

Structuring Tax-Effective Property Transactions

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1. Introduction

The taxation implications of a property transaction will be determined by the character of the transaction:

- (a) A mere realisation of a capital asset – business and private capital assets;
- (b) A profit-making undertaking or scheme:
 - (i) Acquired for profit purpose; and
 - (ii) Subsequent commencement of the profit-making purpose; or
- (c) Trading business involving property as trading stock.

Aside from the usual taxation implications of the distinction between revenue and capital transactions, there are other issues to consider – the implications of the transaction being subject to the CGT rules, differences in timing rules to bring to account the transaction to assessment, deemed cost base rules and finally GST implications.

Having particular regard to the facts in the case study, the starting point would be to consider the nature of the proposed transactions and determine their taxation characteristics, that is whether the proposed transactions represent a “mere realisation” and therefore on capital account and prima facie subject to the CGT provisions, or whether the proposed transaction is on revenue account.

2. Case study discussion

2.1 Background facts

- (a) Taxpayer 1 has owned a 10-acre block of land for 10 years on which the family home is situated. The property was acquired and has solely been used for residential purposes.
- (b) Taxpayer 2 has a 10-acre block of land adjoining taxpayer 1’s property. Taxpayer 2 acquired the property to conduct a small, albeit profitable, farming business growing small crops. The taxpayer is registered for GST purposes. The farm is the taxpayer’s only asset.
- (c) Taxpayers 1 and 2 have been discussing the potential sale of their properties and have come to you to discuss the various taxation implications of a sale.
- (d) Both taxpayers have complained that urban sprawl has resulted in the quietness and remoteness of their properties being disturbed.

2.2 Disposal circumstances

Taxpayer 1

Taxpayer 1’s family has left home and he is now considering selling off the property and downsizing to a smaller property in a regional town.

In previous discussions, the potential sale options for taxpayer 1 have been considered:

- (a) Sell the property;
- (b) Rezone the property to enhance the resale value and then sell;
- (c) Rezone the property and personally undertake a small development project by splitting the property into 10 blocks and then marketing the property for sale; or

- (d) Undertake a joint venture with taxpayer 2 by aggregating the properties and then subdividing the aggregated properties. Profits would be split equally.

Taxpayer 2

Taxpayer 2, who is 60 years of age, has been contemplating retirement for a period of time with the encroachment of the city and the environmental red tape.

Taxpayer 2 has had many discussions with taxpayer 1 and they have shared their views on how to deal with disposal of their properties. Taxpayer 2 sees his options as:

- (a) Sell the property;
- (b) Rezone the property to enhance the resale value and then sell the property en masse; or
- (c) Rezone the property and enter into a joint venture arrangement with a developer to undertake a small development project.

3. Mere realisation

3.1 Preliminary observations

To assist with advices of this type of matter, and in particular whether the disposal of the property is a mere realisation, there is a long history of cases that we can refer to that have considered the characteristics of the sale of a property in determining the taxation outcome. At its simplest, the taxation distinction is based on whether the transaction is:

- (a) A "mere realisation" of the property and therefore of a capital nature; or
- (b) A revenue transaction because the property was either:
 - (i) Acquired for the purposeful intent and/or applied for a profit-making undertaking or sale; or
 - (ii) Applied in a trading business as trading stock.

If the transaction is:

- (a) A revenue transaction: the profit will be dealt with pursuant to section 6-5 ITAA 1997.
- (b) Trading stock: Division 70 and section 6-5.
- (c) A mere realisation of a capital asset: and therefore solely treated within the context of the CGT rules (Part 3-1 ITAA 1997), noting that:
 - (i) All assets are a CGT asset – refer to section 108-5;
 - (ii) There will be a CGT Event applicable to the CGT asset– refer to Division 104;
 - (iii) There will be capital proceeds applicable to the transaction – refer to Division 116;
 - (iv) The asset will have a cost base – refer to Division 112; and
 - (v) Query whether there are any specific provisions dealing which modify the taxation of the CGT gain – for example Division 115, Division 152 or Division 118.

3.2 Real property will be a CGT asset

By way of a simple example to illustrate the interaction of the various taxation rules, in the context of the case study:

- (a) *In either case is the asset a CGT asset?* Yes.
- (b) *Will there be a CGT Event?* Subdivision 104-A applies if there is a change in the beneficial ownership of the land.
- (c) *Will the taxpayer receive some capital proceeds attributable to the CGT Event?* Refer to section 116-20 or the modification rules in section 116-30.
- (d) *Has the asset a cost base?* Yes.
- (e) *Is there any specific CGT provision applicable to impact any capital gain?*
 - (i) Residential property provisions – subdivision 118-B.
 - (ii) Gain is reducible by Division 115.
 - (iii) In the case of the farming property, query whether Division 152 applies.
 - (iv) If the transaction applicable to the property also attracts the revenue provisions (for example section 6-5), will section 118-20 overcome the potential dual taxation of the same transaction?

3.3 Residential property

One of the issues that often occurs with residential properties that are subsequently subdivided is application of the CGT exemption for residential property provided by subdivision 118-B.

This is particularly the situation with “adjacent land”. To qualify for exemption under s 118-120, the adjacent land must satisfy the following conditions:

- (a) Fits the definition of “adjacent land”;
- (b) Used primarily for private or domestic purposes in association with the dwelling;
- (c) Must not be disposed of separately from the dwelling, i.e. the same CGT Event must affect the land and the dwelling; and
- (d) The maximum area of the land (including the land under the dwelling) must not exceed 2 hectares.

Some points in relation to the above:

- (a) Taxation Determination TD 1999/68 states that the land need only be close or near to the dwelling to be “adjacent”, and it does not have to be “contiguous” with the land on which the dwelling is situated.
- (b) Taxation Determination TD 2000/15 deals with the issue of what is meant by the phrase “to the extent that” in subsection 118-120(1) of the Income Tax Assessment Act 1997 where it refers to land that is adjacent to a dwelling ... to the extent that you used the land primarily for private or domestic purposes in association with the dwelling as if it were a dwelling.

Paragraph 1 of the Tax Determination states:

1. This is a question of fact and degree to be determined having regard to all of the circumstances in each particular case. While the application of subsection 118-120(1) of the Income Tax Assessment Act 1997 (ITAA 1997) is to be determined at the time of any CGT event which happens to the dwelling, it is the extent to which you used the land primarily for private or domestic purposes in association with the dwelling throughout the ownership period that is relevant.

Example 63 from the ATO CGT Guide illustrates the above point. The adjacent land area would include, in relation to a rural property, the farmhouse together with the home garden, garage, tennis court, swimming pool and the like, provided that these covered less than 2 hectares. However, it would not extend to storage sheds or a paddock used as part of the farm because these would not be used primarily for private or domestic purposes in association with the dwelling – even though these were within the 2 hectares surrounding the farmhouse.

- (c) Taxation Determination TD 1999/67 supports the proposition that if adjacent land that is used for private or domestic purposes exceeds 2 hectares, the taxpayer can select or choose which 2 hectares of the property will qualify for the main residence exemption (also refer to ATO ID 2001/325). If the larger area of land can be separately valued, it will be subject to CGT on the basis of an apportionment of the capital proceeds and cost base (or reduced cost base) on the basis of a valuation.

3.4 What is a mere realisation?

With regard to the circumstances of either taxpayer in the case study, it is relevant to consider if and to what extent the “mere realisation” principle might apply.

This specific taxation issue was perhaps first addressed by Lord Justice Clerk (the Right Honourable J.H.A. Macdonald) in **Californian Copper Syndicate (Limited and Reduced) v. Harris** [1904] 5 TC 159 at 165-166, where he stated:

It is quite a well settled principle, in dealings with questions of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit ... assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. ... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being - Is the sum of gain that has been made a mere enhancement of values by realising a security, or is it a gain made in an operation of business in carrying out a scheme of profit-making?

As was identified by the Lord Justice Clerk:

... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts;...

The Australian Courts have adopted the Californian Copper principle in numerous cases, albeit that the taxation of property transactions has been subject to shifting taxation rules, the principle has consistently applied.

In **Ruhamah Property Co. Ltd. v. FCT** [1928] 41 CLR 148, at page 151, their Honours said:

The principle of law is that profits derived directly or indirectly from sources within Australia in carrying on or carrying out any scheme of profit-making are assessable to income tax, whilst proceeds of a mere realization or change of investment or from an enhancement of capital are not income nor assessable to income tax ...

