Tax and GST issues with small property developments

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1. INTRODUCTION

1.1 There are many instances where landowners have an opportunity to subdivide and sell land they have owned for a long period of time. This commonly occurs where primary producers own land on the outskirts of urban centres and residential expansion means that the best use of the land is for residential purposes rather than farming. In some cases, these property developments can be quite substantial with the prospect of large profits from the project.

1.2 This raises the question of how the profit should be characterised. Generally there will be three alternatives.

(a) The subdivision and sale of the land may qualify as a mere realisation of a capital asset.

(b) The scale of the development may be such that it constitutes carrying on a business of property development.

(c) The development may move beyond mere realisation of the land but fall short of the requirements for carrying on a business, in which case it will be characterised as a profit making undertaking or scheme.

Correctly classifying the activities will be very important, particularly where the land is a pre-CGT asset or the clients may be able to apply the small business concessions if they make a capital gain on disposal of the land (as opposed to ordinary profit form a development venture).

1.3 There are also different GST outcomes if the project qualifies as a mere realisation rather than a profit making undertaking or business.

1.4 In this paper I propose to consider the circumstances in which a small to medium subdivision may qualify as a mere realisation and when the project may become a profit making undertaking or business.

The paper only deals with issues arising from raw land subdivisions and does no consider additional issues that arise where the development also involves the construction of improvements on the land (e.g. strata title developments).

I will also limit the discussion to the issues that are relevant if the property was not originally acquired with the intention of reselling at a profit or development as, in those situations, the profit will be ordinary income irrespective of how long the property is owned or whether the profit is generated from the precise means that were contemplated at the time of acquisition.1

2. ALTERNATIVE MODELS

2.1 In situations where a party owns lands that is suitable for development and they want to ensure that profits from the development are treated as being on capital account, there are several common approaches that seem to be used in practice with the intention of preserving the capital status of the asset.

2.2 The landowner can elect to sell the entire property in a single sale - generally to a developer.

A sale of a single asset which has not been acquired for purposes of resale at a profit or development will qualify as a capital receipt.

However, the practical disadvantage of this is that clients will usually receive a lesser sum if they are selling to a developer who takes on the development risk.

2.3 The landowner may undertake the development themselves.

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1 Westfield Limited v Commissioner of Taxation [1991] FCA 86 and TR 92/3
2.4 In other cases, clients will enter into a ‘joint venture’ arrangement with a developer where the landowner contributes the land and the developer entity provides expertise/finance with the profits from the project being shared.

The agreement commonly provides that the landowner will get a fixed price for their land but this will be payable in instalments out of sale proceeds as the sale of lots to end buyers are settled.

I understand that the features and implications of this type of structure are being considered by another speaker at this seminar but it is worth noting that these arrangements will not qualify as a joint venture at law or under the GST Act.

The objective with the joint development approach is generally to achieve an outcome where the landowner receives a greater sum than if they merely sold the land to the developer and to save stamp duty by leaving the land in the name of the landowner until developed lots are sold to end buyers.

Also, if the landowner takes a passive role with the developer project managing (and often financing) the development, the landowner enhances the argument that the exercise is nothing more than a mere realisation of the capital asset.

2.5 Where clients do not want to involve third parties but are concerned the ATO will argue the magnitude of the project is such that it will be classified as a land development business or profit making undertaking, a common approach is to adopt the ‘joint venture’ model but with a related entity (usually a company).

The rationale behind this approach is that, because the landowner receives a fixed price for the land and is not actively involved in the development (in their personal capacity), the land value they receive will be characterised as capital from the mere realisation of their asset with the development profit being derived by their corporate co-venturer.

2.6 In the balance of this paper I will consider various issues that may arise with each of these models in the context of the mere realisation/profit making distinction and the consequential GST implications.

3. MERE REALISATION

3.1 There are numerous authorities that confirm that a taxpayer who has land which is a capital asset and who develops the land in an enterprising way can treat the profits from the realisation as capital if the development is nothing more than the ‘mere realisation’ of the capital asset.  

3.2 However, before embarking on a detailed analysis of what is required to establish that the development of land is a mere realisation, it is important to appreciate that, if the land was originally acquired for resale at a profit or development, the profit from the sale or development of the land will be assessable as ordinary income – irrespective of the sale of the project.

