayer in relation to the transaction.

1.3 The taxing regime that may apply in the context of a property transaction can be divided into three possibilities, being:

Account	Description
Capital	as a gain on the disposal of a CGT asset.[1]
Revenue	as a disposal of trading stock, where land is held for sale in the ordinary course of a taxpayer's business.[2]
	as part of a profit-making scheme.[3]

1.4 In broad terms, if the asset (i.e. the land) disposed of is characterised as an item of 'trading stock' or a 'revenue asset', then its disposal consideration it will be subject to income tax (being on 'revenue account'). However, if the asset is a 'CGT asset', then any gain or loss on disposal will be subject to the capital gains tax (i.e. CGT) provisions. The determination of the appropriate taxing regime depends on many factors and is a question of fact. Broadly, the characterisation of the three possibilities are:

Account	Description	Taxation Effect
Capital	Capital account	'Mere realisation' of an investment in land
Revenue	Trading stock	Land sold as part of a property development business, where the property is being held for the purpose of re-sale
	Revenue asset	Land is sold as part of an isolated or 'one-off' transaction. The transaction has been entered into with a profit-making purpose, and in a sufficiently commercial / business-like manner.

[1] Section 6-10 of *Income Tax Assessment Act* 1997 (Cth) (the '1997 Act') as statutory income (via Section 102-5 and Division 104 generally of the 1997 Act).
[2] Division 70 of the 1997 Act, see Section 70-80 where land sold in ordinary course of taxpayer's business, gross receipts assessable as ordinary income under Section 6-5.
[3] Section 6-5 of 1997 Act as ordinary income, Section 6-10 (via Section 15-15 or Section 25A of the *Income Tax Assessment Act* 1936 (Cth) (the '1936 Act')) as statutory income.

2. **Land held as trading stock**

Overview: definition of 'trading stock'

2.1 In the event that property is sold as part of a property development business, then the property will be subject to the trading stock provisions (Division 70 of the 1997 Act). The issue is therefore whether your activities amount to the carrying on of a property development business.

2.2 Although not extremely useful, the term 'business' is defined in section 995-1 of the 1997 Act as including '*… any profession, trade, employment, vocation or calling, but not occupation as an employee…*'. Regard needs to be given to the judicial interpretation of the term. Ascertaining whether a business is being carried on is a question of fact (*Ferguson v FC of T* (1979) 9 ATR 873).

2.3 Section 70-10 of the 1997 Act provides a definition of 'trading stock', as including:

> '*Anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business*'.

2.4 As a result, taxpayers that are not carrying on a business of property development will not hold property as trading stock. The High Court upheld this view in the *FC of T v St Hubert's Island Pty Limited* 78 ATC 4104, where it was held that land would constitute trading stock if it has been acquired for the purpose of resale - including land that is purchased for the purpose of subdivision, development and resale.

2.5 Further, the property must not merely be held for the purpose of manufacture, sale or exchange by a business. Rather, it must be held for the purpose of manufacture, sale or exchange in the *ordinary* course of a taxpayer's business.

Holding land for purpose of resale – land originally acquired as trading stock

2.6 Before land will be considered trading stock, it must be held for sale in the 'ordinary course of business'. The holding of land as trading stock involves the taxpayer having dispositive power in relation to the land (*Sutton Motors (Chullora) Wholesale Pty Limited* 85 ATC 4398). Where the taxpayer has title to the land in question, this would be sufficient (in the context of the trading stock provisions) to arise when the contract for purchase of the land settles (*Gasparin v FC of T* 94 ATC 4280).

2.7 Broadly, virgin land will constitute trading stock *in globo* even before it is converted into a subdivided and improved condition for sale (*FC of T v St. Hubert's Island Pty Limited* 78 ATAC 4104). *In globo* trading stock will become converted into individual articles of trading stock upon being converted into subdivided and marketable components, e.g. when the plan of subdivision is registered (*Barina Corporation v FC of T* 85 ATC 4847 and *Kurts Developments Limited* 98 ATC 4847).

Holding land for purpose of resale – land not originally acquired as trading stock

2.8 While land may not be acquired for resale originally, it may subsequently be held for such purposes – i.e. be held in the ordinary course of a business, and therefore be characterised as an item of trading stock.

2.9 In such situations, it is the use or intention relating to land that has changed – resulting in a change in it's taxation characteristic from, for example, a CGT asset to an item of trading stock.

2.10 Section 70-30 of the 1997 Act deals with this situation, and provides that in such cases, the taxpayer holding the land will be deemed to have:

2.10.1 sold the land for its 'market value' or 'cost' (the taxpayer may elect which value to use); and

2.10.2 immediately reacquired the land for the same amount.

2.11 The value elected by the taxpayer then becomes the property's cost for trading stock purposes. The election must be made by the time of lodgement of the income tax return for the income year in which the item starts to be held as trading stock.

2.12 However, if the election is not made by the required time, because the taxpayer subsequently realises they started to hold the item as trading stock, the election must be made as soon as practicable after the land has changed its characteristic.

2.13 Further, the Commissioner has a discretion to allow a taxpayer to make a later election (subsection 70-30(2) of the 1997 Act).

Cost election

2.14 'Cost' is the value the land would it would have been, calculated as if it had it been acquired as trading stock.

2.15 If cost is elected, the deemed disposal will not give rise to any amount of tax payable by virtue of the CGT provisions. As a result, there are no negative cash flow consequences for the taxpayer (subsection 118-25(2) of the 1997 Act).

