CMT301 Taxation 1

Topic 5 Capital Gains Tax

Objectives

Understand how to apply the 7 levels:

1 : Residence

2 : Must have a CGT event

3 : Identify the CGT asset

4 : Is the CGT event / CGT asset exempt

5 : Do the special rules apply

6 : Calculating the capital gain / loss

7 : Netting of capital gain/ loss

1. Introduction/Overview

Capital gains tax (CGT) is a tax paid on a capital gain. It is part of your income tax. A capital gain (or capital loss) happens commonly by selling assets such as real estate, shares or investments.

The CGT calculation is complex. A net capital gain arises where:

The total capital gains for the year

minus

total capital losses for the year and any unapplied net capital losses from earlier income years

minus

any CGT discount and small business CGT concessions

If total capital losses for the income year are more than your total capital gains, the difference is your net capital loss for the year.

Capital losses are not deductible but can be carried forward indefinitely to later income years to be deducted from future capital gains. Net capital losses are applied in the order that they are made.

There are special rules for capital losses made on collectables. No capital losses can be made on a personal use asset.

A capital gain or capital loss is made if a CGT event happens to a taxpayer (or if a managed fund or other trust distributes a capital gain to them).

Generally, for CGT events, the capital gain is the difference between your capital proceeds and the cost base of your CGT asset.

A capital loss arises where the reduced cost base of the CGT asset is greater than the capital proceeds.

Generally, disregard any capital gain or capital loss made on an asset acquired before 20 September 1985 (pre-CGT).

Many other exemptions apply.

To work out a capital gain or loss, the following is needed:

- whether a CGT event has happened
- the time of the CGT event
- what assets are subject to CGT
- calculate the capital gain or capital loss (determine the capital proceeds, cost base and reduced cost base; how to apply capital losses and the methods available to calculate a capital gain)
- whether there is any exemption or rollover that allows the reduction or disregard the capital gain or capital loss
- whether the CGT discount applies
- whether the small business CGT concessions apply.

2. CGT-operative provisions

The CGT provisions only work when a CGT event occurs (see s 102-20), and the rules for calculating capital gains/losses are set out in accordance with each CGT event: see s 102-22.

If you make a net capital gain you have to include it in your assessable income: see s 102-5.

In contrast, a capital loss cannot be deducted from your assessable income, capital losses can only be offset against capital gains; any losses that have not been applied are carried forward: see s 102-10.

Online Activity 1: Read ITAA 1997 Div 102

Example: Fred makes a capital gain on the sale of jewellery of $5000; He needs to include that in his assessable income.

Wilma made a capital gain of $20,000 and capital loss of $25,000; the net capital loss of $5000 is carried forward into the next tax year.

Generally, if more than one CGT event applies, then you use the one that is most specific: see s 102-25.

CGT events D1 and H2 are measures of last resort, with D1 taking precedence over H2.

3. CGT General rules: ITAA 1997 Div 103

Giving property as part of a transaction, s 103-5

Where a CGT provision states that a payment, cost or expenditure can include giving property, then use the market value of the property in working out the amount of the payment, cost or expenditure, s 103-5.

Entitlement to receive money or property, s 103-10

If the CGT rules apply and a taxpayer applied money or other property for their benefit (including by discharging all or part of a debt they owed) or as they directed, then the taxpayer is taken to have received money or other property. CGT applies if a taxpayer is entitled to receive money or other property if the taxpayer is entitled to have it so applied; or if the taxpayer will not receive it until a later time; or the money is payable by instalments.

Requirement to pay money or give property, s 103-15

If the CGT rules apply and a taxpayer is required to pay money or give other property even if the taxpayer does not have to pay or give it until a later time; or the money is payable by instalments, then the taxpayer is taken to be required to pay money or give other property.

Election/Choices, s 103-25

A choice made under the CGT rules must be made by the day a taxpayer lodges their income tax return for the income year in which the relevant CGT event happened; or within a further time allowed by the Commissioner. The way a taxpayer prepares their income tax returns is generally sufficient evidence of the making of the choice.

Reduction of cost base etc. by net input tax credits, s 103-30

Reduce the cost base and reduced cost base of a CGT asset, and any other amount that could be involved in the calculation of an entity's capital gain or capital loss, by the amount of any net input tax credit of the entity in relation to that amount.

4. Levels approach

The CGT provisions are highly complex and this topic uses a seven level legal analysis as follows:

- Level 1: consider residence
- Level 2: must have a CGT event
- Level 3: identify the CGT asset
- Level 4: is the CGT event/CGT asset exempt?
- Level 5: do the special rules apply?
- Level 6: calculate the capital gain or capital loss
- Level 7: netting the capital gains/losses.

