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Greg Bitomsky
Bond University

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The Principal Place of Residence : Taxation Considerations

Abstract

Very few exemptions have been provided within Part IIIA of the Australian Tax Assessment Act, but the most significant one must be the sole or principal residence exemption provided in Section 160ZZQ. Substantial amendments to Section 160ZZQ were announced in the 1989 August Budget relating to temporary absence, erection of dwellings and deceased estates resulting in increased importance being placed on this exemption for tax planning purposes.

Keywords

taxation, residence

THE PRINCIPAL PLACE OF RESIDENCE—TAXATION CONSIDERATIONS



by **Greg Bitomsky**
B Com LLB(Hons) LLM (Qld)
AASA ACA FTIA CPA
Adjunct Professor of Law
School of Law
Bond University

Very few exemptions have been provided within Part IIIA of the Australian Income Tax Assessment Act, but the most significant one must be the sole or principal residence exemption provided in Section 160ZZQ. Substantial amendments to Section 160ZZQ were announced in the 1989 August Budget relating to temporary absence, erection of dwellings and deceased estates resulting in increased importance being placed on this exemption for tax planning purposes.

Introduction

For the majority of Australians, the purchase of a principal place of residence is the most significant investment decision they will make. The 1988 Australia Bureau of Statistics (ABS) Housing Report reveals that 19% of the weekly income of married couples purchasing their own home goes towards meeting their mortgage payments.

It is, therefore, important that all tax professionals be aware of the income tax considerations regarding the purchase and sale of the principal residence, particularly in relation to the capital gains provisions of the Income Tax Assessment Act 1936-1990 ('the Act') and the principal residence exemption (PRE) contained therein.

Treatment of a gain or loss other than under Part IIIA

Section 25(1)

In most situations the sale of a home will be a capital transaction and therefore s 25(1), which refers to the 'income' of a taxpayer, will not have the effect of including any gain on sale in the taxpayer's assessable income. Likewise, a deduction for a loss resulting from the sale of a home would not normally be deductible under s 51(1).

However, the Commissioner may argue that profits made on the sale of a home are of an income nature, particularly where a taxpayer appears to be in the habit of buying homes, living in them for a short time, and then selling them at a profit.

Although unusual, the potential application of s 25(1) should always be considered prior to looking at the capital gains provisions of the Act.

Section 25A

This section applies to property purchased prior to 20 September 1985 for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme.

It would be unusual for any profit on the sale of a home to be assessable under this section. However it is not unknown. In *Case U62*¹ Dr Gerber held that the section applied to tax a profit realised on a scheme of subdivision whereby the taxpayer purchased a block of land, subdivided it and retained one of the subdivided lots for a home, whilst selling off the remaining lots at a profit.

Application of Part IIIA

The provisions of Part IIIA are generally referred to as the Capital Gains Tax or 'CGT' provisions, although it is important to note that there is no separate capital gains tax as such. Instead, the provisions provide the framework for the inclusion of a taxpayer's 'net capital gain' in his assessable income.

In broad terms, the provisions of Part IIIA apply where an asset acquired after 19 September 1985 is disposed of. Assets acquired by a taxpayer prior to that date are outside these provisions unless some event occurs triggering a deemed acquisition to have taken place after 19 September 1985.

In the first instance, for the CGT provisions to apply, the following conditions must be satisfied:

- there must be an asset;
- the asset must have been acquired, or deemed to have been acquired, after 19 September 1985;
- there must be a disposal, or a deemed disposal, of that asset;
- the asset must have been disposed of after 19 September 1985.

Accordingly, the CGT provisions will apply to homes purchased after 19 September 1985. However, Division 18 of Part IIIA (ie s 160ZZQ) enables most taxpayers to claim an exemption, either totally or partially, in respect of any capital gain arising on the disposal of their principal place of residence.

Sole or principal place of residence exemption (s 160ZZQ)

General

The section provides for exemptions from Part IIIA for 'dwellings' that are the 'sole or principal residence' of the taxpayer.

The broad categories for exemption under the section are as follows:

- Principal place of residence during whole period.

The *total* exemption from Part IIIA where a taxpayer, and in the case

¹ 87 ATC 398.

of a deceased estate, any other relevant person, uses the dwelling as his or her sole or principal residence during the defined period or periods.

- Principal place of residence during part only of defined period.

The *partial* exemption from Part IIIA where the dwelling is not used as the relevant person's sole or principal residence during the whole of the defined period.

- Purpose other than principal place of residence.

The *partial* exemption from Part IIIA where the taxpayer, whilst using the dwelling as his sole or principal residence, also uses the dwelling for income producing purposes.

Definitions

Dwelling

The section provides for the exemption of a 'dwelling'. 'Dwelling' is broadly defined in *inclusive* terms in s 160ZZQ(1) to embrace:

- (a) a unit of accommodation constituted by, or contained in, a building, being a unit that consists, in whole or in substantial part, of residential accommodation; and
- (b) a caravan, houseboat or other mobile home.

Thus, subject to the operation of certain deeming provisions, the exemption only relates to the structure which serves as a sole or principal residence. It does not extend to the land on which the dwelling is situated.

However, s 160ZZQ(3) extends the definition of a dwelling to include:

- (a) land owned by the taxpayer adjacent to the dwelling to the extent that:
 - (i) it is used primarily by the taxpayer for private or domestic purposes in association with the dwelling; and
 - (ii) the sum of the combined area of the adjacent land and the area of land on which the dwelling is situated does not exceed 2 hectares (4.9421 acres); or
- (b) in the case of a flat or home unit, a garage, storeroom or other structure owned by the taxpayer, that is part of or attached to or associated with the block of flats or units, provided that it is used primarily by the taxpayer for private or domestic purposes.