Williams J. in **Scottish Australian Mining Co. Ltd. v FCT** [1950] HCA 16 made the following observations concerning a circumstance where the taxpayers disposed their property post the cessation of their business:

The crucial question is therefore whether the facts justify the conclusion that the appellant embarked on such a business or undertaking or scheme in 1924. The facts would, in my opinion, have to be very strong indeed before a court could be induced to hold that a company which had not purchased or otherwise acquired land for the purpose of profit-making by sale was engaged in the business of selling land and not merely realizing it when all that the company had done was to take the necessary steps to realize the land to the best advantage, especially land which had been acquired and used for a different purpose which it was no longer businesslike to carry out. The plain facts of the present case are that the appellant purchased the Lambton lands for the purpose of carrying on the business of coal mining and carried on that business on the land until it was no longer businesslike to do so. It then had the land on its hands and it was land which because of its locality and size could only be sold to advantage in sub-division. A sale in sub-division inevitably requires the building of roads. If it is advantageous to the sale of the land as a whole to set aside part of the land for parks and other amenities, this does not convert the transaction from one of mere realization into a business. It is simply part of the process of realizing a capital asset.

FCT v Whitfords Beach Pty Ltd [1982] HCA 8, whilst primarily dealing with the then section 26(a) ITAA 1936, included in the judgement of the Court an endorsement of the Californian Copper principle:

When the owner of an investment chooses to realize it, and obtains a greater price for it than he paid to acquire it, the enhanced price will not be income within ordinary usages and concepts, unless, to use the words of the Lord Justice Clerk in Californian Copper Syndicate v. Harris (1904) 5 Tax Cas 159, at p 166, that have so frequently been quoted, "what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business".

In Whitfords Beach, and perhaps, pertinently for our case study examples, Gibbs CJ posed the relevant question to be considered (paragraph 9):

Was what was done merely a realization of the taxpayer's asset, or was it something done in what was truly the carrying on or carrying out of a business? In other words the question is "whether the facts reveal a mere realization of capital, albeit in an enterprising way, or whether they justify a finding that the" (taxpayer) "went beyond this and engaged in a" (business of profit-making) "in land albeit on one occasion where however the words used are "a trade of dealing in land"; the words which I have ventured to substitute seem more consonant with the Australian authorities. The words "merely" and "mere" in these statements seem to me to be an important part of the definition of the line between profits that are taxable and those that are not. If the taxpayer does no more than realize an asset, the profits are not taxable. It does not matter that the taxpayer goes about the realization in an enterprising way, so to secure the best price. As I have said in Federal Commissioner of Taxation v. Williams (1972) 127 CLR, at p 249:

"The situation is not altered by the fact that the landowner seeks and acts upon the advice of an expert as to the best method of subdivision and sale or by the fact that he carries out work such as grading, levelling, road building and the provision of reticulation for water and power to enable the land to be sold to its best advantage."

Further, the mere magnitude of the realization does not convert it into a business: Commissioner of Taxes v. British Australian Wool Realization Association (1931) AC 224, at p 252. But if the taxpayer does engage in an operation of business, the proceeds are income and taxable. (at p368)

Having provided that taxation analysis, Gibbs CJ then considered the more vexed question of how and when the then section 26(a) ITAA 1936 would apply:

Having regard to the existing state of the law to which I have referred, the first limb can in my opinion only have been intended to treat as income profits arising from the acquisition and sale of property which was acquired by the taxpayer for the purpose of profit-making by sale, notwithstanding that the profits did not arise in the carrying on or carrying out of a business - notwithstanding, in other words, that the profits would ordinarily be regarded as a capital gain. The words of the first limb, when given their ordinary and natural meaning, support this conclusion, for they contain nothing to suggest that capital gains are to be excluded, and if they did apply only to profits that constituted income in accordance with ordinary concepts they would effect no alteration to the law as already established.

...

The second limb is expressed in words taken from the judgment of Knox C.J., and Gavan Duffy, Powers and Starke JJ. in Ruhamah Property Co. Ltd. v. Federal Commissioner of Taxation [1928] HCA 22; (1928) 41 CLR 148, at p 151, where their Honours said:

"The principle of law is that profits derived directly or indirectly from sources within Australia in carrying on or carrying out any scheme of profit-making are assessable to income tax, whilst proceeds of a mere realization or change of investment or from an enhancement of capital are not income nor assessable to income tax ... "

Although in many cases the assessment will be the same whether the case is regarded as falling within s. 25(1) or s. 26(a), there may be cases in which a different result will be arrived at depending on which provision is held to be applicable.

...

However, I should make it clear that I regard it as established that profit yielded by the mere realization of a capital asset not acquired for the purpose of profit-making by sale would not be either assessable income within s. 25(1) or the profit arising from the carrying on or carrying out of a profit-making undertaking or scheme within s. 26(a)...

3.5 Change of purpose – passive to commercial intent

In circumstances where property is initially acquired for a capital or private purpose and subsequently applied by the taxpayer for use/conversion in a different manner to facilitate the disposal of the property, the taxation implications identified above have some practical implications:

- (a) What are the factors that influence the taxation characteristics of the transaction; and
- (b) How to calculate the assessable profit where the transaction is not a mere realisation.

Relevantly in Whitfords Beach, having regard to the factors and the implications of the taxpayer's change of purposes, Gibbs CJ noted:

The purpose of those controlling the taxpayer was to engage in a business venture with a view to profit. Moreover, although the taxpayer was not formed for the purpose of selling land, after December 1967 it became a company which existed solely for the purpose of carrying out the business operation on which the new shareholders had decided to embark when they acquired their shares. It is in the light of these circumstances that the extensive work of development and subdivision is seen to be more than the mere realization of an existing asset and to be work done in the course of what was truly a business venture. For these reasons, although the case is not without its difficulties, I have concluded that the profits were income within ordinary concepts and taxable accordingly. (at p371)

Mason J analysed section 26(a) and commented where and how it applied to various types of transactions. His Honour concluded that:

32. *All that I have said indicates that the second limb does not affect the principle enunciated in Californian Copper except to emphasize that an undertaking or scheme may be a profit-making one even if it lacks the characteristics of repetition or recurrence supposedly essential to the carrying on of a business. It is possible that the second limb applies when the taxpayer's activities amount to more than the mere realization of an asset but do not constitute the carrying on of a business because they lack the characteristics of repetition or recurrence. The distinction made in Californian Copper (1904) 5 Tax Cas 159 between a mere enhancement in value by realization of a security and a gain made in an operation of business in carrying out a scheme of profit-making remains a valid distinction for the second limb of s. 26(a). (at p383)*

33. *If the taxpayer's activities do amount to the carrying on of a business then s. 25(1) will certainly apply. It was not intended that the second limb should apply to cases in which the taxpayer is carrying on a business because this would give the second limb a very extensive operation at the expense of s. 25(1). (at p383)*

34. *The principal, if not the essential, question under the second limb of s. 26(a), as under s. 25(1), is whether more is involved than the mere realization of an asset. As Deane J. noted in his dissenting judgment in the Federal Court, we must not overlook the importance and the scope of the word "mere". To bring this case within the second limb the Commissioner does not need to show that the respondent was carrying on a business. As we have seen, it is enough to answer the statutory description that there was a profit-making undertaking or scheme which exhibited the characteristics of a business deal, even though it did not amount to the carrying on of a business. If what has happened amounted to no more than the mere realization of an asset then it was not a profit-making undertaking or scheme. (at p384)*

Then, after considering the nature of the changes to the company holding the land, Mason J concluded with a salient warning:

24. *In the present case, a great deal had to be done in order that the land could be sold in residential subdivision. Its character had to undergo significant change. That which at 20 December 1967 was no more than a distant potentiality had to be brought within the range of practical achievement. I am inclined to question whether some of the earlier cases have not assumed too readily that the conversion of broadacres into residential allotments with all the services and facilities that are requisite to an urban environment is no more than the realization of a capital asset in an enterprising way. But that question need not be pursued here, because this case exhibits the additional feature that at the material time the subject land as a matter of law could not be sold otherwise than in its unsubdivided state. The business upon which the taxpayer embarked in 1967 required active measures to be undertaken in order to remove the legal impediment to development of the subject land. That change in its character was essential to the successful achievement of the taxpayer's purpose. Taken together with all the attendant circumstances, it satisfies me that the taxpayer ventured the subject land as the capital of the business in such a way as to make the proceeds of that business assessable income within the meaning of s. 25 of the Act. (at p401)*

3.6 What are the relevant factors?

Hill J provided a very good summary of the factors that should be considered with regard to isolated transactions in **Westfield Limited v Commissioner of Taxation** [1991] FCA 86. In the course of his judgement, Hill J provided the following analysis of the law to be considered:

31. *The test in Californian Copper was applied in more recent times by the High Court in Federal Commissioner of Taxation v Myer Emporium Limited [1987] HCA 18; (1987) 163 CLR 199 and GP International Pipecoaters Pty Limited v Commissioner of Taxation [1990] HCA 25; (1990) 64 ALJR 392. In appreciating what was said in Myer, it is important to recall that an argument for the taxpayer was that the transaction there involved, of selling land, receiving a mortgage back*

at interest for a long term, and then assigning the income arising under the mortgage for a lump sum, was not income in ordinary concepts, because it was an extraordinary transaction and outside the scope of the taxpayer's business. It was in answering this argument, that the judgment of the court in Myer said (at 209):

"Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a 'one off' transaction preclude it from being properly characterised as income: Federal Commissioner of Taxation v Whitfords Beach Pty Ltd. The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit".

