THE PARTIAL CGT MAIN RESIDENCE EXEMPTION - "LET ME COUNT SOME WAYS IT "PARTIALLY" ADDS TO THE BUDGET DEFICIT"

(by Kirk Wilson, tax author and commentator)

Starting point – MYEFO 2016-17

My starting point for this paper is the "tax expenditure" estimates contained in the Mid-Year Economic and Fiscal Outlook (MYEFO) 2017-18 statement issued by the Government on 18 December 2017.

"Tax expenditures" (for those who are not aware, and at the risk of being patronising) are broadly those tax concessions which result in foregone revenue to the Government – albeit, Treasury specifically defines the term (at page 69 of the statement) as follows:

> *"A tax expenditure arises where the actual tax treatment of an activity or class of taxpayer differs from the benchmark tax treatment. The choice of benchmark unavoidably involves judgment and may therefore be contentious in some cases."*

But what I want to bring to your attention is that the largest estimated "tax expenditure" for 2017-18 was what was termed the "Capital gains tax main residence exemption - discount component" - which came in at a whopping $34.5 billion!

Yes, that is ***billion*** - or $34,500 million.

And to put that into some amazing perspective, that amount equates to the cash budget deficit estimated in the 2017-18 Federal Budget of $29.4 billion!

And by way of some further perspective, second on the list of top "tax expenditures" was the "CGT main residence exemption" itself coming in at $28.5 billion - followed by the "Concessional taxation of superannuation earnings" coming in at $17.7 billion.

Note also this figure could in fact be much higher given that this tax expenditure does not take into account that the CGT small business concessions may also be available to reduce (or eliminate) an assessable capital gain that arises from using part of a main residence as a place of business – and, of course, the fact that many people may not be aware that a partial exemption exists (or may fail to report it).

"CGT main residence exemption - discount component" means what?

So, what is meant by the term "Capital gains tax main residence exemption - discount component"?

Well, for a start, it is not defined in the MYEFO statement itself.

So, I more than reasonably assume, it is the effect of the 50% CGT discount being applied to that part of an assessable gain arising from a partial CGT main residence exemption. (This is because the CGT discount can only apply where there is an assessable capital gain – and this can only occur in relation to the CGT main residence exemption, where a *partial* CGT main residence exemption applies.)

No doubt (or at least presumably), the key factor in this “tax expenditure” being the largest one by a country mile is the effect of the CGT discount being applied to partial capital gain arising in a booming house price environment across the country.

However, I do not intend to examine this highly charged issue of the availability of the CGT discount in this (or other circumstances) – especially where the taxpayer may have also had the significant benefits of negative gearing! You can read daily newspaper or on-line material almost on a daily basis for commentary on this issue!

Instead, I intend to concentrate at examining several key partial main residence scenarios, and perhaps offer suggestions where the relevant partial exemption rules could be changed in order to help reduce the enormity of this particular tax expenditure “problem” – if one perceives it as a problem!

Failure to qualify as main residence – the “basic” partial exemption rule

Now, the first partial main residence exemption rule I will look at is the “basic” rule which applies where a dwelling fails to qualify as main residence throughout the period that it is owned (section 118-185 of the ITAA 1997).

In this case, the assessable partial capital gain is arrived at by apportioning the capital gain (or loss) that would otherwise have been made on the sale or disposal of the main residence (or where another CGT event happens to it) by reference to the period of ownership that it did *not* qualify as main residence.

The reason I have chosen to look at this partial exemption first is that I suspect that it contributes most to the “Capital gains tax main residence exemption - discount component” being the largest tax expenditure (although, I have no evidence for this).

And the reason I say this is because of the apparent irresistible nature of the “double whammy” effect of being able to both negatively gear a property and then also apply the CGT discount to any partial capital gain arising after it later becomes the person’s home and is sold.

I am sure that there are many Australians who use this mechanism to get into the expensive Australian housing market and, moreover, many more who understand how the effect of these tax rules make investment in housing so profitable.

However, on the technical side of things, there are a couple of things I want to say about this partial exemption.

Firstly, the “ownership period” of a dwelling for this purpose is measured from the date of settlement of the respective contracts of sale, and not from the dates of exchange (section 118-125 and section 118-130) – for the obvious practical reason that a purchased dwelling is not usually occupied by the new owners until after settlement of the contract of sale.

Secondly, be aware of the concession for moving into a dwelling that allows an owner to treat a dwelling as their main residence from the time of the settlement of the contract even though they may not move into it until sometime later because it is not “practicable” to do so.

However, be more aware that the Commissioner takes a narrow view of what “practicable” means for these purposes and that it is confined to situations where the taxpayer is ill or there is another such impediment to moving in – and not, for example, where the purchased dwelling is still subject to an on-going lease.

Moreover, in this way this concession also acts as “two-edged sword” to “punish” a taxpayer who does not move into a dwelling and make it their main residence as soon as practicable after settlement – and, thereby, can give rise to a partial main residence exemption in its own right. (But it would be interesting to know to what extent, if at all, taxpayers self-assess a partial capital gain in such cases!)