At common law, structures built on a block of land, ie affixed to it, become part of the land. Thus, garages and other structures built on a block of land on which there is a dwelling will also be treated as part of the dwelling for the purposes of s 160ZZQ(3).

If an adjoining block of vacant land was purchased and used primarily for private purposes in association with the dwelling (home), ss (3) would deem the block to be part of the dwelling, provided the combined area

did not exceed two hectares and the new block of land was not subsequently disposed of separately from the dwelling.

The extended definition only applies where the land or storeroom, garage etc is used primarily for private or domestic purposes. Thus, their use exclusively for a business or other income producing activity, eg home office, crafts workshop etc will exclude them from being part of the dwelling for CGT purposes.

The extended definition does not apply (by virtue of s 160ZZQ(4)) where adjacent land or a garage, storeroom or other structure, that would otherwise be part of a dwelling by virtue of ss (3) is disposed of separately from the rest of the dwelling. Accordingly, where a taxpayer removes a house which was a principal place of residence, and sells the vacant land, the exemption would not apply in respect of the land sold.

Difficulties also arise in the interpretation of the term 'adjacent' used in ss (3) and (4). The question arises as to whether the term refers to that which lies near or whether it refers to that which is adjoining or touching. In *Wellington Corporation v Lower Hutt Corporation*² the Privy Council stated:

'Adjacent' is not a word to which a precise and uniform meaning is attached by ordinary usage. It is not confined to places adjoining, and it includes places close to or near. What degree of proximity would justify the application of the word is entirely a question of circumstances ...

In two Australian cases, *Geneff v Shire of Perth*³ and *FCT v BHP Minerals*⁴, the meaning of the term 'adjacent' was considered, the former in relation to the interpretation of the phrase 'land adjacent to the street', in terms of Western Australian *Local Government Act*, and the latter in relation to the interpretation of the term 'adjacent' used in the definition of housing and welfare in s 122 of that Act. In both cases the term 'adjacent' was also held to have a wider meaning than adjoining, being 'nearby' or 'close to'.

Such an interpretation would be favourable in situations where land, eg a tennis court, is used for private purposes in association with a dwelling, but which is only situated on land near that on which the dwelling is situated rather than on land adjoining it.

Clearly the meaning of the word 'adjacent' depends upon the context in which it appears. Subsection 160ZZQ(3) seems to indicate that the term refers to the land immediately surrounding that upon which the dwelling stands. Presumably, if this interpretation prevailed, where the area of land surrounding a dwelling exceeds two hectares, the exempt and non-exempt portions of any capital gain would be apportioned on the basis of the total area of land sold.

However, difficulties arise in identifying the two hectare area when a portion of the land is sold separately. These difficulties are compounded

2 (1904) AC 773, 775-776.

3 (1967) WAR 124, 128.

4 83 ATC 4407.

where the value attributable to the land varies significantly from one portion of the land to another.

Relevant Period

The 'relevant period' in relation to the disposal of a dwelling by a taxpayer, other than a taxpayer in the capacity of a trustee is defined as:

The period after 19 September 1985 during which the dwelling was owned by the taxpayer and includes any period after that date during which land on which the dwelling was subsequently erected by the taxpayer was owned by the taxpayer.

Acquisition of a dwelling

Section 160ZZQ(2) sets out the circumstances in which a taxpayer is taken to own, or to have acquired, a dwelling constituted by or contained in a building.

Thus, the section does not apply to dwellings such as caravans, houseboats or mobile homes which will be taken to have been acquired when the change of ownership of the asset occurs pursuant to the general CGT provisions (in particular s 160M(1)).

The section provides that where the dwelling is a building other than a flat or home unit, acquisition of the dwelling occurs on the acquisition of:

- a legal or equitable estate or interest in the land on which the dwelling is erected; or
- a licence or right to occupy the dwelling.

In the case of a flat or home unit, the taxpayer will be taken to own the dwelling if he has:

- a legal or equitable estate or interest in a stratum unit in relation to the flat or home unit;
- a licence or right to occupy the flat or home unit; or
- a share in a company, being a company that has a legal or equitable estate or interest in the land on which the building containing the flat or home unit, which entitles the taxpayer to occupancy of the flat or home unit.

Thus, a right or licence to occupy units in a retirement home will be covered by this exemption.

Improvements to pre-20 September 1985 assets

Post-19 September 1985 improvements or additions to pre-20 September 1985 land and buildings will be treated as separate assets for CGT purposes by virtue of s 160P. Broadly, s 160P provides that the following

assets will be deemed to be 'separate assets' for the purposes of the application of the CGT provisions:

1 *Demolition of building and erection of new building*

Where land and building were purchased pre-20 September 1985, and the building was subsequently demolished and a new building constructed after that date, the new building is deemed to be a separate asset from the land.

2 *Construction of building on vacant land*

Where a building is constructed after 19 September 1985 on land purchased prior to 20 September 1985, the building is deemed to be a separate asset from the land.

3 *Acquisition of adjacent land*

Where land is acquired after 19 September 1985 adjacent to pre-20 September 1985 land, the adjacent land will be treated as a separate asset from the pre-20 September 1985 land.

4 *Capital improvements*

Where an improvement of a capital nature has been made to a pre-20 September 1985 asset, after that date the improvement will be deemed to be a separate asset from the original land or building where:

- (a) the cost base exceeds \$50,000 (indexed annually); and
- (b) the proportion of the consideration received on disposal that was attributable to the improvement was greater than 5%.

Thus, while the original home or land purchased prior to 20 September 1985 will automatically be excluded from the CGT provisions by virtue of its acquisition date (s 160L), any improvements, deemed to be separate assets by virtue of s 160P, will only be exempt to the extent that they are classified as part of the principal residence under s 160ZZQ.