Market value election

2.16 In the event that a market value election is made, the deemed disposal and re-acquisition under Section 70-30 of the 1997 Act may have CGT implications. The result may be that there is an income tax liability for the taxpayer, notwithstanding that no actual proceeds are received.

2.17 Specifically, any capital gain will be any difference between the property's market value and cost base (refer to Section 104-220 of the 1997 Act - CGT event K6).

2.18 The Commissioner of Taxation, in Taxation Determination TD 97/1 entitled *If land, originally acquired as a capital asset, is later ventured into a business of development, subdivision and sale, how is the market value of the land calculated at the time it is ventured into the business?,* considers that the market value of the property is to be determined having regard to its 'highest and best use'.

2.19 Such a determination involves a requirement to take into account the land's potential usages and the probability of council approval for any potential use. It is assumed that this would entail a higher value than cost on account of a venture being entered into.

2.20 It should be repeated that in the event that CGT event K4 applies, then the taxpayer may be subject to a negative cash flow impact, given that an amount of income tax may become payable notwithstanding that the taxpayer has not actually received any proceeds.

2.21 However, a market value election may be advantageous, for the following reasons:

2.21.1 the difference between the cost of the property and its market value at the time of the deemed disposal will be taxed under the CGT regime, and therefore may potentially attract some CGT concessions (e.g., 50% general discount in Division 115 of the 1997 Act);

2.21.2 the increase in the tax cost of the property will mean that any future gains subject to tax under the ordinary income provision are reduced; and,

2.21.3 interest referable to borrowings used to fund any income tax liability may be deductible where connected with the carrying on of a business (Taxation Ruling IT 2582: *Income tax: Deductibility of interest incurred on moneys borrowed to pay income tax*)

Ceasing to hold land for purpose of resale but ownership continues

2.22 In the event that a taxpayer decides that property originally held as trading stock should be retained for investment or private purposes, section 70-110 of the 1997 Act will apply to deem the trading stock to be sold for its cost and reacquired for that same amount.

2.23 Section 70-110 of the 1997 Act provides that:

> *'If you stop holding an item as trading stock but still own it, you are treated as if:*
>
> *(a) just before it stopped being trading stock, you had sold it to someone else (at arm's length and in the ordinary course of business) for its cost; and*
>
> (b) *you had immediately bought it back for the same amount.'*

2.24 The amount for which the trading stock is notionally sold is assessable income just like the proceeds of sale of any trading stock. However, given the way in which trading stock is accounted for, the taxpayer receives a deduction for that same amount with the result that there is no actual tax liability.

2.25 In the event that the property is held as a CGT asset, then the cost base for the property will be the deemed purchase price.

2.26 The deemed sale at 'arms length' prevents the non-arms length rules contained in section 70-20 of the 1997 Act applying. Further, as the sale is deemed to be 'in the ordinary course of business' it is also not subject to section 70-90 of the 1997 Act dealing with assessable income on disposal of trading stock outside the ordinary course of business.

Bringing to account trading stock acquisitions and disposals under Division 70 of 1997 Act

2.27 Where a business is being carried on and land is being held for the purpose of resale, the trading stock provisions in Division 70 of the 1997 Act provide the manner in which outgoings and earnings are treated for income tax purposes.

2.28 Division 70 of the 1997 Act, which is intended to '*... produce an overall result that ... properly reflects ... activities with ... trading stock during the income year...*' (section 70-5 of the 1997 Act) provides that:

2.28.1 acquisition and ancillary costs (eg development costs) of purchased trading stock are an allowable general deduction (section 8-1 of the 1997 Act) in the year the trading stock is held for sale in the course of a business (section 8-1 and section 70-15 of the 1997 Act);

2.28.2 the gross consideration received upon disposal of trading stock is assessable as ordinary income (section 70-80 and section 6-5 of the 1997 Act) upon being derived (which will be at the date of settlement in respect of trading stock - *Gasparin v FC of T* 94 ATC 4280); and

2.28.3 the excess of closing value (section 70-45 of the 1997 Act) of trading stock on hand at the end of the income year over the opening value (section 70-40 of the 1997 Act) at the start of the income year is assessable (section 70-35 of the 1997 Act);

2.28.4 and conversely, where the opening value of trading stock is greater than the closing value, the excess is allowable as a deduction (section 70-35 of the 1997 Act).

2.29 Deductions for the cost of the trading stock are only available in the income year in which it is sold. Further, the trading stock regime expressly provides that the cost of trading stock is not a capital outgoing that could otherwise be denied deductibility under the general deduction provision (section 70-25 of the 1997 Act).

2.30 As a result, it is important to determine the cost of trading stock, as it is this amount that is deductible to the taxpayer when the item is sold. Further, a choice must be made as to how trading stock will be valued for the purposes of the above. It is also important to note that the closing value of stock for one year becomes the opening value for the following year.

Valuation of trading stock

2.31 Section 70-45 of the 1997 Act permits three methods for valuing trading stock, being:

2.31.1 cost;

2.31.2 market-selling value; or

2.31.3 replacement cost.

2.32 The Commissioner will generally not accept amendment requests that involve changing valuation methods once an assessment has been issued. However, the amount of value under the chosen method can be changed.

<u>Cost</u>

2.33 When valuing stock according to the 'cost' methodology, an important issue to determine is what is actually included in such a valuation.

2.34 Cost is determined using absorption costing. The Commissioner of Taxation, in Taxation Ruling IT 2350 entitled *Income Tax: Value of trading stock on hand at end of year: Cost Price: Absorption costing,* considered that the following types of items are included when determining the cost of land as trading stock:

2.34.1 insurance costs in relation to equipment used in construction;

2.34.2 insurance of building being developed;

2.34.3 production supervisory wages (including payroll tax, superannuation, workers compensation and holiday pay);

2.34.4 depreciation on plant used during construction; and

2.34.5 electricity used on-site.

