"Sharing the Burden- Tax Reform's Shifting Winners and Losers"

The Australasian Tax Teachers' Association's 30th Annual Conference

"Gaming the tax system with the main residence token"

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Caulfield Campus in Melbourne from 17 to 19 January 2018

In this paper the author identifies, by reference to case studies and conclusions drawn in an earlier paper, a range of issues arising under the main residence exemption including:

- the use of the main residence exemption as an untaxed store of wealth;
- the leveraging of a legislated tax haven to create untaxed stores of wealth;
- the exploitation of the main residence **exemption resulting from the enactment of section 118-147;**
- the adverse impact of legislative complexity on those least equipped to deal with the complexity: parents of adult children with a disability and downsizing baby boomers redeveloping their main residence;

The author considers whether the main residence exemption meets its objectives and whether, in an era of populism, tax expenditure on the main residence exemption passes the "pub test".

The author concludes by identifying reforms to address the issues finding support in other jurisdictions dealing with not dissimilar issues.

Contents

1 Introduction 4

2 Tax concessions for owner occupied housing 5

2.1. Concessions relating to a income 6

2.2. Concessions relating to capital gains 6

2.3. Calculating the capital gain on the disposal of an owner occupied dwelling 6

2.4. The basic case for the main residence exemption 8

2.5. Extensions of the basic case for the main residence exemption 8

2.6. Section 118-147 8

2.7. What is the object of the MRE legislation 9

2.8. Dispelling a myth about house prices 10

3 Case studies involving exploitation of the MRE 11

3.1. The syndicate case study (Fiction) 11

(a) The trophy dwelling scheme 11

(b) How the syndicate chose the target properties 12

(c) The trophy dwelling 12

(d) The trophy dwelling is completed and sold 13

(e) Are the Trophy Dwelling Scheme numbers realistic? 13

3.2. Case Study - Serial main residence developers 15

(a) Who are serial main residence developers 15

(b) Qualifying the original dwelling as a main residence 15

(c) Evidence of occupation as a main residence 16

(d) The extension for a demolished dwelling 17

(e) The new dwelling and the choice under section 118-147 17

3.3. Other examples of leveraging the MRE 18

(a) Adult child nominees 18

(b) Acquisitions by sufficiently well off ex pats 18

4 Cases studies involving the unsophisticated or uninformed 18

4.1. Case Study – Mum and Dad 18

(a) When Mum and Dad acquire and hold a dwelling for a disabled adult child 19

(b) Mum and Dad's story 19

(c) Rita's story 19

(d) The bank's involvement 20

(e) Mum and Dad paid and kept paying 20

(f) Rita receives a ridiculous offer from a developer 21

(g) Rita's spent the proceeds 21

(h) Mum and Dad's ongoing support for Rita 21

(i) Ownership interest 22

(j) Options that were available to Mum and Dad 22

(k) Mum and Dad assessed as having received a capital gain 22

4.2. Case Study – Downsizing baby boomers 23

(a) Downsizing baby boomers - a demographic on trend 23

(b) The $300,000 downsizing superannuation incentive 23

(c) Inhibitors to downsizing 24

(d) The consequences of the inhibitors 25

(e) Downsizing baby boomer project 25

(f) Outcomes in the downsizing baby boomer project 26

5 Issues for consideration 26

5.1. The *raison d'etre* for tax professionals including tax academics 26

5.2. The outcomes 27
(a) The exploiters 27
(b) The effect of principles based drafting on the unsophisticated or uninformed taxpayer 27
5.3. Government tax expenditures on the main residence exemption 28
5.4. Inquiries into home ownership avoid consideration of the MRE 29
5.5. Features within sub-division 118-B that tempt exploitation 30
5.6. Who actually benefits from the the super 100 % CGT discount? 32
5.7. The main residence as an untaxed store of wealth 32
5.8. Is there a case for reform of the main residence exemption? 33
5.9. Possible reforms to address exploiting and leveraging 35
(a) A taxpayer lifetime indexed MRE cap 37
(b) Limiting the capital gain that can be disregarded under sub-division 118-B 37
(c) Imposing a minimum holding or minimum occupancy period 38
(d) Capping the value of the main residence that is eligible for the MRE 40
(e) Capping the area of the main residence that is eligible for the MRE 40
(f) Limiting the curtilage 40
(g) A replacement asset rollover 41
(h) Refine the interaction between section 118-147 and section 118-150 42
5.10. Possible reforms to assist the uninformed and unsophisticated taxpayer 42
(a) Introducing a new CGT event K13 43
(b) Simplifying the requirements for parents seeking to protect adult children 43
5.11. Possible reforms to protect the commissioner and the taxpayer 44
(a) Annual reporting of cost base expenditures for a dwelling 44
(b) Audit activity 45
(c) Keeping track of a life time cap 47
(d) Keeping track of the occupier of a dwelling 47
(e) Extend the Commissioner's review period to 4 years in relation to any disregarded capital gain .. 47
5.12. Would reform result in grandfathering? 48
5.13. Protecting the position of joint owners, spouses and survivors under the suggested reform measures 48
(a) Joint owners 48
(b) Spouses 48
(c) Survivors 48
5.14. What does the future hold? 48

1 Introduction

A good tax system should meet five basic conditions: fairness, adequacy, simplicity, transparency, and administrative ease.

Australia is seen as having a comprehensive capital gains regime along with a number of OECD countries, Canada, Denmark, Finland, Iceland, Ireland, Italy, Norway, Slovak Republic, Spain, Sweden, the United Kingdom and the USA.

It is axiomatic that a comprehensive capital gains tax system would be a "good tax system". It is also axiomatic that each element of a good tax system should meet the criteria of a "good tax system".

In the Executive Summary of a 2006 OECD paper[3] following a study by questionnaire which asked countries countries to report their ***treatment of a taxpayer's personal residence*** Australia is recorded:

> *"[noting] that prior to the introduction of its capital gains tax legislation, opportunities for tax planning to convert income receipts or characterise them as capital gains occurred frequently, and the distinction between income and capital for tax purposes was an important policy concern, one addressed with the introduction of a comprehensive capital gains tax in Australia in 1985.*

The OECD questionnaire responses identified five central considerations factoring into policy-makers' decisions of whether to tax, and if so how to tax, capital gains of individuals.

- Securing tax revenues;
- Efficiency considerations including 'lock-in' effects;
- Contribute to horizontal and vertical equity;
- Encourage savings and promote enterprise;
- Contain taxpayer compliance and tax administration costs.

Australia, in its response:

- pointed out that a comprehensive approach may be more successful than relying on selective provisions to draw certain capital gains in to the tax net;
- identified, along with other countries, the neutrality goal of avoiding tax-driven incentives to invest in portfolio assets that pay returns in the form of tax-exempt capital gains, as a key objective in taxing capital gains;
- pointed out that comprehensively taxing capital gains of individuals may operate to reduce taxpayer compliance and tax administration costs;

- pointed out that compliance costs were also met as tax planning arrangements needed to have regard to the general anti-avoidance provisions in the income tax law.

In this paper through the use of case studies, and by reference to conclusions reached in an earlier paper, the author identifies weaknesses in Australia's comprehensive capital gains tax system.

In Part 2 of this paper the author explores the basic conditions for the main residence exemption and the various extensions that deem occupancy.

In Part 3 the author examines exploitation and leveraging of the main residence exemption ("MRE") by those taxpayers with sufficient means:

- the use of the main residence exemption as an untaxed store of wealth;
- the leveraging of a legislated tax haven to create an untaxed stores of wealth;
- the exploitation of the main residence exemption resulting from the enactment of section 118-147;

In Part 4 the author illustrates the adverse effect of complex MRE provisions on those least equipped to deal with the complexity: parents of adult children with a disability and downsizing baby boomers redeveloping their main residence.

In Part 5 the author sets out a number of observations about the operation of the MRE and considers the cost to the revenue and whether the MRE meets its objectives.

The author concludes that despite the Federal government's annual tax expenditure on the MRE being greater than the government's annual expenditures on Defence the MRE meets none of the criteria of good tax system and fails most of the five central considerations identified by the OECD as factoring into policy-makers' decisions of whether to tax, and if so how to tax, capital gains of individuals.

2 Tax concessions for owner occupied housing

Concessions or tax expenditures are used to reduce the 'normal' tax liability to encourage a particular behaviour.

In Australia tax concessions for owner-occupied housing fall into two broad categories:

- concessions relating to income; and
- concessions relating to capital gains.

Generally a concession applies to particular activities or classes of taxpayer to reduce the tax that they would otherwise have paid.

Concessions are not included as outlays in the budget papers however Treasury issues an annual tax expenditures statement which sets out estimated tax expenditures.

Dr Anne Holmes of UNSW Canberra, School of Business, observed[4]:

> *"Tax expenditures are less transparent than program spending. They do not require annual appropriation, and are not reported in portfolio budget statements. Their target groups are often less clearly defined, and the government has less control over the cost. They are generally not established with a 'sunset' date, and are not regularly reviewed.*
>
> *The quantum and rate of growth of tax expenditures tends not to attract the same attention in the media as do expenditures."*

The estimated tax expenditure of a concession is effectively a measure of the opportunity cost of the concession or revenue foregone.

2.1. Concessions relating to a income

In Australia an owner occupier of a dwelling:

- is not entitled to a deduction for mortgage interest;
- is not entitled to a deduction for those expenses that form part of the cost base of the dwelling: eg stamp duty, rates, insurance or repairs and maintenance;[5]
- does not have an imputed rent included in their assessable income.

2.2. Concessions relating to capital gains

Concessions for capital gains arising on the disposal of a CGT asset, that is a dwelling, are offered at two levels:

- the standard 59% CGT discount available under division 115 of the ITAA 1997;
- the super 100% CGT concession more widely known as the main residence exemption, made available under sub-division 118-B of the ITAA 1997 for capital gains derived by owner occupiers of a dwelling. [6]

Sub-section 118-110(1)(a)[7] provides that the main residence exemption is only available for an individual.

2.3. Calculating the capital gain on the disposal of an owner occupied dwelling

The capital gain for a CGT asset, including a dwelling that qualifies as a main residence, is calculated by comparing the capital proceeds of the CGT event that happens to the CGT asset with the cost base for the CGT asset at the time of the CGT event: See section 100.35 and 102.22

Broadly the cost base for a dwelling (or an interest in a dwelling) will include all acquisition and undeducted holding and disposal costs incurred during the ownership period of the dwelling: See section 110 of the ITAA 1997.

The greater the difference between capital proceeds or value of the dwelling and the CGT cost base for the dwelling the greater the benefit of the super 100% CGT discount.

The value of the dwelling

The value of dwelling, and thus the capital proceeds likely to be received for the dwelling, generally reflects location, quality, size and style and their target market.

The following observations about the value of dwellings are apposite:

- the value of a dwelling located in a capital city will generally appreciate more rapidly than the value of a similar dwelling located in a less central areas;
- the value of a dwelling located in an area with abundant social infrastructure, schools, public transport, hospitals and police, will generally appreciate more rapidly than the value of a similar dwelling located in an outer suburb without adequate social infrastructure;[8]
- the value of a dwelling located in the inner ring of capital cities will generally appreciate more rapidly than the value of a similar dwelling located on the periphery of capital cities;
- the value of a dwelling of a particular size designed by an acclaimed architect will generally appreciate more rapidly that the value of a similarly sized dwelling – even in the same street;

The CGT cost base for the dwelling

The expenditures, other than purchase price, forming part of the CGT cost base of a dwelling for most owners are:

- expenditures within the third element of the cost base including expenditures on interest, maintenance, rates and insurance: see section 110-25(4);
- expenditures within the fourth element of the cost base including expenditures on increasing or preserving the value of the CGT asset: see section 110-25(5);
- expenditures within incidental costs including stamp duty: see section 110-35;

Some CGT cost base expenditures are unavoidable while others are (such as those owner occupiers who do not take out a loan) optional:

- unavoidable expenditures such as stamp duty, council rates and possibly land tax which are a function of the value of the dwelling;
- optional expenditures such as interest (is a function of the borrowed amount, the interest rates from time to time and the outstanding debt from time to time over the loan), bank charges, maintenance costs, and legal fees.