Example

Home and land were acquired prior to 20 September 1985. After 19 September 1985, capital improvements, for example guest wing, separate garage, tennis court etc are made to the home, the cost of which exceeded \$50,000. The house (including improvements) and land are subsequently sold. The consideration attributable to the improvements was greater than 5% of total consideration received. During the whole of the period of ownership the home and extensions were used as a principal residence.

- By virtue of their date of acquisition, the original house and land will be exempt from the CGT provisions (s 160L).
- Extensions to the house which are 'units of accommodation', eg guest wing, will fall within the definition of 'dwelling' (s 160ZZQ(1)) and will therefore be exempt.
- The garage and tennis court are fixtures to the land and will therefore form part of the land. Provided they are located within the two hectare limit around the home, they will be exempt from CGT by virtue of s 160ZZQ(3).

- Should the improvements be disposed of separately they will lose their exemption.

Period of principal residence exemption

The exemption available under Division 18 is available during the period in which the home is deemed to be the sole or principal residence of the taxpayer. Set out below are the provisions which apply to determine and in some cases, limit this period.

Erection of dwelling on vacant land—s 160ZZQ(5)

Where a taxpayer acquires a legal or equitable interest in vacant land after 19 September 1985, and subsequently erects a dwelling on it, which becomes the taxpayer's sole or principal residence, as soon as is practicable after the dwelling was erected, the vacant land will effectively be deemed to constitute the sole or principal residence of the taxpayer (for the purposes of s 160ZZQ) during the 'construction period' being the period from:

- (a) the date of acquisition of the land to the date of completion of the home; or
- (b) the period of four years immediately before the home became the principal residence (less any part of that period during which the taxpayer was a dependant child of another taxpayer);

whichever is the shorter period, reduced by any time during this period which the taxpayer or his spouse owned another dwelling that was used as the principal residence of the taxpayer or spouse.

The Act originally required that the taxpayer must use the dwelling as his or her sole or principal residence for at least twelve months (s 160ZZQ(5)(d)).

However, in his Budget Statement on 15 August 1989, the Treasurer announced that the Government had decided that this period should be reduced to three months. He stated that this change:

Recognises that the current twelve month requirement is, in some circumstances, unduly onerous, and that the objectives of imposing a residency requirement are satisfactorily met where the requirement is reduced to three months.

This announcement was embodied in the *Taxation Laws Amendment Act* (No 6) 1989.

An election must be lodged with the Commissioner, on or before the date of lodgement of the taxpayer's return of the year of income being:

- the year of income in which the dwelling first became the sole or principal residence of the taxpayer;
- the year of commencement of the subsection; or
- such further period as the Commissioner allows (s 160ZZQ(5A)).

Some points to note in relation to this subsection

- The construction of a dwelling on the land will be a separate asset for CGT purposes (s 160P(2)).
- Where it is over four years before the taxpayer occupies the dwelling there would be an apportionment of the exemption for the land based on the total period of ownership. For example, the taxable gain on the land (a separate asset) would be calculated as follows:

$$\text{indexed capital gain} \times \frac{\text{number of days home was not principal residence}}{\text{number of days of ownership}}$$

- The subsection refers to the acquisition of a legal or equitable interest in land. Where a purchaser acquires land under an instalment contract, being one where legal title does not pass until the purchase money is completely paid, the section will still apply by virtue of his equitable interest in the asset.
- Where an election is made pursuant to s 160ZZQ(5A) no other dwelling may qualify as the taxpayer's or his spouse's (refer below) sole or principal residence. Where a taxpayer owns another home during the construction period and the taxpayer has elected that the exemption apply to the new home, no sole or principal residence exemption is available for that other home during the period after which the election has been made. Thus, where a taxpayer owns a pre-20 September 1985 property which has been his sole or principal residence and he purchases a vacant block of land upon which he intends to build a new principal residence within four years, it would be advantageous for him to make an election pursuant to s 160ZZQ(5A) in respect of the new property. The CGT provisions would not apply to the old property by virtue of the date of acquisition and therefore there is no need to apply the s 160ZZQ exemption.
- If an election is not made, the exemption will not apply to the vacant land on which a dwelling is subsequently constructed, where there is another principal place of residence during the relevant period.
- Prior to making such an election, the taxpayer should give consideration as to which property is going to realise the greatest net capital gain.

Originally, one of the conditions of receiving this concession was that it only apply to vacant land. However, in his 15 August speech, the Treasurer stated that:

Taxpayers who construct a dwelling may inappropriately be excluded from the PRE where dwellings were constructed on land acquired before 20 September 1985, where an established dwelling is demolished and replaced with a new home or where a taxpayer acquires and completes a partly constructed dwelling. To overcome these inequities, the provisions are to be extended to situations where taxpayers erect a dwelling on land acquired before 20 September 1985, or construct a new dwelling following the demolition of an existing dwelling or complete a partially constructed dwelling.

To give effect to this change, a new s 160ZZQ(5) was introduced in the *Taxation Laws Amendment Act (No 6) 1989*.

Only one sole or principal residence per family— s 160ZZQ(9) and (10)

Section 160ZZQ(9) provides that where one home is the principal residence of a taxpayer and another home is the principal residence of his spouse or of a dependent child, then the only home that will be exempt will be either:

- (a) the home nominated by both the taxpayer and the spouse as the principal residence; or
- (b) the home nominated by the taxpayer (where the spouse has not made a nomination).
 - A 'dependent child' in relation to a taxpayer, means a child of the taxpayer who is under the age of 18 years and is dependent on the taxpayer for economic support (s 160ZZQ(1)).
 - A 'spouse' is defined to include a de facto spouse but does not include a person who is legally married to the relevant person but is living separately on a permanent basis.
 - A 'de facto spouse' is a person who is living with the relevant person as their husband or wife on a bona fide domestic basis, although not legally married.