2.35 For a development site, when a parcel of land consists partly of infrastructure land, which vests in the Crown upon subdivision, the costs of infrastructure land and costs relating to infrastructure land will be included in the cost of trading stock (*FC of T v Kurts Development Limited v FC of T* 98 ATC 4877). These costs are made up of internal and external infrastructure costs:

2.35.1 internal infrastructure costs include drainage, kerbing, electricity, parks, roads, sewerage, and telephones; and

2.35.2 external infrastructure costs are those costs that relate to items physically external to the land of the developer but may be required as a condition of gaining approval from local council to undertake a subdivision. As the costs are required in order to gain approval they are incurred in bringing into existence individual subdivided lots and are therefore included in the cost of trading stock. Such costs can include upgrading sewerage, water mains or roads that are adjacent to the taxpayers land or contributions by the taxpayer in relation to upgrading such items.

2.36 Before registration of a developer's plan of subdivision creating individual subdivided lots, infrastructure land and the infrastructure costs relating to the infrastructure land are part of the cost of the developer's trading stock consisting of the un-subdivided land. Upon subdivision, those infrastructure costs become part of the cost of trading stock consisting of the individual lots (*FC of T v Kurts Development Limited v FC of T* 98 ATC 4877).

2.37 The costs of holding land are not included in the value of trading stock. Such costs, including interest, council rates, marketing expenses and land tax incurred on and after the purchase of land should be deductible in the year they are incurred (Tax Determination TD 92/132).

<u>Market selling value</u>

2.38 In falling property markets it is feasible that the market value of property may be less than the value of trading stock at the beginning of the year or from its current year cost. To secure potential deductions in the year, a taxpayer should ensure that he or she investigates obtaining a market valuation for the year-end. The valuation of development and partly developed land requires the usage of the land to be taken into account.

2.39 Where land is to be ventured into a business of development, subdivision and sale, the market value of land is to be determined having regard to the 'highest and best use' that can be made of the land. The value of land can be enhanced when it becomes suitable for subdivision (Taxation Determination TD 97/1).

2.40 The land must be valued based on the current state of the land. When looking at subdivided land each lot will only be valued as a separate item of stock if each block is individually marketable. Un-subdivided land will be valued as one lot (*Barina Corporation Limited v FC of T* 85 ATC 4847).

2.41 The Commissioner in Taxation Determination TD 97/1 provides the following example:

> *A taxpayer acquired a rural property on which he conducted farming activity. Some years later, the property is ventured into a business involving the development and subdivision of the land into residential allotments.*
>
> *In calculating the net profit on sale of the residential lots, the taxpayer should take into account an appropriate proportion of the market value of the land when it was ventured into the business of development, subdivision and sale. The market value of the land is its value as broad acres but taking into account its potential for subdivision and the probability of consent being given for such potential use.*

2.42 Where undertaking a market valuation, the choice of who is to undertake a valuation will depend on the nature of the asset and the taxpayer's business circumstances – in particular factors such as:

2.42.1 the value of land versus its cost or opening value;

2.42.2 the complexity of the valuation;

2.42.3 the availability of in-house valuation expertise; and

2.42.4 use of an external valuer.

2.43 It is submitted that where a market value will significantly reduce tax payable, an independent valuation should be obtained.

2.44 Where a market value is used, it must be the value as at the end of the income year. This means events subsequent to year-end should not impact on the valuation.

<u>Replacement cost</u>

2.45 Replacement cost method values land at the amount the taxpayer would have to pay for a replacement item in its normal buying market on the last day of the year of income. For this method to be appropriate, items must be available in the market and be substantially identical to the replaced items.

2.46 In *Parfew Nominees Pty Limited v FC of T* (1986) 85 FLR 370 (86 ATC 4673) the Victorian Supreme Court held that when valuing strata units at year-end, the taxpayer could not use as replacement cost an estimate of the cost of acquiring a similar block of land and developing identical strata units. The Court held that it was wholly unrealistic to postulate a notional rebuilding of a whole development and then to value the units as part of that development. If valuation at replacement cost were open, it was held, then the appropriate value would be the selling price of the units.

2.47 The replacement cost method is not generally appropriate to value land as trading stock.

3. **Land as a revenue asset**

3.1 The disposal of a revenue asset generates ordinary income for the taxpayer. Generally, a 'revenue asset' is one that is purchased with a view to profit upon its eventual realization (*FCT v Whitfords Beach Pty Ltd* 82 ATC 4031). It is more than 'merely' realised, but it is not held as an item of trading stock.

3.2 The Commissioner of Taxation considered in paragraph 6 of *Taxation Ruling TR 92/3* entitled *Income tax: profits from isolated transactions* that receipts derived from an ‘isolated transaction’ would be assessed as ordinary income under section 6-5 of the 1997 Act if:

3.2.1 ***First*** - the taxpayer entered into the transaction with a profit-making purpose; and

3.2.2 ***Secondly*** – a profit was made in the course of carrying on a business or in carrying out a business operation or commercial transaction.

3.3 That is, in *Taxation Ruling TR 92/3* the Commissioner of Taxation uses a broad approach to characterising business gains from isolated transactions. Indeed, at paragraph 12 the Commissioner asserts that for ‘… a transaction to be characterised as a business operation or a commercial transaction, it is sufficient if the transaction is business or commercial in character’.

