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LexisNexis Butterworths

The main residence exemption is like a fairy tale!

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Practitioners are encountering main residence exemption issues more regularly as increasing numbers of baby boomers retire, downsize or leave this world.

Practitioners generally consider that application of the capital gains tax (CGT) exemption relating to the family home will be straightforward. Many simply assume that it will be available. Few have paid sufficient attention to the complexities of the exemption.

In many relatively common situations, application of the exemption is neither straightforward nor simple.

Where a taxpayer seeks to apply the main residence exemption in a scenario involving a deceased partner, or a dwelling that has been used to produce assessable income, quite complex problems arise.

If you ask practitioners who commenced practice post-CGT but before 1997 to explain the exemption, the reply likely will be along the lines of "You mean the principal place of residence exemption".

The expression "principal place of residence" ceased being used when Div 118 was inserted into the Income Tax Assessment Act 1997 (Cth) by Act 46 of 1998 (Cth).

As the Commissioner continues to master the data matching power at his disposal, tax practitioners can expect an increasing number of audits in relation to ill-founded claims for the main residence exemption.

The following example was developed for use in an in-house training session and is based on a scenario that is credible. Subsequently, a senior academic, having heard about the problem, requested permission to use it in a tax exam.

Alan and Betty

Alan and Betty acquired their dwelling as joint tenants on 1 July 1995 at a cost of $300,000. They commenced to use and occupy the dwelling as their main residence at the end of the 90-day settlement period.

In 1998, Alan was posted to London. Alan and Betty departed Australia together on 1 July 1998, at which time the estimated value of the dwelling was $370,000.

They let the dwelling to a series of tenants until their re-occupation on 1 July 2006, at which time the estimated value of the dwelling was $720,000.

Alan died in 2013, when the estimated value of the dwelling was $900,000.

Betty is considering disposing of the dwelling and has sought advice as to the likely tax consequences. The estimated value of the dwelling today is $1.2 million.

One dwelling — two ownership interests

Most, if not all, practitioners would recognise that the rent for a period in excess of six years will have an impact on the availability of the main residence exemption and force recourse to the partial exemption rules at s 118-185.

Some will recognise that Betty acquired Alan's interest under the survivorship rules and that Betty has two separate ownership interests to be considered.

A few will recognise the cost base issues and that the tax outcomes may not be the same for each of Betty's ownership interests in the dwelling.

Joint tenants at law

When Alan and Betty acquired land/dwelling as joint tenants, they each became seised of the whole of the land/dwelling.

At law, when Alan died, Betty alone become seised of the whole of the land/dwelling.

It is not correct to say that under the right of survivorship Alan's interest in the land/dwelling passed to Betty under the rules of survivorship.

The interaction of the main residence exemption in Subdiv 118-B with Div 128 is complex.

Section 128-15 deals with what happens to a CGT asset Alan owned just before dying where that asset "passes to a beneficiary in [Alan's] estate". However, under the rules of survivorship, the deceased's interest in an asset does not pass to a beneficiary in the deceased's estate.

Section 128-50 provides rules for where joint tenants own a CGT asset and one of the joint tenants dies.

The draftsperson's use of the word "you" creates further complexity. In Div 118, the word "you" refers to the taxpayer seeking to disregard the capital gain. In Div 128, the word "you" refers to the deceased person.

Joint tenants under the CGT rules

The land/dwelling is a CGT asset: see s 108-5. The capital gains rules contain three separate provisions dealing with joint tenants and CGT assets:

- under s 108-7, individuals who own a CGT asset as joint tenants are treated *as if*:
  - — they each owned a separate CGT asset constituted by an equal interest in the asset; and
  - — each of them held that interest as a tenant in common;
- under s 118-197, Div 118-B applies to Betty as the surviving joint tenant, *as if* Alan's ownership interest in the dwelling had passed to Betty as a beneficiary of Alan's estate; and
- under s 128-50(2), Betty is *taken to have* acquired Alan's interest in the dwelling/land on the day Alan died.

Betty's assets

It follows that Betty has two separate CGT assets:

- the CGT asset constituted by the interest in the dwelling she acquired in 1996; and
- the CGT asset constituted by the interest in the dwelling she acquired through surviving Alan but which she is taken to have acquired on the day Alan died.

Advising Betty on the disposal of her original interest

Determining the outcome for Betty's original interest is relatively straightforward.

The dwelling has not been Betty's main residence throughout her ownership period: see s 118-110.

However, the dwelling was Betty's main residence for a period and Betty is able to choose to treat the dwelling as her main residence for six of the eight years during which it was rented out: see s 118-145.