Level 1: Residence

Residents are subject to CGT on CGT assets located anywhere in the world. A foreign resident (that is, a non-resident) is only subject to CGT on taxable Australian property: s 855-10. This is generally where the relevant CGT asset is:

- a direct or indirect interest in land or buildings in Australia, or
- a direct or indirect interest in business assets (permanent establishments) in Australia.

As discussed in Topic 2, temporary residents also obtain a tax exemption for net capital gains from assets that do not have the necessary connection to Australia: subdiv 768-R.

Eg: Tony, a non-resident, sells a house in Hong Kong: CGT does not apply since a non-resident is only subject to CGT on taxable Australian property.

Level 2: Must have a CGT event

For CGT to apply you must have a CGT event. Determining the CGT event can be rather complex given the numerous events. This topic focuses on the most common / important CGT events as follows:

CGT event A1 — Disposal of a CGT asset, 104-10

This is the most common and thus the most important CGT event, and it occurs if:

- you dispose of a CGT asset
- you dispose of a CGT asset if a change of ownership occurs, whether because of some act or event or by operation of law

◆ however, a change in ownership does not occur if you stop being its legal owner but continue to be its beneficial owner.

The timing of this event occurs:

◆ when you enter into the contract for the disposal, or

◆ if there is no contract — when you stop owning the asset.

The formulas for calculating a gain/loss are:

◆ you make a capital gain if the capital proceeds from the disposal are more than the asset's cost base

◆ you make a capital loss if the capital proceeds are less than the asset's reduced cost base.

However, this event does not apply where you acquired the asset before 20 September

1985.

Online Activity 2: Read ITAA 1997 s 104-10

Example: Tania sells shares: CGT A1 applies.

CGT event C1 — Loss or destruction of a CGT asset: s 104-20

This event occurs if a CGT asset you own is lost or destroyed. The time of the event is when you first receive compensation for the loss or destruction: or, if you receive no compensation, when the loss is discovered or destruction occurred.

The formulas for calculating a gain/loss are:

◆ You make a capital gain if capital proceeds from the loss or destruction are more than the asset's cost base.

◆ You make a capital loss if those capital proceeds are less than the asset's cost base.

However, a capital gain or capital loss is disregarded if you acquired the asset before 20 September 1985.

Note that if compensation is received in respect of a CGT asset that is permanently damaged

(but not lost or destroyed) then ATO Taxation Ruling TR 95/35 requires a look-through approach to identify the

underlying asset that is being compensated. If the CGT asset is pre-CGT the compensation will be exempt from CGT. If a post-CGT asset, the compensation will represent a reduction in the cost base of the CGT asset.

CGT event C2 — Cancellation, surrender and similar endings: s 104-25

This CGT event happens if a CGT asset you own ends by:

- being redeemed or cancelled, or
- being released, discharged or satisfied, or
- expiring, or
- being abandoned, surrendered or forfeited.

The time of the event is when you enter into the contract that results in the asset ending, or if there is no contract — when the asset ends.

The formulas for calculating a gain/loss are:

- You make a capital gain if the capital proceeds from the ending are more than the asset's cost base.
- You make a capital loss if those capital proceeds are less than the asset's reduced cost base.

Nevertheless, a capital gain or capital loss you make is disregarded if you acquired the asset before 20 September 1985.

CGT event D1 — Creating contractual or other rights: s 104-35

CGT event D1, along with CGT event H2, apply as catch all provisions. They only apply to receipts that are not otherwise assessable income and that do not fall within any of the other CGT events. Note, there remains much uncertainty on how the courts will view the new provisions. In applying these provisions you first need to consider CGT event D1; if that does not apply then you go to H2. CGT event D1 is intended to have an extremely broad coverage, leaving a minor role for CGT event H2.

D1 applies if you create a contractual right or other legal or equitable right in another entity.

Example: Trudy enters into a restrictive trade contract with the purchaser of her business not to compete for 5 years and she receive $110,000. She has created a contractual right in favour of the purchaser that is the right to sue if she breaches her contract.

Examples of the CGT event D1 include:

- entry into an exclusive licensing agreement
- agreeing to play sport only for one club
- agreeing not to appear in a film made by a rival producer

- agreeing to withdraw an objection to a council application
- granting management rights over property
- agreeing to endorse a product
- granting a right to use a trademark
- agreeing to assign an expectancy or a right that is yet to come into existence.

The time of the event is when you enter into the contract or create the other right. The formulas for calculating a gain/loss are:

- You make a capital gain if the capital proceeds from creating the right are more than the incidental costs you incurred that relate to the event.
- You make a capital loss if those capital proceeds are less.

The costs can include giving property: see s 103-5. However, they do not include an amount you have received as recoupment of them and that is not included in your assessable income, or an amount to the extent that you have deducted or can deduct it.

However, a capital gain or capital loss is disregarded if you created the right by borrowing money or obtaining credit from another entity; or the right requires you to do something that is another CGT event.