3.4 However, Hill J in *Westfield Ltd v FCT* (1991) 21 ATR 1398 considered that a taxpayer must contemplate the means by which a taxpayer derives profit. In that case, a taxpayer who acquired an option for the purchase of land with the intention of designing, constructing, letting and managing a shopping centre was not assessed on capital account when, before exercising the option, the taxpayer sold the land. The Commissioner of Taxation assessed the taxpayer on the profit on the basis that it was income according to ordinary concepts. Justice Hill held that whilst a profit-making scheme may lack detail at the time of acquisition, the means of achieving the profit must have been considered by the taxpayer when the option was being acquired.

3.5 At 1406 Hill J observed that:

> *In a case where the transaction, which gives rise to the profit, is itself a part of the ordinary business (e.g. a profit on sale of shares made by a share trader), the identification of the business activity itself will stamp the transaction as one having a profit-making purpose. Similarly, where the transaction is an ordinary incident of the business activity of the taxpayer, albeit not its main business activity, the same can be said. The profit-making purpose can be inferred from the association of the transaction of purpose and sale with that business activity.*

3.6 Further, at 1408 Hill J concluded that:

> *… it is difficult to conceive of a case where a taxpayer would be said to have made a profit from the carrying on, or carrying out, of a profit-making scheme, where, in the case of a scheme involving the acquisition and resale of land, there was, at the time of acquisition, no purpose of resale of land, but only the possibility (present, one may observe, in the case of every acquisition of land) that the land be resold.*

3.7 That is, if the scope of the taxpayer’s business / profit making means is narrowly defined, the gains may not be assessed on revenue account. Property developers do well to keep in mind this development tip.

3.8 The carrying on of a business is also not an essential element when considering whether there is a disposal of a revenue asset. In *FC of T v Whitfords Beach Pty Ltd* (1982) 12 ATR 692 at 710 Mason J observed that:

> *… it is enough that the statutory description that there was a profit-making undertaking or scheme which exhibited the characteristic of a business deal, even though it did not amount to the carrying on of a business. If what has*

happened amounted to no, more than a mere realisation of an asset then it was not a profit-making undertaking or scheme.

3.9 It seems that profits from an isolated transaction will be treated as assessable income where a profit-making intention exists when a transaction is first entered into: *FC of T v Myer Emporium* 87 ATC 4363. This will typically be when a taxpayer purchases property.

Is realisation sufficiently business-like? Decisions in Casimaty, McCorkell and Case W59 (Stevenson)

3.10 Where the taxpayer is not engaged in the business of a property developer, but subsequently sells the land, the manner in which the land is subdivided, developed and sold will provide the basis for determining whether the transaction amounts to a business operation or commercial transaction, such that the profit is potentially assessable as ordinary income.

3.11 It is considered that a more passive role rather than an active role is likely to cause land development and subsequent sale to be regarded as the mere realisation of a capital asset.

3.12 *McCorkell* provides an illustration of a passive role. In *McCorkell*, the taxpayer entered into two contractual arrangements. The first arrangement involved a surveyor and engineer who subcontracted the work on the subdivision. The second arrangement involved joint estate agents who recommended sale prices and dealt with all potential purchasers.

3.13 The taxpayer did not contract or deal with the contractors or purchasers and had no business office or letterhead. The taxpayer had minimal involvement with advertising. It was thus held that the adoption of a relatively passive role rendered the land development and sale of the allotments as the realisation of a capital asset.

3.14 In *Casimaty*, Ryan J held that the purpose for which the property was held remained unchanged - the taxpayer held land as a capital asset for income-producing purposes. Ryan J contrasted *Casimaty* with *Whitfords Beach* (where the profits made on the sale of land were held to be ordinary income of the taxpayer), imputing the change of purpose pertaining to the land to the change in ownership of the company incorporated by the fishermen to the three property development companies.

3.15 In contrast to the passive role, *Case W59* provides an illustration of circumstances where a taxpayer has adopted an active role in the property development. In *Case W59*, the extent to which professional advice was received in respect of the subdivision and sale of the land was limited to the original planning application.

3.16 The taxpayer alone conducted the remainder of the subdivision and sale of the land. Thus the taxpayer made all decisions of significance, and directed the entire project. The taxpayer was directly involved in the negotiations with the local council and water authority, employed the contractors, and sought – and received – finance.

3.17 Moreover, the taxpayer controlled the sale of the allotments by instructing a number of local real estate agents to act on his behalf. Whilst no site office was constructed on the property, the taxpayer utilised a home office to manage the subdivision, including to maintain the associated accounts and to deal with prospective purchasers.

3.18 The Administrative Appeals Tribunal held that the taxpayer in *Case W59* was engaged in the business of subdividing, developing and selling land as opposed to merely realising the capital asset in the most advantageous way. The decision of the AAT was affirmed in the Federal Court on appeal by the taxpayer in *Stevenson*.[4]

Taxation implications when a property is a revenue asset

3.19 Where an asset is characterized as a 'revenue asset', income tax is levied on the 'profit' that the taxpayer derives upon sale. The High Court in *Whitfords Beach* held that the net profit on the land sales fell within the concept of 'gross income' under the ordinary income provision of section 6-5 of the 1997 Act.

3.20 That is, gains realized on the sale of revenue assets are assessed as ordinary income under section 6-5 of the 1997 Act and losses incurred on disposal are deductible under section 8-1 of the 1997 Act.

3.21 Given that gains made on revenue assets are taxed on a profit and loss basis outgoings are recognised as a cost when the gain is brought to account – with the deduction not recognised when the asset is initially acquired.