32. The judgment, not only in this passage, but in several later passages (at 211-213), emphasises that where a transaction occurs outside the scope of ordinary business activities, it will be necessary to find, not merely that the transaction is "commercial" but also that there was, at the time it was entered into, the intention or purpose of making a relevant profit.

That being said, the taxation issues that need to be considered are:

- (a) Whether the taxpayer's intention in entering into the transaction was to make a profit;
- (b) Whether the manner of making the profit is a "commercial" transaction; and
- (c) Notwithstanding that the profit-making scheme may lack specificity of detail, the mode of achieving that profit has been one that was contemplated by the taxpayer as at least one of the alternatives by which the profit could be realised.

Often with older cases, the factual context of the decision is based on the commercial environment of the day. For this reason, it is often significant to consider whether the past legal decisions will be applicable to present day property development requirements. For that purpose, I have considered a recent case, **August v FCT** [2012] FCA 682, which dealt with a sale of a property development. The judgement in this case referenced the legal authorities cited above and confirmed that a gain will be on revenue account.

Ultimately (as with most cases on this subject matter) the judgment was based on the relevant facts and the application of the following legal principle.

In the case, the primary issue was:

The first is whether profit derived by Toorak Management Pty Limited (Toorak) as a result of the sale of property at Melba was income according to ordinary concepts or income of a capital nature. The Commissioner assessed Mr and Mrs August on the basis that the profit was income according to ordinary concepts. Mr and Mrs August contend that the property was acquired by

Toorak as a long term investment, and that the profit arising as a result of the sale of the property was of a capital nature.

Relevantly, such cases are based on the objective analysis made of all of the facts. In that regard the evidence of the taxpayers is particularly relevant. In the case of August, the Judge made the following reference:

In McCormack v Federal Commissioner of Taxation (1979) [1979] HCA 18; 143 CLR 284 Gibbs J (at 302) said:

The taxpayer's evidence must of course be considered on its merits, in the light of the circumstances of the case, without any prepossession, favourable or unfavourable. If the taxpayer gives evidence that the property in question was not acquired by him for the purpose of profit-making by sale, and that evidence is accepted, he of course succeeds. In some cases the taxpayer may establish that the case does not fall within s. 26 (a), even though he does not give evidence or does give evidence but is disbelieved. Of course the fact that the taxpayer did not give evidence, if unexplained, could be taken into account in deciding what inferences should be drawn from the evidence (Jones v. Dunkel [1959] HCA 8; [(1959) 101 C.L.R. 298, at pp. 308, 312, 320-322]). And the fact that the taxpayer was disbelieved could, in appropriate circumstances, itself give rise to an inference adverse to the taxpayer's case (Steinberg v. Federal Commissioner of Taxation [1975] HCA 63; [(1975) 134 C.L.R. 640, at p. 694]). Nevertheless, if the proper inference to be drawn from the evidence is that the taxpayer bought the property for a purpose other than that of profit-making by sale, the appeal will succeed. An obvious example would be a case in which it clearly appeared that a taxpayer purchased a house and for many years thereafter occupied it as his own home. In those circumstances the natural inference, in the absence of evidence to the contrary, would be that the taxpayer had bought the house for the purpose of dwelling in it, and the fact that the taxpayer was not an honest witness would hardly matter. However, if the taxpayer's evidence of the purpose with which he acquired the property is not accepted, and it does not appear from the other evidence on the balance of probabilities that he did not acquire the property for the purpose of profit-making by sale, he will fail to discharge his onus of proof. When I speak of purpose I mean, of course, the main or dominant purpose actuating the acquisition.

Critically with all tax cases, and as was emphasised with the above citation, the taxpayer bears the onus of proof.

In August, it was concluded that:

*In the present case it is accepted by Mr and Mrs August that the relevant profits will constitute income according to ordinary concepts **if** the properties were acquired for the purpose of profit-making by sale. In this regard, it is now settled that the purpose of profit-making by sale need not be the sole or dominant purpose: Commissioner of Taxation v Cooling (1990) 22 FCR 42 per Hill J (with whom Lockhart and Gummow JJ agreed) at 56-57, and Moana Sand Pty Limited v Federal Commissioner of Taxation (1988) 88 ATC 4897 at 4,902-4,904. It is enough, at least in the case of a commercial or business dealing, that the purpose is a substantial (or a not insubstantial) one.*

3.7 Application of the legal principles to a "change of use" situation

The practical difficulty with all of the above is that the legal principles are relevantly simple to understand but are difficult to apply in practice. In that regard, there are a number of cases that seek to apply the general principles and illustrate the points of practical differences:

- (a) Statham
- (b) Stevenson

(c) Casimaty

These cases are discussed below in some detail, however the importance of these cases is not the legal principles but the subtle differences the cases illustrate to be the defining points to treat one transaction as a mere realisation and another a revenue transaction.

The importance of these cases when reviewing the facts and the decisions is *how* and *why* the facts give rise to the different outcomes.

Statham v FCT [1988] FCA 463

The facts in summary were:

- (a) Taxpayer (Statham as executor) acquired a farm near Kingaroy of about 270 acres from his late father so that he might raise his family in a rural environment and engage in some desultory farming. He did not acquire the property with the purpose, let alone the dominant purpose, of subdividing it and selling off the subdivided parts.
- (b) The Bickertons (partners in partnership with the deceased), connected with Dr Bickerton's medical practice for various reasons, had their hands full. In addition, the cattle market was in a depressed state. For these and other reasons, a decision was made in the middle or latter half of 1979 by the deceased and the Bickertons (owners) to change direction by selling the whole or part of the land.
- (c) The owners decided to seek approval for a staged plan of subdivision which allowed readily saleable and cheaply developed land with a street frontage to be sold first. The owners applied to the Kingaroy Shire Council for approval to subdivide.
- (d) All that was required of them was the making of applications to the Kingaroy Shire Council and the provision of a bond by way of a bank guarantee.
- (e) The owners sold the sub-divided land simply by listing it with local real estate agents. The marketing of the land was attended to by the agents without participation by the owners. No site office was set up to cater for sales at the site of the subdivision. No office was set up to conduct the affairs of the owners. The financial books and the accounts in respect of the subdivision were kept by Mrs Bickerton. Dr Bickerton continued in his medical practice.
- (f) The owners did not advertise the sale of the subdivided lots by, for example, television, radio or newspaper advertisements.
- (g) Apart from arranging the bond by way of a bank guarantee, they did not borrow money to enable the subdivision to take place.
- (h) Although the owners obtained some professional advice from an engineering firm, they did not engage any contractors to carry out work, leaving that to the Kingaroy Shire Council.

Held: The sale constituted a mere realisation.

Stevenson v FCT [1991] FCA 224

The facts in summary were:

- (a) The taxpayer owned farming land.
- (b) Conditions required for development permission included substantial expenditure on the provision of water and sewerage reticulation before any blocks could be sold.

- (c) The taxpayer sought finance from CC, a finance company, to enable him to pay for the external water supply and sewerage works to be carried out and for Stage 1 of the subdivision to proceed.
- (d) The taxpayer had not done anything to implement a marketing strategy. He had not engaged the services of any agent to market the blocks, nor had he engaged in the scale of advertising which his advisers considered appropriate. Although he did place some advertisements in the national and local press inviting inquiries to be made to himself.

Relevant dicta:

5. It is no doubt true that a determination as to whether a man is carrying on a business turns largely on a consideration of the activities being undertaken, rather than of the personal activities of that man, as distinct from the servants, agents and others who undertake activities pursuant to contracts with him. But in distinguishing between mere realization of an asset and the carrying on of a business it cannot in my opinion be irrelevant that the owner of the asset undertook much of the planning and managing of the activities.

...

...It is, I think, difficult to discriminate between mere realization and the conduct of a business by reference directly to the magnitude of the physical activity or the physical effect of the activity, although Mason J. does seem to regard the degree of development and improvement of the land as critical. The magnitude of a substantial subdivisional enterprise does, however, commonly entail such a degree of systematic organization, planning, management and repetition of purposeful profit-making activity that the carrying on of a business may be more clearly discerned than in a case "where an area of land is merely divided into several allotments."

Held: Profit assessable.

Casimaty v FCT [1997] FCA 1388

Facts:

- (a) The property and its farming activities were suffering badly from drought. Substantial losses were incurred causing severe financial hardship. Sometime during 1972 – 1973, unsuccessful representations were made to Government to purchase the whole property. The taxpayer sought advice as to whether it was advisable to sell the whole property. The taxpayer continued farming.
- (b) To satisfy the costs associated with loan financing, the taxpayer undertook a subdivision of the property over 9 stages.
- (c) The taxpayer did no more in preparing the allotments for sale than was required by the Council, apart from slashing and clearing scrub, filling in some creeks and waterholes and pushing up levy banks on creek lines to improve the presentation of certain allotments. His developmental activities never extended to the proposal or creation of public facilities.
- (d) All sales were negotiated through the taxpayer's stock and station agents. The taxpayer's only role was to assist with inspections when requested to do so. There were no sales facilities on site, nor did the taxpayer maintain records of enquirers or possible purchasers. He conducted no private dealings.