Therefore when advising clients in relation to these issues it is important to ascertain whether there is any evidence of a profit making intention at the time of acquisition.

This was the problem that confronted the taxpayer in Reiger and Commissioner of Taxation.  

The taxpayer in that case argued they had acquired land near Noosa for the purpose of establishing a palm nursery and in fact did plant some palm trees on the property but did not go about this in a business like way.

The problem for the taxpayer was that, some time after acquiring the property they said in a letter to the Noosa Shire Council that:

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2 For example, Allied Pastoral Holdings v FCT 83 ATC 4015, Statham v. FCT 89 ATC 470 and Casimaty v FCT 97 ATC 5135.
3 [2002] AATA 88
I have bought the property with the intend (sic) to subdivide the land in accordance with the strategic plan in force at the time, thus creating the opportunity of having housing lots for my own family, my parents, my brother, other family members and other nature loving families.

This statement of intention to subdivide the land was fatal to the taxpayer’s argument that their intention had been to establish a business on the land.

3.3 The ATO’s views as to the issues the courts have considered in determining whether a taxpayer who develops land has undertaken a mere realisation or embarked on a profit making undertaking or business have been encapsulated in a number of public rulings.

3.4 The ‘mere realisation principle’ is succinctly stated in the commonly cited decision of Lord Justice Clerk in Californian Cooper Syndicates v Harris:

It is quite a well settled principle in dealing with questions of assessment 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 in the sense of Schedule SD of the Income Tax Act of 1982 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.

3.5 In Westfield Limited v Commissioner of Taxation Hill J held that:

Once it is clear that the activity of buying and selling, which generated the profit was not an activity in the ordinary course of business, or, for that matter an ordinary incident of some other business activity, the profit in question will only form part of the assessable income of the appellant by virtue of its being income in accordance with the ordinary concepts of mankind, if the appellant has a purpose of profit making at the time of acquisition.

Later in the judgment His Honour said that:

While a profit-making scheme may lack specificity of detail, the mode of achieving that profit must be one contemplated by the taxpayer as at least one of the alternatives by which the profit could be realised...

It is difficult to conceive of a case where a taxpayer would be said to have made a profit from the carrying on, or carrying out, of a profit-making scheme, where, in the case of the scheme involving the acquisition and resale of land, there was, at the time of acquisition, no purpose of resale of land but only the possibility...that the land may be resold.

3.6 The ATO appears to disagree with the views expressed by Justice Hill on this latter point (not withstanding that its application for special leave to appeal was rejected by the High Court).

In TR 92/3 the ATO argued that His Honour’s comments that the ultimate profit had to have at least been one of the means contemplated at the time of acquisition were obiter dicta and were inconsistent with the earlier Full Federal Court decision in Moana Sand Pty Ltd v. FCT.

The ATO position in TR 92/3 is that ‘an assessable profit arises if a taxpayer enters into a transaction or operation with the purpose of making a profit by one particular means, but actually obtains the profit by a different means.’

3.7 However, those authorities and extracts from the rulings relate to whether there was a profit making intent at the time of acquisition of the land.

As indicated above, the discussion in this paper will focus more on situations where it is accepted the land was not for acquired for a profit making undertaking.

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4 TR 92/3, and MT 2006/1.
5 (1904) 5 TC 157 at 165-166.
6 [1991] FCA 86
7 Paragraph 39.
8 Paragraph 42.
9 88 ATC 4897.
10 Paragraph 57.
In those circumstances, the issue is whether the development activities that the landowner undertakes have the character of a business operation or commercial transaction.

The ATO identified some factors they consider are relevant to that question in TR 92/3\(^{11}\) and later issued MT 2006/1 where these factors are considered in more detail.

3.8 It appears from the approach taken by the ATO in a number of private rulings my firm has obtained since the issue of MT 2006/1, that the ATO is mainly relying on the views set out in MT 2006/1 when determining whether profits from a one-off subdivision will constitute a mere realisation or a profit making undertaking or business, even though that ruling is directed at the question of whether the activities of a taxpayer amount to an ‘enterprise’.

