CGT: Everything you need to know as a property investor

Capital gains tax (CGT) is one of the most misunderstood tax issues for property investors, so *Eddie Chung* explains in detail what it means for you

Under the income tax system in Australia, an amount of income or gain is assessable for tax as either revenue or capital. The differentiation between revenue and capital may be clear-cut in some circumstances but less so in others.

A common analogy in differentiating revenue and capital is the fruit tree example – the fruit that is produced by the fruit tree is likened to revenue, while the fruit tree itself is analogous to capital. Applying this principle to property investment, rent is revenue while the thing that actually produces rent – the property itself – is capital.

Characterising an amount of income or gain as revenue or capital is important because our current tax system contains an inherent bias towards capital in many cases: revenue is taxable in full, while a capital gain may be eligible for the capital gains tax (CGT) discount before the discounted amount is subject to tax.

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What is capital gains tax?

Capital gains tax may arise when an investment property is sold. That is not to say the sale of a property will always give rise to CGT. If the property was held on revenue rather than capital account (eg you acquired land with the intention to construct a building on it for resale to realise a profit), then any income or gain from the sale of the property would be fully taxed as revenue. In contrast, if you bought the property with the intention of renting it out to derive rent, and it was subsequently sold, then any capital gain accrued on the property would be subject to CGT instead. In other words, CGT subjects the capital growth of an investment property to tax, regardless of whether the property is located in Australia or outside of Australia.

CGT applies to the sale of 'CGT assets', which extend beyond real estate. For instance, any gain you make on the capital growth of your share portfolio, if it is sold, will also be caught by CGT. However, certain assets are specifically CGT-exempt assets (cars, for example), while the capital gain derived on other assets, including your main residence, is specifically disregarded.

While the most common transaction that triggers CGT is the sale of an asset, other transactions may also give rise to CGT. Examples of this include the creation of a contractual right; loss or destruction of a CGT asset; or receipt of a capital amount in respect of a CGT asset that you own. Given the wide range of transactions that can be caught by CGT, it is advisable that you seek tax advice before you enter into any contractual arrangements.

How is capital gains tax calculated?

Capital gain

To calculate the CGT on the sale of an investment property, the 'net capital gain' will need to be calculated, which is added to the relevant entity's taxable income that is subject to tax in the ordinary manner. For instance, as an individual selling an investment property, the net capital gain on the sale of the property is added to your taxable income, which is subject to tax at your marginal tax rates.

The net capital gain is generally the capital proceeds (ie the sale price of the property) less the 'cost base' of the property. Therefore, the higher the cost base of the property, the lower the net capital gain and therefore the CGT associated with the sale.

The cost base of a property includes a number of elements, such as the original purchase price, the incidental costs (stamp duty, legal costs, etc) on both the purchase and sale of the property, capital expenditure to improve the property's value, and costs to preserve or defend your title to the property.

Further, provided that the property was acquired after 20 August 1991, certain costs (known as the 'third element' of the cost base) that would ordinarily be revenue in nature but have not been claimed as a tax deduction may also be included in the cost base, including interest on money you borrowed to acquire the property; costs of maintaining, repairing, or insuring the property; rates or land tax, etc.

The cost base will be reduced, however, by the total capital works deduction amounts claimed, if any, on the property before it was sold.

CGT discount

The amount by which the capital proceeds exceed the cost base will be the

capital gain. If the entity that owned the asset is an individual or a trust, the capital gain will be halved under the 50% CGT discount and the remaining amount will be the net capital gain that is subject to tax. If the entity that owned the property is a complying superannuation fund, the CGT discount is 33.33%, but if the entity is a company, no CGT discount is available. For the CGT discount to apply, the relevant entity must have owned the property for at least 12 months.