Held:

Ryan J, after an extensive coverage of the relevant cases, delivered the following conclusion:

Conclusion

Taking the approach suggested by the authorities canvassed above, I have been led to resolve the question of fact in this case in favour of the taxpayer. In coming to that conclusion, I have been influenced primarily by the indisputable fact that he acquired and continued to hold "Acton View" for use as a residence and the conduct of the business of a primary producer. Apart from the activities necessarily undertaken to obtain approval from time to time for subdivision of parts of the property, there is nothing to suggest a change in the purpose or object with which "Acton View" was held.

In this respect, the present is to be contrasted with those cases in which particular circumstances provided an occasion for imputing to the landholder a change of purpose. In Whitfords Beach those circumstances were the passing of control of the landholding company from the owners of the fishing shacks to the three development companies. In Official Receiver v Federal Commissioner of Taxation (Fox's Case) the critical circumstance was that control of the land passed to the Official Receiver who sought the instructions of the creditors as to whether he should dispose of the land in its undeveloped state or undertake its extensive development to increase the return to the creditors. In the Melbourne Trust Case one critical consideration was the formation of the realization company as a distinct entity with shareholders unrelated to the failed banks or their creditors.

Nor did the present taxpayer acquire other land to be added to the original "stock" represented by "Acton View". Had he done so, that would have facilitated the imputation of an intention to carry on a business of land development as occurred, for example, in Crow v Federal Commissioner of Taxation. See also the Melbourne Trust Case where a second critical factor was the pooling of land which had belonged separately to each of the failed banks.

It is also significant that, although the taxpayer had previously always carried on his business activities of farming and fencing in partnership with his wife and his son respectively, he made no attempt to bring "Acton View" into account as a partnership asset. Nor did he seek to claim as a business expense the interest on moneys borrowed to defray the subdivisional costs.

A related consideration is the fact that the development and subdivision of "Acton View" was undertaken piecemeal in response to the exigencies of increasing debt and deteriorating health. No coherent plan was conceived at the outset for the subdivision of the whole property, even in stages, to maximise the return from the aggregate of the individual lots. Even at the date of the last of the assessments to which these proceedings are related, an area considerably over one-third of the whole of the original property had not been subdivided.

Nor did the taxpayer undertake any works on, or development of, the land beyond what was necessary to secure the approval by the municipal authorities of the successive plans of subdivision and enhance the presentation of individual allotments for sale as vacant blocks. Had he constructed dwelling houses, internal fencing or other improvements, it would have been easier to impute to him an intention to carry on a business of land development and improvement. Similarly, had he set up his own sales organization or advertised or conducted sales himself instead of entrusting those activities entirely to his traditional agents, Roberts Ltd, the inference would have been more strongly available that he had gone into the business of selling farmlets or rural residential allotments. That inference was drawn by the Tribunal in Stevenson's Case where the taxpayer, at least from stage 2 of his development, personally dealt with prospective purchasers as well as "multi-listing" the blocks with a variety of agents.

Accordingly, I find that the sales from 1977 of lots on the second and subsequent subdivisions occurred as part of the mere realization of a capital asset of the taxpayer. The proceeds from

those sales did not amount to income upon the application of the ordinary principles embodied in s 25(1) of the Act.

Moreover, it follows from my conclusion that "Acton View" had been acquired by the taxpayer for the purpose of primary production that no "profit" from those sales is assessable in accordance with the first limb of s 25A(1). Nor does the second limb of that sub-section have any application because the sales did not occur in the course of carrying on or carrying out any profit-making undertaking or scheme. To adapt the analogy suggested by Deane J in this Court in Whitfords Beach (1979) 44 FLR 312 at 330 this is not even a case of selling by a goldsmith in his shop of his patrimony of a gold bar. The taxpayer, as I have found, never conducted a business of a land developer or vendor to which any part of "Acton View" was devoted."

From his Honour's conclusion, it is possible to discern various factors that might determine whether the taxpayer had embarked on a profit-making scheme, namely:

- (a) Original purpose for acquiring the land had not changed – contrast the facts of Casimaty with those of Whitfords Beach;
- (b) No other property was acquired to augment the existing land holding;
- (c) Continuation of original business activity;
- (d) Piecemeal subdivision (that is there was no coherent plan);
- (e) Subdivision activities were associated with the health and financial distress of the taxpayer;
- (f) No claim for the interest costs associated with moneys borrowed for the subdivision costs; and
- (g) Minimum subdivision works, and there were no improvements constructed on the land.

What is important to note with circumstances that the taxpayer has embarked on a profit-making scheme, is that the cost base of the property is the market value of the property at the time the scheme commences.

That being the case, it is not necessary to "transfer" the property to a special purpose entity merely to recognise the value proposition at the time to profit-making scheme commenced.

3.8 Application of the legal principles – private binding rulings (PBR)

There are many examples of PBRs, which while are not a precedent for other taxpayer's circumstances, however they do provide a general guide of the approach adopted by the ATO with property transactions. A review of a couple of selected PBRs illustrates the issues and factors applied:

- (a) PBR 49856
- (b) PBR 1012630326484
- (c) PBR 1012829759699

PBR 49856

THE SUBJECT OF THE RULING:

- *You acquired a property for the purpose of farming before 20 September 1985.*
- *You have used the property for farming from the date of purchase.*
- *The local council re-zoned properties in the area to allow for subdivisions. You did not apply for re-zoning.*
- *You no longer farm the land as intensively as in prior years.*

- You decided to sell some of your land.
- You continue to use the remaining land for farming.
- The blocks were only developed by subdivision and connecting electricity and water.

YEAR: 2008

RULING:

1. Are the proceeds from the sale of your subdivided land assessable under section 6-5 or section 15-15 of the ITAA 1997?

No. The sale of part of your land represents a mere realisation of a capital asset.

2. Are the proceeds from the sale of your subdivided land subject to the CGT provisions in Part 3-1 of the ITAA 1997?

No. The land is excepted from the CGT provisions. You acquired the land prior to 25 September 1985.

EXPLANATION

Mere realisation

- The mere realisation of a capital asset is not assessable income.
- However, if a capital asset is ventured into a business operation or commercial transaction with a profit making intention, the profit may be assessable as income according to ordinary concepts.

The question is whether the gain has been made as a mere enhancement of values by realising a security, or in the operation of business in carrying out a scheme of profit-making (*Californian Copper Syndicate (Limited and Reduced) v. Harris* (1904) 5 TC 159).

Isolated transactions

Taxation Ruling TR 92/3 states the Commissioner's views on whether profits on isolated transactions are assessable income.

An isolated transaction is defined as:

- (a) transactions outside the ordinary course of business of a taxpayer carrying on a business; and
- (b) transactions entered into by non-business taxpayers.

TR 92/3 represents the Commissioner's application of the High Court's decision in *Federal Commissioner of Taxation v. The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693 (Myer Case).

Generally, a profit from an isolated transaction will be income when both of the following are present:

- (a) the intention or purpose of entering into the transaction was to make a profit or gain, and
- (b) the transaction was entered into and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

The intention of the taxpayer is determined by an objective consideration of the facts and circumstances of the case.

Profit-making does not need to be the sole or dominant purpose for entering the transaction. Profit-making must be a significant purpose. The purpose must exist at the time the transaction or operation was entered into.

If a taxpayer not carrying on a business makes a profit, that profit is income if:

- (a) the taxpayer had a profit-making intention when entering the transaction or operation; and*
- (b) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.*

A transaction may be characterised as a business operation or commercial transaction if the transaction is business or commercial in character.

Some of the factors that may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are:

- (i) the nature of the entity undertaking the operation or transaction. For example, if the entity is a corporation with substantial assets rather than an individual, this may be an indication that the operation or transaction was commercial in nature.*
- (ii) the nature and scale of the activities undertaken*
- (iii) the amount of money involved in the transaction and the size of the profit that was sought or obtained*
- (iv) the nature, scale and complexity of the operation or transaction*
- (v) the manner in which the operation or transaction was carried out. For example, whether professional agents and advisers were used and whether the operation or transaction was in a public market*
- (vi) the nature of any connection between the taxpayer and any other party to the operation or transaction. For example, the relationship may suggest that the operation was essentially a family dealing*
- (vii) The nature of any property disposed of. For example, if the property has no use other than as a subject of trade, it is easier to infer the transaction was commercial in nature, and*
- (viii) The timing of the transaction or the various steps involved. For example, if the transaction involves the acquisition and disposal of property, then holding the property for many years may indicate the transaction was not business or commercial in nature.*

Factors considered

You purchased the land to operate as a farm.

- Your decision to subdivide and sell part of the land was motivated by a downturn in the primary production business.*

- You could get a better price and retain part of the land if you subdivided it.
- You have retained a majority of the property for your continuing primary production business.
- You are not a land developer. You have no formal qualifications, previous experience or knowledge of property development.
- You contracted professionals to carry out the subdivision.
- You do not have any plans to develop other property.