3.9 The factors the ATO has identified in MT 2006/1 are as follows:

(a) Is there a change of purpose for which the land is held?
(b) If additional land is acquired and added to the original parcel.
(c) If the parcel of land is brought into account as a business asset.
(d) Whether there is a coherent plan for the subdivision of the land.
(e) Is there a business organisation - e.g. a manager, office and letterhead.
(f) Are funds borrowed to finance the acquisition or subdivision?
(g) Is interest on money borrowed for subdivisional costs claimed as a business expense.
(h) Whether the level of development of the land is being that necessary to secure that council for the subdivision (e.g. erecting buildings).

The ATO acknowledge that no one factor is determinative but that, if several of these factors are present, it may be an indication that there is a venture or concern in the nature of trade (i.e. profit making undertaking or business).\(^{12}\)

On the other hand, if a client has acquired and held land for a long period of time, and none or very few of the factors listed above are present, it is highly likely that the subdivision and sale will be characterised as a mere realisation in which case the proceeds will be on capital not revenue account.

3.10 The ATO has adopted a reasonably balanced approach in applying these criteria in numerous private rulings my firm has obtained for clients.\(^{13}\)

4. SOME AUTHORITIES

4.1 In our experience, many advisers tend to assume that subdivisions involving more than a small number of lots will not qualify as a mere realisation of the land.

In fact this is not the case and, when giving advice in this area, it is important to appreciate that the decided cases indicate that developments involving a significant number of lots may still qualify as a mere realisation.

4.2 For example, in Casimaty v FCT\(^{14}\) the court held that a subdivision involving 80 lots over eight stages was a mere realisation of the farmland.

In that case the court accepted that the property had been used for farming purposes for many years and that the reason for the subdivision was due to increasing debt and health problems of the taxpayer.

\(^{11}\) Paragraph 49.
\(^{12}\) Paragraph 265.
\(^{13}\) For example, PBRs. 57808, 61376, 80502, 83046 and 84107.
\(^{14}\) 97 ATC 5135
It was important that the taxpayer did not undertake any activities in relation to the development other than those necessary to obtain the local authority approval and that the marketing and selling of the developed lots was left to a real estate agent.

4.3 Similarly in *McCorkell v FCT*\textsuperscript{15} the court held that the subdivision of a 15 hectare property which had been previously used as an orchard was a mere realisation.

This subdivision involved 40 lots and the court accepted the subdivision was undertaken in conjunction with the retirement of the taxpayer.

In that case, there were in fact two separate subdivisional approvals - one for 40 lots in 1984 and another for a further 17 lots in 1990.

4.4 In *Statham v FCT*\textsuperscript{16} a development involving 105 lots over four stages was held to be nothing more than the mere realisation of a capital asset.

4.5 Our firm has obtained quite a number of successful private binding rulings for clients proposing to undertake the subdivision of land which has been held as a capital asset (generally farming properties or acreage residential properties) where the subdivision involved the development of significant lots.

For example:

(a) PBR 61376 which involved the subdivision of part of a rural property into 50 lots.

(b) PBR 80502 which involved the subdivision of vacant land on the outskirts of Brisbane held for 10 years which was subdivided into 44 lots.

(c) PBR 71028 where clients had obtained approval to subdivide rural land into 40 lots and, at the time the ruling was applied for, had made further application for development approval to develop a second stage of the development (involving 40 hectares of adjacent land).

5. **SOME RISK FACTORS**

5.1 See *August v FCT* [2012] FCA 682

5.2 It is important to determine at an early stage whether there is a reasonable argument that the development will meet the criteria of a mere realisation.

In some cases, advisers tend to assume that a subdivision of any scale will trigger a profit making undertaking and enter into arrangements designed to ensure that the perceived ‘development profit’ is derived in a corporate entity at a 30% tax rate.

However, taking steps to ‘corporatize’ the venture may actually result in the clients paying tax on ordinary income that could have been characterised as capital.

If the land is a pre-CGT asset this is a very disadvantageous outcome.

5.3 The facts involved in private binding ruling 90191 illustrate the problems that can arise where clients incorporate a company to undertake a role in the development of land that is clearly a capital asset.