Example: Entering into a contract to sell land, you create a contractual right in the buyer to enforce its completion. Disregard D1 as a CGT event, A1 applies.

Note: If the receipt is otherwise assessable income (that is, ordinary income under s 6-5), this event will not apply: s104-35(4)

CGT event H2 — Receipt for event relating to a CGT asset: s 104-155

Where a capital receipt does not fall within any of the other CGT events, CGT event H2 needs to be considered as the provision of last resort. CGT event H2 happens if an act, transaction or event occurs in relation to a CGT asset that you own, and the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base.

There are two major requirements, first, that the taxpayer own the relevant asset and, second, that there be sufficient connection between the asset and the act, transaction or event.

The time of the event is when the act, transaction or event occurs. The formulas for calculating a gain/loss are:

- You make a capital gain if the capital proceeds, because of the CGT event, are more than the incidental costs you incurred that relate to the event.

- You make a capital loss if those capital proceeds are less.

The costs can include giving property: see s 103-5. However, they do not include an amount you have received as recoupment of them and that is not included in your assessable income. A capital gain or capital loss you make is disregarded if the act, transaction or event is the borrowing money or obtaining credit from another entity; or the act, transaction or event requires you to do something that is another CGT event.

This provision will only have a residual role. It will usually apply where consideration is given for refraining from exercising a right, or for the use or exploitation of an asset (where it is not otherwise included as assessable income).

Example: You own land in which you intend to construct plant, and an organisation pays you a $50,000 inducement to commence construction early (no contractual rights have been created so that event D1 applies), thus H2 applies — a transaction has occurred in respect of the taxpayer's asset, land. Using the above example, the capital gain is $50,000 under CGT event H2 less any incidental costs.

CGT event I1 — Individual company or trust stops being a resident: subdiv 104-I

If an individual, company or trust ceases being a resident, then a capital gain or loss may occur for assets owned by the taxpayer that are not taxable Australian property. Take notice of the exceptions for individuals: see s 104-165.

Level 3: Identify the CGT asset

This is very important since most CGT events will only operate if there is a CGT asset: that is, s 104-10. There are three types of CGT assets, as follows: CGT assets, collectables and personal use assets (PUA). Most assets fall within the widely defined term 'CGT asset', and special rules apply to assets that are collectables and PUAs.

CGT assets

Section 108-5 broadly defines a CGT asset as any kind of property or a legal or equitable right that is not property. To avoid doubt the CGT assets include:

- part of or an interest in an asset
- goodwill, or an interest in it
- an interest in an asset of a partnership
- an interest in a partnership that is not covered above.

Property can be tangible (real property) or intangible (patents, copyrights). Gummow J in *Hepples v FCT* 90 ATC 4497 at 4516 (on appeal in the Full Federal Court) stated the general requirement for property:

> … while in all circumstances assignability was not an essential characteristic of a right of property, by statute some forms of property being expressed to be inalienable, nonetheless it was generally correct to say that a proprietary right must be capable in its nature of assumption by third parties.

Online Activity 3: Read ITAA 1997 s 108-5

Example: Sonia has the following assets: a rental house and shares: these are all CGT assets.

Collectables

Section 108-10 defines collectables as the following categories of CGT assets kept mainly for your personal use or enjoyment:

- artwork, jewellery, an antique or a coin or medallion
- rare folio, manuscript or book, or
- a postage stamp or first-day cover.

Also, interests in collectables, a debt that arises from collectables, or an option or right to acquire collectables are also included. Other special rules apply to sets of collectables. A set of collectables is treated as a single collectable. Also, the third element of the cost base is disregarded (about non-capital costs of ownership).

Special tax treatment applies to collectables. Capital losses can only offset capital gains from collectables. Also, capital gains are ignored for collectables acquired for $500 or less.

Online Activity 4: Read ITAA 1997 s 108-10

Example: Emily has the following assets in her house: a bracelet, watch and a antique cupboard: these are all collectables.

Personal use assets (PUAs)

Sections 108-20-108-30 deal with PUAs and provide for special treatment of PUAs; that is, the net capital losses from PUAs are disregarded; they cannot be offset against other non-PUA gains or carried forward. Also, capital gains are ignored if a PUA is acquired for $10,000 or less.

There are four types of PUAs (see s 108-20):

1 a CGT asset (except a collectable) that is used or kept mainly for your personal use or enjoyment, or

2 an option or right to acquire such an asset, or

3 a debt arising from a CGT event affecting that asset, and

4 a debt arising other than in the course of producing your assessable income or from your carrying on a business.

Also, sets of PUAs are treated as a single PUA (s 108-25) and the cost base of a PUA disregards the third element (about non-capital costs of ownership).