Thirdly, for completeness sake, notwithstanding all the marvels of the “absence concession”, it can *never* be used to treat a dwelling as a main residence unless the dwelling is first occupied on a “bona-fide” basis as a main residence and then “ceases” to be a taxpayer’s main residence (see the opening words of section 118-145 which requires the dwelling to “cease” to be a main residence). Accordingly, the absence concession can never be used where the property is first rented.

Now, in terms of offering a view as to how this rule could be changed to reduce its contribution to the “tax expenditure” issue, perhaps this provision could be amended to provide that no exemption arises unless the dwelling is occupied as a main residence for at least, say, 10% to 20% of its total period of ownership.

Of course, this would be a very “brave” proposal. But perhaps it would be more palatable than suggesting, say, that either negative gearing or CGT discount benefits be denied to the extent that a taxpayer has benefited significantly from both.

Income use – and the “mystery’ of the “first income use” rule

The second partial main residence exemption I wish to look at is the partial exemption which applies where a dwelling is used to produce assessable income at the same time it is a taxpayer’s main residence – such as in the case where part of the home is also used to carry on a business (section 118-190).

Without going into technical detail the partial exemption in this case – and therefore the assessable capital gain component – is calculated on a “reasonable basis” by attributing part of the overall capital gain (or loss) that would otherwise be made to that part of the

dwelling that it is used to produce assessable income, and the period for which it is so used. Furthermore, any partial assessable gain will be entitled to the 50% CGT exemption if the home has been owned for more than 12 months.

I do not wish to say more on this. Instead, I want to concentrate on the complexities of the accompanying “first use to produce income rule” in section 118-192 - which in some ways is only a “quasi” partial exemption rule depending in the circumstances.

The key to understanding all aspects of the practical operation of this rule is to understand that where a dwelling is first used to produce assessable income after 20 August 1996 then the owner is both “deemed” to have acquired the dwelling at that time and also “deemed” to have acquired it for its market value at that time.

In other words, this deemed “time of acquisition” and “cost base” will be used for calculating any future CGT liability (full or partial) depending on how the “residence” s used from that time and its interaction with other provisions.

Now there are several vital things to observe about the practical operation of this rule (including some apparent contradictions):

Firstly, the rule not only applies in the “classic” case where the dwelling is rented for the first time from that date, but also where part of it is also used as a place of business for the first time from that date. In this latter case, this means a partial exemption will arise under the “reasonable attribution” rules in section 118-190 for income usage – but as calculated by reference to the deemed “time of acquisition” and market value “cost base” under section 118-192. Note also that the absence concession cannot be used in this case as there is no “absence” from the dwelling.

Secondly, the rule does not apply where the dwelling where, prior to its first income use after 20 August 1996, it is subject to a partial exemption under section 118-185 for “failing to qualify as a main residence throughout its ownership period”. This is because the rule only applies if the taxpayer would have been entitled to a full CGT main residence exemption just before the time of such first income use (see section 118-192(1)(b)). And this is because it is impossible to combine a partial exemption under section 118-185 with the “deeming” effects of the rule in section 118-192.

Thirdly, because this rule deems the taxpayer to have acquired the dwelling for a market value cost base at this time of first income use, the original “incidental costs of acquisition” such as stamp duty and legal fees incurred before this deemed acquisition date cannot be included in the cost base. Likewise, other cost base expenditure, such as mortgage interest and other costs of ownership incurred before this date cannot be included in this deemed cost base. However, there is no prohibition to prevent cost base expenditure incurred after that time being added to the deemed market value cost base (such as capital improvements).

Fourthly, the Commissioner takes the view that the effect of a deemed acquisition at time of first income use after 20 August 1996 means that the dwelling would have to be owned for at least 12 months after that deemed acquisition date in order to qualify for

the 50% CGT discount on any assessable gain – regardless of how long the dwelling may have actually been owned before then (see ATO ID 204/945).

Fifthly (and here is a real contradiction), where a main residence is first rented after 20 August 1996, the Commissioner takes the view that the absence concession can in fact be used to preserve its main residence status for up to 6 years. This is despite the fact that the deemed acquisition at that time of first income use means the dwelling has never qualified as the taxpayer's main residence – being the pre-requisite to being able to use the absence concession (see the opening words of section 118-145 which requires the dwelling to "cease" to be a main residence.)

Finally, where the absence concession is applied and the 6 years period of income use is exceeded, then a partial exemption will apply under section 118-185 (failure to qualify as main residence for the ownership period). This is because the effect of the absence concession is to continue to treat the dwelling as a main residence while it can apply and thereafter such deemed main residence status is lost.

By way of example, where a dwelling is first rented for 8 years under this rule and then sold and the absence concession is chosen, a partial exemption will apply to reflect the fact that for 6 years out of the 8 years of its "deemed" ownership the absence concession applied to continue to treat it as the taxpayer's main residence for 6 of those years. As a result, a partial CGT liability will arise to reflect the 2 years out of 8 years it did not qualify as a main residence. And, of course, the CGT 50% discount can be applied to reduce this partial assessable capital gain.