The taxpayer in that case owned farmland on the outskirts of a provincial city. The land had been owned for many years but was now suitable for development and the local authority had encouraged the clients to apply for development approvals.

The first stage involved only 37 lots but, when the material change of use approval not only the initial 37 lots but also the balance of the farmland – which meant that the balance land had the potential to be developed into a large number of lots. At the time the ruling was applied for the clients had no plans to subdivide the balance land.

\textsuperscript{15} 98 ATC 2199
\textsuperscript{16} 89 ATC 4070
Because of the concern that the scale of the project would result in the profits being treated as ordinary income (or at least some portion of them), the clients established a company to act as the development entity and that company actually lodged the necessary planning applications.

Subsequently the clients applied for a private ruling as to whether the development of the first 37 lots would constitute a mere realisation of their farmland. Based on numerous other private rulings issued for developments of a similar size, it would have been reasonable to assume the ATO would rule that the first stage of the development would qualify as a mere realisation.

However, the ATO ruled not only that the project was not the mere realisation of the land, but that it constituted the carrying on of a business.

A significant factor in the ATO’s reasoning, was that the planning application was submitted by a corporate entity rather than the individuals. The ATO considered this pointed to the taxpayer having ‘business structure’ for the project which is one of the factors identified in MT 2006/1.

5.4 It is also important to ensure that the taxpayer has a passive role in the development if possible.

The more actively involved the owner of the land is in the project, the more likely that the ATO may argue they are carrying on a profit making undertaking or even a business because of their involvement in recurrent activities etc.

This was a significant factor in Stevenson v FCT. In that case the magnitude of the subdivision and the degree of involvement of Mr Stevenson in planning and managing the subdivisional activities was a significant factor in the court determining that the proceeds from the subdivision should be assessed as income rather than as capital. In the judgement the court said:

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.

This was also a factor that initially led the ATO to rule that the proceeds from a subdivision undertaken by a client of my firm were assessable as ordinary income because the project was not a mere realisation.

In that case, the client had lived on rural acreage which had been rezoned and was now suitable for development. The client proposed to subdivide the land into about 25 allotments which would normally qualify as a mere realisation.

The problem was that the client was the managing director of a construction company and that company was engaged to do the civil works for the subdivision.

Because the client was the owner and managing director of the contracting company, the ATO initially ruled that he was taking an active role in the development and that this amounted to carrying on a business.

The client successfully objected to that ruling decision. In the objection decision the ATO acknowledged that, although a related company would be undertaking construction work in relation to the project, the individual client would not be personally involved. Rather, employees of the company would be undertaking the work.

It was also relevant that the client was paying a commercial fee to the company.

5.5 In another matter, the ATO originally provided a ruling that the development of rural land into 30 lots was a mere realisation. When applying for the initial ruling the clients indicated they would contract out work involved in the project including the marketing and sale of the lots.

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17 91 ATC 4476
18 at 4483
19 PBR 81713
20 PBR 1011294865718
The clients subsequently decided to market the lots themselves rather than engaging a real estate agent and sought a fresh ruling based on this amended scenario.

The ATO ruled that the project would still be a mere realisation notwithstanding that the landowner handled all of the marketing activities.\(^{21}\)

### 5.6

Another factor identified in MT 2006/1 as being indicative of a profit making undertaking or project rather than a mere realisation is if the landowner has acquired additional land that is consolidated with a pre-owned parcel and the combined site is developed.

This is illustrated in a ruling my firm recently applied for clients who owned acreage on the outskirts of Brisbane.\(^{22}\)

They subdivided part of their land into about 12 lots which were substantially larger than other acreage lots in the area and proposed to continue to live on their house block but also intended to subdivide the balance area at some time in the future.

In a GST audit, the ATO accepted that this first development was a mere realisation and that no GST was payable.

Their neighbours later decided to sell their property and advertised it as being suitable for a town house development. The clients were concerned about the impact this would have on the amenity of the area and agreed to buy the neighbour’s land to prevent its development for town houses.

They then proceeded to subdivide the neighbour’s land and the balance of their original property – again into acreage lots larger than most developments in the area.