Example: Darren has the following assets in his house: a TV, bicycle and a bed all used for private use: these are all PUAs.

Separate CGT assets, subdiv 108-D

Under CGT there are exceptions to the common law principle that what is attached to the land is part of the land. A building or structure acquired after 19 August 1985 is treated as a separate CGT asset: s 108-55.

Example: Sonia bought a block of land with a building on it on 10 August 1985. On 1 December 2005 she constructed another building on the land. The other building is taken to be a separate CGT asset from the land.

Also, a depreciating asset that is part of a building is a separate asset: s 108-60.

Example: Zen owns an office building from which he carries on a business. He installs rest rooms for his staff. The plumbing fixtures and fittings are depreciating assets. These are separate CGT assets from the office building.

Land acquired on or after 20 September 1985 that is adjacent to land (the original land) acquired before that day is taken to be a separate CGT asset from the original land if it and the original land are amalgamated into one title: s 108-65.

Example: On 1 January 1983 Hubert bought a block of land. On 11 June 2008 he bought another block of land adjacent to the first block. He amalgamates the titles to the two blocks into one title. The second block is treated as a separate CGT asset. He can make a capital gain or loss from it if he sells the whole area of land.

Further, certain capital improvements to a CGT asset are treated as being a separate CGT asset, ss 108-70 to 108-85.

Time of acquisition of CGT assets

This is vitally important given that CGT only applies to assets acquired after 19 September 1985, for indexation purposes and CGT discounts etc. While timing varies according to the CGT event, the general rule is that you acquire an asset when you become the owner.

Division 109 provides specific rules for each CGT event; for example:

EVENT	IN THESE CIRCUMSTANCES	YOU ACQUIRE THE ASSET AT THIS TIME
A1	An entity disposes of a CGT asset to you (except where you compulsorily acquire it).	When the disposal contract is entered into or, if none, when the entity stops being the asset's owner.

When you acquire a CGT asset without a CGT event, s109-10 provides:

◆ If you construct/create a CGT asset — when the construction/creation started.

◆ If a company allots/issues shares — when the contract is entered into, if none, when the shares are issued/allotted.

◆ If a trustee of a unit trust issues units — when the contract is entered into, if none, when the units are issued.

Note: You do not acquire a CGT asset if the asset was disposed of to you to provide or redeem a security and in a few other situations: see s 109-15.

Online Activity 5: Read ITAA 1997 Div 109

Level 4: Is the CGT event/CGT asset exempt?

The CGT provisions do not apply to the following exempt assets, transactions and exempt CGT events.

Exempt assets: You disregard the capital gains and losses arising from: cars, motorcycles and valour decorations: s 118-5.

Pre-CGT assets: Assets acquired prior to 20 September 1985 are generally excluded from CGT. For example, see s 104-10(5).

Collectables and personal use assets: s 118-10: Certain collectables and personal use assets are exempted:

◆ Capital gain/loss from a collectable is disregarded if you acquired it for a market value of $500 or less.

◆ Capital gain/loss from a PUA or part of the asset is disregarded if you acquired it for $10,000 or less.

Assets used to produce exempt income: s 118-12

Shares in a pooled development fund: s 118-13

Anti-overlap provisions: Reducing capital gains if amount otherwise assessable: s 118-20 : A capital gain is reduced where another provision of the ITAA includes an amount as assessable income. The reduction is the amount that is included as assessable income. Thus, you disregard capital gains that constitute ordinary income under s 6-5.

Carried interests: s 118-21

Eligible termination payments and superannuation lump sums: s 118-22

Depreciating assets: s 118-24: Any capital gain or loss from a CGT event (that is also a balancing adjustment event) that happens to a depreciating asset or a research and development allowances depreciating asset (ITAA 1936 s 73BA) is disregarded. Division 40 deals with the capital allowance provisions:

Trading stock: s 118-25: Trading stock is exempt from CGT since it is dealt with in Div 70.

Division 230 financial arrangements: s 118-27

Film copyright: s 118-30

Research development: s 118-35

Exempt or loss-denying transactions:

Compensation, damages: s 118-37 : Disregard the following capital gains or losses from a CGT event happening in respect of:

- compensation or damages you receive for any wrong or injury you suffer in your occupation
- compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally
- winnings or prizes from gambling, a game or a competition with prizes
- a re-establishment grant
- a dairy exit payment.

Also, a capital gain from a reimbursement or payment is disregarded for:

- general practices rural incentives program or remote program
- Sydney aircraft noise insulation
- M4/M5 cash back
- sugar industry exit grant.

<u>Online Activity 6:</u> Read ITAA 1997 ss 118-5 to 118-37

<u>Other exemptions</u>

Additionally, there are exemptions for the following:

- expiry of a lease: s 118-40
- transfer of stratum units: s 118-42
- sale of rights to mine: s 118-45
- foreign currency hedging gains and losses: s 118-55
- gifts under cultural bequests program: s 118-60
- later distributions of personal services income: s 118-65
- transactions by exempt entities: s 118-70
- marriage breakdown settlements: s 118-75
- boat capital gains: s 118-80.