Betty is eligible for a partial exemption and her capital gain will be calculated using the following formula: see s 118-185:

$$\text{CG or CL amount} \times \frac{\text{Non-main residence days}}{\text{Days in your *ownership period}}$$

CG is defined as the capital gain that Betty would have made apart from Div 118-B.

Alan and Betty first used the dwelling to produce assessable income after 20 August 1996: see s 118-192.

The operation of the special rule at s 118-192 is triggered because Betty is only eligible for a partial exemption now, but if Alan and Betty had sold the dwelling just before they first used the dwelling to produce assessable income on 1 July 1998, they would have been eligible to disregard the entire capital gain.

Under s 118-192(2), Betty *is taken* to have acquired her original interest:

- just before 1 July 1998, the first day on which the dwelling was rented out: see s 118-192(2); and
- for its market value just before 1 July 1998: see s 118-192(2).

Arguably, the special rule at s 118-192 deems the first element of the cost base for Betty's interest in the dwelling: see s 110-25(2)(a).[1]

Betty's deemed ownership period under the special rule at s 118-192 commences on 1 July 1998 and is ongoing (for the purposes of the calculation, assume until 1 July 2014 to provide 16 years or 5844 days).

Using the deemed ownership period commencing on 1 July 1998, Betty's capital gain, measured in accordance with the formula in s 118-185, using the "estimated" values, will be $51,839.[2]

The use of the deemed ownership period in the formula in s 118-195 delivers a larger capital gain than would have been delivered using the actual ownership period.[3]

Advising Betty on the interest she acquired through survivorship

Where Betty becomes seised of the entirety of the land/dwelling, as the surviving joint tenant, the land/dwelling cannot be said to have passed to Betty as a beneficiary in Alan's estate.

Section 128-50 provides special rules for assets owned by joint tenants where a joint tenant dies:

- Betty, as the survivor, is taken to have acquired (on the date of Alan's death) Alan's interest as a joint tenant in the dwelling (Alan's Interest): see s 128-50(2); and
- as Alan acquired his interest in the dwelling on or after 20 September 1985, the first element of the cost base of the interest in the dwelling Betty is taken to have acquired is determined in accordance with the formula in s 128-50(3):

$$\frac{\text{Cost base of the interest of the individual who died (worked out on the day the individual died)}}{\text{Number of survivors}}$$

Just before Alan died, the special rule in s 118-192[4] would have applied in relation to Alan's Interest:

- to deem Alan's Interest to have been acquired "just before" 1 July 1998; and
- to deem Alan to have acquired that interest at market value "just before" 1 July 1998.

Section 118-195 allows Betty to disregard any capital gain on an ownership interest in the dwelling that passes to her as a beneficiary of a deceased estate. However, Betty did not acquire Alan's Interest by the rules of survivorship.

Another special rule in s 118-197 applies in relation to Alan's Interest to ensure that Div 118-B applies to Betty as if Alan's Interest had passed to Betty as a beneficiary of Alan's estate. The effect of this second special rule is to ensure that Betty is able to rely on s 118-195.

Under s 118-195:

- for as long as Betty occupies and uses the dwelling as her main residence, she is able to disregard any capital gain arising in relation to Alan's interest: see s 118-195(1) and item 1 column 2, together with item 2 column 3 sub-item (a); and
- if Betty chooses to rent the dwelling out, she can choose to treat the dwelling as her main residence for a further period of six years and will be able to disregard any capital gain arising from a CGT event happening during that period to Alan's interest: see s 118-145 and s 118-195(1) and item 1 column 2, together with item 2 column 3 sub-item (a).

If s 118-195 applies, Alan's original non-main-residence days arising from the rental for eight years are disregarded.

If Betty chooses to rent the dwelling out beyond six years, such that there will be non-main-residence days in the future, s 118-195 will not apply but, under s 118-200, Betty will be eligible for a partial exemption calculated in accordance with the formula:

$$\text{CG or CL amount} \times \frac{\text{Non-main residence days}}{\text{Total days}}$$

If s 118-200 applies, the numerator in the formula would include Alan's original non-main-residence days, as well as the new non-main-residence days, but because the dwelling was Alan's main residence at the time of his death the original non-main-residence days can be ignored: see s 118-200(4).

Because Alan was a joint tenant of the land/dwelling that was his main residence just before he died, the first element of Betty's cost base for Alan's Interest is deemed by s 128-50(3) to be Alan's cost base for Alan's Interest at the date of Alan's death.[5]

The building of a fairy story

The complexity of the main residence exemption lies in the repeated substitution of the notional for the actual. The substitution is achieved by the use of three expressions, all of which are used liberally in Div 118:[6]

- "is taken to be"; or
- "is treated as"; or
- the permissive "you can treat…".