Before 8 May 2012, the CGT discount was available to both residents and non-residents of Australia for taxation purposes. However, the Government announced in the 2012 Federal Budget that the CGT discount was no longer available to individuals and beneficiaries of trusts who were non-residents in respect of taxable capital gains accrued on CGT assets after 8 May 2012. These rules are currently in draft form and are subject to change, but when they are eventually passed as law they will apply retrospectively from 8 May 2012.

Under the draft legislation, if you are a non-resident and acquired a CGT asset in Australia after 8 May 2012, you would not be eligible for the 50% CGT discount at all if you made a capital gain upon the sale of the asset. If you bought the asset before 8 May 2012 and sold it after that date, you could elect to use the 'market value approach' – you could choose to apply the 50% CGT discount to any accrued capital gain up to 8 May 2012, based on the market value of the asset on that day, and pay full CGT without the discount on any capital gain accrued after that point. If you did not choose this approach, you would not be eligible for the CGT discount on the entire capital gain.

While the CGT discount will more often than not produce a better tax outcome, the indexation method may give rise to a lower tax liability for older properties

Under the draft law, there is no specific requirement for you to obtain a formal valuation of the asset by a qualified valuer. However, you will need to be able to defend the market value adopted.

Indexation

Alternatively, instead of applying the CGT discount, the entity may elect to index the cost base of the property to calculate the net capital gain. However, indexation is frozen as at 30 September 1999, so regardless of when the property is actually sold, you may only index its cost base up to that date. (The frozen CPI index on 30 September 1999 is 123.4.)

Capital loss

On the other hand, if the cost base of the property is equivalent to or exceeds the capital proceeds on sale, no CGT will arise. If the capital proceeds fall somewhere between the cost base and the 'reduced cost base' of the property, no further tax implications will result. However, if the reduced cost base exceeds the capital proceeds, the excess will be a capital loss, which will be available to offset against any current year or future capital gains but not other income.

The reduced cost base is designed to limit the amount of capital loss crystallised. It specifically excludes the third element of the cost base and the total capital works deductions that have been previously claimed.

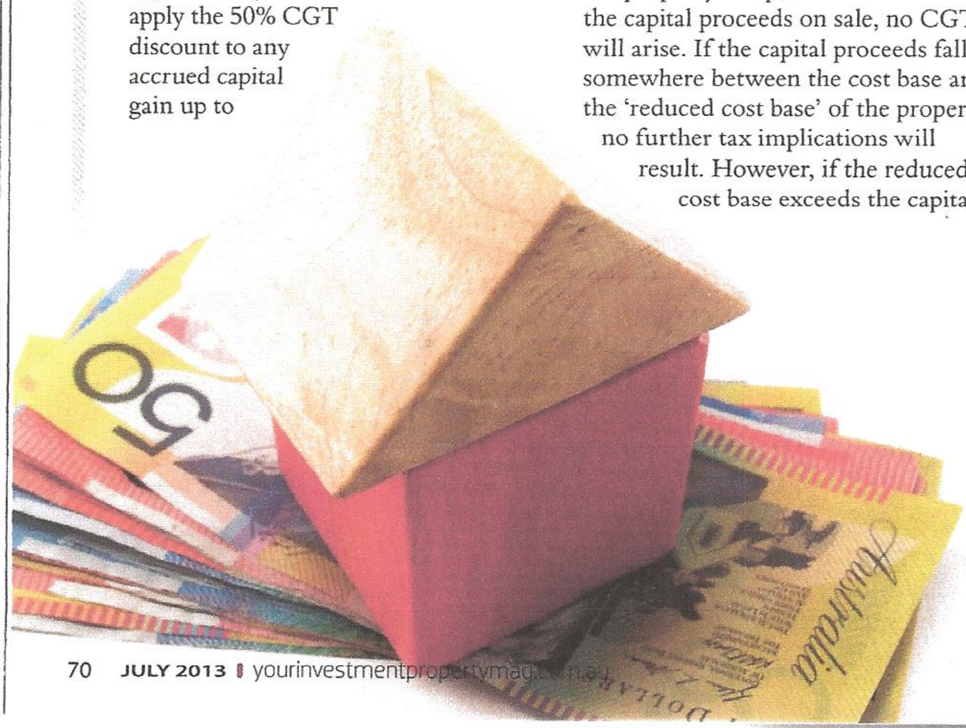
Main residence exemption

In the most straightforward case where you buy a home and live in it until it is sold, it is safe to say that the sale will not give rise to any tax liability under the current law as any capital gain derived on a property that is your main residence is generally tax free to the extent that the property is covered by the main residence exemption during your ownership.