<u>Main residence exemption: subdiv 118-B</u>

In accordance with subs 118-110(1), you disregard a capital gain or loss from a CGT event in relation to a CGT asset that is a dwelling if you are an individual and the dwelling was your main residence throughout your ownership period, and the interest did not pass to you as a beneficiary or was acquired as trustee of a deceased estate.

A dwelling includes any building, caravan, houseboat, mobile home and any land immediately under it. The maximum area of adjacent land to the dwelling is two hectares.The exemption is extended from the time of acquisition to the time it was first practicable for the taxpayer to move in: see s 118-35. The exemption will cover two residences for a maximum period of six months where a taxpayer acquires a second residence before the first was disposed of: see s 118-140.

The exemption is extended indefinitely provided the dwelling is not used for the purpose of producing assessable income. If it is used for such a purpose the exemption will only apply for a maximum of six years: see s 118-145.

You can only own one main residence per family. If there are two residences, a choice must be made: see s 118-170.

The main residence CGT exemption extends to a compulsory acquisition or other involuntary realisation of adjacent land or structures where the dwelling itself is not also compulsorily acquired. It is extended to the compulsory creation of an easement over adjacent land and the compulsory variation of the taxpayer's rights in relation to adjacent land.

Where the dwelling is used for income-producing purposes during the ownership period, (see s 118-190(2)), the capital gain is increased by an amount that is reasonable having regard to the extent to which you would have been able to deduct any interest on borrowing for the dwelling. In certain circumstances a capital gain is ignored where a dwelling passes to a beneficiary in, or a trustee in a deceased estate: see s 118-195.

Insurance and superannuation exemptions: subdiv 118-D

Units in pooled superannuation trust: subdiv 118-E

Venture capital exemption: subdivs 118-F, 118-G

Demutualisation of Tower Corporation: subdiv 118-H

CGT discounts

A CGT discount may apply to reduce the amount of the capital gain as follows: subdiv 115-A. The requirements for a discount capital gain are:

◆ must be made by an individual, trust or complying superannuation fund

◆ result from a CGT event happening after 11.45 am EST, 21 September 1999

◆ no indexation applies to the cost base

◆ asset must be owned by the taxpayer for at least 12 months.

The CGT events that do not qualify for a discount are: D1-D3, E9, F1, F2, F5, H2, J2, J3 and K10.

Exceptions to the discount capital gains

Note certain exceptions apply to the availability of the CGT discount to prevent manipulation of the rules:

◆ agreement entered into within 12 months of the CGT event so as to artificially extend the 12-month period

◆ changes to equity interests in a company or trust where more than half the cost base of the CGT assets was acquired within the 12-month period before the sale of equity interests.

Discount percentage

Individuals and trusts 50 per cent; complying superannuation funds 33 1/3 per cent. Application for assets acquired after 11.45 am EST, 21 September 1999. The CGT discount applies for such assets held for 12 months, but there is no indexation if the discount is taken.

Application for assets acquired before 11.45 am, EST 21 September 1999. If the asset was held for at least 12 months there is a choice between:

1 50 per cent CGT discount but no indexation, or

2 100 per cent of the capital gain, but indexation applies up until 30 September 1999 (where it is frozen).

Level 5: Do the special CGT rules apply?

The special CGT rules in Part 3-3 of the ITAA 1997 can be summarised as follows:

Transfer of assets to a wholly owned company: Div 122

Replacement asset rollovers: Div 124: Rollover relief is available where ownership of certain CGT assets ends and replacement CGT assets are acquired.

Rollover relief is provided to the following replacements CGT assets:

- Asset compulsorily acquired, lost or destroyed
- Statutory licences
- Strata title conversion
- Exchange of shares or units
- Exchange of rights or options
- Exchange of shares in one company for shares in another company
- Exchange of units in a unit trust for shares in a company
- Conversion of a body to an incorporated company
- Crown leases
- Depreciating assets
- Prospecting and mining entitlements
- Scrip for scrip roll-over
- Disposal of assets by a trust to a company
- FSR (financial services reform) transitions
- Exchange of a membership interest in an MDO for a membership interest in another MDO
- Exchange of stapled ownership interests for ownership interests in a unit trust

- Water entitlements

Demerger relief: Div 125

Same asset rollover relief: Div 126: Rollover relief is available where a CGT asset is transferred:

- to a spouse in a marriage breakdown
- a company disposes of a CGT asset to another company which is a member of the same wholly owned group (due to consolidated group laws, this does not apply from 1 July 2003)
- where a CGT asset is transferred because of changes to a trust deed
- where superannuation entities merge
- for certain transfers of assets between trusts.