PBR 1012630326484

Subject: Land subdivision mere realisation

Questions and Answers:

1. Will your gains from the disposal of subdivided land be treated as a mere realisation of a capital asset under section 104-10 of the Income Tax Assessment Act 1997 (ITAA 1997) and be taxable under section 102-5 and section 6-10 of the ITAA 1997 (rather than taxable as ordinary income under section 6-5 of the ITAA 1997)?

Yes.

2. Will your subdivision **not** constitute carrying out an enterprise for the purposes of section 9-5 and 9-20 of A New Tax System (Goods and Services Tax) Act 1999 (GST Act)?

Yes.

YEAR: 2012

Relevant facts and circumstances

You are a discretionary trust established after 20 September 1985. You were formerly registered for GST in respect to a commercial rental property. You have owned X properties for many years and you and your director have never owned any other properties or undertaken any other activities.

The non-rental property was purchased as vacant land after 20 September 1985, where soon after a family dwelling was constructed on a portion of the land and used until the current time for that residential purpose. With the progressive rezoning and development of the local area, the land remains undeveloped and council rates have steadily increased.

After a number of failed attempts to sell the surplus (non-residential) land to property developers, you recently entered into a contract with an engineering company that will pay for the subdivision of the surplus land subject to a deposit (which you borrowed from a major bank) and the pre-sale of a number of blocks (which was successfully done).

A planning services company was employed to lodge a development application, which was approved, the subdivision has commenced, you will retain your residential lots and the other lots will be sold through a real estate agent.

Reasons for decision

Income tax treatment

Profits from a land sub-division can be treated in at least three ways for taxation purposes:

- (1) As ordinary income under section 6-5 of the ITAA 1997, as a result of carrying on a business of property development, involving the sale of land as trading stock.*
- (2) As ordinary income under section 6-5 of the ITAA 1997, as a result of an isolated commercial transaction entered into by a non-business taxpayer or outside the ordinary course of business of a taxpayer carrying on a business.*
- (3) As capital gains under Part 3-1 and Part 3-3 of the ITAA 1997, from the mere realisation of a capital asset.*

...

*In the Federal Court of Australia case of *Casimaty v Federal Commissioner of Taxation* 97 ATC 5135, at 97 ATC 5152, Ryan J described a salient characteristic of the mere realisation of land as follows:*

...[to not] undertake any works on, or development of, the land beyond what was necessary to secure the approval by the municipal authorities of the successive plans of subdivision and enhance the presentation of individual allotments for sale as vacant blocks.

In distinguishing mere realisation from a commercial transaction, Justice Ryan further said:

Had he constructed dwelling houses, internal fencing or other improvements, it would have been easier to impute to him an intention to carry on a business of land development and improvement.

In your case, your gains from the disposal of subdivided land will be treated as a mere realisation of a capital asset because:

- (ix) the land was not originally purchased for the purpose of subdivision;*
- (i) the land had another purpose other than the subject of trade, namely, long term residential;*
- (ii) you are merely realising or selling an old asset;*
- (iii) you will not undertake any works on the land apart from what is necessary by the municipal authorities; and*
- (iv) you will not engage in a business of selling land since real estate agents will sell the land*

GST tax treatment

Section 9-20 of the GST Act defines the term 'enterprise' to include:

- an activity, or series of activities, done in the form of a business;*
- an adventure or concern in the nature of trade; or*
- provision of a lease, licence or other grant of an interest in property on a regular or continuous basis.*

Subsection 9-20(2) of the GST Act provides certain additional tests in relation to carrying on an enterprise. In particular, the activity or activities must not be a private recreational pursuit or hobby and there must be a reasonable expectation of profit or gain.

Miscellaneous Taxation Ruling MT 2006/1 provides the Australian Taxation Office (ATO) view on whether or not an activity or series of activities constitutes an enterprise for the A New Tax System (Australian Business Number) Act 1999. Further to this, Goods and Services Tax Determination GSTD 2006/6 provides that the ATO view provided by MT 2006/1 can be applied equally to the term enterprise as used in the GST Act.

Paragraph 234 of MT 2006/1 states an adventure or concern in the nature of trade may be an isolated or one-off transaction.

Paragraph 263 of MT 2006/1 states activities are an enterprise in that they are of a revenue nature as they are considered to be activities of carrying on a business or an adventure or concern in the nature of trade (profit making undertaking or scheme) as opposed to the mere realisation of a capital asset

In your case, as your subdivision of land will result in the mere realisation of a capital asset, it will not constitute carrying out an enterprise for the purposes of section 9-5 and 9-20 of the GST Act.

PBR 1012829759699

Subject: CGT - subdivision - mere realisation

Question 1

Will the proceeds received from the sale of the subdivided blocks be assessable pursuant to sections 6-5 or 15-15 of the Income Tax Assessment Act 1997 (ITAA 1997)?

Answer

No.

Question 2

Will the proceeds received from the sale of subdivided blocks be taxed under the capital gains tax provisions of the ITAA 1997?

Answer

Yes.

YEAR: 2015

Relevant facts and circumstances

You purchased the property in December 20XX.

The property is zoned rural residential and comprises XX hectares.

The property was purchased with a conditional approval for a subdivision of 6 blocks between X to X acres each. The approval was subject to a number of conditions.

Your intention at the time of purchasing the property was to live there upon your return from living overseas.

You leased the property to unrelated parties from 20XX to 20XX, while you were living overseas.

You returned to Australia in September 2011 and made the property your main residence.

In August 20XX, you began working on satisfying the conditions contained in the conditional approval for the subdivision.

In 20XX, you had met all the conditions and you obtained the approval to begin work on the subdivision.

You completed some of the land clearing activity, however you engaged contractors to complete specialist clearing of the land.

You also engaged contractors to carry out:

- *Road works and culvert installations*
- *Concrete works*
- *Electrical reticulation*
- *Surveys*
- *Geotechnical works*
- *Telephone installation*
- *Engineering works, and*
- *Asphalting.*

You have not carried out any previous property subdivision and or development activity.

You have not borrowed funds to finance the subdivision.

Apart from rudimentary fencing, you are only completing the work required to satisfy the approval conditions.

You are relying on the technical expertise of others to complete the subdivision and the marketing and sale of the blocks.

You will not be erecting any buildings on the land.

You expect that it may take several years to sell all the blocks.

Reasons for decision

...

Paragraph 6 of TR 92/3 provides that a profit from an isolated transaction will generally be income when both the following elements are present:

- *your intention or purpose in entering into the transaction was to make a profit or gain,*
and

- *the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.*

In contrast, paragraph 36 of TR 92/3 notes that the courts have often said that a profit on the mere realisation of an investment is not income, even if the taxpayer goes about the realisation in an enterprising way. However, if a transaction satisfies the elements set out above it is generally not a mere realisation of an investment.

...

In your case, you do not carry on a business of buying, selling or developing land. You purchased the property with the intention of living there upon your return from overseas. You leased the property during the period you lived overseas and upon your return you moved in to the property and made it your main residence.

You have had minimal involvement in the subdivision of the land and you will be reliant upon professional planners and contractors to carry out the works associated with the subdivision. You are only completing the work required to satisfy the approval conditions.

Accordingly, the proceeds from the sale of the subdivided blocks will not be included in your ordinary income. Rather, the subdivision is considered to be a mere realisation of a capital asset and the proceeds will be subject to the capital gains tax provisions in Part 3-1 of the ITAA 1997.

4. Profit making scheme

Where a taxpayer's activities and involvement with the development of the property go beyond a mere realisation, then section 6-5 ITAA 1997 will apply to assess the "profit".

It is to be noted that a profit-making scheme does not necessarily mean that the taxpayer is carrying on a business. For a business to be conducted, the types of factors outlined in TR 97/11 must be evident (referred to below).

As will be noted, both from the case law and the ATO's various rulings, an isolated transaction conducted outside the taxpayer's usual business activity can still come within the ambit of section 6-5.

4.1 Isolated transaction

The taxation implications of an isolated transaction and the directional legal precedents in relation to the subject are fairly standard, but what is not standard are the defining factors.

What can be stated with a degree of certainty is that if a taxpayer:

- Intends to undertake a profit-making scheme when the property was originally acquired, irrespective whether the strategy to implement that scheme is known, the resulting profit is assessable as ordinary income (note the loss would similarly be deductible).
- Commences to apply the property for some commercially and profit motivated purpose, it most likely the resulting profit will be assessable pursuant to section 6-5.

In **Taxation Ruling TR 92/3**, the ATO have ruled on whether profits on isolated transactions are income for the purposes of, now, section 6-5 ITAA 1997.