2.4. The basic case for the main residence exemption

The basic case of the main residence exemption ("MRE") ensures that an owner occupier can disregard the entire capital gain arising from a CGT event happening to the CGT asset that is a dwelling (and the land underneath the dwelling[9]) if the dwelling was the taxpayer's main residence throughout the ownership period: See section 118-110.

Technically the capital gain must be calculated before it can be disregarded.

Calculation of the capital gain requires access to all the cost base records and those records must be kept until five years after the end of the financial year in which the dwelling is sold.

2.5. Extensions of the basic case for the main residence exemption

In a range of relatively common circumstances that fall outside the basic case the owner occupier must rely on extensions that effectively deem the requirements of the basic case to be satisfied.

If the owner occupier is deemed or taken to have satisfied the basic conditions the owner occupier is entitled the super 100% CGT discount on any capital gain: See 118-110.

> *"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"* [10]

The extensions deem the requirements of the basic case to be satisfied where:

- a dwelling has been rented out for less than six years after an initial qualifying occupancy;
- bare land to be a dwelling if a dwelling is built on the land and occupied within 4 years;
- a dwelling to be occupied even if it is not occupied until as much as four years after acquisition;
- a dwelling to be substituted for a dwelling that was destroyed;
- inclusion of up to 2 hectares of adjacent land as part of a dwelling.

Other extensions, such as using a dwelling to produce assessable income, cause an apportionment of the super 100% CGT concession rather than disqualify the concession even though in many cases the apportionment will be recovered in full through the small business CGT concessions.

2.6. Section 118-147

Section 118-147, enacted with effect from 3 June 2010[11], allows the substitution of the dwelling after the original dwelling is demolished.

A taxpayer choosing to apply section 118-147 precludes the operation of section 118-150 and the need to occupy the dwelling as soon as practicable after completion.

2.7. What is the object of the MRE legislation

Sub-division 118-B was enacted by Tax Law Improvement Act (No. 1) 1998 Act. The legislation does not specify an object.

The relevant Explanatory Memorandum (Senate)[12] explained that the Bill is the third instalment of the Tax Law Improvement Project to make general improvements in structure, presentation and readability of the areas of legislation being rewritten and that:

- it includes a rewrite of the provisions of the ITAA 1936 that dealt with capital gains tax;
- in addition to the rewrite the Bill makes a number of specific changes to the operation of the law.

Relevantly those changes are summarised:

> ***"Capital gains and losses***
>
> *5. Main residence exemption - changing main residences*
>
> ***Change:*** *Extend the period during which an individual can have exemption for two dwellings to six months.*
>
> ***Existing law:*** *If a person moves into a new dwelling before disposing of their old dwelling, the exemption can be claimed for two main residences for up to three months. The extended period allows more time for selling.*
>
> *6. Main residence exemption - destruction of dwelling and sale of land*
>
> ***Change:*** *Apply the main residence exemption rules to a disposal of vacant land where the dwelling on the land is accidentally destroyed, for example, by bushfire.*
>
> ***Existing law:*** *Under the 1936 Act a person loses the main residence exemption if:*
>
> - *the residence is destroyed; and*
> - *the vacant land on which it stood is disposed of."*

Accordingly, the objective of sub-division 118-B remains the objective of the original principal residence exemption enacted as Division 18 of Part IIIA of the ITAA 1936, which was enacted by Income Tax Assessment Amendment (Capital Gains) Act 1986 No. 52, 1986 (the "1986 CGT Act")

Neither the 1986 CGT Act nor the Explanatory Memorandum for the 1986 CGT Bill specifies a purpose or objective for the principal residence exemption although the Explanatory Memorandum relevantly includes the following:

"Sub-section I6OZZQ(5) covers the situation where, after 19 September 1985 a taxpayer acquires land on which to erect a dwelling. in such circumstances, the land may. subject to certain conditions, be deemed to be the principal residence of the taxpayer, notwithstanding that no dwelling has yet been erected on the land, if the dwelling that is subsequently erected on the land by the taxpayer becomes his or her sole or principal residence as soon as practicable after the dwelling was erected and continues to be so for a period of not less than twelve months (paragraph (5)(d)). Where the taxpayer fulfils these conditions, the period for which the dwelling that was subsequently erected on the land will be taken to be the sole or principal residence of the taxpayer will include the period (up to a maximum period of 4 years) from the date on which the land was acquired by the taxpayer to the date on which the taxpayer commenced occupation of the dwelling, during which the taxpayer was not a dependent child, or the taxpayer or the spouse of the taxpayer did not own another dwelling which was the sole or principal residence of either person."

2.8. Dispelling a myth about house prices

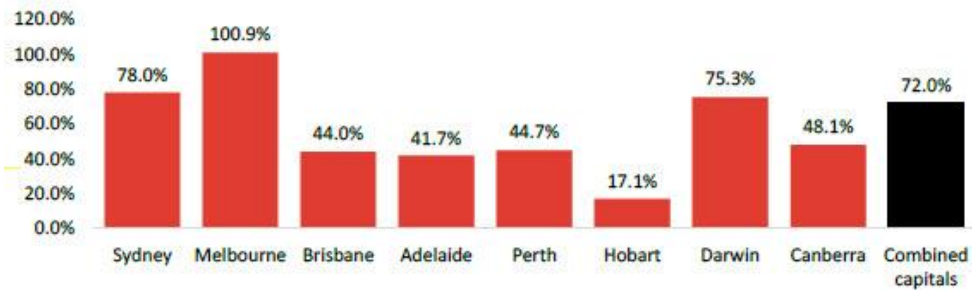
An oft repeated statement myth in real estate circles is that house prices double every ten years. The empirical evidence doesn't support the myth. A recent report by research group CoreLogic[13] found that

"Over the 10 years to January 2016, home values across the combined capital cities have increased by a total 72.0% which is well short of values doubling over the decade."

Although combined capital city home values haven't doubled over the past decade, the previous decade was quite a different story. Between 1996 and January 2006 combined capital city home values increased by 151.7%. Later in the report Corelogic set out the following[14]:

The combined capital city index is weighted so it is heavily influenced by the performance of the larger capital cities. Taking a look at value growth over the past decade across individual capital cities shows a diversity in results.

Cumulative change in capital city home values, 10 years to Jan '16



Melbourne is the only capital city housing market in which home values have doubled over the past decade. In fact, many cities are a long way from having doubled with values in Brisbane, Adelaide, Perth, Hobart and Canberra having all increased by less than 50% over the past decade. Home values in Sydney and Darwin have each recorded increases of more than 75% over the past decade however, they too fell well short of seeing values double over the decade.

3 Case studies involving exploitation of the MRE

3.1. The syndicate case study (Fiction)

The syndicate of three couples, each of which commanded the financial resources, planned to implement an expensive and exansive project.

The syndicate, whose objective was to split profit, which would otherwise be assessable income, as a multi-million dollar tax free gain within a few years[15].

The syndicate spared no expense on professional fees and in documenting their project.

(a) The trophy dwelling scheme

The syndicate objective was be achieved by building and offering for sale a dwelling on a single title of more than 6000 square metres with a private jetty, boat ramp, 180 degree water views including views of the Opera House and the Bridge that could never be built out (the Trophy Dwelling").

The syndicate sourced loan funds to purchase an older, large nondescript but habitable 3 level dwelling on 950 square metres with limited views over Sydney harbor (the "Initial Acquisition"). Earlier subdivisions had resulted in vehicle access to the Initial Acquisition being through a narrow shared right of way straddling two blocks.

On settlement of the Initial Acquisition the syndicate carried out a quick repaint and tidy up of the dwelling and commenced occupation of the dwelling as their main residence.

During the following three months:

- to quickly assemble the requisite land, the syndicate paid "over the odds" prices to owners of 5 target properties, selected for their strategic value;
- the syndicate developed solid working relationships with the local planning authority;
- after acquiring the target properties.

After the syndicate acquired the fifth target property:

- the syndicate "leaked" their plans to the remaining neighbours;
- the syndicate removed the dividing fences;
- the syndicate demolished the five target property dwellings but retained a swimming pool and an outbuilding;
- the syndicate constructed a sweeping driveway with dual access to the road, landscaped the aggregated land and constructed a new perimeter privacy fence complete with electric security gate.

The syndicate's project clearly constitutes a scheme (the "Trophy Dwelling Scheme").

(b) How the syndicate chose the target properties

The target properties had become land adjacent to the initial dwelling.

(c) The trophy dwelling

The proposed 6 star energy efficient dwelling (the "Trophy Dwelling") , comprising more than 3800 square metres over three storeys, with a budgeted construction cost of $27 million, would take 20 months to construct and incorporate living spaces for immediate family use including bedroom ensuites with walk in robes and dressing rooms, a heated indoor lap pool with spa, a gym, an underground garage with capacity for 12 cars, a turntable and lift access, a 25 seat theatre, a wine cellar (with separate lift access internally and externally) accommodation for domestic staff, a ballroom, a full scale commercial kitchen, an outdoor kitchen and a separate wing of numerous guest suites each comprising a bedroom and an ensuites with spa, balcony, kitchenette and living room.

The dwelling would be set amidst carefully landscaped grounds a north south tennis court, a 100 square metre putting green and pair of bunkers, a private lagoon style swimming pool with spa and poolside private bar.

Immediately the planning authority granted the necessary permits and just 18 months after the Initial Acquisition, the syndicate pressed ahead.

The syndicate relocated from the Initial Dwelling and then demolished the Initial Dwelling.

Simultaneously agents commenced advertising the Trophy Dwelling on an "off the plan basis" in China and India.

As construction progressed the agents finessed their plans to accommodate FIRB requirements.

(d) The trophy dwelling is completed and sold

A Hong Kong based Chinese businessman agreed to purchase the Trophy Dwelling for $94 million.

Construction of the Trophy Dwelling was completed a little over budget, at a cost of $30 million, about 45 months after the Initial Acquisition.

The syndicate's total outlays, including all acquisition and construction costs and all professional fees over the four year period amounted to $55 million.

No member of the syndicate ever occupied the Trophy Dwelling.

Each of the syndicate members applied section 118-147 to disregard their interest in the $39 million capital gain.

(e) Are the Trophy Dwelling Scheme numbers realistic?

An assessment of whether the numbers in the project are realistic is best made by reference to information about the Sydney property market.

"Aussie" John Symond withdrew his Point Piper mansion from sale early in 2017 when the market had thought a $100 sale price likely. *"Sydney's increasingly prominent place on the international property market would see trophy home values more than double in the next 10 years, according to Mr Symond."*

When pushed to name other properties that could sell for more than $100 million Mr Symond said the Fairfax family estate Elaine in Point Piper would be worth more than that amount once it has been developed, as will the four properties in Vaucluse purchased by Menulog co-founder Leon Kamenev last year for $79.7 million once the estate is consolidated.[16]

Sydney

The value of properties for sale in Sydney at the end of 2017 support Symond's view and include:

Property	Address	Square metres	Price	Price at last sale	Last publicly offered for sale
RONA	Ginagulla Road, Bellevue Hill	5700 sq m	$65 million	$20.5 million	2005
AKUNA	Wolseley Road Point Piper	1000 sq m	$48 million	$7.5 million	1997
BOOMERANG	Billyard Avenue Elizabeth Bay	4233 sq m	$60 million	$20 million	2005

BLUNDY HOUSE	Bayview Hill Rd, Rose Bay	1040 sq m	$45 million	$32 million	2013

A quick perusal of 2017 property results in the Sydney area revealed the following:

- the sale for $71,000,000 of the seven-bedroom, five-bathroom 1860s Point Piper estate “Elaine”, on a 7000sqm waterfront block to Scott Farquhar[17];
- the sale for $60 million of the eight-bedroom, seven-bathroom ‘Altona’ on the Point Piper waterfrong, last sold in 2013 for $52 million[18], to a Chinese-born businessman.
- 3 sales in Sydney were for more than $60,000,000 each;[19]
- the sale for $45 million of Deauville, a beachfront home at Point Piper[20], last sold in 2012 for $13.5 million, to luxury car importer Neville Crichton;
- the top 20 house sales in Sydney yielded $521,512,691.