This not uncommon situation illustrates the vital importance of understanding the "deeming" effect of section 118-192 in order to arrive at the right CGT outcome.

Now, in terms of any suggestions as to how this rule could be amended to take some of the whack out the "tax expenditure" issue, perhaps one thing to do would be to just abolish it entirely in the apparently never ending heated property market – as its deeming effect in this market is to presumably give the taxpayer a very high market value cost base from which to calculate (and reduce) any future CGT exposure. Instead, perhaps the original "pro-rata" approach where any partial gain was calculated by reference to dwelling's actual cost base should be re-introduced.

And for those who cynically thought that the rule in section 118-192 was originally introduced to prevent large sums of mortgage interest and other costs of ownership being included in the cost base, and thereby generated over-inflated cost bases (as opposed to the Government's stated aim of reducing compliance issues), the matter may well now have back fired on the Government in the heated property market in relation to any such "cynical" revenue protection aim.

Don't forget CGT event K4

In the property development frenzy that has gripped Australia for many years it is also probably necessary to say something about CGT event K4 which applies where any

CGT asset becomes trading stock – including where a main residence and adjacent land is ventured into some form of property development activity.

Under this CGT event, where a CGT asset becomes trading stock (including a main residence), the taxpayer can elect to have disposed of the CGT asset for its market value at that time and to have immediately re-acquired it for that market value. This means that any future profit from trading stock activities will be calculated by reference to this market value "cost" under the relevant trading stock rules in Division 70 of the ITAA 1997.

Moreover from a CGT point of view, the effect of the rule is that a capital gain (or loss) will arise in the income year that the asset becomes trading stock by reference to the asset's CGT cost base and capital proceeds equal to this market value amount. And in the case where the CGT asset is a main residence, there will be no CGT consequences if the residence has always been the taxpayer's main residence and was never used for income producing purposes (and, of course, if the adjacent land met the CGT exemption main residence requirement of being less than 2 hectares).

But here's the rub. Where the property is subject to a potential partial CGT main residence exemption, then CGT event K4 will apply to trigger this partial exemption and generate a partial capital gain or loss - but subject, of course, to the application of the CGT discount to reduce any capital gain if the residence had been owned for more than 12 months.

It is an easy matter to overlook – and one that presumably has (or should have) contributed to the "CGT main residence exemption – discount component" being the largest tax expenditure in recent years.

However, there are a couple of other key things to note about the operation of CGT event K4 in these circumstances.

Firstly, because it deems there to be a disposal at market value, there will be no actual funds available from the CGT event to meet any CGT liability in a case where a capital gain is generated.

Secondly, apart from the usual difficulty of determining the market value of any CGT asset at a particular time, there is also the issue of determining when exactly a CGT asset becomes trading stock in these circumstances for this purpose. However, see Determination TD 92/124 for the Commissioner's views on when land is treated as trading stock and also "indirectly" factors set out in Taxpayer Alert TA 2014/1 (point 3).

<u>Some wonders of absence concession - briefly</u>

Finally, it would be remiss not mention a couple of things about the many "wonders" of the absence concession in helping to preserve a CGT main residence exemption – or ameliorate the effects of a partial one (a couple of instances of which have already been touched upon in this paper). But there are two more unusual instances in which the

absence concession can be applied to work in this way and which are not always properly understood.

The first is the case where an inherited main residence can be sold CGT-free within two years of the deceased's death, provided it was the deceased's main residence at his or her date of death. And this can be achieved by applying the absence concession where the deceased ceased to reside in the dwelling (eg on entering a nursing home).

Moreover, this should be the case, even if the residence is rented for up to 6 years as the effect of applying the absence concession is to "continue to treat" the dwelling as the taxpayer's main residence regardless of whether it is rented or not.

Further, it has even been suggested by the late, great Gordon Cooper that there would be nothing to prevent the absence concession being applied at any time for this purpose as the requirement for the exemption is only that the dwelling was the deceased main residence (actual or deemed) at their date of death, and not throughout the whole period from their absence until their date of death.

Secondly, the Commissioner allows the absence concession to be used to preserve the CGT exempt status of a foreign main residence that a foreign resident later sells after becoming a residence of Australia – notwithstanding that there is a deemed acquisition of the foreign main residence on the taxpayer becoming a resident, which technically means that the taxpayer cannot satisfy the "absence concession" requirement that the dwelling is first the taxpayer's main residence before they cease to occupy it (see Determination TD 95/7).

Conclusion

I hope this paper has offered some worthwhile technical insight into the operation of several key, and unusual, partial main residence provisions – and also highlighted how they may contribute to the Government's revenue woes when they operate in conjunction with the CGT discount to give rise to the largest "tax expenditure" item.

I also hope it has at least raised the idea that the perhaps there is the possibility that the measures could be tightened up in some ways to reduce the variety of partial exemptions to help address the apparent "woe" associated with this particular tax expenditure (instead of trying to tackle the charged "CGT discount" issue).

Nevertheless the statement of Treasury accompanying the 2017-18 MYEFO "tax expenditure" estimates (at page 69) should also be stressed:

> "Revenue forgone estimates therefore 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."