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ABOUT CAPITAL GAINS TAX



Do you need to read this part of the guide?

To find out, answer the following questions. If you answer NO to all questions, you don't need to read part A. Go to **part B** starting on page 95.

Do you need information about the three methods of calculating a capital gain?

YES Read part A chapter 2, on page 23.

Have you received a distribution of a capital gain from a managed fund or other unit trust in 2005–06?

YES Read part A chapter 4, on page 33.

Have you sold shares or units in a unit trust in 2005–06?

YES Read part A chapter 5, on page 37.

Did you sell real estate or your home (main residence) in 2005–06?

YES Read part A chapter 6, on page 58.

Do you need help completing the capital gains item on your individual tax return?

YES Read the relevant chapters in part A, then work through part B.

Do you need help completing the capital gains item on your entity's tax return?

YES Read the relevant chapters in part A, then work through part C.

DOES CAPITAL GAINS TAX APPLY TO YOU?

01

This chapter provides general background information about capital gains tax and whether and how it applies to you.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

WHAT IS CAPITAL GAINS TAX AND WHAT RATE OF TAX DO YOU PAY?

Capital gains tax (CGT) is the tax that you pay on any capital gain you include on your annual income tax return. It is not a separate tax, merely a component of your income tax. You are taxed on your **net capital gain** at your marginal tax rate.

Your net capital gain is:

- your total capital gains for the year
minus
- your total capital losses for the year and any **unapplied net capital losses** from earlier years
minus
- any **CGT discount** and **small business CGT concessions** to which you are entitled.

If your total capital losses for the year are more than your total capital gains, the difference is your **net capital loss** for the year. It can be carried forward to later income years to be deducted from future capital gains. (You cannot deduct capital losses or a net capital loss from your income). There is no time limit on how long you can carry forward a net capital loss. You apply your net capital losses in the order that you make them.

There are special rules for capital losses made on collectables – see the next page. You cannot make a capital loss on a **personal use asset** – see page 10.

If you are completing a tax return for an individual and want more information on how to apply your capital losses, see steps 5 and 6 in **part B** of this guide. For more information for companies, trusts and funds or for completing the CGT summary worksheet, see step 2 in **part C** of this guide.

Capital gain or capital loss

You make a **capital gain** or **capital loss** if a CGT event happens. You can also make a capital gain if a **managed fund** or other trust distributes a capital gain to you.

For most CGT events, your capital gain is the difference between your **capital proceeds** and the cost base of your CGT asset – for example, if you sell an asset for more than you paid for it, the difference is your capital gain. You make a capital loss if your **reduced cost base** of your CGT asset is greater than the capital proceeds.

Generally, you can disregard any capital gain or capital loss you make on an asset if you acquired it before 20 September 1985 (**pre-CGT**). For details of some other exemptions, see **Exemptions and rollovers** on page 18.

There are special rules that apply when working out gains and losses from depreciating assets. A depreciating asset is a tangible asset (other than land or trading stock) that has a limited effective life and can reasonably be expected to decline in value over the time it is used. Certain intangible assets are also depreciating assets.

If you use a depreciating asset for a taxable purpose (for example, in a business) any gain you make on it is treated as ordinary income and any loss as a deduction. It is only when a depreciating asset has been used for a non-taxable purpose (for example, used privately) that you can make a capital gain or capital loss on it. For details on the CGT treatment of depreciating assets, see **CGT and depreciating assets** on page 20.

To work out whether you have to pay tax on your capital gains, you need to know:

- whether a CGT event has happened to you
- the time of the CGT event
- what assets are subject to CGT
- how to calculate the capital gain or capital loss (how to determine your 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 you to reduce or disregard the capital gain or capital loss
- whether the CGT discount applies, and
- whether you are entitled to any of the small business CGT concessions.

WHAT IS A CGT EVENT?

CGT events are the different types of transactions or events that may result in a capital gain or capital loss. Many CGT events involve a CGT asset; some relate directly to capital receipts (capital proceeds).

You need to know which type of CGT event applies in your situation because it affects how you calculate your capital gain or capital loss and when you include it in your net capital gain or net capital loss.

The range of CGT events is wide. Some happen often and affect many people while others are rare and affect only a few people. There is a summary of the various types of CGT events at appendix 1.

The most common CGT event happens if you dispose of a CGT asset to someone else – for example, if you sell it or give it away, including to a relative. **Note:** If you are registered for GST, or required to be registered for GST, a GST liability may also arise when you dispose of a business asset.