As a comparison the top 20 sales in the Sydney area in 2012 totalled around $280 million.

Could the vendor of Deauville pocket as much as $32,000,000 tax free in just five years?

And what of the new owner of Deauville who has been involved four high-end sales worth of prime waterfront real estate in Point Piper in the past year as either a buyer or seller. The value of those four transactions totalled more than $160 million.

Melbourne

A not dissimilar situation exists in Melbourne, although the values are lower:

Address	Square metres	Price	Price at last sale	Last publicly offered for sale
18 St George’s Road, Toorak	4000 sq m	$40 million	$4.9 million	
9 Towers Road,Toorak	2300 sq m	$26.25 million	$5.55 million	2006

Melbourne property developer, Harry Stamoulis took three years to build his mega mansion, at 39 St Georges Rd, Toorak. Although the property has not been offered for sale the total cost, including $24 million for 3200 square metres of land acquired in 2010, is rumoured to be around $70 million.[21]

Alan Bond’s former home in Dalkeith

Alan Bond’s former mansion in Dalkeith, which has undergone a string of renovations by subsequent owners, has been offered for sale with hopes of a price of more than $50 million.

Bond’s former 1980’s home now occupies 4 levels and now has 6 bedrooms, a 21 seat theatre, a function room for 400 guests, two caterer’s kitchens, a walk in cool room, a gym, a squash court, tennis court, wine cellar, swimming pool with 12 seat swim up bar, spa and boat launch.

A realtor in Perth, William Porteous, observed:

- that Perth's most expensive deal involved a $57.5 mansion in Mosman Park in 2009;
- if Bond's former home was in Sydney it would likely sell "for close to $100 million";
- in 1993 the purchaser from Bond paid $7.65 million and was said to have spent $11 million on renovations;
- in 1999 the next purchaser paid $9.5 million and was said to have spent $6 million on renovations;
- most recently in 2011 another purchaser paid $39 million.

3.2. Case Study - Serial main residence developers

(a) Who are serial main residence developers

Anecdotally there has been a growth in the number of serial main residence developers in recent years. The success of reality television renovation shows is often cited as the reason behind that growth.

The phenomena is not restricted to Australia and has become so common in the United Kingdom that Steve Sims who authored "Understanding and Pay Less Property Tax for Dummies: UK Edition"[22] wrote:

> *"Serial developers are homeowners who climb the property ladder by buying, moving in, renovating, selling houses at a profit and then move on to something bigger and better". … No tax is paid as the developer lives in the house while refurbishing. … Technically, not paying the right tax on serial developing activity is tax evasion, not tax avoidance."*

Serial main residence developers ("SMR developers") appear in at least two forms in Australia:

- those who qualify the dwelling as a main residence by occupying the dwelling as they renovate ("live in developers");
- those who qualify a strategically acquired dwelling as a main residence by occupying the dwelling for a period before demolishing the dwelling and building a new and generally much larger dwelling (: the "serial occupy demolish rebuild developers or SODR developers".

This case study focuses on the SODR developer.

(b) Qualifying the original dwelling as a main residence

Although sub-division 118-B does not specify a minimum period of occupation the rule of thumb is that occupation of the dwelling as a main residence will be established on as little as 90 days

occupation. SODR developers will gather, quite carefully, evidence of occupation of a derelict or virtually uninhabitable dwelling.

(c) Evidence of occupation as a main residence

Demolition rebuild developer's evidence of occupation

A demolition/rebuilder's evidence will generally substantiate the occupation requirement by assembling the documents establishing the following transfers at the appropriate times:

- electoral addresses;
- medicare address;
- driving licence;
- car registration;
- bank details;
- gun licences.

A demolition/rebuilder may find useful and probative evidentiary support in insurance policies; school enrolment addresses, private health insurance, previously lodged ITR and the connection of utilities at the relevant address in the name of the owner occupier.

A redirection of mail from the address of the dwelling to a convenient PO Box makes occupation quite painless.

SODR developers have been known to provide a dwelling and all utilities to tenants on a cash basis.

Evidence contradicting an assertion of occupation

The Commissioner can identify and rely on any deficiencies in the demolition rebuilder developer's assertion of occupation.

In addition the Commissioner can contradict a claim that the demolition/rebuilder had occupied the dwelling as a main residence by using relatively easily obtained electronic data pertaining to the demolition rebuild developer's claimed occupation of the dwelling:

- smart meter records disclosing the electricity usage pattern;
- records showing where the mobile phone was being used of an evening, either for calls or data downloads;.
- phone company records showing where the mobile phone was pinging overnight;
- movements in and out of Australia;
- private club memberships;
- location of credit card spending; and

- the location of ATM transactions;
- google earth photographs showing cars in the front yard or bikes on the verandah;
- toll road records;
- mail redirections from the dwelling.

The Commissioner will frequently find further contradictory evidence in:

- bank loan applications which disclose the purpose of the funds and the duration of any proposed loan;
- the claiming of interest expenditure on the dwelling as a deduction;
- real estate sale boards and websites which will likely disclose whether the dwelling was habitable at the time of purchase;
- rental property websites.

The Commissioner has made useful trawls of social media accounts and may even stumble across the cash tenants.

(d) The extension for a demolished dwelling

Section 118-147 is being exploited by SODR developers.

Under s 118-147(2), an amendment introduced in 2010, the SODR developer can extend the basic case by choosing to treat the new dwelling as the SODR developer's main residence from one year before demolishing the old dwelling.

(e) The new dwelling and the choice under section 118-147

The SODR developer has the goal of selling a new dwelling rather than a dwelling that has been previously occupied and exploit section 118-147 to get that result.

Generally the SODR developer constructs a dwelling often designed and directed at a particular demographic, whether through marketing or geographic location of the dwelling to maximise the sale price and profit,.

The better designs make skillful use of style, colour and features such as smart building control systems, a butler pantry, gold plated taps, stone bench tops and a parents' retreat.

In an earlier article[23] the author concluded that the combined effect of s 118-147(5) and 118-147(6)(a) ensured that the SODR developer need not occupy the new dwelling to qualify it as a main residence.

Of greatest importance for the SODR developer relying on the substituted dwelling provision is the stipulation in section 118-147(6)(a) that the requirement in section 118-150 to occupy the dwelling as a main residence as soon as practicable after completion will not apply.

By making a choice that s 118-147(5) apply, the serial demolition/developer can treat the new dwelling as if it was their main residence indefinitely even though the SODR developer never occupies the dwelling.

3.3. Other examples of leveraging the MRE

These case studies reflect real taxpayers.

(a) Adult child nominees

The sufficiently well off can nominate an adult child, usually in the years immediately after they turn 18 and before they are in a position to buy their own property, to further leverage the super 100% CGT concession.

This is relatively easily achieved by paying for a dwelling in the adult child's name[24], have the adult child occupy the property for the minimum period and then rent the property for next six years.

(b) Acquisitions by sufficiently well off ex pats

A sufficiently well off Australian tax resident working and or living overseas is able to exploit the MRE by purchasing and keeping unoccupied a dwelling that they choose to renovate or rebuild as long as they occupy the dwelling as their main residence as soon as practicable after completion of the renovation or rebuild, and that occupation occurs within 4 years of purchasing the dwelling.

Alternatively a sufficiently well off ex pat Australian tax resident can acquire a dwelling in Australia, qualify it as a main residence in as little as 90 days and retain the dwelling as a main residence indefinitely after moving overseas.

Finally by coupling the alternatives the sufficiently well off ex pat Australian tax resident can surf the residential property market on a CGT free basis for 10 years with as little as 90 days occupation while renting the dwelling out for six years. With a little refreshing a further six years CGT tax free surfing is possible.

4 Cases studies involving the unsophisticated or uninformed

4.1. Case Study – Mum and Dad

This case study closely reflects a real life example – with the key identifier changed to protect the client's privacy. The client has consented to the use of the case study in this paper.

(a) When Mum and Dad acquire and hold a dwelling for a disabled adult child

A relatively common scenario encountered by tax professionals is that of uninformed or unsophisticated parents attempting to provide secure lifelong accommodation for an adult child with a disability by acquiring a dwelling for the child.

The dwelling acquired may need to be modified for wheelchair access or to provide accommodation for a live in carer or to provide additional medical facilities such as alarms, or back-up power supplies.

Where the adult child has an intellectual disability the concerns usually focus on ensuring that an opportunist short term partner does not get to walk away with a share of the dwelling following a broken relationship.

Often the intention to secure the child's accommodation is provoked by a life changing event happening to one or other of the parents which prompts the realisation of their own mortality and the resulting vulnerability of their adult child.

(b) Mum and Dad's story

Mum and Dad had a couple of adult children and had been lifelong carers for one of those children, Rita, who suffered a disability: Ehlers Danlos Syndrome[25] made worse in hot weather.

Rita was on a disability pension[26].

In 2012 Mum was diagnosed with cancer and Mum and Dad's chief concern was what would become of Rita once they were too old or frail to provide the support and stability she required.

In April 2012 Mum and Dad resolved to secure Rita's future accommodation by ensuring she had her own home as Rita was unlikely to ever be able to purchase another home, even with her share of their estates, given her disability, limited earning capacity and virtually non-existent borrowing capacity.

They made enquiries about their borrowing limit and advised Rita that they would provide $550,000 to buy her house.

(c) Rita's story

Rita had only a brief and chequered work history with no stable employers and limited earning capacity.

Although the banks were happy to hand Rita credit cards and increase her credit limits they would not advance her a loan.

Rita's disability restricted her to driving an automatic car but she did not have a car. Consequently location and proximity to amenities and services was of greater importance to Rita than many other people.

With Mum and Dad's assistance Rita found a house along a main road that met all her requirements. The house was close to Mum and Dad's home, within 300 metres of a train station and within 200 metres of a significant shopping centre.

(d) The bank's involvement

When Mum and Dad attempted to borrow $550,000 of the purchase price of $560,000 they encountered a problem – the bank was not willing to take a third party mortgage from Rita and insisted that Mum and Dad have the title in their name.

Mum and Dad, clear in their own mind that the house was Rita's, didn't think twice about putting the house in their name.

As Mum and Dad instructed *"they were on the title to obtain that bank loan, and to protect Rita from freeloaders."*

Despite the bank refusing to take a third party mortgage from Rita the thought of obtaining legal advice about the implications didn't enter into Mum and Dad's thoughts. Nor did the bank suggest it.

(e) Mum and Dad paid and kept paying

The bulk of the loan obligation was met by Mum and Dad. Rita never paid rent.

Mum and Dad:

- paid the stamp duty, foregoing the first home owner incentives;
- paid for and carried out a lot of renovations;
- installed a substantial air conditioning system to enable Rita to deal more comfortably with the heat;
- saw themselves as holding the house for Rita and following enquiries by the State Revenue Office satisfied the State Revenue Office that this was their status;
- later adjusted their Wills to reduce Rita's distribution from their estates.

Shortly after Rita moved in to her new house in 2012 the next 3 houses along the strip were demolished and a new multi storey development commenced.

Even part way through the construction the new development, comprising a three storey block of flats, had severely reduced the amenity of Rita's house.

Then another couple of houses further along the strip were demolished and the construction of another block of flats commenced.

(f) Rita receives a ridiculous offer from a developer

In October 2014 the developer building the 3 storey block of flats next door made an outrageous $1.32 million offer for Rita's house.

Aware of the offer Rita urged the sale of the house and that the proceeds to used purchase a new house in a nearby side street.

Eventually Mum and Dad accepted that Rita could sell the house but Mum and Dad received nothing from the sale, other than the release of a mortgage.

(g) Rita's spent the proceeds

With the net proceeds of $770,000 ($1.32m – $550k) Rita selected a house around the corner from the original dwelling.

Rita paid $850,000 for the new house which is in her name.

Mum and Dad agreed to a new mortgage of $250,000 – the bank this time accepting that Mum and Dad need not be on title.

Rita expended the remaining $170,000:

- furnishing the house and purchasing new white goods etc;
- buying herself a new automatic car;
- somewhat inexplicably chose to pay off her HECS debt of close to $50,000;
- paid off $8,000 she had run up on her boyfriend's visa card;
- paid for her wedding and honeymoon to Japan.