Section 160ZZQ(1) provides the framework for determining the period during which the PRE will apply where the taxpayer and his spouse nominate different dwellings, being (T) and (S) as follows:

- (a) where during the period of the double nomination, the taxpayer's interest in T did not exceed 50% of the interests in T, then T shall be deemed to have been the taxpayer's principal residence for the whole period during which the spouse nominated S as her principal place of residence.
- (b) where the taxpayer's interest in T at any time during the period was greater than 50%, T shall be deemed to have been the taxpayer's principal residence only during half of the period in which the double nomination occurs.

Converse rules apply in the case of the dwelling nominated by the spouse.

Where (b) applies, subsection 160ZZQ(10)(a)(i) would apply to proportionately reduce the exemption from CGT for any subsequent capital gain.

Example

The taxpayer purchased the home (100%) on 31 December 1985 and for the period 30 June 1986 to 31 December 1986, (ie 182 days), the taxpayer and his spouse nominated different principal places of residence. Property was sold on 1 January 1987. Thus the proportion of any future capital gain or capital loss which is not subject to the exemption is as follows:

(1990) 1 Revenue L J

$$\begin{aligned}
 & \frac{\text{number of days home was not principal residence}}{\text{number of days of ownership}} \\
 = & \frac{(183 \text{ days} \times 50\%)}{365} \\
 = & 25\% \text{ taxable}
 \end{aligned}$$

Unlike s 160ZZQ(5A), the legislation in respect of ss (9) does not provide for the timing of the nomination to the Commissioner, nor does it provide guidance as to how the nomination is to be made, eg in the taxpayer's returns.

Home also used to produce income—s 160ZZQ(8)(a)

The effect of this paragraph is to provide that a dwelling will still be the sole or principal residence of the taxpayer during the relevant period, notwithstanding that it may have been used both as a residence and for another purpose, eg as a doctor's surgery or home office.

However, if the other purpose is income producing, the exempt proportion of the capital gain or capital loss will be reduced proportionately pursuant to ss 21 (discussed later).

Change of residence—temporary ownership of two homes

Section 160ZZQ(8)(b)

Where, before disposing of his principal dwelling, a taxpayer acquires another dwelling, both dwellings will be taken to be his sole or principal residence for a period up to three months, provided:

- that the dwelling that was disposed of was the sole or principal residence of the taxpayer for a continuous period of at least three months in the twelve months prior to disposal; and
- the dwelling was not used for income producing purposes during the twelve months prior to disposal, except where it was *also* used as a sole or principal residence (refer above);
- where a taxpayer acquires his new dwelling more than three months before the time of disposal of his former dwelling, both dwellings will only qualify as the taxpayer's sole or principal residence for a period of three months ending at the disposal of the old dwelling. This is illustrated by the following example:

<i>Home 1</i>	Date of acquisition	31.9.86
	Date of sale	31.1.90
	Occupied as principal residence to	31.9.89
	Net capital gain	\$50,000
<i>Home 2</i>	Date of acquisition	31.8.89
	Date of sale	31.8.92
	Occupied as principal residence from	1.10.89
	to	31.8.92
	Net capital gain	\$60,000

Thus:

- *Home 1*
 - Principal residence for 36 months to 31.9.89 as it was actually occupied as a principal place of residence.
 - Deemed principal residence for three months prior to disposal (1.11.89-31.1.90) during which Home 2 was owned, pursuant to s 160ZZQ(8)(b).
 - Not exempt for one month period (1.10.89-31.10.89) being four months prior to disposal.

Therefore the non-exempt capital gain is:

$$\$50,000 \times \frac{1}{40} = \$1,041.67$$

- *Home 2*
 - Principal residence for the 35 months of actual residence from 1.10.89 to 31.8.92.
 - Deemed principal residence for one month to 31.1.90 in which it was occupied pursuant to s 160ZZQ(8)(b).

Therefore the dwelling is exempt for the whole of the period of ownership.

- As highlighted above, in order for the subsection to apply, the taxpayer must acquire a new dwelling before disposing of his original principal residence. Thus, taxpayers must be careful to ensure that a contract on their new dwelling takes place before the contract on their existing dwelling.

Obviously this is an area in which conveyancing solicitors should highlight the potential pitfalls to the purchaser to ensure that, where possible, the three month extension applies.

- It may also be noted in respect of this exemption that it is not relevant how the acquisition of the new dwelling occurs. Thus the acquisition of a new dwelling as a beneficiary in a deceased estate would, where the other relevant circumstances exist, satisfy the conditions for the extension to the period of principal residence.

Dwelling temporarily ceasing to be a principal residence

Section 160ZZQ(11)

Provision is made, by virtue of ss (11), for the preservation of the status of a taxpayer's principal residence where the taxpayer temporarily ceases to use the dwelling as a principal residence and then again resides in the dwelling as a principal residence within four years of the original cessation. The section would apply to a temporary absence from a principal residence:

- due to job transfer

- during extended holidays
- during major renovations

Where the original dwelling was totally demolished it is likely that this subsection would not apply as there would be no 'dwelling' to which can be attributed the vacant land. Instead the taxpayer would have to rely on the exemption contained in ss (5).

- during extended stays in hospital, nursing home

The effect of the subsection is that during the period of absence:

- no other dwelling shall be deemed to have been the taxpayer's principal residence; and
- any use of the dwelling for the purpose of gaining or producing assessable income eg by way of rental, will be disregarded.