4. Land as a Capital Gains Tax Asset

4.1 When property acquired on or after 20 September 1985 is not held as trading stock of the taxpayer or otherwise on revenue account, but rather is held on capital account by the taxpayer, any gain or loss arising upon disposal of the land will be calculated and assessed under the CGT provisions.

4.2 As stated above, property held by a taxpayer may be characterised as either a:

4.2.1 ***a revenue asset*** - on the basis that there is an intention by the taxpayer to make a profits on the disposal of the property; or

4.2.2 ***a capital asset*** - on the basis that the property forms part of the profit yielding structure of the taxpayer therefore its disposal will be subject to CGT.

4.3 *Scottish Australian Mining Co Ltd v FC of T* (1950) 4 AITR 443 established that a profit derived from the sale of a capital asset, undertaken in an enterprising manner is not income according to ordinary concepts. A taxpayer is not assessable on the profits if the taxpayer does everything possible to realise to the best advantage a capital asset, and the asset was not initially acquired for the purpose of being eventually disposed at a profit. At 450-1 Williams J held that:

> *The crucial question is therefore whether the facts justify the conclusion that the appellant embarked on …[a profit-making] …business or undertaking or scheme. The facts would, in my opinion, have to be very strong indeed before a court could be induced to hold that a company which had not purchased or otherwise acquired land for the purpose of profit-making by sale was engaged in a business of selling land and not merely realising it when all that company had done was to take necessary steps to realise the land to best advantage, especially land which had been acquired and used for a different purpose which it was no longer businesslike to carry out.*

[4] *Stevenson v FCT* 91 ATC 4475

4.4 Land held on capital account will be a CGT asset (section 108-5 of the 1997 Act). Joint tenants are treated as owning separate CGT assets proportionate to each tenant's interest in the CGT asset (section 108-7 of the 1997 Act).

4.5 A disposal of a CGT asset occurs upon the occurrence of a 'CGT event'. Some of the relevant CGT Events applicable to property transactions include:

CGT Event	Description
CGT event A1	disposal of a CGT asset by a change in beneficial ownership to another person
CGT event E2	transfer of a CGT asset to a trust
CGT event E4	capital payments from a unit trust to a unit holder
CGT event E5	a beneficiary of a trust becoming entitled to a trust's CGT asset
CGT event K4	a CGT asset becomes trading stock

CGT Concessions

4.6 For CGT assets acquired before 21 September 1999 and held for at least 12 months, the taxpayer can choose to calculate the capital gain based on either:

4.6.1 the indexed cost base (cost base adjusted for the 'consumer price index' up to 30 September 1999); or

4.6.2 by applying the 'CGT 50% discount', which is unavailable for companies (Division 115 of the 1997 Act).

4.7 Where the capital gain is made by a trust, the CGT 50% discount is applied and the balance distributed to an individual beneficiary, the beneficiary will 'gross up' the distribution apply losses if any then apply the CGT 50% discount to the grossed-up amount. That is the discount effectively flows from the trust to the beneficiary. A similar result occurs when the payment passes through a chain of trusts.

4.8 A number of other CGT concessions may apply, such as:

4.8.1 The CGT main residence exemption (Division 118-B of the 1997 Act); and

4.8.2 The CGT small business concessions (Division 152 of the 1997 Act).

4.9 The small business concessions contained in Division 152 of the 1997 Act may significantly reduce a capital gain made in respect of an 'active asset' of a 'small business taxpayer'.

4.10 A 'small business taxpayer' is one that owns, together with related entities, assets valued at $6m or less (section 152-15 of the 1997 Act). An 'active asset' is an asset used or held ready for use in a business and, in certain circumstances, includes shares and trust interests in an entity that holds active assets (section 152-40 of the 1997 Act). However, an active asset does not include an asset whose main use in the course of carrying on the business was to derive rent, unless its main use for deriving rent was only temporary (subsection 152-40(4)(e) of the 1997 Act). This has particular significance for property developers that lease property to increase revenues pending its sale.

4.11 The exclusion of assets used to produce rental income effectively limits the availability of the concessions to property projects used by the taxpayer or a related entity in a business (eg a factory or shop). Accordingly, the concessions are of limited application.

5. **Characterisation of a Company for Taxation Purposes**

5.1 Companies are treated as an entity seperate from its owners (i.e. the shareholders). As a result, a company is an autonomous taxpayer. Section 4-1 of the 1997 Act provides that:

> '*Income tax is payable by each individual and **company**, and by some other entities.*' [emphasis added]

5.2 Further, item 2 in section 9-1 of the 1997 Act provides that a company that is a body corporate or an unincorporated body (except a partnership) is required to pay income tax.

5.3 The term 'company' is defined in section 995-1 of the 1997 Act as a body corporate or any other unincorporated association or body of persons, but it does not include a partnership.

Taxation Treatment of Companies

5.4 Like other taxpayers, corporate taxpayers pay tax on their taxable income. The taxable income for a company is calculated in the same way as for other taxpayers – i.e. 'assessable income' less 'allowable deductions'.

5.5 However, corporate taxpayers are subject to modifying rules, such as those applicable to the calculation of losses and bad debts where there has been a change in ownership and control of the company, and they may also use 'concessions' such as the consolidation regime.

Dividends from Companies - Franking Credits

5.6 Subject to the debt/equity rules, shareholders are generally assessed on distributions of corporate profits when they receive 'dividends'.

5.7 The 'imputation system', has the aim of removing the double taxation of corporate profits by integrating taxation at both the corporate and shareholder level.