The clients had records that indicated that, at the time they negotiated to buy the additional land:

(a) their purpose was to protect the amenity of the area where they wanted to continue to live;

(b) the purpose of subdividing the land was to recoup the purchase cost; and

(c) the financial viability of the project was marginal at best and might generate an overall loss.

In their ruling decision the ATO determined that the development of the neighbours’ land in conjunction with the balance of the original land was a ‘land development enterprise’ and not a mere realisation.

In reaching this conclusion the ATO indicated that:

- the clients’ actual motive was not relevant ‘if an objective assessment … indicates that the activities are in the nature of trade’; and

- the clients’ actions in buying the adjacent land and developing it in conjunction with the balance of their original land ‘changed the character of (the original land) from a capital asset into a trading asset’.

### 5.7

Clients who opt to enter into a ‘joint venture’ agreement with a developer and receive payment by instalments (usually out of sale proceeds from each lot) need to be careful that the payments they receive on the settlement on each lot are instalments of a pre-agreed land value rather than a share of profits as, in some circumstances, payments for a capital asset by a series of regular instalments may be characterized as ordinary income rather than capital proceeds.\(^{23}\)

In *Egerton-Warburton v Deputy Federal Commissioner of Taxation* a father transferred land to his sons in consideration of them agreeing to pay annuities for an indefinite term. The High

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\(^{21}\) PBR 1011461833699

\(^{22}\) PBR 1011675778134

\(^{23}\) E.g., *Chadwick v Pearl Life Insurance Co* (1903) A.C. 299; *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; *Egerton-Warburton v. Deputy Federal Commissioner of Taxation* (1934) 51 CLR 568
Court held that the payments to the father were income, even though they were paid in consideration for the transfer of a capital asset. The court said that:

> The difficulty is that no definite or ascertainable capital sum is agreed upon between the parties. ... With no fixed price expressed by the parties, ... it is, we think, impossible to find in the transaction a purchase price for the annuity. ...

> In other words, the annual payments are not necessarily deferred payments of principal, they may be income the right to which has been purchased by an outlay of capital.  

Therefore, it will be important to ensure that, if the landowner is paid out of the proceeds from lot sales, the agreement makes it clear the amounts payable to the landowner are instalments of a predetermined price for the land (or in accordance with a predetermined valuation methodology) and not a share of profits from the development.

6. **WHAT ARE THE CONSEQUENCES IF THE DEVELOPMENT IS NOT A MERE REALISATION?**

6.1 If the proposed subdivision goes beyond a mere realisation then it will either be a profit making undertaking or may amount to carrying on a business of land development.

6.2 Our firm has lodged several rulings where the ATO has determined in relation to projects involving a relatively small number of lots that, where the development goes beyond a mere realisation, the taxpayer is carrying on a business – rather than a profit making undertaking.

For example, in private binding ruling 81713, the ATO initially determined that a project involving the subdivision of rural residential land into 36 lots in two stages amounted to carrying on a business (but subsequently reversed this decision when the taxpayer objected).

In private ruling 90191, the ATO determined that a subdivision involving 37 lots (but with the potential for development of a much larger number of lots on adjacent land) also amounted to carrying on a business of land development.

6.3 This approach of the ATO to characterise relatively small one off developments as a business may be a product of some uncertainty as to the taxation consequences if the development falls short of being a business and is a profit making undertaking.

6.4 The consequences of a development project being characterised as a business or profit making undertaking are quite different and I will deal with these alternative scenarios separately.

7. **CONSEQUENCES IF DEVELOPMENT IS A BUSINESS**

7.1 If land which is a capital asset becomes an asset of a land development business, then it will be treated as trading stock from the date the business commences. The taxpayer will be deemed to have sold the land at its market value or cost (at the taxpayer’s election) and to have immediately reacquired the land for the same amount.

There are a number of significant issues here.

The taxpayer must make the election to treat the land that has become trading stock as having been sold and acquired at market value or cost by the time they lodge their tax return for the income year in which they started holding the land as trading stock.

This means the taxpayer must be aware that their activities have crossed the line and now amount to carrying on a business and they must also know exactly when this change in circumstances occurred.