A - Transactions with a profit-making purpose

6. Whether a profit from an isolated transaction is income according to the ordinary concepts and usages of mankind depends very much on the circumstances of the case. However, a profit

from an isolated transaction is generally income when both of the following elements are present:

- (a) the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and*
- (b) the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.*

7. The relevant intention or purpose of the taxpayer (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case.

8. It is not necessary that the intention or purpose of profit-making be the sole or dominant intention or purpose for entering into the transaction. It is sufficient if profit-making is a significant purpose.

9. The taxpayer must have the requisite purpose at the time of entering into the relevant transaction or operation. If a transaction or operation involves the sale of property, it is usually, but not always, necessary that the taxpayer has the purpose of profit-making at the time of acquiring the property.

10. If a transaction or operation is outside the ordinary course of a taxpayer's business, the intention or purpose of profit-making must exist in relation to the transaction or operation in question.

11. The transaction may take place in the course of carrying on a business even if the transaction is outside the ordinary course of the taxpayer's business.

12. For a transaction to be characterised as a business operation or a commercial transaction, it is sufficient if the transaction is business or commercial in character.

13. Some matters which may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are the following:

- (a) the nature of the entity undertaking the operation or transaction;*
- (b) the nature and scale of other activities undertaken by the taxpayer;*
- (c) the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;*
- (d) the nature, scale and complexity of the operation or transaction;*
- (e) the manner in which the operation or transaction was entered into or carried out;*
- (f) the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;*
- (g) if the transaction involves the acquisition and disposal of property, the nature of that property; and*
- (h) the timing of the transaction or the various steps in the transaction.*

14. It is not necessary that the profit be obtained by a means specifically contemplated (either on its own or as one of several possible means) when the taxpayer enters into the transaction. It is sufficient that the taxpayer enters into the transaction with the purpose of making a profit in the most advantageous way and that a profit is later obtained by any means which implements the initial profit-making purpose. It is also sufficient if a taxpayer enters into the transaction with the purpose of making a profit by one particular means but actually obtains the profit by a different means.

4.2 Profit calculation

If a property has been applied to a profit-making scheme, the profit will be assessable when the property is sold. The elements of the profit calculation include:

- (a) The proceeds from the sale of the property;
- (b) The cost base of the profit; and
- (c) The development and financing costs.

Where the property was acquired, originally for investment or passive ownership, the cost base of the property accounted for in the profit calculation will be the market value of the property at the time the scheme commenced. This principle was endorsed in **Re Whitfords Beach Pty Ltd v FCT** [1983] FCA 97.

The High Court held that the proceeds of sale of any part of the taxpayer's land at Whitfords Beach in each of the relevant income years constituted assessable income of the taxpayer under sub-s.25(1) of the Income Tax Assessment Act 1936 ("the Act"). It is common ground between the parties that the amount to be included in the taxpayer's assessable income each year is the amount of the taxpayer's profit from the material sales: see per Gibbs C.J. 56 ALJR at p. 245. It is also common ground between the parties that the land was not trading stock of the taxpayer and that the profit is to be calculated by deducting, inter alia, the value at the relevant date of the land sold from the gross proceeds of sale. It is also common ground between the parties that the relevant date at which the land sold is to be valued is the date at which the taxpayer's business of developing, subdividing and selling land at Whitfords Beach extended to that part of the land; or, in other words, the date when that part of the land was 'ventured in' or 'committed to' the taxpayer's business: cf. Federal Commissioner of Taxation v Williams (1972) 127 CLR 226.

4.3 Carrying on a business

As stated above, in those unusual circumstances that the land becomes the "trading stock" of the taxpayer's business, there are a number of different matters to consider:

- (a) Is the taxpayer carrying on a business as distinct to an isolated profit transaction? Refer to Taxation Ruling TR 97/11 – Characteristics of a business:

Some indicators of carrying on a business of primary production

12. Whilst each case might turn on its own particular facts, the determination of the question is generally the result of a process of weighing all the relevant indicators. Therefore, although it is not possible to lay down any conclusive test of whether a business of primary production is or is not being carried on, the indicators outlined below provide general guidance. This is explained further at paragraph 25 of this Ruling.

13. The courts have held that the following indicators are relevant:

- *whether the activity has a significant commercial purpose or character; this indicator comprises many aspects of the other indicators (see paragraphs 28 to 38);*
- *whether the taxpayer has more than just an intention to engage in business (see paragraphs 39 to 46);*
- *whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity (see paragraphs 47 to 54);*
- *whether there is repetition and regularity of the activity (see paragraphs 55 to 62);*

- whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business (see paragraphs 63 to 67);
- whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit (see paragraphs 68 to 76);
- the size, scale and permanency of the activity (see paragraphs 77 to 85); and
- whether the activity is better described as a hobby, a form of recreation or a sporting activity (see paragraphs 86 to 93).

(b) What are the immediate taxation consequences of the property becoming trading stock?

In the first instance, section 70-30 applies to set the “cost base” for future taxation assessment. The section provides:

Section 70.30 Starting to hold as trading stock an item you already own

Section 70-30 (1) *If you start holding as * trading stock an item you already own, but do not hold as trading stock, you are treated as if:*

*(a) just before it became trading stock, you had sold the item to someone else (at * arm's length) for whichever of these amounts you elect:*

- its cost (as worked out under subsection (3) or (4));
- its * market value just before it became trading stock; and

(b) you had immediately bought it back for the same amount.

Example: You start holding a depreciating asset as part of your trading stock. You are treated as having sold it just before that time, and immediately bought it back, for its cost or market value, whichever you elect. (Subdivision 40-D provides for the consequences of selling depreciating assets.)

However, the CGT provisions then interact with the above trading stock provision, if the taxpayer has elected to use the “market value” of the property as the deemed cost base for future trading stock purposes.

Section 104.220 CGT asset starts being trading stock: CGT event K4

(1) CGT event K4 happens if:

*(a) you start holding as * trading stock a * CGT asset you already own but do not hold as trading stock; and*

*(b) you elect under paragraph 70-30(1)(a) to be treated as having sold the asset for its * market value.*

Note 1: Paragraph 70-30(1)(a) allows you to elect the cost of the asset, or its market value, just before it became trading stock.

Note 2: There is an exemption if you elect its cost: see section 118- 25.

(2) The time of the event is when you start.

*(3) You make a capital gain if the asset's * market value (just before it became * trading stock) is more than its * cost base. You make a capital loss if that market value is less than its * reduced cost base.*

Exception

*(4) A * capital gain or * capital loss you make is disregarded if you * acquired the asset before 20 September 1985.*

Accordingly, the options available to a taxpayer who holds property as a passive asset and then applies the property for the purposes of a trading business are:

- (a) Use the original cost of the asset for the trading stock provisions; or
- (b) Use the market value of the property and crystallise a capital gain.

5. GST issues

Finally, in the context of the typical property subdivision arrangement, it is necessary to consider whether the transaction attracts any GST obligations.

One of the special features of the GST regime is that it is a transactional tax based on the nature of the transaction, not whether the transaction is capital or revenue.

The threshold issue is whether the transaction is a taxable supply. This term is described by section 9-5 as follows:

You make a taxable supply if:

- (a) you make the supply for * consideration; and*
- (b) the supply is made in the course or furtherance of an * enterprise that you * carry on; and*
- (c) the supply is * connected with the indirect tax zone; and*
- (d) you are * registered, or * required to be registered.*

Accordingly, the critical factors, having regard to the case study, are:

- (a) Whether the taxpayer is, or ought to be, registered;
- (b) Whether the supply is made in the course of an enterprise; and
- (c) What constitutes an enterprise.

Where the taxpayer is:

- (a) Already registered: the fact that the transaction is a capital transaction is irrelevant if the asset is part of the taxpayer's enterprise.
- (b) Not registered: the nature of the transaction (mere realisation or profit making ("enterprise")) is relevant as is the anticipated turnover.

With regard to an entity that commences a property subdivision in relation to a passive asset, the question is whether the nature of the entity's activities constitutes an enterprise.

Section 9-20 GST Act provides that definition of the term "enterprise".

Relevantly for the purpose of this presentation, the term "enterprise" includes:

Section 9-20(1) An enterprise is an activity, or series of activities, done:

- (a) in the form of a * business; or*

(b) *in the form of an adventure or concern in the nature of trade; or ...*

Obviously there is some correlation between the GST definition of an enterprise and the income tax rules dealing with a revenue profit making scheme. This is well illustrated by the ATO's miscellaneous taxation ruling MT 2006/1.

This taxation ruling provides guidance of the meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number ('ABN'). Inter alia, the ruling provides:

Activity, or series of activities

154. For an entity that has to carry on an enterprise to be entitled to an ABN, it is necessary to identify one activity or a series of activities that amount to an enterprise. If an entity carries on a number of activities, only one of those activities need constitute an enterprise in order for the entity to be entitled to an ABN. However, not every activity or series of activities that an entity carries on would by themselves amount to an enterprise or be activities carried on by them in an enterprise. Some activities will be specifically excluded while others may not fall within the definition of enterprise.

...

Example 15 - activities associated with the sale of real property

161. Giovanna sold a block of units. What are the relevant activities in determining whether Giovanna carried on an enterprise?