Effect of death: Div 128

Any notional capital gain/loss on assets held by the deceased are generally disregarded on death. A final income tax return must be completed which must include any capital gains and losses realised prior to death.

Impact on the beneficiary or legal personal representative

A capital gain/loss on death is also generally disregarded on the passing of the asset from the deceased estate to the beneficiary. Nevertheless, a capital gain or loss may arise if CGT event K3 applies. This occurs where an asset passes to a non-resident beneficiary or exempt entity or the trustee of a complying superannuation fund.

Investments: Div 130

Leases: Div 132

Options: Div 134

When an asset stops being a pre-CGT asset: Div 149

CGT small business exemptions: Div 152

Basic conditions

Under ITAA 1997 Div 152 capital gains tax exemptions are available to entities if the following conditions are satisfied:

- a CGT event happens in relation to a CGT asset of the entity
- apart from Div 152, the CGT event would have resulted in a capital gain

- the CGT asset satisfies the active asset test in s 152-35, and

- the entity is a SBE, or it satisfies the $6 m maximum net asset value test in s 152-15, or

- the entity is a partner in a partnership that is a small business entity for the income year and the CGT asset is an asset of the partnership.

If the CGT asset is a share in a company or an interest in a trust then two further requirements must be met. Just before the CGT event:

- the entity claiming the concession is a CGT concession stakeholder in the company or trust under s 152-60, or

- CGT concession stakeholders in the company or trust together have a small business participation percentage in the entity claiming the concession of at least 90 per cent.

The CGT concessions are:

15-year exemption: subdiv 152-B

A small business entity can disregard a capital gain arising from a CGT asset where it owned the CGT asset for at least 15 years if certain requirements are met.

50 per cent Reduction: subdiv 152-C

Under s 152-205 the amount of a capital gain remaining after applying Step 3 in the method statement in s 102-5(1) is reduced by 50 per cent if the basic conditions (subdiv 152-A) are met in respect of the gain, if certain requirements are met.

CGT retirement exemption: subdiv 152-D

An individual can choose to disregard all or part of a capital gain per s 152-305(1), , if certain requirements are met.

CGT rollover: subdiv 152-E

Section 152-410 provides that a taxpayer can choose to obtain a small business rollover if the basic conditions in subdiv 152-A are satisfied for the capital gain.

Parts 3-5 to 3-95 provide further special rules as follows:

PART 3-5 - CORPORATE TAXPAYERS AND CORPORATE DISTRIBUTIONS

PART 3-6 - THE IMPUTATION SYSTEM

PART 3-10 - FINANCIAL TRANSACTIONS

PART 3-25 - PARTICULAR KINDS OF TRUSTS

PART 3-30 - SUPERANNUATION

PART 3-32 - CO-OPERATIVES AND MUTUAL ENTITIES

PART 3-35 - INSURANCE BUSINESS

PART 3-45 - RULES FOR PARTICULAR INDUSTRIES AND OCCUPATIONS

PART 3-90 - CONSOLIDATED GROUPS

PART 3-95 - VALUE SHIFTING

Level 6: Calculating the capital gain/loss

The formulas for calculating a capital gain/loss are set out in each particular CGT event, although the following equations are typically used:

- Capital gain = Capital proceeds - Assets cost base
- Capital loss = Reduced cost base - Capital proceeds

We need to work out what constitutes capital proceeds, cost base and reduced cost base.

Capital proceeds

Section 116-20 provides generally that capital proceeds from a CGT event are the total of:

◆ the money you have received, or are entitled to receive, in respect of the event happening, and

◆ the market value of any other property you have received, or are entitled to receive, in respect of the event happening.

Note that indexing applies only to assets acquired before 21 September 1999, and is frozen to 30 September 1999.

However, there are six modifications that potentially apply to this rule. See s 116-25 for the table of modification rules that apply to the various CGT events. The modifications are:

1. Market substitution rule: s 116-30

If you receive no capital proceeds you are taken to have received the market value.

Also, if there are capital proceeds they can also be replaced with a market value where:

◆ the proceeds cannot be valued, or

◆ where the proceeds do not equal market value and it is a non-arm's length transaction or it is CGT event C2.

2. Apportionment rule: s 116-40

If you receive a payment that relates to more than one CGT event the capital proceeds are so much of the payment that is reasonably attributable to that event. If you receive a payment in a transaction that relates to one CGT event and something else, the capital proceeds are so much of the payment that is reasonably attributable to that event.

3. Non-receipt rule: s 116-45

The capital proceeds are reduced by the unpaid amount, if you are not likely to receive some or all of the proceeds, and it is not as a result of anything you have done or omitted and you took reasonable steps to get the unpaid amount. However, if you reduce by the unpaid amount and later receive part of this amount, the capital proceeds are increased by that part.