However, the following conditions must be satisfied:

- (a) The home, owned by the taxpayer, must only temporarily cease to be the principal residence.
- (b) The dwelling must again become the principal residence within four years.

For example

Where a taxpayer returns to Brisbane after the termination of a temporary job transfer and prior to his return he sells the old dwelling in order to purchase a new dwelling, the exemption will be lost for the whole of the period of the absence, because the old dwelling did not again become his principal residence.

The subsection does not apply to preserve the exemption during the period in which the taxpayer 'intends' to reside in the dwelling within four years but is unable to do so due to unforeseen circumstances eg ill health, extension of temporary transfer.

- (c) The taxpayer must notify the Commissioner in writing, no later than the date of lodgement of the taxpayer's income tax return for the year in which the dwelling again becomes the principal residence, that the subsection is to apply.

Originally, the subsection did not provide for the exercise of the Commissioner's discretion to extend the time period in which the notification must be made. However, the Treasurer announced in the 15 August 1987 Budget that the Government proposed to allow a discretion for the Commissioner of Taxation to accept late elections from taxpayers (including beneficiaries/trustees) in respect of this exemption and this is provided for in s 160ZZQ(11A).

Exemptions in relation to principal residence during relevant period

Subsections (12) to (20)

Subsections (12) to (20) contain the provisions which allow for either the total or partial exemption from Part IIIA of a capital gain arising from the sale of a home which is a principal place of residence. Each of

the subsections is specifically made subject to ss (21). That subsection deals with the situation in which a dwelling is used as a principal residence and also for 'an income producing purpose' and is discussed in further detail later.

It should be noted that as the legislation now stands, the exemption provided for under these subsections is not available if the dwelling is owned by a company and is only available in limited situations where the dwelling is owned by the trustee of a deceased estate. Accordingly, it is important that when advising clients we consider the relevance of placing family homes in the hands of taxpayers other than individuals.

In 1987, the Treasurer announced a number of extensions to the PRE which included the availability of a PRE in respect of homes owned by a trustee, other than as a trustee of a deceased estate. Those amendments are set out in more detail later in this paper.

Disposals by the homeowner

Total exemption—s 160ZZQ(12)

This provision provides for a total exemption of any capital gain or capital loss on sale of a principal residence where the disposal relates to:

- (a) a dwelling which is *owned* by the taxpayer, being *natural person* other than:
 - (i) a beneficiary under a will; or
 - (ii) a trustee; and
- (b) which was the sole or principal residence of the taxpayer throughout the relevant period.

Partial exemption—s 160ZZQ(16)

Where the dwelling was used by the taxpayer as his principal residence during only part of the relevant period, a partial exemption of the relevant capital gain (or loss) from the application of Part IIIA is available under ss (16).

This subsection provides that a deemed capital gain (or loss) will be assessable to the taxpayer on the disposal of such a dwelling, in accordance with the following formula:

$$\frac{AB}{C}$$

where

A	=	capital gain or capital loss as the case may be
B	=	number of days in the relevant period (ie period of ownership) that the dwelling was not the principal residence
C	=	number of days in relevant period (ie of ownership)

Joint owners

Section 160ZN(1) provides that where an asset is owned by persons as joint tenants:

- (a) Part IIIA applies as if those persons owned the asset as tenants in common in equal shares.
- (b) If one of the joint tenants dies and the deceased person's interest in the asset was acquired pre-19 September 1985, the interest of the deceased person is deemed to have been acquired by the survivors on the date of death for consideration equal to market value of the interest at that date.
- (c) If one of the joint tenants dies and his interest in the asset was acquired post-19 September 1985, the interest of the deceased will be deemed to have been acquired on the date of death for a consideration equal to:
 - (i) for the purposes of calculating a capital gain on subsequent disposal, the amount that would have been the indexed cost base to the deceased immediately prior to death; or
 - (ii) for the purpose of ascertaining the capital loss on subsequent disposal, the amount which would have been the reduced cost base to the deceased immediately prior to death.

Thus, by virtue of s 160ZN(1)(a), a joint owner of a dwelling is the 'owner' for the purposes of applying ss (12).

In IT 2485 the Commissioner stated that where the dwelling is not the principal residence of all joint owners and the joint owners are not spouses, the exemption under ss (12) is only available to the joint owner(s) in respect of their share in the dwelling where they occupied the dwelling as their principal residence.

Any other joint owner will be subject to the provisions of Part IIIA in respect of his share as though the property was not a principal residence of any party.

Where a dwelling was used for the purpose of gaining or producing assessable income during the relevant period, the above exemptions will be subject to ss (21).

Disposals by trustee or beneficiary of a deceased estate

The division also provides for either the total or partial exemption from the operation of Part IIIA where the taxpayer acquires the dwelling as a beneficiary or trustee of a deceased estate and the dwelling was the principal residence of the deceased. In effect, provided certain conditions are satisfied, the benefit of the exemption previously held by the deceased (ie by virtue of the asset being purchased pre-20 September 1985, or pursuant to s 160ZZQ) is rolled over to the beneficiary or trustee of the estate.

It is important to note that in order for a beneficiary to claim the exemption, he must be a natural person.

The exemptions are subject to ss (21) where the dwelling was previously or subsequently used for the purpose of gaining or producing assessable income.

Disposals by beneficiary

A reference to a taxpayer having acquired a dwelling as a beneficiary in the estate of a deceased person occurs where the taxpayer acquired the dwelling:

- (a) under the will of a deceased person, or under such a will as varied by an order of a court; or
- (b) by operation of law as a result of the intestacy of a deceased person, or by operation of law as a result of such an intestacy as the operation of the law is varied by an order of a court;

whether the dwelling was transmitted directly to the taxpayer or was transferred to the taxpayer by the executor of the will, or by the administrator of the estate, of the deceased person.