5.8 Under the regime, dividends paid by companies to their shareholders included in the assessable income of the shareholders and grossed-up to the extent that the company has paid tax on the profits referable to the dividend payment. After tax has been calculated on the shareholder's taxable income, the shareholder obtains a 'franking credit' referable to the tax paid by the company on the profits out of which the dividends have been paid. The franking credit is equal to the gross-up amount of the dividend. The practical effect is that the tax paid by the company is imputed to the shareholder.

Losses of Companies

5.9 Given that companies are treated as separate taxpayers from their owners, any losses incurred in a company cannot be distributed to the shareholders. Rather, they are retained in the company to be off-set (subject to specific anti-avoidance provisions regarding carry-forward losses) against future income of the company.

Advantages and Disadvantages of the Company Structure

Advantages	**Disadvantages**
Income is taxed at the company rate of 30%	Company profits (including those derived from rental income) are taxed as dividends when distributed to shareholders. Profits cannot be distributed to specific shareholders. Companies cannot distribute losses to shareholders. Any losses must stay within the company and can only be offset against company income. This makes it difficult to maximize the benefits of negative gearing. Companies cannot gain the 50% discount for capital gains on assets held for 12 months or more (Division 115 of the 1997 Act).

6. Characterisation of a Trust for Taxation Purposes

6.1 The 1936 and 1997 Acts do not provide a definition of 'trust estate'. However, the term 'trust' is defined in subsection 6(1) of the 1936 Act[5] as:

> *'... in addition to every person appointed or constituted trustee by acts of parties, by order, or declaration of a court, or by operation of law, includes –*
>
> *(a) an executor or administrator, guardian, committee, receiver, or liquidator; and*
>
> *(b) every person having or taking upon himself the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity, or having the possession, control or management of the income of a person under any legal or other disability.'*

6.2 The definition of 'trustee' is provided in subsection 6(1) of the 1936 Act as:

[5] and given the same meaning in the 1997 Act by section 995-1 of that Act.

(i) *a person who has control over property (whether or not they hold the property) and who owes a fiduciary duty to another in exercising that control; and*

(ii) *a person under a fiduciary duty, with the duty relating to the administration or control of the relevant property.*

Taxation Treatment of Trusts

6.3 Income referable to trust estates are brought to tax under Division 6 of Part III of the 1936 Act.

6.4 Section 97 of the 1936 Act applies to a beneficiary who is not under a legal disability and who is presently entitled to a share of net income of the trust estate. The assessable income of an Australian resident beneficiary includes the beneficiary's share of the net income of the trust estate. The assessable income of a non-resident beneficiary includes so much of the beneficiary's share of net income of the trust as is attributable to sources in Australia.

Trust Losses

6.5 Trusts are partial look through entities for taxation purposes.

6.6 Carry forward losses, for example, are retained within a trust, and cannot be distributed to beneficiaries. Such carry-forward losses can only be used by a trust in future income years for the purpose of calculating the net income of the trust estate for that year – subject to the trust loss provisions within Schedule 2F to the 1936 Act.

Advantages and Disadvantages of the Trust Structure

Advantages	**Disadvantages**
Distributions from trusts retain their character. Trusts are eligible for the Division 115 discount on capital gains. Profits can be distributed to a wide group of beneficiaries.	Losses remain in the trust, they are not distributed. To avoid the trustee paying tax at the highest marginal tax rate beneficiaries must be made presently entitled to all of that year's income.

7. Specific Issue relating to trusts - *CPT Custodians* case

7.1 One of a number of issues concerning trusts, but one particularly relevant to property investors or developers, is a beneficiary's interest in property that is subject to a trust relationship – as considered by the High Court in *CPT Custodians Pty Ltd v Commissioner of State Revenue; Commissioner of State Revenue v Karingal 2 Holdings Pty Ltd* [2005] HCA 53.

Finding in CPT Custodians

7.2 The High Court in *CPT Custodians* held that for the purposes of the Victorian *Land Tax Act* 1958 (Vic), unit holders of a unit trust own a beneficial interest in the trust property, rather than an ownership interest in any particular asset of the unit trust. As a result, the unit holders were not considered to own the land held by a unit trust. This is on the basis that the trustee's (and manager's) entitlement to the assets of the trust effectively dilutes, or defeases the unit holder's entitlements to the assets, income and capital of the trust.

A trustee's right to reimbursement – the scope of the right pre-CPT Custodians

7.3 Arguably, the decision of the High Court in *CPT Custodians* regarding a beneficiary of a trust only having a residuary entitlement to the assets of a trust was already authority recognised by past decisions of the High Court.

7.4 Under the general law, as the legal owner of trust property, the trustee is considered to be personally liable for debts incurred in the course of carrying out the activities of the trust. However, under the general law, the various trustee legislation,[6] and also as typically provided for in the particular trust deeds, with respect to the debts that a trustee may become personally liable for, a trustee might seek to:

7.4.1 reimburse itself – i.e. a trustee has a ***right of indemnity***; and / or

7.4.2 pay or discharge out of the trust property (i.e. a ***right of exoneration***) all expenses properly incurred or expended in or about execution of the trustee's trusts or powers.

7.5 In *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360, the High Court expressed the view, which had been confirmed in *Chief Commissioner of Stamp Duties v Buckle* (1998) 151 ALR 1, that a trustee's right of indemnity is property – that is, a right for the benefit of the trustee in the trust fund.