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24 at 575
25 s70-30
However, if they do not make the election because they do not realise that the land has become trading stock, they have a reasonable time after realising that the land has become trading stock in which to make the election.  

7.2 Generally, a taxpayer who considers their development qualifies as a mere realisation and that the proceeds of sale can be treated as capital receipts will only become aware that they are considered to have commenced carrying on a business if they obtain a ruling or are subject to an audit. 

If the Commissioner refuses to exercise his discretion to extend the time for making the election, the taxpayer will have to include all of the profit from the project (based on the historical cost of the land) as ordinary income without the benefit of any CGT discounts.

7.3 This is a significant issue as determining when this business commenced can be quite problematical.

*Stevenson v FCT* provides a good illustration of this. In that case, the initial development plans were submitted for approval in 1976 and the subdivision actually commenced in 1979.

The court found that the land development business had commenced by the end of the 1976 year even though actual works on the subdivision did not occur for approximately another three years. The difficulty in ‘picking’ the commencement date of the business is highlighted by the fact that the date on which the court considered the business had commenced was an earlier date than either of the alternatives proposed by the ATO and the taxpayer.

In the situation involved in private binding ruling 90101, the ATO determined (in a subsequent objection decision) that the farmland which was being developed had been converted to trading stock as a result of the commencement of a business when the development application was approved (rather than lodged).

This is slightly different to the decision of the court in *Stevenson* where they held that the business activities commenced in the year on which the applications were lodged with council.

7.4 There are no guidelines as to what will be regarded as a reasonable time to make the election if the taxpayer has failed to do so in their tax return for the relevant year.

This issue arose for a client of our firm where the ATO ruled the client who was doing a 37 lot development had commenced carrying on a business of land development that had commenced when the relevant approval had issued (several years previously).

Because the client had been operating under the assumption that the project was a mere realisation and the receipts would be capital, they had not treated the land as trading stock in their return for the year in which the ATO considered the business had commenced and consequently had not made any election as to whether the opening value of the trading stock would be cost or market value.

The ATO agreed to exercise their discretion to allow an extension of the time to make the election under section 70-30(1) and indicated that, if the taxpayer made the election under section 70-30(1) within one month after receiving notice of the ATO decision, this would be a reasonable time.

7.5 The potential implications of the development being characterised as a business are compounded where the taxpayer is entitled to apply small business CGT concessions on disposal of the land if the land is an ‘active’ asset and they realise a capital gain. These concessions will not be available in relation to profit from a business of land development.

In that situation the taxpayer can elect that the land will be deemed to have been sold and reacquired at market value under section 70-30 and apply the small business concessions to the gain.

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26 s70-30(2)
27 91 ATC 4476
28 PBR 1011434816895
However, the time at which the business is deemed to commence will be critical and, as illustrated in Stevenson, it will often be difficult to determine the precise date when this occurs.

Also many clients will prefer to argue that the development is a mere realisation rather than a business and they will generally not be aware the ATO will treat the development as a business until after the due date for lodgement of returns and making CGT elections.

If it is determined after the event that the activities amount to a business the small business taxpayer will have to request that the Commissioner not also exercise their discretion to allow them more time to elect that the land converted at market value but also in which to make the necessary choices required to access the small business concessions.

7.6 Given the uncertainty surrounding these issues and the significant consequences of making the wrong decision, clients should consider getting a private ruling as to whether the development is a mere realisation, profit making undertaking or a business and, if a profit making undertaking or business, the date on which the undertaking or business commences.

8. WHAT IF THE DEVELOPMENT AMOUNTS TO A PROFIT MAKING UNDERTAKING BUT IS NOT A BUSINESS?

8.1 The profit arising from the carrying on or carrying out of a profit-making undertaking or plan in relation to property acquired prior to the introduction of CGT is specifically included in assessable income under section 15-15 of the 1997 Tax Act.

However, section 15-15 does not apply if the profit is assessable as ‘ordinary income under section 6-5.

This clearly suggests that ‘profit’ from a profit making undertaking that falls short of a business activity may be assessable income under ordinary concepts – whereas in most circumstances the Tax Acts operate on the basis that the taxpayer is required to include gross receipts in assessable income and can then deduct expenses that are allowable deductions.