162. Giovanna carried out a series of activities that led to the sale of the units. All of Giovanna's activities need to be considered. These included:

- *assessing the economic viability of the project;*
- *purchasing the land;*
- *engaging an architect;*
- *constructing a block of units on the land;*
- *engaging a real estate agent and auctioneer; and*
- *arranging for the sale of the units at auction.*

163. An activity such as the selling of an asset may not of itself amount to an enterprise but account should also be taken of the other activities leading up to the sale to determine if Giovanna carried on an enterprise.

...

In the form of a business

170. An enterprise includes an activity, or series of activities, done in the form of a business. The phrase 'in the form of a business' is broad and has as its foundation the longstanding concept of a business. The meaning of this phrase has not been considered in significant detail by Australian courts.

...

174. Although the phrase 'in the form of a business' is broad it requires a focus on and understanding of the concept of a business. Section 195-1 of the GST Act defines 'business' to include:

any profession, trade, employment, vocation or calling, but does not include occupation as an employee.

175. The definition is the same as the definition of 'business' in subsection 6(1) of the Income Tax Assessment Act 1936 (ITAA 1936), and section 995-1 of the ITAA 1997.

...

Indicators of a business

177. To determine whether an activity, or series of activities, amounts to a business, the activity needs to be considered against the indicators of a business established by case law.

...

179. There is no single test to determine whether a business is being carried on. Paragraph 12 of TR 97/11 states that 'whilst each case might turn on its own particular facts, the determination of the question is generally the result of a process of weighing all the relevant indicators'. TR 97/11 can be referred to for a fuller discussion on whether a particular activity constitutes the carrying on of a business.

...

In the form of an adventure or concern in the nature of trade

233. There is no definition of 'in the form of an adventure or concern in the nature of trade' in the ABN Act. However, the concept of 'an adventure or concern in the nature of trade' has arisen in the context of Australian and United Kingdom (UK) revenue law. While UK law is of assistance in understanding this concept, it is considered that Australian revenue law and judicial decisions should be the starting point to give it meaning.

234. Ordinarily, the term 'business' would encompass trade engaged in, on a regular or continuous basis. However, an adventure or concern in the nature of trade may be an isolated or one-off transaction that does not amount to a business but which has the characteristics of a business deal.

235. In Australia, there are specific income tax provisions that include in assessable income the profit made from an isolated transaction. These have been developed from earlier provisions that ensured that, 'profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme' was included in a taxpayer's assessable income.

...

237. The term 'profit making undertaking or scheme' like the term 'an adventure or concern in the nature of trade' concerns transactions of a commercial nature which are entered into for profit-making, but are not part of the activities of an on-going business. Both terms require the features of a business deal, see *McClelland v. Federal Commissioner of Taxation*, in which Lord Donovan, delivering the opinion of the majority, said:

It seems to their Lordships that an 'undertaking or scheme' to produce this result must - at any rate where the transaction is one of acquisition and resale - exhibit features which give it the character of a business deal. It is true that the word 'business' does not appear in the section; but given the premise that the profit produced has to be income in its character their Lordships think the notion of business is implicit in the words 'undertaking or scheme'.

...

240. Taxation Ruling TR 92/3 sets out the Commissioner's views of the general principles and factors that have been considered in determining whether an isolated transaction is of a revenue nature.

241. The meaning of the phrase, 'in the form of an adventure or concern in the nature of trade' has at its foundation the concept of 'an adventure or concern in the nature of trade' which is discussed above.

242. As a matter of statutory interpretation the phrase 'in the form of an adventure or concern in the nature of trade' is wider than 'an adventure or concern in the nature of trade'. However, the underlying concept of an adventure or concern in the nature of trade does not logically lend itself, in any meaningful way, to being broadened. In a practical sense, an activity is either an adventure or concern in the nature of trade or it is not.

Trade v investment assets

258. United Kingdom cases categorise assets as either trading assets or investment assets. Assets purchased with the intention of holding them for a reasonable period of time, to be held as income producing assets or to be held for the pleasure or enjoyment of the person, are more likely to be purchased for investment purposes rather than trading purposes.

259. Examples of investment assets are rental properties, business plant and machinery, the family home, family cars and other private assets. The mere disposal of investment assets does not amount to trade.

260. Assets can change their character but cannot have a dual character at the same time.

261. Investment assets such as business plant and machinery are used by entities in carrying on a business. The purchase and disposal of those types of assets is ordinarily considered not to be an adventure or concern in the nature of trade for UK income tax purposes.

Isolated transactions and sales of real property

262. The question of whether an entity is carrying on an enterprise often arises where there are 'one-offs' or isolated real property transactions.

263. The issue to be decided is whether the activities are an enterprise in that they are of a revenue nature as they are considered to be activities of carrying on a business or an adventure or concern in the nature of trade (profit making undertaking or scheme) as opposed to the mere realisation of a capital asset. (In an income tax context a number of public rulings have issued outlining relevant factors and principles from judicial decisions. See, for example, TR 92/3, TD 92/124, TD 92/125, TD 92/126, TD 92/127 and TD 92/128.)

264. The cases of *Statham & Anor v. Federal Commissioner of Taxation (Statham)* and *Casimaty v. FC of T (Casimaty)* provide some guidance on when activities to subdivide land amount to a business or a profit-making undertaking or scheme. In these cases, farm land was subdivided and sold. Minimal development work was undertaken to meet council requirements and to improve the presentation of certain allotments. On the particular facts of these cases the courts held that the sales were a mere realisation of a capital asset.

265. From the *Statham* and *Casimaty* cases a list of factors can be ascertained that provide assistance in determining whether activities are a business or an adventure or concern in the nature of trade (a profit-making undertaking or scheme being the Australian equivalent, see paragraphs 233 to 242 of this Ruling). If several of these factors are present it may be an indication that a business or an adventure or concern in the nature of trade is being carried on. These factors are as follows:

- there is a change of purpose for which the land is held;
- additional land is acquired to be added to the original parcel of land;
- the parcel of land is brought into account as a business asset;
- there is a coherent plan for the subdivision of the land;
- there is a business organisation - for example a manager, office and letterhead;
- borrowed funds financed the acquisition or subdivision;

- interest on money borrowed to defray subdivisional costs was claimed as a business expense;
- there is a level of development of the land beyond that necessary to secure council approval for the subdivision; and
- buildings have been erected on the land.

266. In determining whether activities relating to isolated transactions are an enterprise or are the mere realisation of a capital asset, it is necessary to examine the facts and circumstances of each particular case. This may require a consideration of the factors outlined above, however there may also be other relevant factors that need to be weighed up as part of the process of reaching an overall conclusion. No single factor will be determinative rather it will be a combination of factors that will lead to a conclusion as to the character of the activities.

267. No two cases are likely to be exactly the same. For instance, while the conclusions reached in the *Statham* and *Casimaty* cases were similar, different facts and factors were considered to reach the respective conclusions.

...

269. The Commissioner recognises that in some cases practical difficulties may arise in deciding whether the activities involved in a particular subdivision amount to an enterprise. The question is necessarily one of fact and degree. As outlined above, it requires a careful weighing of the various factors and exercising judgment in the light of decided case law and commercial experience. If an entity is experiencing practical difficulty reaching a decision they can seek guidance from the Tax Office.

Land bought with the intention of resale

270. In isolated transactions, where land is sold that was purchased with the intention of resale at a profit (which would be ordinary income) the Commissioner considers these activities to be an enterprise. This would be so whether the land was sold as it was when it was purchased or whether it was subdivided before sale. An enterprise would be carried on in this situation because the activities are business activities or activities in the conduct of a profit making undertaking or scheme and therefore an adventure or concern in the nature of trade.

Examples of subdivisions of land that are enterprises

Example 28

271. Stefan and Krysia discover that the local council has recently changed its by-laws to allow for smaller lots in the area. They decide to take advantage of the by-law change. They purchase a block of land with the intention to subdivide it into two lots and to sell the lots at a profit. They carry out their plan and sell both lots of land at a profit.

272. Stefan and Krysia are entitled to an ABN in respect of the subdivision on the basis that their activities are an enterprise being an adventure or concern in the nature of trade. Their activities are planned and carried out in a businesslike manner.

Example 29

273. Tobias finds an ocean front block of land for sale in a popular beachside town. He devises a plan to enable him to afford to live there. He decides to purchase the land and to build a duplex. He plans to sell one of the units and retain and live in the other. The object of his plan is to enable him to obtain private residential premises in an area that would otherwise be unaffordable for him.

274. Tobias carries out his plan. He purchases the land, and lodges the necessary development application with the local council. The development application is approved by the council, Tobias engages a builder and has the duplex built. He sells one unit, and lives in the other.

275. Tobias is entitled to an ABN. His intentions and activities have the appearance of a business deal. They are an enterprise.

276. Further, there is a reasonable expectation of profit or gain (see paragraphs 378 to 405 of this Ruling) as his plan has enabled him to be able to keep and live in one of the units.