7.6 A trustee's right of indemnity and exoneration is replicated in legislation. For example, in New South Wales[7] subsection 58(4) of the *Trustee Act 1925* (NSW)[8] provides that:

> *A trustee may reimburse himself or herself, or pay or discharge out of the trust property all expenses incurred in or about execution of the trustee's trusts or powers.*

7.7 The High Court explained a trustee's right of indemnity in *Octavo* at 367 as follows:

> *[A trustee] ... is entitled to be indemnified against those liabilities from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge or right of lien over those assets ... The charge is not capable of differential application to certain only of such assets. It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which under the terms of the trust deed the trustee is not authorised to use for the purposes of carrying on the business ... In such a case **there are then two classes of persons having a beneficial interest in the trust assets**: first, the cestuis que trust, those for whose benefit the business*

[6] See for example section 59(4) of the *Trustee Act 1925* (NSW).
[7] And also the Australian Capital Territory.
[8] See also: section 72 of the *Trusts Act* 1936 (QLD); subsection 35(2) of the *Trustee Act* 1936 (SA); subsection 36(2) of the *Trustee Act* 1958 (Vic); section 71 of the *Trustees Act* 1962 (WA); section 26 of the *Trustee Act* 1893 (NT).

was being carried on; ***and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former****, so that the ceruis que trust are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied …* ***The creditors of the trustee have limited rights with respect to the trust asset****s. The assets may not be taken in execution … but in the event of a trustee's bankruptcy the creditors will be subrogated to the beneficial interest enjoyed by the trustee …*

7.8 That is, *Octavo* is authority for the proposition that a trustee's interest in a trust fund (e.g. due to its right to indemnity) trumps the right of a beneficiary to the assets subject of a trust.

7.9 Quoting *Scott on Trusts*, the Full Court of the High Court observed in *Buckle's case* at 13:

> *Where the trustee acting within his power makes a contract with a third person in the course of the administration of the trust,* ***although the trustee is ordinarily personally liable to the third person on the contract, he is entitled to indemnity out of the trust estate****. If he has discharged the liability out of his individual property, he is entitled to reimbursement; if he has not discharged it, he is entitled to apply the trust property in discharging it, that is, he is entitled to exoneration.* [emphasis added]

7.10 The right to the beneficiaries interest in the assets held by the trust has been distinguished between the assets themselves – with the beneficiaries entitled to the residuary of the trust fund after the trustee's right to reimbursement or exoneration has been discharged. In citing the decision in *Dodds v Tuke* (1884) 25 Ch D 617 at 619, the Court in *Buckle's Case* observed at 13:

> *'Until the right to reimbursement or exoneration has been satisfied, 'it is impossible to say what the trust fund is' …. . The entitlement of the beneficiaries in respect of the assets held by the trustee which constitutes the 'property' to which the beneficiaries are entitled in equity is to be distinguished from the assets themselves. The entitlement of the beneficiaries is confined to so much of those assets as is available after the liabilities in question have been discharged or provision has been made for them. To the extent that the assets held by the trustee are subject to their application to reimburse or exonerate the trustee, they are not 'trust assets' or 'trust property' in the sense that they are held solely upon trusts imposing fiduciary duties which bind the trustee in favour or the beneficiaries …*

7.11 The above statements are consistent with the High Court's reasoning in *CPT Custodians* at [51] where it was held that:

> *In the present case, the unsatisfied trustees' right of indemnity was … an actual liability …. Until satisfaction of rights of reimbursement or exoneration, it was impossible to say what the trust fund in question was.*

7.12 Given precedent on the issue, the author queries whether there actually has been a change in the law following the decision in *CPT Custodians*. Rather, it seems that the various Chief Commissioners of State Revenue has seized upon the decision in *CPT Custodians* to argue that there was been a fundamental shift in the view relating to a unit holders rights in the trust fund of a trust estate in order to raise extra revenue.

8. **Partnership for Tax Purposes**

8.1 The definition of 'partnership' contained in the 1997 Act consists of two limbs, which include:

8.1.1 an association of persons carrying on business as partners;

8.1.2 an association of persons in receipt of ordinary income or statutory income jointly. This limb is sufficiently wide to include, for example, a passive co-ownership of income producing property.

8.2 A 'partnership' for tax law purposes needs to be distinguished from a joint venture. This is presently an issue in many GST cases.

8.3 The advantages and disadvantages of establishing a partnership are:

Advantages	**Disadvantages**
Income and losses shared according to predetermined agreement. Losses distributed directly to partners. Capital losses are calculated in the hands of the individual partners. Partners who are individuals, trusts or superannuation funds may receive the Division 115 discount on capital gains.	Income from property are taxed at the individual partner's marginal rate of tax. Capital gains are calculated directly in the hands of the individual partners. Partners are jointly and severally liable for the partnership debts.

Taxation Treatment of Partnerships

8.4 Section 90 of the 1936 Act defines the 'net income' of a partnership as:

> *'…the assessable income of the partnership, calculated as if the partnership were a taxpayer who was a resident, less all allowable deductions except deductions allowable under section 290-150 or Division 36 of the Income Tax Assessment Act 1997.'*

8.5 That is, the 'net income' of a partnership is basically the 'taxable income' (ie. assessable income less allowable deductions) arising from the partnership's activities. However, there are two modifications to the application of Australian tax law to the calculation of a partnership's net income:

8.5.1 the deduction for contributions to superannuation funds under Section 290-150 of the 1997 Act is not applicable in calculating a partnership's 'net income';

8.5.2 deductions for tax losses carried forward under Division 36 of the 1997 Act are not applicable in calculating net income of a partnership. This is because partnership losses are claimed by the individual partners in the year of income in which the loss was incurred. If the loss is not fully absorbed against the partner's other income, then it can be carried forward under the tax lass carry-forward rules by the individual partners for offset against future assessable income that they may derive.