(h) Mum and Dad's ongoing support for Rita

Mum and Day pay:

- the mortgage on Rita's current dwelling ($400 per week);
- pay all her medical expenses (average $200-$300 per week);
- pay for a substantial portion of her food; and
- pay all of the major bills like rates, car registration and insurance and servicing, house and contents insurance, vet's bills for Rita's pets etc.

(i) Ownership interest

Section 118-130 provides that "you have an ownership interest in a dwelling if ... for a dwelling that is not a flat or home unit you have a legal or equitable interest in the land on which it is erected, or a licence or right to occupy it".

Rita's house was not a flat or home unit.

For the purposes of the main residence exemption Rita would hold an ownership interest in the dwelling if she held a license or a right to occupy the dwelling.

Rita will have a licence or right to occupy property, which satisfies the requirements of section 118-130, for as long as Rita is permitted by the registered owner, or legal owner, to occupy the property.

(j) Options that were available to Mum and Dad

If Mum and Dad had been more sophisticated or informed they may have foreseen the need to obtain documents recording their arrangement with Rita, whether in the manner the Commissioner had previously accepted or by establishing a special disability trust.[27]

In 2011 Parliament made changes to Subdivision 118-B to extend[28] the main residence exemption for the trustees of special disability trusts ("SDT").[29]

The trustee of an SDT[30] will disregard any capital gain or capital loss on the principal beneficiary's main residence, to the extent that the principal beneficiary would have been able to do so had they owned the main residence directly: See section 118-215.

Each of the Social Security Act 1991 at section 1209L and the Veterans' Entitlements Act 1986 at section 52ZZZW set out substantively similar complicated and cumbersome rules for SDT's.

(k) Mum and Dad assessed as having received a capital gain

Rita was the only person who had occupied the house as her main residence and the only individual to whom the basic case could apply.

The only documents in existence relating to Rita's house established Mum and Dad as legal owners.

Over time in other situations the Commissioner has accepted:

- ♦ that a person who leases property in a retirement village considered to be a dwelling has a licence or right to occupy the property;[31]
- ♦ that a trust deed signed by a taxpayer and their spouse (who were registered owne4rs) along with the taxpayer's parent is evidence that the taxpayer and their spouse were holding the property in trust for the taxpayer's parent; [32]

- a surviving life tenant has an ownership interest in a dwelling under subsection 118-130(1)(b) of the ITAA 1997.[33]

The Commissioner subsequently identified Mum and Dad as having not reported a CGT event and assessed them to a capital gain of $630,768, essentially on the basis of an absence of documents.

Despite being in possession of the facts set out above the Commissioner's decisions for each of Mum and Dad, relied on a draft ruling TR 2004/D25, and stated:

> *"We have no documentary evidence such as a title deed, showing that [Mr and Mrs X] held their interest in the property as trustees. During the period of ownership you're your spouse resided at a different address. Your agent confirmed that "There was no document entered into in relation to the bare trust arrangement with their daughter at the time. … You and your spouse have not provided any evidence of the existence of a trust relationship"*

4.2. Case Study – Downsizing baby boomers

(a) Downsizing baby boomers - a demographic on trend

Around the capital cities an increasing number of baby boomers, the mid point of whom are now turning 61, are turning their mind to downsizing their dwellings, superannuation and retirement. [34]

In 2016 Duncan, James, Leong, Ong and Rowley[35] observed, in a study focused on Western Australia, that:

- the most common reason for downsizing is to live in a smaller house that is easier to run;
- 16 per cent of 55-64 year olds and 25 per cent of those aged 65 years of over had already downsized with a further 31 per cent and 29 per cent respectively having thought about downsizing;
- among those who had not already downsized, 80 per cent stated they would certainly downsize in the future.

Substantially similar findings would be likely if the same survey was repeated in other states.

(b) The $300,000 downsizing superannuation incentive

The recently introduced Federal Government initiative that has as its aim the reduction of barriers to downsizing and which allows home owners, aged 65 and over selling a home they have lived in for 10 or more years to make a non-concessional contribution of up to $300,000 into their superannuation from the proceeds of the sale will likely increase the pool of potential downsizers.[36]

The measure enables both members of a couple to take advantage of this measure for the same home.

(c) Inhibitors to downsizing

Duncan (et al) identified that of the 80%, who would certainly downsize in the future, 58% specified the cost of downsizing as an inhibiting factor.

Erika Altmann, an urban sociology researcher at the University of Tasmania, believes high transfer costs are a critical factor behind baby boomers' reluctance to downsize and pointed to the related real estate and legal fees of changing, and when they buy a new property, stamp duty plus. Altman estimated that in cities such as Melbourne and Sydney, these costs are likely to exceed A$70,000.[37]

The Productivity Commission concedes there is a lack of affordable downsizing options for older Australians, partly because of the financial costs incurred in property transactions and inconsistencies with state and territory land-planning regimes.[38]

Other inhibitors to downsizing include:

- a very strong desire to age in place;
- lack of available cash resources that would provide flexibility - 100% of financial resources are inaccessible because they are represented by the family home and superannuation;
- the lack of suitable downsizing options;
- reports of problems in aged-care facilities and retirement villages, including exorbitant exit fees and mistreatment of some residents;
- the growth in the provision of in-home care;
- the exclusion of the family home from the Age Pension Test.
- the capital released under downsizing would be taken into account in the Age Pension Assets Test[39].

Any contribution to superannuation under the downsizer initiative will count towards the Age Pension assets Test.[40]

A negative mortgage may provide a "work around" and enable deferral of the downsizing to a time when there would be no impact on the age pension assets test.

Given the stated aim of the concession the effective lock-in effect generated by the likely impact of the age pension test is illogical and suggests that the concession was ill thought out or consensus of a committee.

In the meantime it is likely that the downsizer initiative will only be pursued by those who already fail the age pension assets test.

(d) The consequences of the inhibitors

The large pool of potential but frustrated downsizers provides fertile ground for door knocking opportunist developers, well versed in the intricacies of planning and development law, who promise:

- to redevelop the current property to provide several smaller, single-story dwellings to enable continuing independence and current lifestyle in the same location;
- to construct a granny flat on their current property which they can live in to enable them rent out their main home for income.[41]

Consequently many of the potential downsizing baby boomers, most of whom have worked a lifetime as an employee and are not sophisticated investors, are at the mercy of spruikers operating with a well practised magical spiel, generally along the lines of:

> *"It will be a joint venture - you will get a new house – everything will be new. It won't cost you anything. It will be airconditioned and have a lock up garage. All you have to is to relocate for 9 months. We do everything else, its all in the documents. As well as your new house you will get to share in the profit of the other two units. There is no downside for you."*

The essence of the arrangement is that the developer will not incur stamp duty. In some nasty arrangements they leave the owner occupier with the GST liability.

The representations of the uninvited granny flat spruikers are even more odious: See Annexure.

(e) Downsizing baby boomer project

In an earlier article[42] the author considered a project wherein:

- an owner demolished a dwelling (the "Old Dwelling") that, together with less than 2 hectares of land (the "Original Land"), qualified for the main residence exemption;[43]
- the owner constructed three new townhouses and subdivided the Original Land so that each townhouse was on a separate title;
- some of the land that had been under the Old Dwelling formed part of each of the 3 blocks on which each new townhouse was constructed;[44]
- the owner disposed of two of the completed townhouses (to non related parties);
- the owner occupied the third townhouse as their main residence.

The author defined some expressions to assist discussion:

- the Embedded Gain is the excess of the Starting Market Value over the Project Cost Base;
- the Starting Market Value is the market value, of the Old Dwelling and adjacent land, on the Starting Day;

- the Starting Day for the project is the day the owner committed the Old Dwelling and adjacent land to the Project.

The market value of each new townhouse and its adjacent land will include a Construction Margin.

The Construction Margin is the excess of the market value of the new townhouse (and its adjacent land) over the sum of:

- the relevant construction costs for the townhouse; and
- the proportionate share of the Starting Market Value.

The rapid escalation of property values in metropolitan areas, principally in the inner areas of Melbourne and Sydney, in recent years has left many owner occupiers, particularly long-term owner occupiers, with a substantial Embedded Gain.

(f) Outcomes in the downsizing baby boomer project

When the uninformed or under-informed downsizer disposes of one of the townhouses that they have not occupied as a main residence that CGT event will result in the realisation of a capital gain that the under informed downsizer cannot disregard under the super 100% CGT concession.

However that capital gain, approximately equal to one third of the Embedded Gain, will be eligible for the standard 50% CGT concession.

A similar tax liability will arise on the disposal of the second townhouse.

If the downsizing baby boomer had sought and been willing to pay for tax advice before proceeding they may have been able to protect the entirety of the embedded gain with the super 100% CGT discount.

5 Issues for consideration

5.1. The *raison d'etre* for tax professionals including tax academics

Identifying tax arbitrage opportunities is the *raison d'etre* for tax professionals including tax academics.

> *"Speak in French when you can't think of the English for a thing--*
> *turn your toes out when you walk---*
> *And remember who you are!"* [45]

Experienced tax professionals use "bread and butter" skills daily to identify and exploit arbitrage opportunities, without triggering Part IVA issues, that arise through:

- the capital / income dichotomy;

- the difference in the legislative treatment of ordinary income and statutory income;
- the difference in marginal tax rates amongst natural persons and as between natural persona and non natural persons;
- the opportunities provided by the use of deferral and or acceleration techniques;
- the interposition of entities.

The courts have long accepted tax avoidance is legitimate[46]. Whether tax avoidance is ethical and whether tax avoidance or tax evasion can occur when it is a concession that is exploited are issues for another day.

However, tax professionals, including tax academics, operate with a social licence, as do the banks.

5.2. The outcomes

(a) The exploiters

The Trophy Dwelling syndicate members were winners – each pocketing $6.5 million tax free because they had arranged to occupy the Initial Acquisition and the adjacent land as their main residence before completing a dwelling that could be sold as a new dwelling.

Those who use adult children to qualify a subsequent property, which might even be the holiday house, in order to leverage a second super 100% concession, represent a further group of winners.

There is no requirement in Australia to notify occupancy of a dwelling as a main residence in any financial year. Multiple residences can qualify simultaneously and a choice, as to which capital gain is disregarded, can be made with perfect hindsight.

The adult child need only claim in arrears to have occupied the new dwelling for as little as 90 days to ensure the availability of the super 100% CGT concession for at least the next years – and possibly the previous four years.

The expats leveraged the extensions to the basic case, thereby being deemed to satisfy the basic conditions to protect their exposures to the property market for extended periods without ever losing the ability to claim any losses as capital losses. They too can arrange ten years exposure to the property market on a tax free basis.

The exploitation and leveraging of the super 100% CGT concession by those with substantial wealth allows the conclusion that the MRE is a legislated tax haven for those with sufficient means.

(b) The effect of principles based drafting on the unsophisticated or uninformed taxpayer

Section 118-110 lacks precision in its drafting and leaves the Commissioner with a difficult audit task.

Mum and Dad can win their battle with the Commissioner.

Whether they win or lose their battle with the Commissioner Mum and Dad lose either because,

- they pay the tax relating to the disposal of Rita’s house; or
- they incur fees to fight the effects of the Commissioner’s incorrect decision.

The Commissioner’s approach of requiring that the license or right to occupy a dwelling is not supported by the legislation but, for integrity reasons, that approach is understandable.

It is unfortunate that the losers are those who most need what are now termed “bright line” provisions. The Commissioner administration of the MRE would also benefit from bright line provisions.

5.3. Government tax expenditures on the main residence exemption

Treasury publishes an overview of Australian Government tax expenditures, as required by the Charter of Budget Honesty Act 1998 (CBHA).