Total exemption—s 160ZZQ(13)(13A) and (14)

A total exemption from the application of Part IIIA will apply in respect of the disposal of dwelling by a beneficiary in any of the following situations:

- (a) If the taxpayer's disposal of the dwelling occurs within twelve months of the deceased's death, neither a capital gain nor a capital loss arises on the disposal provided that, if the dwelling was acquired by the deceased after 19 September 1985, the dwelling was the principal residence of the deceased during the period from the date of acquisition to the date of death (ss (14)).
- (b) If the dwelling was the principal residence of the taxpayer during the period the taxpayer beneficiary was the actual owner of the dwelling, ie the period commencing with the transmission of the dwelling to the taxpayer, neither a capital gain nor a capital loss will arise on the disposal of the dwelling by the taxpayer provided that throughout the period the dwelling was owned by the legal personal representative of the deceased it was principal residence of the person who, immediately before the deceased's death, was his or her spouse.

If the dwelling was acquired by the deceased person after 19 September 1985, the dwelling must, during the period it was owned by the deceased, have been used by the deceased person as his or her sole or principal residence (ss (13)).

- (c) If the dwelling was, throughout the period from the deceased's death to the taxpayer's disposal of the dwelling, the principal residence of the taxpayer neither a capital gain nor a capital loss arises on the taxpayer's disposal. Again, if the dwelling was acquired by the

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deceased person after 19 September 1985, the dwelling must, throughout the period during which the dwelling was owned by the deceased, have been the sole or principal residence of the deceased (ss (13A)).

Partial exemption—s 160ZZQ(17), (17A) and (18)

Where in the case of (a), (b) or (c) above, the dwelling was not used by the relevant person(s) as their principal residence during the whole of the relevant period, ss (17), (17A) and (18) may provide for a reduced amount of a capital gain or loss as follows:

- (a) (Re ss (14) above) where the deceased acquired the home after 19 September 1985, but it was not always the sole or principal residence of the deceased, the capital gain or loss that will be attributable to the beneficiary or subsequent sale will be calculated using the following formula:

$$\frac{AB}{C}$$

- where A = indexed capital gain (or capital loss)
 B = the number of days during deceased ownership the dwelling was not the deceased's principal residence
 C = the number of days the deceased owned the dwelling (ss (18))

- (b) Where in relation to ss (13) above, either:

- (i) if the home was acquired by the deceased post-19 September 1985, it was not the principal residence of the deceased during the whole period of ownership; and/or
- (ii) it was not the principal residence of the deceased's spouse during the whole period it was owned by the personal legal representative; and/or
- (iii) it was not the beneficiary's principal residence for the whole period from the date of transmission until the date of disposal by the beneficiary,

ss (17) will apply so that part of the capital gain or capital loss will not be exempt.

The proportion of the capital gain or loss attributable to the taxpayer-beneficiary will be:

$$\frac{AB}{C}$$

- where A = indexed capital gain (or capital loss)
 B = number of days it was not the principal residence of:

- (i) the deceased during the period it was owned by the deceased (if a post-19 September 1985 home); and/or

- (ii) the spouse of the deceased during the period it was owned by the legal personal representative; and/or
- (iii) the taxpayer-beneficiary, from the date of transmission to the date of disposal.

$$C = \begin{array}{ll} \text{(i)} & \text{if purchased by the deceased pre-20 September 1985, the number of days from the date of death to the day before disposal by the taxpayer-beneficiary; or} \\ \text{(ii)} & \text{if purchased by the deceased post-19 September 1985, the number of days from acquisition by the deceased to the day before disposal by the taxpayer-beneficiary (ss (17)).} \end{array}$$

(c) Where in relation to ss (13A) above, either:

- (i) the dwelling was not the beneficiary-taxpayer's principal residence for the whole period from date of the deceased's death to the date of disposal by the beneficiary; and/or
- (ii) if it was a post-19 September 1985 dwelling, it was not the deceased's principal residence for the whole of the period it was owned by the deceased.

The proportion of any capital gain (or loss) which will be attributable to the taxpayer-beneficiary, will be calculated using the following formula:

$$\frac{AB}{C}$$

where A and C have the same definitions as detailed above; and
 B = the number of days it was not the principal residence of:

- (i) the taxpayer-beneficiary during the period from the date of death to the disposal by the beneficiary and/or;
- (ii) the deceased during the period of ownership by the deceased (if a post-19 September 1985 home), ss (17A).

Other amendments

The Government has amended the operation of the provisions relating to a disposal of a deceased person's former home within twelve months where the dwelling had not been used solely as the deceased's principal residence. Under the former provision, the PRE available in the period from the time of death to the date of disposal was determined in proportion to the period of ownership in which the deceased had used the property as a principal residence. As a result, where a beneficiary used the dwelling as a principal residence for a proportionately greater period than had the deceased, the beneficiary was denied a proportion of the PRE relating to a period where the home was occupied as a principal residence. The Government decided to amend the provisions that apply in these circumstances so that the whole of the period of use

of a dwelling as a principal residence by a beneficiary can be taken into account in determining the PRE to be available. This amendment will only apply where it provides a greater PRE to the taxpayer.

Disposals by trustee

Total exemption—s 160ZZQ(15)

A total exemption is available where the taxpayer owns a dwelling in the capacity of the trustee of a deceased estate and either:

- the disposal of the dwelling takes place within twelve months after the date of death, or
- the dwelling was the principal residence of the deceased's spouse throughout the period from that date of death to the time of disposal.