8.6 Section 90 of the 1936 Act also defines the term 'partnership loss'. It provides that:

> *'...means the excess (if any) of the allowable deductions, other than deductions allowable under section 290-150 or Division 36 of the Income Tax Assessment Act 1997, over the assessable income of the partnership calculated as if the partnership were a taxpayer who was a resident.'*

8.7 The basis for the calculation of a 'partnership loss' is similar to that applicable to the calculation of 'net income' except that in a 'partnership loss' situation the allowable deductions exceed the assessable income.

8.8 When the net income or partnership loss is calculated, it is allocated to the individual partners. Under section 92 of the 1936 Act, it is the partner's individual interest in the net income or partnership loss that is taken into account in determining the individual partner's taxation position. As such, the allocation of net income or partnership loss is based on the partners' interests, and not on the distribution of partnership profits.

8.9 In respect of first limb partnerships, a partner's individual interest is generally determined via the partnership agreement. Therefore, for such a partnership the partners can agree to share income and losses in whatever proportions they choose. Further, it may be possible, under the partnership agreement, to nominate that particular partners receive particular items of income.

8.10 The position is different under second limb partnerships. In such situations, the partner's individual interest in net income and partnership loss is determined according to the individual partner's interest in the property producing the income.

8.11 In *Taxation Ruling TR 93/32*, the Commissioner of Taxation stated that, for a second limb partnership, it is the legal interests of the parties in the property which ultimately determine their individual interests in the net income or partnership loss. However, if it is established that the equitable interests in the property do not follow the legal interests, then the equitable interests will be used for the purposes of determining individual interests in net income or partnership loss.

8.12 Income retains its character (eg. rental income) as it passes through a partnership to the individual partners[9]. Further, it may be possible for a partnership to nominate that particular partners take particular items of income (ie. partners may not be entitled to a pro rata share of each item of income derived by a partnership)[10].

9. Interest Deductibility

9.1 Generally, interest is deductible if it is referable to borrowings to fund business activities where the loan is used to acquire income producing assets (including capital assets), or to meet day-to-day expenses. That is, interest costs will be deductible under

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[9] In *Taxation Ruling TR 92/13*, the Commissioner accepted that income passing through a trust retains its character in the hands of a beneficiary. It is submitted that a similar principle must apply to partnerships, as a partnership is a complete look-through entity.

[10] In *Taxation Ruling IT 2125*, the Commissioner accepted, in relation to prescribed payment system income of a partnership, that it may be shared differently from other net income of a partnership.

section 8-1 of the 1997 Act where they are incurred in gaining or producing assessable income or carrying on a business to produce such income, provided that the outgoing is not on capital account.

9.2 The deductibility of interest is determined by looking at the purpose of the loan and the use to which the loan funds are put. In the event that a loan is used to acquire capital assets, the interest may still be deductible if it is necessarily incurred for the purpose of gaining or producing assessable income.

9.3 As a result, if a taxpayer purchases a property which is intended to be rented out, and is on capital account, any interest referable to borrowings used to acquire the property will be deductible to the taxpayer on the basis that it has the expectation of deriving (rental) income from the property;

9.4 The same principle applies if a taxpayer incurs interest on monies borrowed to purchase land that is a revenue asset or trading stock.

9.5 In *NMRSR Ltd v FCT* (1998) 38 ATR 308 the Federal Court held that even though a capital asset acquired by a business may not directly produce income itself, it may contribute to the efficient operation of the business which produces assessable income, and therefore, the interest expense associated with that asset should be deductible.

Pre- commencement and post-cessation deductibility of business expenditure

9.6 When carrying on a business involving property transactions, it will be important to determine deductibility of outgoings. The ‘second limb’ of the general deduction provision[11] provides that losses and outgoings may be deducted from assessable income to the extent that ‘… it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

9.7 As a result, an important consideration is whether a loss or outgoing is incurred too soon, or too late after a business activity has commenced / ceased.

(i) Pre-commencement of a business activity

9.8 Broadly:

9.8.1 Costs incurred prior to a business commencing (e.g. feasibility studies and tests) are not considered to be incurred in carrying on a business, and are therefore not typically deductible (*Softwood Pulp and Paper Ltd v FC of T* 76 ATC 4439).

9.8.2 Further, costs incurred in establishing a new component of a taxpayer’s business are also not usually deductible (*Griffin Coal Mining Company Ltd v FC of T* 90 ATC 4870).

9.8.3 Expenditure incurred on research and development activities are considered too preliminary to the carrying on of a business activity to be deductible (*Goodman Fielder Wattie Ltd v FC of T* 91 ATC 4438)

(ii) Post – cessation of a business activity

9.9 Broadly:

[11] Comments will be restricted to cases determined under subsection 8-1(b) of the 1997 Act.

9.9.1 Expenditure incurred in selling or winding-up a business is generally not deductible, as it is not incurred 'in carrying on a business' (*Pye v FC of T* (1959) 12 ATD 118).

9.9.2 The fact that expenditure is incurred after a business activity ceases does not automatically mean that it is not deductible.

9.9.3 In determining deductibility in post-cessation situations, it needs to be determined whether the '*... occasion of the business outgoing ...*' is to be found in the '*... business operations directed toward the gaining or production of assessable income ...*' (*Case 17/96* 96 ATC 230).

9.9.4 It needs to be shown that the cessation of the business activities does not operate to break the nexus between the carrying on of the business and the incurring of the liability (*FC of T v Brown* 99 ATC 4600)