The most recent Tax Estimates show the revenue foregone through the MRE in its current form as far and away the largest of the tax expenditures exceeding by a significant margin the tax expenditures on superannuation which were drastically cut during 2017:

Table A1: Estimates of large measured tax expenditures[47]

Tax expenditure		Estimate $m			
		2017-18	2018-19	2019-20	2020-21
Large positive tax expenditures					
E6	Capital gains tax main residence exemption — discount component	34,500	34,500	36,000	36,000
E5	Capital gains tax main residence exemption	28,500	29,000	30,000	30,000
C4	Concessional taxation of superannuation entity earnings	17,700	20,650	24,050	26,500
C2	Concessional taxation of employer superannuation contributions	16,200	17,800	18,800	20,000
E13	Capital gains tax discount for individuals and trusts	11,080	11,310	12,090	13,060
H28	GST — Food	7,200	7,500	7,800	8,100
H16	GST — Education	4,850	5,250	5,700	6,200
H19	GST — Health — medical and health services	4,300	4,600	4,900	5,250
H2	GST — Financial supplies — input taxed treatment	3,700	3,900	4,200	4,450
A24	Concessional taxation of non-superannuation termination benefits	2,500	2,400	2,300	2,150
B12	Exemption from interest withholding tax on certain securities	2,310	2,310	2,310	2,310
A40	Exemption of Family Tax Benefit payments	2,100	2,110	2,070	2,090
A19	Medicare levy exemption for residents with taxable income below the low-income thresholds	2,090	2,160	2,230	2,300
B2	Local government bodies income tax exemption	2,130	2,410	2,730	3,080
A17	Exemption of the Private Health Insurance Rebate	1,580	1,650	1,750	1,770
A27	Exemption of Child Care Assistance payments	1,745	2,420	2,460	2,485
D14	Exemption for public benevolent institutions (excluding hospitals)	1,600	1,700	1,800	1,900
D10	Exemption for public and not-for-profit hospitals and public ambulance services	1,550	1,650	1,750	1,850
H5	GST — Child care services	1,560	1,840	2,030	2,240
A54	Philanthropy — deduction for gifts to deductible gift recipients	1,350	1,410	1,460	1,510
F7	Concessional rate of excise levied on aviation gasoline and aviation turbine fuel	1,330	1,400	1,510	1,560
B73	Capital works expenditure deduction	1,240	1,320	1,410	1,495
H20	GST — Health — residential care, community care and other care services	1,230	1,320	1,410	1,510
B50	Lower company tax rate	1,300	1,600	1,800	2,200
Large negative tax expenditures					
F11	Higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco	-2,420	-2,645	-2,925	-3,210
F23	Customs duty	-1,060	-1,170	-1,340	-1,500

By way of comparison the Government budgeted expenditure of $34.6 billion on Defence in 2017 – 18. [48]

5.4. Inquiries into home ownership avoid consideration of the MRE

The House of Representatives Standing Committee on Economics established an inquiry to assess issues related to home ownership in Australia, and potential policy responses by government.

The committee, anticipated that increased tax rates on the sale of housing would have a negative impact on the housing market and broader economy, and did not support increases to capital gains tax rates on the sale of housing.

However, the Committee report does not reflect any consideration of:

- owner occupied dwellings; or
- reducing the super 100% CGT concession; or
- whether any limitation or reduction of the super 100% CGT concession would be construed as an increase in tax rates on the sale of housing.

Inquiries into home ownership have consistently avoided examining the impact of the super 100% CGT concession.

Why? Does the omission of consideration of the super 100% CGT concession from the terms of reference of inquiries reflect:

- ♦ a failure to appreciate the level of tax expenditures directed to its maintenance as Dr Anne Summers suggests?
- ♦ is it a repeated simple oversight?
- ♦ does it reflect acquiescence to powerful and lobbyists?
- ♦ a naïve belief the super 100% CGT discount benefits all owner occupiers equally?

5.5. Features within sub-division 118-B that tempt exploitation

There are features within division 118-B that tempt that exploitation the most attractive being:

- ♦ the ease with which the various extensions enable the occupancy test to be satisfied;
- ♦ the substituted dwelling arrangement implemented by section 118-47.

Effective and efficient ATO auditing of abuses is made more difficult by the same provisions.

Tax professionals and broader property industry professionals[49] have long recognised that the main residence exemption has been exploited to report, as tax free capital gains, amounts that would be properly reported as ordinary income assessable under section 6-5.[50]

There is no measure currently available of the tax avoided that is attributable to any of the single leveraging techniques but practitioners in discussion groups report regular approaches from clients inspired by, and envious of, SMR developers.

The author has been approached on several occasions by SMR developers. They exist in reasonable numbers.

The Commissioner could use his powers to determine how many dwellings each taxpayer and their spouse has sold in any period of time.

As far back as 2004 tax advisers flagged the inevitable growth of tax avoidance in an extended residential property boom.

The late Gordon Cooper, a former President of The Tax Institute, was quoted as saying: [51]

> *"Obviously when you have a booming property market and people are making substantial profits, some will try to mitigate tax on those profits. The more adventurous who haven't got legitimate tax-planning strategies prepared are tempted to stray into something that falls on the wrong side of the law."*

In 2004 Cooper was reported in the same article as having said that he had been approached by promoters who ***are*** *"peddling schemes to eliminate substantial profits"* from property developments*. Cooper added "And I am very dubious about their efficacy."*

In the same BRW article Arthur Athanasiou, President of the Tax Institute in 2016, is reported as believing that many property speculators are demanding that their tax advisers devise arrangements to reduce or eliminate the tax that is legally payable on their enormous profits. This pressure on advisers is intensifying as the property boom seems to be coming to an end.

Athanasiou is quoted as saying:

> *"Too many times I hear from accountants that their clients are subjecting them to undue pressure to perform miracles to make their tax obligations go away. They threaten to leave advisers who cannot find a way around the tax system."*

Amendments made to sub-division 118-B by Act No 56 of 2010 and once again a booming property market have ensured that the super 100% CGT concession has become a key playground for those whose objective is to exploit or leverage the concession.

Some of those involved in the broader property industry justified the exploitation on the basis that the live in developer who goes through the upheaval of constantly moving children "deserves the break".

That line of justification reflected little more than concern about the loss of a potential business benefit, an observation itself that identifies the proceeds as ordinary income under section 6-5.

A live in developer uses the entirety of the dwelling in their business, but on one view, not to produce assessable income.

No one involved in the broader property industry disputed that SODR developers ought be returning sale proceeds as ordinary income under section 6-5.

A new dwelling that can be substituted as a main residence, thereby qualifying for the super 100% CGT concession, provides an attractive opportunity in a rising market. The absence of any occupancy requirement has proved to be irresistible to SODR developers.

Unfortunately section 118-147 is apt to be exploited by a SODR developer through the use of a sham owner occupier in an arrangement supported by a slew of legal documents. Lessons can be learned from the GST abuses of property developers and the use of sham directors in payroll companies.

5.6. Who actually benefits from the the super 100 % CGT discount?

The benefits of the super 100% CGT discount accrue principally to owner occupiers whose capital proceeds (or deemed capital proceeds) for a CGT event happening to a dwelling exceed the CGT cost base for the dwelling.

The owner occupier likely to benefit to the greatest extent from the super 100% CGT discount is the owner who acquired an architect designed multi bedroom multi bathroom dwelling with a short term low loan to valuation ratio, located in an area of Melbourne or Sydney well served with social infrastructure who did not need to borrow;

The owner occupier likely to receive the least benefit from the super 100% CGT discount is the owner of the dwelling acquired with a long term loan on a high loan to valuation ratio, located in an outer suburban or rural area poorly served by social infrastructure.

The 2016 census data confirmed that:

- 31% of Australians own their home outright and that figure had fallen from the 2011 census;
- since 1992 the proportion of Australians owning their home outright has declined by more than 10 per cent;
- the proportion of those paying off a mortgage decreased slightly from 34.9 per cent in 2011 to 34.5 per cent in 2016;
- housing costs for owners with a mortgage remained stable in real terms at an average of $452 a week in 2015–16.

It follows that a significant proportion of the tax expenditures supporting the super 100% CGT concession:

- are directed to as few as 31% of Australian taxpayers, and likely not to those amongst the 31% who occupy dwellings other than in the inner ring of Melbourne and Sydney; and
- to no more than 67% of Australians and likely not to those amongst the 67% who occupy dwellings other than in the inner ring of Melbourne and Sydney.

It would be naïve to believe that the tax expenditures are directed predominantly to the owners of the trophy dwellings in Sydney and Melbourne.

It is likely that the greater proportion of the tax expenditures benefits owner occupiers of houses with a value of less than $5 million.

5.7. The main residence as an untaxed store of wealth

In June 2015 ASFA[52] published a report “Superannuation and the economy” in which the following was stated:

> *In Australia, owner occupied housing is a key savings vehicle for most families… Before compulsory superannuation, owner occupied housing was the only store of wealth for the majority of families.*

Following the budget in 2017 the message below appeared on a website of a financial advisor;

> *"Because capital gains on a family home are tax-free, the family home is actually a fantastic place to store wealth and this discourages people from swapping a more valuable home for a less valuable one."*[53]

In 2017 community concern at the role of superannuation concessions, and the extraordinarily large fund balances of a small number of taxpayers, forced a policy recalibration of the laws relating to superannuation.

The "pub test" identified the key issue for the ordinary wage earner as being whether those of sufficient means ought be able to accumulate wealth on a tax free basis far beyond what the wage earner thought was reasonable.

The MRE as an untaxed store of wealth that can be liquidated years later to fund retirement (or to leave bequests to future generations) is susceptible to community scrutiny, and the arguments that forced the introduction of the $1.6 million superannuation cap.

5.8. Is there a case for reform of the main residence exemption?

When the single largest tax expenditure is targeted to a declining proportion of the population the expenditure deserves critical scrutiny.

The Productivity Commission noted that the MRE exemption may encourage over-investment in owner-occupied housing and that there have been various calls to reform this aspect of the taxation system.[54]

Whether reform is required ought be determined by whether the current MRE meets its objectives or purpose.

Given the absence of a legislative objective or purpose a suitable proxy to assess the performance of the MRE is the purpose of good tax system recorded in the OECD response to the 2006 OECD questionnaire in which Australia participated:

- Secure tax revenues;
- Efficiency considerations including 'lock-in' effects;
- Contribution to horizontal and vertical equity;
- Encourage savings and promote enterprise;
- Contain taxpayer compliance and tax administration costs.

Secure tax revenues;

In its current form the MRE raises no tax revenue and provides a legislated tax free haven, at considerable cost to the revenue, for a relatively small group of owner occupiers.

When a person invests their savings in an ever more expensive main residence rather than in equities or rent producing property, whether residential or commercial, the person removes the income that would flow from those investments, from their assessable income.

In addition all owner-occupiers enjoy a benefit from residing in their own home, which is often referred to as 'net imputed rent'.

> *By effectively renting their dwelling to themselves, the owner-occupier avoids paying tax on the imputed rent they would be paying to themselves.* [55]

When Australia's federal income tax was introduced in 1915, net imputed rental income was included as part of the income tax base, but was removed in 1923.

That an owner-occupier's notional imputed rent income is not taxable provides a sharp contrast with the fate of the restaurateur who is assessed on the imputed cost of goods, $4,640 in the current income year, deemed to have been applied to own use.[56]

Efficiency considerations including 'lock-in' effects

The current deemed occupancy arrangements provide a lock in effect – they allow an absentee owner occupier to continue holding the dwelling on a tax free basis.

Contribution to horizontal and vertical equity;

The vertical equity principle that those who are more able to pay taxes should contribute more than those who are not as able to pay is contravened by the MRE in its current form.

The horizontal equity principle that those with similar income and assets should pay the same tax is also contravened.

Encourage savings and promote enterprise;

The Re:think Tax Discussion Paper notes that the availability of the CGT discount encourages purchasers to make bigger investments in property by borrowing, in addition to using their own savings because 'larger investments can result in greater capital gains and therefore benefit more from the [standard 50%] CGT discount'.[57] Even greater benefits are available from investments in owner occupied property through the super 100% CGT discount.

In its *First Home Ownership* inquiry, the Productivity Commission considered that aspects of the personal taxation system, including the CGT regime and negative gearing, had combined to magnify the attractiveness of investing in residential property. The Commission accordingly recommended

that these aspects of the taxation system be reviewed [58]. That recommendation was made without consideration of the MRE.

Investing in residential property neither encourages savings in the traditional sense nor promotes enterprise.