In addition, if the dwelling was acquired by the deceased after 19 September 1985, the dwelling must also have been the deceased's principal residence throughout the period of his ownership.

Partial exemption: sale outside twelve months—s 160ZZQ(19)

Where the trustee disposes of a dwelling more than twelve months after the death of the deceased and ss (15) would otherwise have applied, but for the fact that:

- the dwelling was not the principal residence of the deceased's spouse from the date of death to the date of disposal; and/or
- where the home was a post-19 September 1985 asset, it was not the deceased's principal residence for the whole of the period of ownership.

Subsection (19) will apply to treat a portion of the capital gain (or loss) to the taxpayer-trustee as non-exempt from the provisions of Part IIIA using the following formula:

$$\frac{AB}{C}$$

where A and C have the same definition as apply in ss (17) (refer above)

B = number of days the dwelling was not the principal residence of:

- (i) the deceased during the period it was owned by the deceased (if a post-19 September 1985 asset); and/or
- (ii) the spouse of the deceased, during the period it was owned by the legal representative.

Partial exemption: sale within twelve months—s 160ZZQ(20)

Where the trustee disposes of a dwelling which was acquired by the deceased after 19 September 1985, within twelve months of the date of death and the dwelling was the principal residence of the deceased during part only of the period in which the dwelling was owned by the taxpayer,

the exemption from Part IIIA will not apply to a portion of the gain calculated using the following formula:

$$\frac{AB}{C}$$

where A and B and C have the same meanings as set out in ss (18).

Dwelling also used for income producing purposes— s 160ZZQ(21)

As stated earlier, each of the ss (12) to (20) containing the provisions for the total or partial exemption from Part IIIA, is subject to ss (21) which in effect provides that the exemption otherwise available will be reduced where the principal residence is also concurrently used for an income producing purpose.

Subsection (21) provides that a capital gain (or loss) shall be deemed to have arisen of such an amount as the Commissioner determines having regard to:

- the amount of the capital gain (or loss)
- the extent to which the dwelling was also used for producing assessable income
- the period during which the home was also used for producing assessable income.

In the Taxation Office Booklet, *Income Tax and Capital Gains*, the Commissioner states that:

Generally, unless the part of the home used to gain assessable income is distinctly of a greater or lesser proportionate value than the dwelling part, this extent will be determined on an area basis.

The Treasurer has cited the use of part of a residence as a place of business, such as a doctor's surgery, a lawyer's professional office or shop, as examples of situations to which ss (21) would apply.

He also stated that where a person used the principal residence as a home office, merely because it is not convenient for the work to be done at the usual place of work, the residence is not regarded as being used to gain or produce assessable income. In such a case, income tax deductions would also not be allowed for the expenses incurred in respect of the home office.

Marital disputes

Section 160ZZM provides that where a taxpayer transfers an asset to his or her former spouse pursuant to either:

- an order of a court under the *Family Law Act* 1970 or under a corresponding law of a foreign country; or
- a maintenance agreement approved by a court under s 87 of the *Family Law Act* 1970, or a corresponding agreement approved or otherwise sanctioned by a court under a corresponding law of a foreign country, Part IIIA will not apply to the transfer between the spouses.

- For the purposes of this section, spouse refers only to a taxpayer's legally married spouse (the extended definition in s 160K(2) to include a de facto specifically does not apply).
- Where the asset was acquired by the transferor prior to 20 September 1985, s 160ZZM deems the asset to have been acquired by the spouse before that date.

- Where the asset was purchased after 19 September 1985 by the transferor, for the purposes of applying Part IIIA in respect of the subsequent disposal by the transferee spouse, the following will apply:

For the purposes of calculating an assessable gain the consideration deemed to have been paid is the indexed cost or cost base which would have applied in respect of the transferor taxpayer (had Part IIIA applied in respect of the disposal). The unindexed cost base will apply where the asset is disposed of by the transferee spouse within twelve months of purchase by the transferor.

For the purposes of ascertaining a capital loss on subsequent disposal, the consideration deemed to have been paid by the transferee spouse is the reduced cost which would have applied in respect of the transferor taxpayer (had Part IIIA applied in respect of the disposal).

- However, in respect of a post-19 September 1985 asset, the section does not deem the transferee spouse to have acquired the asset at any earlier time than the date on which the relevant order or agreement took effect.

Thus in the case of a dwelling transferred, provided that the transferee spouse commences to reside in the transferred dwelling prior to or at the time ownership passes and continues to do so until the dwelling is disposed of, it is irrelevant what purpose the dwelling was used for prior to the change of ownership eg as a rental property or holiday home.

- It should be noted that s 160ZZM does not apply where a taxpayer owns a home and retains ownership under orders of the Family Court, and the CGT liability arising on subsequent disposal will depend on whether the dwelling was the principal residence during the whole period of ownership (ie during and after the marriage).
- Section 160ZZM only applies to the transfer of an interest. Thus where the home is owned jointly during the marriage, a CGT liability may still arise in respect of the disposal of the original interest where:
 - the dwelling was not a principal residence throughout the period of ownership (and one of the s 160ZZQ exemptions eg ss (11) does not apply); or
 - the provision of ss (9) and (10) discussed previously are deemed to take effect.

Section 160ZZMA provides for election rollover relief where an asset is disposed of on or after 19 September 1985 by a company or trustee to a spouse pursuant to a Family Court Order of the type also referred to in s 160ZZM. Where the conditions for relief are met, the other provisions of Part IIIA do not apply in respect of the disposal by the company or trustee.

- The effect of this rollover relief is that the transferee acquires the relevant asset with the same CGT attributes that it had in the hands of the transferor company or trust.