However, life is seldom straightforward and circumstances may change. Very often, it is the change of use of the main residence that may potentially affect the extent to which the main residence exemption is available. For example, you may have bought a home in which you live but are subsequently required to temporarily leave your home for one reason or another. The issue that will then arise is whether the main residence exemption will cover the period of your temporary absence, which is when the 'temporary absence rule' comes in handy.

Under the temporary absence rule, as long as you do not treat another property elsewhere as your main residence when you temporarily leave your home, you may continue to treat your home as your main residence and retain its tax-free status, even if you are not actually living in it.

If the property is not income producing, you may continue to treat it as your main residence for an indefinite period, as long as you do not



treat another property that you own as your main residence.

If you use the property to produce income during your absence (ie you rent it out), you may continue to treat the property as your main residence for up to six years. However, if the property is only income producing on and off (ie you only rent it out some of the time), the non-income-producing periods are not counted, as long as each income-producing period does not exceed six years.

When you return to the property to live after your temporary absence, you can essentially reset the clock for another six years if you subsequently vacate the property again, as long as you do not treat any other property as your main residence.

There is nothing in the law to say how long you need to live in the property before you leave again and restart the clock – and whether you live in the property or not is a question of fact, which takes into account a number of factual circumstances (ie the address for your correspondence, the status of your utility accounts in relation to the property, etc).

For completeness, regardless of whether or not the property has been used for income-producing purposes, there is no requirement that you actually have to move back into the property to qualify for the exemption. For example, you could sell the property before the six years are up and still be exempt from CGT on the sale. The key is that you must have lived in the property first, immediately after its purchase. Otherwise, the temporary absence rules will not apply, and you may be exposed to an apportioned CGT to reflect the period during your ownership when the property was rented out.

If you move out of your home where you have always lived since its purchase, and then rent it out, the market value of the property at the time it ceases to be your main residence and becomes income producing will become the cost base of the property for CGT purposes if it is sold in the future. Documentation to defend this market value should be obtained and maintained in case of future enquiries or audit by the tax office.

Top three tips for reducing capital gains tax

Here are my top three tips for reducing your CGT liability:

1 Ensure that you legitimately maximise the cost base of your property. Common omissions of amounts that are often inadvertently excluded from the cost base are the third-element cost-base amounts and incidental costs on the purchase or sale of the property.

2 Calculate the net capital gain under both the CGT discount and indexation methods to see which one will give you a lower CGT amount. While the CGT discount will more often than not produce a better tax outcome, the indexation method may give rise to a lower tax liability for older properties.

3 CGT becomes payable in the income year during which the relevant 'CGT event' occurs, which is the time at which an obligation to sell an asset rises – ie when the sale contract is signed. Where possible, a deferral of the contract date may defer the associated CGT liability to a later year, which will be beneficial – tax deferred is tax saved.

Final words

CGT is generally straightforward, except in the case of specific exceptions and exemptions that may apply. To minimise your CGT exposure, it is advisable that you provide as much information as possible regarding the background
of the transaction to your tax accountant, who may prompt you to provide further information that may potentially reduce your CGT liability.

Eddie Chung is partner, tax & advisory, property & construction at BDO (QLD) Pty. For more information please contact: Direct: +61 7 3237 5927, Mobile: +61 0 438 663 513, eddie.chung@bdo.com.au

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