4. Repaid rule: s 116-50

The capital proceeds are reduced by any part that you repay, and compensation you pay that can be reasonably regarded as a repayment of part of them. You cannot reduce the capital proceeds for any part that you can deduct.

5. Assumption of liability: s 116-55

The capital proceeds are increased if another entity acquires the CGT asset subject to a secured liability, by the amount of the liability assumed by the other entity.

6. Misappropriation rule: s 116-60

The capital proceeds from a CGT event are reduced if a taxpayer's employee or agent misappropriates (whether by theft, embezzlement, larceny or otherwise) all or part of those proceeds. The capital proceeds are reduced by the amount misappropriated.

Note that further special rules apply for capital proceeds for certain options, leases, shares or interests in a trust etc. See ss 116-65 to 116-105.

Cost base

Division 110 defines the cost base.   Certain CGT events though do not require a cost base, see s 110-10. For all other CGT events (such as A1) the cost bases include five elements, of which indexation (where applicable) is calculated for elements 1, 2, 4 and 5.

These <u>five elements are</u> set out in s 110-25(2)-(6):

1 The total of:

◆ the money you paid, or are required to pay, in respect of acquiring it, and

◆ the market value of any property you gave, or required to give, in respect of acquiring it (worked out as at the time of acquisition).

2 Incidental costs you incurred. These costs can include giving property: see s 103-5.

3 The costs of owning the CGT asset you incurred (but only if you acquired the asset after 20 August 1991). These costs include:

◆ interest on money you borrowed to acquire the asset, and

◆ costs of maintaining, repairing or insuring it, and

◆ rates of land tax, if the asset is land, and

◆ interest on money you borrowed to refinance the money you borrowed to acquire the asset, and

◆ interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value. These costs can include giving property: see s 103-5.

4 The capital expenditure you incurred:

(a) the purpose or the expected effect of which is to increase or preserve the asset's value, or

(b) that relates to installing or moving the asset.

The expenditure can include giving property: see s 103-5.

5 Capital expenditure that you incurred to establish, preserve or defend your title to the asset, or a right over the asset. These costs can include giving property: see s 103-5.

What is not part of the cost base?

The main exclusions from the cost base are:

◆ expenditure to the extent that you can deduct it: ss 110-40, 110-43, 110-45, 110-50

◆ expenditure to the extent that you have received a recoupment and it is not included in your assessable income

◆ expenditure in the third element for personal use assets and collectables: s 108-17, 108-30.

Section 110-38 also provides that the following expenditure does not form part of any element of the cost base to the extent:

◆ expenditures on illegal activities: s 26-54

◆ that it is a bribe to a foreign public official or a bribe to a public official

◆ that it is in respect of providing entertainment

◆ that s 26-5 prevents it being deducted (even if some other provision also prevents it being deducted)

◆ non-business boat expenses: s 26-47.

The most common example would be deductible depreciation, interest and maintenance expenses on business assets.

Example: Cynthia sells a business and a rental property; the insurance, interest, council rates and maintenance costs do not form part of the cost base as these expenses are deductible under s 8-1.

Example: Rod sells a holiday home acquired in 1992. The insurance, interest, council rates and maintenance costs form part of the cost base per s 110-25 (as these expenses are not deductible).

Incidental costs

There are a number of incidental costs you may have incurred. Except for the ninth, they are costs you may have incurred to acquire a CGT asset or that relate to a CGT event (s 110-35):

1 remuneration for a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser

2 costs of transfer

3 stamp duty or other similar duty

4 costs of advertising or marketing for a buyer/seller

5 valuation costs for apportionment for the purposes of the CGT provisions

6 search fees relating to a CGT asset

7 the cost of a conveyancing kit (or a similar cost)

8 borrowing expenses (such as loan application fees and mortgage discharge fees)

9 expenditure that:

a is incurred by the head company of a consolidated group to an entity that is not a member of the group, and

b reasonably relates to a CGT asset held by the head company, and

c is incurred because of a transaction that is between members of the group.

10 termination or other similar fees.

Modifications to cost base and reduced cost base: Div 112

Generally a cost base will be modified where any of the following apply:

◆ market value substitution rule (eg, non-arm's length transactions)

- split, changed or merged assets
- apportionment rules on acquisition or disposal of part
- assumption of liability rule.

Also, there are special rules that will modify the cost base where the CGT event involves an acquisition that is listed in the table at s 112-45. Other special rules apply for the situations set out at ss 112-40 to 112-97 and for replacement asset rollover events — subdiv 112-C applies, and for same asset rollover events — subdiv 112-D.