A CGT event also happens when:

- an asset you own is lost or destroyed (the destruction may be voluntary or involuntary)
- shares you own are cancelled, surrendered or redeemed
- you enter into an agreement not to work in a particular industry for a set period of time
- a trustee makes a **non-assessable payment** to you from a managed fund or other **unit trusts**
- a company makes a payment (not a dividend) to you as a shareholder
- a liquidator or administrator declares that shares or financial instruments you own are worthless
- you receive an amount from a local council for disruption to your business assets by roadworks
- you stop being an Australian resident
- you enter into a conservation covenant, or
- you dispose of a depreciating asset that you used for private purposes.

Subdividing land does not result in a CGT event if you retain ownership of the subdivided blocks. Therefore, you do not make a capital gain or a capital loss at the time of the subdivision.

Australian residents make a capital gain or capital loss if a CGT event happens to any of their assets anywhere in the world. As a general rule, non-residents make a capital gain or capital loss only if a CGT event happens to a CGT asset that has a 'necessary connection with Australia' (see page 17).

Non-Australian residents may also make a capital gain or capital loss where CGT events create:

- contractual or other rights (CGT event D1), or
- a trust over future property (CGT event E9).

Order in which CGT events apply

If more than one CGT event can happen, you use the one that is most specific to your situation.

Time of the CGT event

The timing of a CGT event is important because it determines in which income year you report your capital gain or capital loss.

If you dispose of a CGT asset to someone else, the CGT event happens when you enter into the contract for disposal. If there is no contract, the CGT event generally happens when you stop being the asset's owner.

EXAMPLE: Contract

In June 2006, Sue enters into a contract to sell land. The contract is settled in October 2006.

Sue makes the capital gain in the 2005–06 income year (the year she enters into the contract), not the 2006–07 income year (the year settlement takes place).

If a CGT asset you own is lost or destroyed, the CGT event happens when you first receive compensation for the loss or destruction. If you do not receive any compensation, the CGT event happens when the loss is discovered or the destruction occurred.

EXAMPLE: Insurance policy

Laurie owned a rental property that was destroyed by fire in June 2005. He received a payment under an insurance policy in October 2005. The CGT event happened in October 2005.

The CGT events relating to shares and units, and the times of the events, are dealt with in chapter 5.

WHAT IS A CGT ASSET?

Many CGT assets are easily recognisable – for example, land, shares in a company, and units in a unit trust. Other CGT assets are not so well understood – for example, contractual rights, options, foreign currency and goodwill. All assets are subject to the CGT rules unless they are specifically excluded.

CGT assets fall into three categories:

- collectables
- personal use assets, and
- other assets.

Collectables

Collectables include the following items that you use or keep mainly for the personal use or enjoyment of yourself or your associate(s):

- paintings, sculptures, drawings, engravings or photographs, reproductions of these items or property of a similar description or use
- jewellery
- antiques
- coins or medallions
- rare folios, manuscripts or books, and
- postage stamps or first day covers.

A collectable is also:

- an interest in any of the items listed above
- a debt that arises from any of those items, or
- an option or right to acquire any of those items.

You can only use capital losses from collectables to reduce capital gains (including future capital gains) from collectables. However, you disregard any capital gain or capital loss you make from a collectable if any of the following apply:

- you acquired the collectable for \$500 or less
- you acquired an interest in the collectable for \$500 or less before 16 December 1995, or
- you acquired an interest in the collectable when it had a market value of \$500 or less.

If you dispose of a number of collectables individually that you would usually dispose of as a set, you are exempt from paying CGT only if you acquired the set for \$500 or less. This does not apply to collectables you acquired before 16 December 1995.

Personal use assets

A personal use asset is:

- a CGT asset, other than a collectable, that you use or keep mainly for the personal use or enjoyment of yourself or your associate(s)
- an option or a right to acquire a personal use asset
- a debt resulting from a CGT event involving a CGT asset kept mainly for your personal use and enjoyment, or
- a debt resulting from you doing something other than gaining or producing your **assessable income** or carrying on a business.

Personal use assets may include such items as boats, furniture, electrical goods and household items. Land and buildings are not personal use assets. Any capital loss you make from a personal use asset is disregarded.

If a CGT event happened to a personal use asset, you disregard any capital gain you make if you acquired the asset for \$10,000 or less. If you dispose of a number of personal use assets individually that would usually be sold as a set, you get the exemption only if you acquired the set for \$10,000 or less.

Other assets

Assets that are not collectables or personal use assets include:

- land
- shares in a company
- rights and options
- leases
- units in a unit trust
- goodwill
- licences
- **convertible notes**
- your home (see **Exemptions** on page 18)
- contractual rights
- foreign currency, and
- any major capital improvement made to certain land or pre-CGT assets.

Partnerships

It is the individual partners who make a capital gain or capital loss from a CGT event, not the partnership itself. For CGT purposes, each partner owns a proportion of each CGT asset. Each partner calculates a capital gain or capital loss on their share of each asset.