Contain taxpayer compliance and tax administration costs

The MRE:

- neither ensures taxpayer compliance nor assists with administration of the tax system;
- neither encourages record keeping nor dispenses with the need for record keeping.

Where the operation of the MRE intersects with the cost base modifications in Division 128, in particular Item 1 of section 128-15(1) and section 128-50(3), the availability of records becomes a critical issue.

Where the interest acquired was acquired by the deceased after 20 September 1985:

- by a legal personal representative or beneficiary of the estate of the deceased the legal personal representative or beneficiary requires the full suite of cost base records to calculate the first element of the cost base of the interest acquired through the estate of the beneficiary: See Item 1 of section 128-15(1).
- through survivorship a surviving joint tenant requires the full suite of cost base records to calculate the first element of the cost base of the interest acquired through survivorship: See section 128-50(3).

Both issues are emerging with increasing regularity.

The MRE meets none of the key criteria, imposes significant costs on the revenue and fails its key stakeholders.

5.9. Possible reforms to address exploiting and leveraging

"A dream is not reality, but who's to say which is which?"[59]"

The main residence exemption could be reformed to address the issues of exploitation and leveraging identified, while still protecting the tax free status of the inflation component of any capital gain, by adopting some or all of the following:

- by introducing a taxpayer life time MRE indexed cap: See paragraph (a) below;
- by limiting the capital gain that can be disregarded under sub-division 118-B: See paragraph 5.9(b) below;
- by imposing a minimum holding period or minimum occupancy period: See paragraph **Error! Reference source not found.** below;

- by capping the value of the main residence that is eligible for the MRE: See paragraph 5.9(d) below;
- capping the area of a main residence that is eligible for the MRE; See paragraph 5.9(e) below
- by limiting the curtilage: See paragraph 5.9(f) below;
- by introducing a replacement asset roll-over: See paragraph 5.9(g) below;
- by refining the interaction between section 118-147 and section 118-150: See paragraph 5.9(g) below.

None of the reform measures identified interfere with:

- an owner occupier's right to apply the ordinary cost base rules in subdivision 110;
- an owner occupier's right to the standard 50% CGT discount.

As at the date of the OECD report only New Zealand amongst the OECD countries did not have a regime dealing with the taxation of main residences or as termed by the OECD principal residence. However New Zealand would capture the profits of SODR developers.

The taxation systems of each of the other 29 countries dealt specifically with gains on the disposal of the principal residence:

- some absolutely exempted from taxation any gains arising on the disposal of the principal residence: France, Greece, Luxembourg, Italy and Switzerland, while Denmark limited the exemption to principal dwellings of less than 1400 square metres.
- the majority exempted from taxation any gains arising on the disposal of the principal residence if certain use or occupancy requirements were satisfied;
- the only OECD country to use an occupancy deeming provision was Australia;
- a number of countries made satisfaction of a requirement that the principal residence not be used in a business, a condition, either alone or in conjunction with other conditions, of obtaining relief: Czech Republic; Germany, Iceland, Netherlands and Norway.
- no country other than Australia reported apportioning an exemption if there had been business use of the principal residence;
- Canada imposed a restriction that a family could hold only a single principal residence at any time which must be nominated annually;
- a couple of countries specifically addressed disposals of principal residences related to speculative conduct (Belgium) or development opportunities (Ireland) while Korea differentiated between principal residences located in the metropolitan area and those located in other areas;

- Spain exempts any gain arising on the disposal of a dwelling by an owner older than 65 years.

An idea whose time has come is irresistible.

(a) A taxpayer lifetime indexed MRE cap

A lifetime indexed MRE cap, modeled on the $1.6 million superannuation cap, would be set for each taxpayer. The indexation would apply relate to the unused portion of the cap. The cap could.

A lifetime indexed MRE cap:

- would limit the extent to which gains on owner occupied housing could be disregarded under the super 100% CGT discount;
- if carefully calibrated would have little or no impact on the vast majority of homeowners would have its greatest impact on the SODR developers and scheme participants;
- will result in tiered CGT rates for a single CGT asset but would not diminish on any taxpayer's ability to access the standard 50% CGT discount;
- would only address the leveraging of the MRE by the nomination of an adult child indirectly;

Too much regulation

The usual objection, in discussions, with people involved in the broader property industry, was that any lifetime MRE cap would "stop people getting ahead" although no one could explain how a person properly reporting their business income would be prevented from getting ahead.

Too much record keeping

A properly designed system would have the ATO retain the records of disregarded capital gains just as the ATO currently keeps records of carried forward losses.

Use in OECD countries

No OECD country reported a life time cap on gains arising on the disposal of a principal residence.

(b) Limiting the capital gain that can be disregarded under sub-division 118-B

Limiting the amount of the capital gain that can be disregarded by the super 100% CGT concession is simple and easily understood.

The balance of the capital gain would be protected under the standard 50% concession.

An appropriate indexed cap:

- would impact most severely scheme participants and those engaging in leveraging of the more valuable properties;

- would limit the 100% discount capital gain available to SODR developers on each disposal but would not impact on their ability to access the super 100% concession for successive disposals;
- would only address the leveraging indirectly;
- if properly calibrated would have little or no impact on the vast majority of homeowners.

The United States limits the extent to which the capital gain can be disregarded to $250,000 or $500,000 for a couple subject to a minimum occupancy condition.

Sweden exempts a limited proportion of the capital gain by taxing only 22/30 of the gain arising on disposal of the principal residence but also provides rollover relief for a principal residence purchased in the EU.

(c) Imposing a minimum holding or minimum occupancy period

The Introduction of a minimum holding period for a main residence could be approached in two ways:

- use objective or bright line drafting to specify the period for which a dwelling must be held before the MRE becomes available;
- limit the frequency with which a person can claim MRE.

A minimum holding period:

- would have little or no impact on the vast majority of homeowners as the median holding period for a main residence in Australia is approaching 10 years;
- depending on its length and conditions could create a lock in effect for some taxpayers.
- would virtually eliminate SODR developers but some may by-pass the holding period using sham owners;
- would not impact on any taxpayer's ability to access standard 50% CGT discount.

It is unlikely that a minimum holding period could be any longer than five years. Imposing a minimum occupancy period would bring an end to SODR developers but may cause a rise in sham occupancies.

Use in OECD countries

Japan uses a tiered taxation approach to gains[60] arising on the disposal of a principal residence, apparently without any occupancy or usage requirement:

- for a principal residence held for 10 years, the first part of any gain is taxed at 10% and the excess at 15%:

- for a principal residence held for 5years, the first part of any gain is taxed at 20% and the excess at 40;
- for a principal residence held for a shorter period of time any gain is taxed at 39 percent (30 percent national income tax and nine percent local inhabitant tax).

The United Kingdom exempted a gain if the residence was occupied as the principal dwelling throughout the ownership period.

Poland exempts any gain on the disposal of a principal residence that has been held for at least 5 years.

Turkey exempts any gain on the disposal of the main residence if it was occupied as the principal residence for at least four years.

A number of OECD countries imposed a minimum 2 year holding requirement, often in conjunction with other requirements: Czech Republic; Finland; Slovak Republic

In Korea a disposal on the gain of a principal residence is exempt if it has been held for at least 3 years but if the principal residence is in the Metropolitan area an extra condition applies; the taxpayer must have occupied the principal residence for at least two years.

In the United States the minimum holding period is effectively self determined. The taxpayer must have lived in the house for a minimum of two (not necessarily consecutive years out of the last five years immediately preceding the date of the sale.

This generally means that the exclusion can only be claimed once every two years but some exceptions apply to create a tiered discount:

- apportionment may be allowed where occupation of the home was for less than 24 months
- any gain on a home owned for one year or less is reported as a short-term capital gain which is taxed without any concession;
- any gain on a home owned for more than two years is reported as a long-term capital gain which are taxed on a more favorable: zero, 15 or 20 percent, depending on the taxpayer's marginal tax rate.

In Mexico there is no stipulated minimum occupancy period but an unqualified requirement that the owner occupies the principal residence makes the effective minimum occupancy period the period for which the principal residence is held.

Austria imposes a two year minimum holding period unless the owner occupier had constructed the principal residence

Norway imposes only a one year occupancy requirement but that year must be within the two years before disposal.

(d) Capping the value of the main residence that is eligible for the MRE

Capping of the value of the main residence that is eligible for the MRE, on an indexed basis, by reference to its purchase price, would enable taxpayers to know whether they were eligible for the main residence exemption when they bought the dwelling.

However a capped value would be open to exploitation by owner occupiers who assembled a site or constructed a trophy dwelling.

(e) Capping the area of the main residence that is eligible for the MRE

The integrity of a rule to determine eligibility for the MRE by dwelling area would be problematic unless the area included all roofed areas and adjacent structures.

In Denmark the detached house rule ensures profits from selling residential property measuring less than 1,400 sq m which have served as the owner's principal residence either fully or partially throughout the ownership period are exempt from taxation.

(f) Limiting the curtilage

The reasonable person in the street, if asked, will quickly confirm that "main residence" identifies the "family home, garage and backyard".

The Australian Bureau of Statistics recently released a feature article entitled "Are we building on smaller blocks?"

The average site area of new houses in Australian capital cities:

- In 1993-94 was 802sqm.
- in 2003-04 was 735sqm;
- in 1999-00 was 702sqm.

In 2003-4 the average block size in Melton east of Melbourne was 571 square meters while in Bankstown in Sydney it was 614 square metres.

In 2017 in Perth[61] blocks had shrunk to as small as 80 to 120 square metres, even smaller than the 150 square metre blocks on which workers' cottages were built in inner Melbourne suburbs 120 years ago.

While an argument can be made for a 2 hectare curtilage outside capital cities it is relevant to ask whether a 10,000 square metre curtilage in capital cities is any more than a tool to leverage the super 100% CGT concession.

Regard may be required for Constitutional limits on any changes to the curtilage that discriminate between taxpayers so that a remote area allowance type approach might be necessary. Alternatively a simpler approach would be to allow the 2 hectare curtilage for dwellings up to a specified indexed value.

Use in OECD countries

Ireland allows up to an acre of adjacent land to be included as part of the principal residence while Denmark allows up to 1400 square metres to be included.

(g) A replacement asset rollover

The introduction of a replacement asset rollover:

- would defer the taxing point, and available resources, for as long as the owner occupier kept reinvesting in more expensive properties;
- might deter older owner occupiers from downsizing thereby generating a lock in effect.

There are issues that need to be addressed in relation to the mechanics of any withholding for a replacement asset rollover to be politically saleable.

There are four likely scenarios under a replacement asset rollover regime:

- Outcome 1 - there is no intention to purchase a replacement dwelling - easy tax paid and any adjustment issued;
- Outcome 2 - the house is sold and a more expensive replacement dwelling already acquired - no issue;
- Outcome 3 - the house is sold and a less expensive replacement dwelling acquired - no issue - refund from withheld amount;
- Outcome 4 - the house is sold but no decision is made on what to do.

The troubling mechanics of any withholding relate to Outcome 4. How long can the rollover be deferred and how is the withheld amount treated during that period?

Australia has accepted in recent years that a withholding tax in relation to property disposals is necessary to ensure compliance.

Use in OECD countries

A replacement asset rollover approach is used:

- in Hungary if the sale proceeds are reinvested in a replacement dwelling but if that replacement dwelling is sold within 5 years the exempted amount becomes taxable;
- in Iceland if a dwelling is sold within 2 years, a rollover with a two year reinvestment period, is available;

Liability limited by a scheme approved under Professional Standards Legislation

- in Poland if the proceeds of the disposal of principal residence held less than 5 years are reinvested in a principal residence within 2 years the disposal will be exempt;
- in Portugal a rollover will be available if the proceeds are reinvested in a principal residence within 2 years;
- in Spain to the extent the proceeds are invested in a new principal residence any gain will be exempt.
- in Sweden a rollover is available for any gain realised on the disposal of the principal residence if a replacement principal residence purchased in the EU but tax is levied on the deferred gain at 0.5% per annum.

(h) Refine the interaction between section 118-147 and section 118-150

It is likely precluding the operation of section 118-150 reflects a simple failure to foresee the exploitation that the amendment facilitated.