8.2 While there is very little commentary in relation to the correct tax treatment of a profit making undertaking in respect of land acquired post-CGT, it appears that these tax consequences should be determined in accordance with the principles outlined by the High Court in FCT v Whitfords Beach Pty Ltd.29

8.3 Whitfords Beach involved a company which acquired land without any intention of development and many years later the shares were acquired by a syndicate with the clear intention of developing the land.

8.4 The High Court held that, while the taxpayer company did not acquire the land with any profit making intent:

(a) the land was ventured into a profit making undertaking at the time the syndicate assumed control of the company; and

(b) the ‘profit’ from the development was taxable.

8.5 Based on this authority the correct approach where the land is ventured into a profit making undertaking is that:

(a) any unrealised gain on the land up to that point will still be treated as capital when realised from sales; and

(b) the development profit (after allowing for the value of the land at the point it is ventured into the project) will be treated as ordinary income as the profit emerges.

This is the approach adopted by the High Court in Whitfords Beach and in the subsequent decision when the matter was referred back to the Federal Court.30

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29 [1982] HCA 8
30 [1983] FCA 97
8.6 The significant difference between the project being classified as a profit making undertaking rather than a business is that:

(a) the unrealised gain at the point the land is committed to the venture will be treated as capital when it is realised;

(b) there is no need for the taxpayer to make any election at the time the profit making undertaking is commenced; and

(c) the profits from the venture will not be taxed until realised.

9. GST ISSUES FOR SMALL DEVELOPMENTS


9.2 Section 23-5 of the GST Act states that an entity is required to be registered under the GST Act if:

(a) the entity is carrying on an enterprise; and

(b) the entity’s annual turnover meets the registration turnover threshold.

9.3 What is an enterprise?

An enterprise includes an activity, or series of activities, done in the form of a business or in the form of an adventure or concern in the nature of trade (section 9-20 of the GST Act).

Miscellaneous Taxation Ruling MT 2006/1 deals with the question of whether an entity is carrying on an enterprise where there are isolated property transactions.\(^{31}\)

In MT 2006/1 the Commissioner appears to conclude that a land development that constitutes the mere realisation of a capital asset will not be an enterprise for the purposes of the GST Act.

Paragraph 263 summarises the Commissioner’s position:

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.)

9.4 If the subdivision and sale of land as part of an isolated transaction by a taxpayer will be the mere realisation of a capital asset for income tax purposes, it should follow (based on the reasoning in MT 2006/1) that the taxpayer is not:

(a) carrying on an enterprise;

(b) entitled to claim input credits on expenditure in relation to the development; nor

(c) required to remit GST on sales;

assuming the landowner is not otherwise required to be registered for GST.

9.5 However, the Federal Court decision in Commissioner of Taxation v Swansea Services Pty Ltd\(^{32}\) creates some doubt as to whether it is correct that an activity that is limited to capital transactions can never amount to the carrying on of an enterprise.

In particular, the court in that case indicated that:

(a) there is nothing in the GST Act that indicates that investment activities would not amount to carrying on of an enterprise;\(^{33}\)

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\(^{31}\) paragraphs 262 to 302

\(^{32}\) [2009] FCA 402

\(^{33}\) paragraph 63
(b) one activity alone may qualify as an enterprise;\textsuperscript{34} and
(c) it appears to have been the intention of Parliament that input tax credits may be available in relation to the acquisition of capital items even though a deduction would not be available for income tax purposes.\textsuperscript{35}

9.6 In view of the substantial risks involved if a client assumes they are not required to account for GST because their development is a mere realisation and the ATO takes a different position, my view is that it is prudent to apply for a private ruling on this issue.

In a number of situations, our firm has obtained private rulings confirming that a small scale development is a mere realisation and that the proceeds will be capital and then obtained a second GST private ruling to confirm the client is not required to register or account for GST on the sale proceeds.

9.7 However, the position is different where the land is an asset of a business and the landowner is registered for GST. The mere fact that the subdivision and sale of the land is a mere realisation for tax purposes will not mean that the sale of the subdivided lots is not a taxable supply.\textsuperscript{36}

Where the land is an asset of a business, the client will not have to account for GST if they cease their business and de-register before selling off the sub-divided lots. This may be a viable strategy for clients with farm land acquired prior to the introduction of GST where there is no issue of having to deal with any increasing adjustments on de-registration.