Through the use of many substitutions and in a circuitous manner, each of Betty's two interests have the same cost base.

However, the two interests have different CGT outcomes.

Clients don't want to pay

Clearly, the solution to what might have seemed like a simple problem is not simple.

Changing facts to generate an entirely different problem can be as simple as:

- using the dwelling to produce assessable income at the time of death;
- changing the purchase date;
- changing the first rental date;
- if Betty failed to use the entire dwelling as a main residence after Alan's death;
- Alan and Betty holding the dwelling as tenants in common; and
- Alan holding the property alone.

Understanding the risks of getting it wrong might persuade practitioners of the need to sell the need for advice.

Generally, clients are unwilling to pay for any advice in relation to the main residence exemption:

- in part because the practitioners upon whom they rely lack sufficient understanding of the complexities to be effective salespeople of the advice they could be selling; and
- in part because clients are often willing to "chance it and see".

Understanding how wrong conclusions might be identified by the Commissioner is an essential skill in persuading a client of the need to pay for the advice.

Data matching activity

The Commissioner's data matching activity regularly involves externally generated records, including passenger movement records from the immigration department, electricity usage, driver licence details, internet connections, loan applications, electoral rolls, Medicare records, mobile phone records and rental advertisements, which could be the old style "available for rent" in newspapers or the newer style websites, such as www.airbnb.com and or www.stayz.com.au.

Each year, the Commissioner collects ever more information from the taxpayer that may later form the basis of a data matching exercise, including taxpayer

claims for expenses such as interest, insurance, and repairs and maintenance when a dwelling is rented out, and, of course, the rental income.

A taxpayer may have made other statements along the way:

- income tax returns, including home office allowance claims;
- claimed satisfaction of the personal services business test by reliance on the use of a garage or granny flat;
- business activity statements and declarations about principal place of business;
- addresses for goods and services tax registration and fringe benefits tax returns;
- to State Revenue Offices in relation to First Home Owner Grant applications and/or stamp duty exemptions;
- to other authorities and entities (WorkCover and local municipalities); and
- to insurance companies and/or banks.

To avoid making false or misleading statements in relation to the main residence exemption, clear thinking is required as to the information that the Commissioner can obtain to establish that the dwelling is being used, or at one time was used, to produce assessable income or even to establish that a person was not using the dwelling during a period of time.

If the Commissioner turns his mind to it, he has the information to determine that only a portion of interest expense has been claimed as deduction. He can apply the same techniques in relation to utility expenses or mobile phone records to determine that a person was not using the residence as their main residence.

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Footnotes

1. Under s 118-192, the extent to which the market value replaces existing cost base elements is unclear. On one view, the market value just before the dwelling was first used to produce assessable income replaces only the first element of the cost base and preserves all other elements. On another view, the market value replaces all elements of the cost base that existed just before the dwelling was first used to produce assessable income.
2. That is:

   [1/2 of (1,200,000–370,000)] x [730] / [5844]
3. Betty's actual ownership period commenced on 1 October 1996 (allowing for a 90-day settlement) and is ongoing (assume until 1 July 2014 to provide 17 years and 9 months, or 6479 days). Section 118-130(2) provides that where Betty acquired the dwelling under a contract, she has had an ownership interest in the dwelling from the settlement date, 90 days after the contract date.
4. This rule and its impact on cost base are discussed above in relation to Betty's original interest.
5. Had Alan owned the dwelling that was his main residence just before he died, Betty's cost base for the entire dwelling would have been the market value of the dwelling on the day Alan died: see item 3 of s 128-15(4).
6. Those expressions are employed as follows:

   - once in s 118-135;
   - once in s 118-140;
   - four times in s 118-145 and twice in the example following s 118-145;
   - seven times in s 118-147;
   - once in s 118-150;
   - once in s 118-155;
   - once in s 118-160;
   - twice in s 118-180(2);
   - once in the example following s 118-180;
   - twice in s 118-190;
   - five times in s 118-218 and once in the example following s 118-218(1);
   - three times in s 118-225; and
   - once in s 118-230.

   The expression "is taken to" appears:

   - four times in s 118-170 and twice in an example following s 118-170;
   - twice in an example following s 118-185;
   - once in s 118-192(2);
   - once in s 118-210(2)(b);
   - once in s 128-15(2);
   - once in s 128-25(2);
   - five times in s 128-50, a special rule dealing with assets acquired by a surviving joint tenant, and three times in an example to that section;
   - twice in notes to s 128-15(1);
   - once in notes to s 128-15(4);
   - once in an example after s 128-15(5); and
   - in seven separate notes within Div 128.

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