However the problems brought about by section 118-147 and its interaction with section 118-150 were foreseeable and raise questions about how the problem was not addressed. Was it the result of lack of foresight, servile acquiescence to noisy lobbyists, poor drafting or simply the chaos of the lead up to a leadership coup against the then Prime Minister.

The issues is that section 118-147(6) precludes the operation of 118-150 and allows the marketing of new houses with the benefit of the super 100% CGT concession.

A simple cure would be to require the substituted dwelling to be occupied as a main residence as soon as practicable after completion for a minimum period.

Such a requirement would align with measures in other jurisdictions to limit concessions in relation to the main residence where the taxpayer was not occupying the dwelling as a main residence at the time of sale.

An alternate less satisfactory resolution would be to refine the definition of demolished to exclude voluntary demolition events but that would likely trigger “suspicious fires” in older dwellings.

5.10. Possible reforms to assist the uninformed and unsophisticated taxpayer

The main residence exemption could be reformed to address the issues identified in relation to the uninformed and unsophisticated taxpayer, including the legal personal representative of a deceased or a beneficiary who takes from the deceased’s esatte by:

- introducing a new CGT event K13 to enable downsizing baby boomers to elect that a CGT event occurs to their main residence: see paragraph 5.10(a) below;
- by simplifying the requirements for parents like Mum and Dad seeking to protect adult children with a disability: see paragraph 0 below;

- the annual capturing and carrying forward of cost base expenditures for a dwelling.

(a) Introducing a new CGT event K13

The introduction of a new CGT event K13, to enable downsizing baby boomers to elect that a new CGT event K13 occurs to their main residence.

The operation of CGT Event K13 for a downsizing couple would have similar effect to CGT Event K4 for a business. CGT Event K13 would result in the downsizing baby boomers' capital gain being determined at the start of any redevelopment and overcome the absence of a sale by the downsizing baby boomers to the developer.

Neither the developer nor the downsizing baby boomers want to incur stamp duty.

(b) Simplifying the requirements for parents seeking to protect adult children

Mum and Dad are just one pair of many parents are in similar positions. The child's disability may be intellectual or physical. The disability may have existed from birth or have been acquired later in life, perhaps from a sporting injury or a motor vehicle accident. Increasingly the disability may be related to substance abuse.

Parents in this position are often distracted by events. The process ought be as simple as possible while protecting the revenue.

Mum and Dad's concerns were not unusual. There are mums and dads all around Australia whose concern is to look after an adult child whose disability renders them not capable of finding their way in the world alone.

Section 118-130

The requirements in section 118-130 are in the alternative and while the legal or equitable interest requirement distributes to "the land on which the dwelling is erected" that requirement does not distribute over "the licence or right to occupy [the dwelling]".

While it can be accepted that since the Statute of Frauds which was enacted more than 300 years ago to compel certain promises, agreements and contracts to be evidenced in writing to be enforceable in a court of law, the current relevant legislation in Victoria requires only "contracts for the sale or other disposition of land or any interest in land" to be in writing.

The fact that a contract is not enforceable as between the parties in a court of law is not to the point when it comes to determining whether the requirements of section 118-130 has been satisfied, a distinction illustrated in the Thomas cases which began in the Queensland Supreme Court.[62]

There is no reason why a licence or right to occupy a dwelling need be in writing. If the legislation intended to limit the right or licence to enforceable rights or licences it ought to have said so.

The SDT provisions

The SDT provisions are complex and cumbersome and also expensive to implement and potentially expensive to maintain.

One would be entitled to believe that the department dealing with disabled people would provide to carers basic educational materials in relation to the provision of accommodation.

The problems arising for parents seeking to protect adult children with a disability by providing a house are not adequately dealt with in the SDT provisions.

A simpler model

A simpler model ought be available for parents of adult children with a disability. Eligibility for a simplified requirement could be dependant on the level of disability as assessed by the relevant department.

Simplifying the requirement for parents protecting an adult child with a disability could be achieved b making provision for:

- ♦ a simpler "dwelling only" trust option"; or
- ♦ an election document that would allow for parents seeking to protect adult children to elect, in the year of acquisition, that the property is held for the adult child;
- ♦ an annual reporting arrangement modeled on the Canadian T2091 form[63] for reporting the arrangement.

An integrity measure could provide for any dwelling, the subject of a simplified arrangement, to be included automatically in the assets test for the disabled person's disability support pension.

Another option would be for the Commissioner to issue a Ruling clarifying that a license or right for a person with a disability to occupy a dwelling could be by proved by usage in various ways or by a trust deed. This would address the propensity of ATO officers to treat rulings as if they are legislation.

5.11. Possible reforms to protect the commissioner and the taxpayer

(a) Annual reporting of cost base expenditures for a dwelling

Annual reporting on tax returns of cost base expenditures for a dwelling could and should be introduced.

Reporting cost base expenditures on an annual basis would facilitate more accurate assessment of the tax expenditure for providing the main residence exemption and make ATO auditing of reported capital gains more straightforward.

Once reported on a tax return the record keeping holding period would commence. With an annual reporting regime a taxpayer would only need to retain records of cost base expenditures for five years after they were reported on the tax return.

Annual recording on a tax return of cost base expenditure:

- would be of considerable assistance to beneficiaries of deceased estates and would resolve the issues emerging from the intersection of the MRE with division 128;
- ease the record retention for the taxpayer and provide certainty for all stakeholders including the Commissioner.

This measure would relieve the cost base issues and record retention issues that might otherwise arise under some of the suggested reforms.

Keeping the information on the ATO computer systems should be no harder to keeping track of carry forward losses and as a safeguard the running total could pre-populate the return each year in the way interest income does now.

A side benefit of annual reporting of cost base expenditures would be that owner occupiers would be less be willing to forgo tax invoices for tradesmen working on the dwelling. The cash price would no longer be as attractive.

In the United States the Emergency Economic Stabilization Act in 2008 introduced annual reporting for cost base information for investment products.

The reporting is implemented through an IRS Form 1099-B.

The aim of Form 1099-B was to reduce the burden on taxpayers to maintain extensive records for lengthy periods. Form 1099-B is used in conjunction with Form 8949 where cost base has not been reported annually.

(b) Audit activity

Identifying serial main residence developers ought not be difficult for the ATO which can use its powers to identify well known indicators of potential concern:

- which taxpayers had multiple addresses in a short period;
- which taxpayers are living off the proceeds of sale of a series of main residences.

However SODR developers using sham owner occupier arrangements will be much harder to detect.

Older empty run down or derelict dwellings in areas recently rezoned for higher density or with rapidly rising property values flag potential trading stock for serial main residence developers.

"According to the 2006 ABS census data, there were 830,376 unoccupied dwellings during the time the survey was taken, out of a total of 8,426,559, or 10% of the dwelling stock. Unfortunately, no indication is given to the status of the vacant properties (derelict, holiday house, undergoing sale, renovations, speculative vacancy).

The Melbourne-based organisation Prosper Australia performed an innovative study of vacant properties using water usage figures. Applying a conservative methodology, it was found that almost 45,000 properties were lying vacant in the areas under study, and extrapolated across Melbourne, 61,000 properties were lying vacant for more than six months. This gives credibility to the idea that speculators are withholding properties from the market to capture capital gains rather than rental income.[64]"

While the ATO does carry out some profiling of taxpayers, whose characteristics suggest there might areas of concern, well rehearsed taxpayers know how to answer the ATO questions on any review or audit.

Before section 118-147 was enacted the ATO had success in matters after taxpayers incorrectly disregarded gains. In each case the owner failed to occupy the dwelling as a main residence as soon as practicable:

- after purchase as required by section 118-35:
  - in respect of the 2005 year of income Chapman and Commissioner of Taxation [2008] AATA 421 (21 May 2008);
  - in respect of the 2006 year of income ~ Couch and Commissioner of Taxation [2009] AATA 41; (2009) 74 ATR 724 (22 January 2009);;
- after construction or renovation as required by section 118-150 or its predecessor, section 160ZZQ(5):
  - in respect of the 1995 year of income Husband and Wife and The Commissioner of Taxation [2003] AATA 342 at [10];
  - in respect of the 2004 year of income Summers and Commissioner of Taxation [2008] AATA 152 (26 February 2008);
  - in respect of the 2004 year of income Erdelyi and Commissioner of Taxation [2007] AATA 1388.
  - in respect of the 2006 year of income James Keep and Commissioner of Taxation [2013] AATA 709;

The enactment of section 118-147 in 2011 may have left the ATO unwilling to allocate scarce resources to pursue SMR developers.

(c) Keeping track of a life time cap

A common response from those in the broader property industry was that a lifetime CGT cap would introduce more regulation, more red tape and more paperwork.

The ATO computer systems are more than adequate to track the unused balance of a lifetime MRE cap. Those ATO systems already record:

- ♦ residential addresses;
- ♦ taxpayer's industry code;
- ♦ disregarded capital gains during an income year;
- ♦ the basis on which capital gain are disregarded;
- ♦ all property holdings in a taxpayer's name.

A minor tweaking of the income tax return for an individual would be necessary. The pre-populated information on each return could show the unused portion of the lifetime indexed MRE cap.

(d) Keeping track of the occupier of a dwelling

Annual nomination of a main residence could be implemented as an administrative measure. Such a step would prevent "residence shopping", the process where the choice as between qualified dwellings is made with 20:20 hindsight so as to ensure the optimal outcome.

This measure would also eliminate loss swapping on qualified dwellings.

In Canada in 2018 capital gains arising on the disposal of the principal residence are exempt from tax for each year the property is designated on the tax return as the principal residence.

Canada Revenue Agency will be able to accept a late designation in certain circumstances, but a penalty may apply.

(e) Extend the Commissioner's review period to 4 years in relation to any disregarded capital gain

The current review period, 2 years or 4 years might be usefully extended for any owner occupier who disregards a capital gain by relying on a super 100% CGT concession.

In an environment where the serial main residence exploitation has been rife the Commissioner's failure to bring any main residence matters to the Tribunal relating to any year since ____ year of income raises questions about the adequacy of the review period.

An amendment of that type will only affect individuals with a 2 year review limit, generally the live in serial main residence developers, and will not affect any individual who is the beneficiary of a trust.

5.12. Would reform result in grandfathering?

The reform measures proposed below assume that all unrealised gains retain the current treatment up until the date of any change but thereafter any further gains are subject to the changed treatment. This would result in all unrealised gains at the reform date being grandfathered.

All unrealised gains would be preserved outside the taxpayer lifetime indexed MRE cap. A protective measure would be to require all owner occupiers to obtain a valuation of their main residence within a specified time of the start date of any reform and to include that valuation in the next following tax return.

The current CGT treatment of main residences could be stepped down over an appropriate period during the retention period.[65]

5.13. Protecting the position of joint owners, spouses and survivors under the suggested reform measures

Any reform will need to consider the position of spouses and survivors of owner occupiers and dwellings pregnant with unrealised capital gains as at the date reforms commenced.

(a) Joint owners

The introduction of a life time MRE cap would require an extension of the joint ownership rules currently found at sections 108-7, 118-197 and 128-150 to ensure that the disregarded gain was appropriately share as between joint owners.

(b) Spouses

If spouses had held the dwelling as joint owners an individual's lifetime MRE cap would become a quasi tax asset to be considered in a relationship breakdown. The starting point would be the position under section 108-7.

(c) Survivors

Surviving joint owners would have multiple CGT assets, each being a fractional interest in a main residence. Each of those interests would have an entitlement to a proportion of the limit.

Apparently useless tax invoices are some of the first things discarded after a person dies.

The emerging record keeping issue would be largely addressed through annual reporting of cost base expenditures.

5.14. What does the future hold?

In the United Kingdom in 2017 any capital gain arising on the disposal of the principal residence is exempt if a series of requirements are satisfied:

- it was occupied as a principal residence during the entirety of the ownership period; and
- part of it has not been let out (although a lodger is permitted); andr
- part of it hasn't been used for business only; and
- the grounds, including all buildings, are less than 5,000 square metres (just over an acre) in total;
- it wasn't purchased just to make a gain.

It is likely that other countries will see the need to adopt the potpourri approach taken in the United Kingdom.

If the United Kingdom approach was taken in Australia it would address some but not all of the issues identified.