Example 30

277. Steven buys a 100 hectare property. He believes that the property may be suitable to be developed as a resort. After investigation he decides that it would be more profitable to subdivide and sell the property. He decides to subdivide the property into one hectare lots and sell these.

278. He engages a town planner and a surveyor to survey the 100 hectare property and to establish how many hectare lots it can be subdivided into. Steven then approaches the local shire council and is advised that he may subdivide his property into 65 one hectare lots.

279. However, Steven must satisfy various shire council conditions if he wishes to obtain development approval. They are:

- the making of new sealed roads with kerbing and channelling within the subdivision;
- the provision of water, electricity and telephone services to the new lots;
- the provision of culverts and other storm water drainage works; and
- the transfer of certain areas of land to the shire council for parks, environmental and other public purposes.

280. Steven consults his accountant and legal advisers. Together they prepare a comprehensive business plan for the project. They approach a commercial lender to arrange a substantial loan, secured by the property, to cover all development costs and related expenses.

281. After gaining development approval from the council, Steven then engages a project manager who arranges for all the survey and subdivisional works to be carried out. Contractors are engaged to put in the roads, complete all the necessary drainage works and install the water, electricity and telephone services.

282. Steven also investigates a marketing strategy that will provide the best return for his project. Sales agents are retained to carry out the marketing program which involves a comprehensive advertising campaign using a promotional estate name, 'Bush Turkey Hill'.

283. Steven is entitled to an ABN on the basis that the subdivision is an enterprise and it is more than a mere realisation of a capital asset. Significant factors that are relevant which lead to this conclusion are as follows:

- there is a change of purpose for which the whole property is held;
- there is a comprehensive plan for the development of the property;
- the subdivision is developed in a businesslike manner for example there is a project manager, significant development costs, a comprehensive marketing campaign including an estate name for the land; and
- a substantial loan has been taken out to finance the development.

Example 31

284. Prakash and Indira have lived in the same house on a large block of land for a number of years. They decide that they would like to move from the area and develop a plan to maximise the sale proceeds from their land.

285. They consider their best course of action is to demolish their house, subdivide their land into two blocks and to build a new house on each block.

286. Prakash and Indira lodge the necessary development application with the local council and receive approval for their plan. They arrange for:

- their house to be demolished;
- the land to be subdivided;
- a builder to be engaged;
- two houses to be built;
- water meters, telephone and electricity to be supplied to the new houses; and
- a real estate agent to market and sell the houses.

287. Prakash and Indira carry out their plan and make a profit. They are entitled to an ABN in respect of the subdivision on the basis that their activities go beyond the minimal activities needed to sell the subdivided land. The activities are an enterprise as a number of activities have been undertaken which involved the demolition of their house, subdivision of the land and the building of new houses.

Examples of subdivisions of land that are not enterprises

Example 32

288. Astrid and Bruno live on a large suburban block. The council has recently changed their by-laws to allow for smaller lots in their area. They decide to subdivide their land to allow their only child, Greta, to build a house in which to live.

289. They arrange for the approval of the subdivision through the council, for the land to be surveyed and for the title of the new block to be transferred to Greta. She pays for all the costs of the subdivision and the cost of her new house.

290. Astrid and Bruno have not carried on an enterprise and are not entitled to an ABN in respect of the subdivision. It is a subdivision without any commercial aspects and is part of a private or domestic arrangement to provide a house for their daughter.

Example 33

291. Ursula and Gerald live on a 2.5 hectare lot that they have owned for 30 years.

292. They decide to sell part of the land and apply to subdivide the land into two 1.25 hectare lots. The survey and subdivision are approved. They retain the subdivided lot containing their house and the other is sold.

293. Ursula and Gerald are not carrying on an enterprise and are not entitled to an ABN in respect of the subdivision as the subdivision and sale are a way of disposing of some of the land on which their home is situated. It is the mere realisation of a capital asset.

Example 34

294. A number of years ago Elsie and Karin purchased some acreage on which to keep their horses, which they rode on weekends. Karin now accepts a job overseas and they decide to sell the land.

295. They put the land on the market with little success. The local real estate agent then advises that it would be easier to sell the land if it was subdivided into smaller lots. They arrange for a development application to be lodged with the local council and obtain approval to subdivide the land into nine lots. Elsie and Karin arrange for the land to be surveyed. The land has a road running along its boundary and has some existing services such as electricity. Only minimal activity is required to subdivide the land.

296. Elsie and Karin are not entitled to an ABN. The sale is not considered to be an enterprise and is the mere realisation of a capital asset.

Example 35

297. Oliver and Eloise have lived on a rural property, Flat Out for the last 30 years. They live a self-sufficient lifestyle. As a result of a number of circumstances including their advancing years, Oliver's deteriorating health, growing debt and drought conditions they decide to sell.

298. Oliver and Eloise put Flat Out on the market and are unable to find any buyers. They then receive advice from the real estate agent that they may be able to sell smaller portions of it. They initially arrange for council approval to subdivide part of Flat Out into 13 lots. They undertake the minimal amount of work necessary and sell the lots. They continue to live on the remaining part of their property.

299. A few years later Oliver and Eloise decide to sell some more land to meet their increasing debt obligations. They arrange for council approval to subdivide another part of Flat Out into four lots. Again they undertake the minimal amount of work necessary to enable the lots to be subdivided and arrange for the real estate agent to sell these lots.

300. Three years later Oliver's and Eloise's personal and financial circumstances are such that they again decide to sell some more land. They arrange for further council approval to subdivide part of their remaining property into three lots. Again they undertake the minimal amount of work necessary to enable the lots to be sold and arrange for the real estate agent to sell the lots.

301. Over the years involved Oliver and Eloise have subdivided 30% of Flat Out. They continue to live on the remaining part of their property.

302. Oliver and Eloise are not entitled to an ABN as they are not carrying on an enterprise. They are merely realising a capital asset. In this example the following factors are relevant:

- There is no change of purpose or object with which the land is held - it has remained their home.
- There is no coherent plan for the subdivision of the land - the subdivision has been undertaken in a piecemeal fashion as circumstances change.
- A minimal amount of work has been undertaken in order to prepare the land for sale. There has been no building on the subdivided land. The only work undertaken was that necessary to secure approval by the council for the subdivision.

The guidance provided by MT 2006/1 is not exceptional, however great care needs to be taken to ensure that GST registration is contemplated and, if then necessary, applying GST to the price for the supply.

MT 2006/1 has been reinforced by **GSTD** 2006/6.

This GST determination provides:

2. A brief summary of some of the main principles in MT 2006/1 follows.

...

An activity or series of activities

10. Essentially, this is any act or series of acts that an entity does. The meaning of the term 'activity or series of activities' for an entity can range from a single act or undertaking, to groups of related activities, to the entire operations of the entity.

In the form of a business

11. An enterprise includes an activity, or series of activities, done in the form of a business. The phrase 'in the form of a business' is broad and has as its foundation the longstanding concept of a business. The

wider phrase has not been considered by Australian courts. The definition clearly includes a business and the use of the phrase 'in the form of' indicates a wider meaning than the word 'business' on its own. This occurs in the case of non-profit entities. In such instances we consider that not all of the main features of a business such as a capacity to earn and distribute profits need to be present before an activity has the form of a business.

12. The definition of 'business' in section 195-1 is the same as that used in subsection 6(1) of the Income Tax Assessment Act 1936 and in section 995-1 of the ITAA 1997. It follows that the meaning of 'business' should be interpreted in a similar way. As such, it is appropriate to refer to Taxation Ruling TR 97/11 which considers the meaning of 'business'.

In the form of an adventure or concern in the nature of trade

13. An adventure or concern in the nature of trade includes a commercial activity that does not amount to a business but which has the characteristics of a business deal. However, the sale of the family home, a private car or other private assets is not, without other factors being present, an adventure or concern in the nature of trade.

14. As a matter of statutory interpretation the phrase 'in the form of an adventure or concern in the nature of trade' is wider than 'an adventure or concern in the nature of trade'. However, the underlying concept of an adventure or concern in the nature of trade does not logically lend itself, in any meaningful way, to being broadened. In a practical sense, an activity is either an adventure or concern in the nature of trade or it is not.¹²

If the entity is registered, because they are an enterprise, the remaining GST issues concern the application of:

- (a) The usual GST obligation associated with a supply;
- (b) The potential application of the margin scheme (Division 75 GST Act); and
- (c) If the farmer intends to restructure the holding of the land pending the development and sale by an associated entity (GST free supply – section 38-475).

6. Other matters to consider

- (a) Restructure the ownership of the land pending the subdivision:
 - (i) Risk protection;
 - (ii) Duty issues;
 - (iii) Transfer taxation issues; and
 - (iv) Taxation benefits;
- (b) Establish a development/project management entity;
- (c) Use of the margin scheme if the subdivided lots are sold to non-registered residential purchasers; and
- (d) If a joint venture is to proceed, take care to ensure the arrangement is not a partnership (an association between persons with a profit sharing intention).