Indexation of cost base: Div 114

The cost base also includes indexation if Div 114 is satisfied. Generally, expenditure is indexed from when it is incurred22 (see s 114-1) (except for the third element of the cost base, as indexing does not apply). Indexing applies only to CGT assets held for more than 12 months. It does not apply to the reduced cost base and to assets acquired after 21 September 1999 since indexation is frozen as at 30 September 1999.

Each element of the cost base (except the third element) is multiplied by the indexation factor for the quarter of the year when the CGT event happened, divided by the indexation factor when the expenditure was incurred: s 960-275(1).

Although indexation is not relevant for certain CGT events listed at s 110-10.

The note in s 960-275(2) makes clear that you index the cost base from the time you incur the expenditure (that is, examine the contract to find out when this occurred). This is so, even if you pay for the asset over a number of instalments.

Reduced cost base: subdiv 110-B

The reduced cost base is relevant in ascertaining whether a capital loss from a CGT event has occurred. The reduced cost base consists of five elements, although indexation does not apply: see s 110-55. All of the elements of the RCB except the third are the same as those of the cost base: s 110-35(2). The third element is any amount worked out in accordance with subs 110-55(3).

Note: The reduced cost base does not get indexation! This is a common error by first-time students of taxation law.

Not all CGT events produce capital gains or losses

Note that not all CGT events will result in a capital gain or a capital loss. If the capital proceeds are less than the indexed cost base but greater than the reduced cost base, there will be no capital gain or loss. There will also be no capital gain or loss where the capital proceeds equals the indexed (or unindexed cost base) or the reduced cost base. See the key equations in s 104-10(4).

Level 7: Netting capital gains/losses

A separate calculation of a capital gain or loss is required for each asset, with the net capital gain included in assessable income. Section 102-5 sets out the following five-step process:

Working out your net capital gain

Step 1.

Reduce the *capital gains you made during the income year by the *capital losses (if any) you made during the income year.23

Step 2.

Apply any previously unapplied *net capital losses from earlier income years to reduce the amounts (if any) remaining after the reduction of *capital gains under step 1 (including any capital gains not reduced under that step because the *capital losses were less than the total of your capital gains).24

Step 3.

Reduce by the *discount percentage each amount of a *discount capital gain remaining after step 2 (if any).25

Step 4.

If any of your *capital gains (whether or not they are *discount capital gains) qualify for any of the small business concessions in Subdivisions 152-C, 152-D and 152-E, apply those concessions to each capital gain as provided for in those Subdivisions.26

Step 5.

Add up the amounts of *capital gains (if any) remaining after step 4. The sum is your net capital gain for the income year.27

However, if during the income year you became bankrupt or you were released from debts under a law relating to bankruptcy any net capital loss you made for an earlier income year must be disregarded in working out whether you made a net capital gain for the income year or a later one.

Under s 102-10 a net capital loss is calculated:

Working out your net capital loss

Step 1.

Add up the *capital losses you made during the income year. Also add up the *capital gains you made.

Step 2.

Subtract your *capital gains from your *capital losses.

Step 3.

If the Step 2 amount is more than zero, it is your net capital loss for the income year.

If there is a capital loss this cannot be offset against assessable income but can be carried forward indefinitely to be set off against other capital gains. Also, note that special rules apply to gains and losses arising from collectables and personal use assets (as outlined previously), per s 102-10.

* refers to defined terms in the ITAA 1997

Online Activity 7: What CGT event takes precedence?

(a) A1, D1 or H2

(b) D1 or H2

Online Activity 8: Joe a non -resident, sells his New York house. Does CGT apply?

Online Activity 9: Selling a building, sales contract dated 30 June previous tax year and settlement is on 1 August of current tax year. What is the time of the CGT event?

Online Activity 10: Sell a radio license for $1M and a warehouse burns down. What CGT events apply?

Online Activity 11: What is exempt from CGT?

a. Z8 Winery sells a case of wine to a customer
b. Jaqcui gifts her record collection to her friend
c. ABC acquires land for $4M on 1/2/85 and sells it

Online Activity 12: Don acquires an asset, incurring costs of $10,000 on 20 December 1986. What indexation factors apply and indexed cost base?

Online Activity 13: Simon acquires an Australian rental for house $300,000 on 15 June 1990. The stamp duty and legal cost on acquisition at 15 June 1990 are $23,000. On 15 June 1996 Simon builds a new shed on the rental property for $13,000. Total interest of $36,000 and total rates and taxes of $6,000 are paid since acquiring the property. In the current tax year Simon sell the rental property for $550,000 (a capital gain) and he pays a total of $5,000 for advertising, sales commissions and conveyance costs on sale. This is Simon's only CGT event in this current tax year. What is the capital gain using indexing and the CGT discount methods?

Online Activity 14: Australian Tax Practice Chapter 8, Practice Problems 24-31. Optional, if you need more practice also attempt problems 1-23.