Thus,

- Where the asset was acquired by the company or trustee prior to 19 September 1985, the transferee is deemed to have acquired the asset before that date.
- Where the asset was acquired by the company or trustee after 19 September 1985, the transferee spouse is deemed to have acquired the asset at the indexed cost base (or reduced cost base) which would, apart from this section, have applied to the company or trustee at the time of disposal.

(Where the asset is disposed of by the transferee spouse within twelve months of purchase by the company, the cost base rather than the indexed cost base will apply).

For the purposes of applying the PRE pursuant to Division 18, s 160ZZQ(1A) provides that where a post-19 September 1985 asset is disposed of by a company or trust, and pursuant to s 160ZZMA, Part IIIA does not apply, the following provisions will have effect:

- (a) the transferee taxpayer will be deemed to have owned the asset during the whole of the prior period of ownership by the company or trustee; and
- (b) a dwelling to which the asset relates shall *not* be treated as the sole or principal residence of the taxpayer during the prior period of ownership.

Thus, the dwelling may only qualify for a partial exemption in the hands of the transferee spouse, calculated by reference to the period commencing when the transferor company or trust acquired the land.

Amendment—1989/90 Federal Budget

As part of the 1989/90 Federal Budget announced on 15 August 1989, the Treasurer proposed a number of additional amendments in relation to the PRE. These amendments are generally backdated to apply to properties acquired on or before 20 September 1985.

Consequences of death

During construction of dwelling

Under the former provisions, no PRE was available where a taxpayer died prior to the completion of a new dwelling and only a partial exemption was available if the taxpayer died within the minimum residency period. It was enacted in the amendments to s 160ZZQ(5) that the PRE should be available in situations where a taxpayer dies during the period after the commencement of construction of a dwelling on his/her land but prior to fulfilling the three month residency requirement.

During period of temporary residence

It is enacted in the amendments to s 160ZZQ(11) that the PRE should also be available in situations where a taxpayer dies during a temporary period of absence (of less than four years) from their principal residence. Formerly, a dwelling retained tax exempt status as a principal residence where the taxpayer was temporarily absent provided the taxpayer returned to reside in that dwelling within four years. Where the taxpayer died during a period of absence, this requirement was not met and a beneficiary may have inherited a dwelling with only a partial PRE.

Under the amendments, the law applies on the assumption that the taxpayer would have returned to the residence within four years had death not occurred.

Chain of beneficiaries

Where a taxpayer is in a 'chain of beneficiaries', that is, where he or she inherited the home from a deceased person, who in turn had inherited the home from another deceased person (and so on) because CGT liabilities do not arise on death, the amendments will apply to an unbroken chain of beneficiaries back to the point at which the home was first acquired on or after 20 September 1985.

The difficulty overcome was that the availability of the PRE was solely determined by reference to use of the home as the principal residence of the person disposing of the home, and the person from whom the home was inherited. However, where an asset acquired on or after 20 September 1985 passed through one or more deceased estates, accrued CGT liabilities were effectively 'passed on' because the cost base of the asset to the beneficiary was its indexed cost base (rather than market value) to the deceased person.

The availability of the PRE for the sale of a home should therefore refer to the use of the home as the principal residence of the person who first acquired the home on or after 20 September 1985 and of all subsequent beneficiaries who owned the home prior to sale.

The amendments apply where their effect is to reduce a taxable capital gain realised after 19 September 1985 and before 15 August 1987, but they will not apply in respect of that period where their effect would be to increase a taxable capital gain or to reduce an allowable capital loss.

Another amendment contained in s 160ZZQ(6A) relates to the availability of the PRE to surviving joint tenants. Technically, the former CGT provisions which extended the PRE otherwise available to a deceased person to disposals of homes by beneficiaries applied only where a home passed to the beneficiary under the will of the deceased or under a law relating to intestacy. The provisions did not, therefore, apply to surviving joint tenants who previously owned the home jointly with the deceased, who obtain title automatically. No policy reason existed to deny the availability of the PRE to beneficiaries who acquired an interest in a home under the law relating to joint tenancies. The PRE provisions were therefore amended so that they also apply in that situation.

Beneficiaries of trust estates

The former CGT provisions did not allow a PRE for homes owned by a trustee and occupied by a beneficiary.

The Treasurer announced that the Government had decided that, in some circumstances, the restriction was not appropriate. Therefore, the PRE became available in limited cases where a home is occupied by beneficiaries of certain trust estates for periods where the title of the home remains vested in the trustee as follows:

- A PRE is to apply on the sale of a deceased person's home for any period, since the date of death, during which the dwelling has been the principal residence of a person who holds a life tenancy under the terms of the deceased's will.
- A PRE will apply for a period where a home is occupied as the sole or principal residence by a beneficiary under a legal disability and the home is sold before title passes to that beneficiary.
- Where, in the administration of a deceased estate, the trustee acquires a home to be occupied by a beneficiary in accordance with the terms of the will of the deceased person, that dwelling will be eligible for the PRE while occupied by the beneficiary.
- A PRE will be available to the trustee of a person who is legally incapable of handling his or her affairs, for the period that the home is occupied as the principal residence of that person. This situation could arise either where title to the home passed from the person to the trustee or where the home was purchased by the trustee in the course of administering that person's estate.

The former Division 18 provisions were also amended so that the trustee of the estate of a person under a legal disability will be provided the same treatment under the division as the trustee of a deceased estate.

Conclusion

The provisions which provide the framework for the CGT exemption in respect of a taxpayer's principal residence are complex. Most individuals would not be aware of the potential implications and complications which may arise from their simple investment in a family home. There is an onus on all tax professionals to provide timely advice to their clients to ensure that they are made aware of these implications prior to the purchase or sale of a residence.