The tax expenditures on concessions are presently a matter of government focus:

- the concessions for superannuation were drastically cut during 2017 following public outrage;
- the private health insurance rebate has been trimmed again;
- the GST exemptions that for low value imports has been amended.

There has also been noise about the cost of the GST exemptions that apply for private school fees, and food.

Once the public understand the inequitable results that flow from the present super 100% CGT concession, and that the only benefit most taxpayers receive under the present system is being freed from record keeping, the political risk will dissipate.

Wider realisation that some in the community have the means to exploit the main residence exemption and the accumulated wealth to leverage and scale the exploitation will generate outrage.

Once focus groups show that the public is not willing to accept the present inequitable outcomes reform will occur.

When the exploitation involves the Australian sacred cow, the family home, the outrage will be ongoing, more so because the tax free gains made by many are far in excess of the median house value in Australia.

The resulting polemic will drive political responses.

An opposition with established positions in relation to both the issue of home ownership, and the issue of a fairer Australia, will not quickly dismiss any opportunity to focus on the absence of fairness and what can easily be characterised as class issues.

A government, reliant on cross bench support, will not likely ignore the short term opportunity to shift blame to the tax professionals who devise and advise on the exploitation.

What that means for tax professionals in the longer term is an issue that deserves consideration.

The Australia Institute[66] has already "loaded the guns" for the politicians by backing Labor's May 2017 Budget Reply Speech proposal to limit deductions for tax advice to $3,000[67].

The Government's long term response to the exploitation is more likely to echo its response to the community pressure over superannuation than its tardy acquiescence to establishing a Royal Commission into Bank conduct.

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The author wishes to acknowledge the valuable and timely insights contributed by Professor Chris Evans, Professor Michael Walpole and Tony Evans.

All errors are the author's alone.

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[1] This paper has been written in memory of Gordon Cooper, the co-author of a CGT book and a close enough friend to have had dinner with at his house and in a pub in New Zealand and every Australian State and Territory except WA. His co-author, Chris Evans, made valuable contributions to this paper.
[2] Rachel K Ritchie is a freelance legal researcher working from the central coast area of NSW and did much of the research for Gordon Cooper's 2017 Patron's Address

[3] Taxation of Capital Gains of Individuals; Policy Considerations and Approaches (OECD Tax Policy Studies 2006)

[4] Dr Anne Holmes, Economics; https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BriefingBook45p/TaxExpenditures

[5] Land tax may be imposed on the dwelling for some or all of the years of its ownership.

[6] Sub-division 118-B of the ITAA 1997 was enacted by Act 46 of 1998. Prior to the enactment of subdivision 118-B substantively similar provisions were located within Division 18 of Part IIIA of the 1936 Act albeit the provisions employed the expression "principal residence" rather than "main residence".

[7] ITAA 1997

[8] See https://propertyupdate.com.au/property-values-really-double-every-7-10-years/ and https://www.mebank.com.au/the-feed/property-prices-double-every-10-years-or-do-they/

[9] An extension of the basic case treats up to 10,000 square metres of adjacent land as part of the dwelling: See section 118-120.

[10] Lewis Carroll, Alice's Adventures in Wonderland & Through the Looking-Glass

[11] The Prime Minister of the day, Kevin Rudd was replaced by Julia Gillard on 24 June 2010 who went to the polls a few weeks later on 21 August 2010.

[12] The ATO database holds only the Senate Explanatory Memorandum. Austlii holds no copy of the Explanatory Memorandum.

[13] https://www.corelogic.com.au/news/property-prices-double-every-decade#.WlHhzlWWZhE

[14] https://www.corelogic.com.au/news/property-prices-double-every-decade#.Wk1Ni1WWZhE
[15] In an earlier paper the author examined the impact of amendments made to the main residence exemption in 2010.

[16] https://www.domain.com.au/news/aussie-john-withdraws-100m-mansion-from-sale-but-says-trophy-values-will-double-20170203-gu4hlc/

[17] If Elaine had sold to a foreign buyer it would have incurred a $700,000 fee to FIRB just to buy it, an extra $10.44 million in purchase duty and premium property duty payable on foreign buyers, and a land tax of $1.9 million payable each year after that.

[18] https://www.domain.com.au/news/point-piper-mansion-altona-sold-for-more-than-60-million-to-billionaire-family-from-china-20161119-gssy1n/

[19] https://www.domain.com.au/news/sydneys-top-20-trophy-homes-sales-in-2017-20171217-h02jo4/

[20] https://www.domain.com.au/news/neville-crichton-buys-45m-point-piper-mansion-next-door-to-malcolm-turnbull-20171207-h013tb/

[21] https://www.domain.com.au/news/homes-worth-100-million-the-depth-of-wealth-in-melbourne-real-estate-20160930-grq288/

[22] ISBN 9781119997719 published February 2011, John Wiley & Sons

[23] Wallis C with research by Rachel K Ritchie); The real difficulty for advisers dealing with main residence redevelopments. WTB Issue 43, 13 October 2017

[24] Some documentation might be prepared to protect the parent's investment.

[25] The Ehlers-Danlos syndromes (EDS) are a group of thirteen individual genetic conditions, all of which affect the body's connective tissue. In EDS, a gene mutation causes a certain kind of connective tissue – the kind will depend on the type of EDS but usually a form of collagen – to be fragile and stretchy. These are complex syndromes affecting many systems of the body at once, despite this EDS is often an invisible disability. Symptoms commonly include, but are not limited to, long-term pain, chronic fatigue, dizziness, palpitations and digestive disorders. Such problems and their severity vary considerably from person to person, even in the same type of EDS and within the same family. (https://www.ehlers-danlos.org/what-is-eds/)
[26] More than 500,000 Australians receive some level of disability support pension in 2017 although that number has declined from 830,454 in June 2014 and 814,391 in June 2015.

[27] Any subsequent contract of sale wherein Mum and Dad were vendors would need to provide for:

- Rita to relinquish her licence or right to occupy;
- Mum and Dad to dispose of their remainder interest.

[28] The original measure to provide a CGT main residence exemption to SDTs was announced jointly by the Minister for Families, Housing, Community Services and Indigenous Affairs and the then Parliamentary Secretary for Disabilities and Children's Services in Media Release Extra support for people with disability and their carers on 12 May 2009 as part of the 2009-10 Budget. Extensions to this measure were announced in the Assistant Treasurer and Minister for Financial Services and Superannuation's and the Parliamentary Secretary for Disabilities and Carers' joint Media Release No. 070 of 10 May 2011, as part of the 2011-12 Budget. See the General Outline in Explanatory Memorandum for Tax Laws Amendment (2011 Measures No. 7) Bill 2011

[29] Tax Laws Amendment (2011 Measures No. 7) Act 2011 (No. 147, 2011)Section 3 and Item 4 of Schedule 1 inserted Item jeuoni Act 147 of 2011

[30] Section 995 defines a special disability trust to mean:

(a) a special disability trust within the meaning of the *Social Security Act 1991* ; or

(b) a special disability trust within the meaning of the *Veterans' Entitlements Act 1986* .

[31] Private Binding Ruling Authorisation Number: 1013035564214

[32] Private Binding Ruling Authorisation Number: 1012971424318

[33] Private Binding Ruling Authorisation Number: 1011645317274

[34] In 2014 an Australian Housing and Urban Research Institute (AHURI) survey found that 43 per cent of Australians aged 50–59 have moved to a smaller dwelling or different location as they approached retirement. Judd, B., Liu, E., Easthope, H., Davy, L. and Bridge, C. (2014) *Downsizing amongst older Australians*, AHURI Final Report No. 214, Australian Housing and Urban Research Institute Limited, Melbourne, https://www.ahuri.edu.au/research/final-reports/214.

[35] Duncan A, James A, Leong K, Ong R and Rowley S (2016), ‘Keeping a Roof Over Our Heads: BCEC Housing Affordability Report 2016’, Bankwest Curtin Economics Centre, *Focus on Western Australia Series*, Issue #7, June 2016

[36] The new incentive is in addition to concessions already permitted and will be exempt from the age test, work test and $1.6 million balance test. See TREASURY LAWS AMENDMENT (REDUCING PRESSURE ON HOUSING AFFORDABILITY MEASURES NO. 1) ACT 2017 (NO. 132, 2017)

[37] https://www.intheblack.com/articles/2017/12/01/why-baby-boomers-wont-move

[38] Productivity Commission Research Paper: December 2015; Housing Decisions of Older Australians See Key Points at page 2

[39] Productivity Commission Research Paper: December 2015; Housing Decisions of Older Australians. Page 123

[40] See Budget 2017. Fact Sheet 1.5.

[41] https://www.realestate.com.au/news/baby-boomers-adding-to-their-real-estate-windfall-by-downsizing/

[42] Wallis C G with research by Rachel K Ritchie: The real difficulty for advisers dealing with main residence redevelopments; Weekly Tax Bulletin Issue 43, 13 October 2017

[43] For the purposes of the article it is assumed that the dwelling was acquired after 20 September 1985.

[44] Once the project subdivision is completed the subdivided area of land on which a new dwelling is located may be an area of the original land on which there was no dwelling; or an area of the original land on which the entirety of the old dwelling was located; or an area of the original land on which part of the old dwelling was located.

[45] — **Lewis Carroll**, **Alice's Adventures in Wonderland & Through the Looking-Glass**

[46] The Australian Tax Handbook, published by Thomson ATP, defines tax avoidance as an activity that complies with the law while trying to obtain a tax advantage not intended by the legislators. Tax evasion is a deliberate understatement of income or overstatement of deductions; it is a criminal offence.

[47] Revenue forgone estimates do not indicate the revenue gain to the Australian Government budget if specific tax expenditures were abolished, as there may be significant changes in taxpayer behaviour were tax expenditures to be removed.

[48] 2016 Defence White Paper and Portfolio budget statements 2017–18: budget related paper no. 1.4A: Defence Portfolio.

[49] Participants in broader property industry include architects, mortgage brokers, real estate agents, interior designers, property developers, builders, engineers, plumbers, electricians, tilers, painters, plasterers and more recently home automation personnel.

[50] Steve Sims; Understanding and Paying Less Property Tax For Dummies, Wiley 2004

[51] BRW volume 26, number 8
[52] Superannuation and the economy; Association of Superannuation Funds of Australia, June 2015.
[53] https://www.incitewealth.com.au/2017/05/24/superannuation-changes-1-july-2017-2/

[54] Productivity Commission Research Paper: Housing Decisions of Older Australians. December 2015. Page 132

[55] Audrey E Pulo: Tax expenditure considerations for owner-occupied housing A footnote to the article records "The author is from the Tax Analysis Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Thomas Abhayaratna, Scott Bartley, Colin Brown, Phil Gallagher, Chris Leggett, Maryanne Mrakovcic, George Rothman, and David Tellis. The views in this article are those of the author and not necessarily those of the Australian Treasury."
[56] TR 2017/9. The restaurateur is also deemed to have provided a similar value to their spouse and smaller amounts to children.

[57]

[58] Productivity Commission 2004

[59] Alice Through the Looking Glass

[60] Japan allows losses made on a principal residence

[61] http://www.abc.net.au/news/2017-02-21/house-blocks-shrink-to-80-square-metres-in-perth/8287902

[62] Thomas Nominees Pty Ltd v Thomas and Ors [2010] QSC 417 (11 November 2010)
[63] Designation of a property as a principal residence by an individual (other than a personal trust)

[64] https://independentaustralia.net/business/business-display/australia-does-have-a-housing-market-bubble,3839

[65] The stepping down might reflect the way that the GST liability on new residential premises is stepped down over five years.

[66] The Australia Institute: Targeted: Review of limit on tax advice deductions 19 May. The Australia Institute analysed ATO figures:

- to determine that less than half (47 per cent) of taxpayers claimed a deduction for getting assistance to manage their tax affairs;
- to establish those earning more than a million dollars claimed an average $12,657 in deductions for help in managing their tax affairs whereas the mean deduction was just $165.

2017http://www.tai.org.au/content/targeted-review-limit-tax-advice-deductions

[67] http://www.billshorten.com.au/speech_budget_in_reply_house_of_representatives_canberra_thursday_11_may_2017