Also, if the business has not been terminated, but has been wound down to a point where the annual turnover is under $75,000 the client may again choose to de-register. If they then sell off capital assets, the proceeds from these assets will not have to be taken into account in determining their projected GST turnover.\textsuperscript{37} The ATO confirms this outcome in example 1 in GSTR 2001/7.\textsuperscript{38}

9.8 What is the situation where a client undertakes a small scale subdivision involving land that is not an asset of an existing enterprise? Can they argue that they are not required to register for GST because their only turnover consists of sale proceeds from the sale of capital assets.

An entity is only required to register for GST if their ‘GST turnover meets the registration turnover threshold’.\textsuperscript{39}

Sections 188-10(1) and (2) provide that the entity will not exceed the registration turnover threshold if the entity’s:

(a) ‘current GST turnover’ is at or below the turnover threshold; or
(b) ‘projected GST turnover’ is at or below the turnover threshold.

Any supplies the entity may makes by way of transfer of ownership of capital assets is disregarded when calculating the projected GST turnover.\textsuperscript{40}

9.9 The GST Act and Explanatory Memorandum do not define the term ‘capital asset’ but the meaning of this expression is considered in GSTR 2001/7. The following extract from that ruling outlines the ATO position.

31. The GST Act does not define the term ‘capital assets’. Generally, the term ‘capital assets’ refers to those assets that make up ‘the profit yielding subject’ of an enterprise. They are often referred to as ‘structural assets’ and may be described as ‘the business entity, structure or organisation set up or established for the earning of profits’.

32. ‘Capital assets’ can include tangible assets such as your factory, shop or office, your land on which they stand, fixtures and fittings, plant, furniture, machinery and motor vehicles that are
retained by you to produce income. ‘Capital assets’ can also include intangible assets, such as your goodwill.

33. Capital assets are ‘radically different from assets which are turned over and bought and sold in the course of trading operations’. An asset which is acquired and used for resale in the course of carrying on an enterprise (for example, trading stock) is not a ‘capital asset’ for the purposes of paragraph 188-25(a).

34. ‘Capital assets’ are to be distinguished from ‘revenue assets’. A ‘revenue asset’ is ‘an asset whose realisation is inherent in, or incidental to, the carrying on of a business’.

35. If the means by which you derive income is through the disposal of an asset, the asset will be of a revenue nature rather than a capital asset even if such a disposal is an occasional or one-off transaction. Isolated transactions are discussed further at paragraphs 46 and 47.

36. Over the period that an asset is held by an entity, its character may change from capital to revenue or from revenue to capital. For the purposes of section 188-25 the character of an asset must be determined at the time of expected supply.

9.10 In a recent GST private ruling, in which the ATO determined that a subdivision involving 10 lots was more than a mere realisation, the ATO rejected the argument that the sales of the lots involved the transfer of capital assets and determined that the sale proceeds should be taken into account in determining whether the taxpayer exceeded the registration turnover threshold.

Although the ATO acknowledged that the development involved a one off transaction, they considered that the taxpayers were carrying on a ‘land development enterprise’ and that this resulted in a change in the character of the land from a capital asset to a trading asset which meant that the sale proceeds were not the proceeds from the disposal of capital assets and should be included in the turnover calculations.

10. CONCLUSION

Hopefully this paper has demonstrated the difficulties for advisers in determining how small to medium subdivisions should be characterised and illustrated some practical issues and approaches that need to be considered.

Because it will often be difficult to determine whether a particular project is a mere realisation or has ‘crossed the line’, this is an area where we often recommend clients obtain private rulings as, even if the ATO determine there is a business or profit making undertaking, the clients can generally adopt a strategy that will allow them to treat the increase in value up to the point the business or scheme commences as being on capital account.

If the clients proceed on the assumption that a project is a mere realisation and the ATO disagrees the opportunity to trap unrealised gains as capital may be lost and the client could also face significant penalties and interest.

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This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

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Note – footnotes that appear in the ruling have been deleted from the text of this paper
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