Tenants in common

Individuals who own an asset as tenants in common may hold unequal interests in the asset. Each tenant in common makes a capital gain or capital loss from a CGT event in line with their interest in the asset. For example, a couple could own a rental property as tenants in common with one having a 20% interest and the other having an 80% interest. The capital gain or capital loss made when the rental property they dispose of (or another CGT event happens) is split between the individuals according to their legal interest in the property.

Joint tenants

For CGT purposes, individuals who own an asset as joint tenants are each treated as if they own an *equal* interest in the asset as a tenant in common (see above). Each joint tenant makes a capital gain or capital loss from a CGT event in line with their interest in the asset. For example, a couple owning a rental property as joint tenants split the capital gain or capital loss equally between them.

When a joint tenant dies their interest in the asset is taken to have been acquired in equal shares by the surviving joint tenants on the date of death.

Separate assets

For CGT purposes, there are exceptions to the rule that what is attached to the land is part of the land. In some circumstances, a building or structure is considered to be a CGT asset separate from the land.

Other improvements to an asset (including land) acquired before 20 September 1985 may also be treated as a separate CGT asset.

Buildings, structures and other improvements to land you acquired on or after 20 September 1985

A building, structure or other **capital improvement** on land that you acquired on or after 20 September 1985 is a separate CGT asset, not part of the land, if a balancing adjustment provision applies to it. For example, a timber mill building is subject to a balancing adjustment if it is sold or destroyed, so it is treated as an asset separate from the land it is on.

Buildings and structures on land acquired before 20 September 1985

A building or structure on land that you acquired before 20 September 1985 is a separate asset if:

- you entered into a contract for the construction of the building or structure after that date, or
- construction began on or after that date.

Other capital improvements to pre-CGT assets

If you make a capital improvement to a CGT asset you acquired before 20 September 1985, this improvement is treated as a separate asset and is subject to CGT if, at the time a CGT event happens to the original asset, the cost base of the capital improvement is:

- more than the improvement threshold for the year in which the event happens (see table below), and
- more than 5% of the amount of money and property you receive from the event.

If there is more than one capital improvement and they are related, they are treated as one separate CGT asset if the total of their cost bases is more than the threshold.

The improvement threshold is adjusted to take account of inflation. The thresholds for 1985–86 to 2005–06 are shown in the following table.

IMPROVEMENT THRESHOLDS FOR 1985–86 TO 2005–06

| Income year | Threshold (\$) | Income year | Threshold (\$) |
|-------------|----------------|-------------|----------------|
| 1985–86 | 50,000 | 1996–97 | 88,227 |
| 1986–87 | 53,950 | 1997–98 | 89,992 |
| 1987–88 | 58,859 | 1998–99 | 89,992 |
| 1988–89 | 63,450 | 1999–2000 | 91,072 |
| 1989–90 | 68,018 | 2000–01 | 92,802 |
| 1990–91 | 73,459 | 2001–02 | 97,721 |
| 1991–92 | 78,160 | 2002–03 | 101,239 |
| 1992–93 | 80,036 | 2003–04 | 104,377 |
| 1993–94 | 80,756 | 2004–05 | 106,882 |
| 1994–95 | 82,290 | 2005–06 | 109,447 |
| 1995–96 | 84,347 | | |

EXAMPLE: Adjacent land

On 1 April 1984, Dani bought a block of land. On 1 June 2006, she bought an adjacent block. Dani amalgamated the titles to the two blocks into one title.

The second block is treated as a separate CGT asset acquired on or after 20 September 1985 and is therefore subject to CGT.

WHAT ARE CAPITAL PROCEEDS?

Whatever you receive as a result of a CGT event is referred to as your 'capital proceeds'. For most CGT events, your capital proceeds are an amount of money or the value of any property you receive (or are entitled to receive).

If you receive (or are entitled to receive) foreign currency, you work out the capital proceeds by converting it to Australian currency at the time of the relevant CGT event.

In some cases, if you receive nothing in exchange for a CGT asset (for example, if you give it away as a gift) you are taken to have received the market value of the asset at the time of the CGT event. You may also be taken to have received the market value if:

- your capital proceeds are more or less than the market value of the CGT asset, and
- you and the purchaser were not dealing with each other at arm's length in connection with the event.

This is known as the **market value substitution rule for capital proceeds**.

You are said to be dealing at arm's length with someone if each party acts independently and neither party exercises influence or control over the other in connection with the transaction. The law looks not only at the relationship between the parties but also at the quality of the bargaining between them.

EXAMPLE: Gifting an asset

On 7 May 2004, Martha and Stephen bought a block of land.

In November 2005 they complete a transfer form to have the block transferred to their adult son, Paul, as a gift.

Because they received nothing for it, Martha and Stephen are taken to have received the market value of the land at the time it was transferred to Paul.

You reduce your capital proceeds from a CGT event if:

- you are not likely to receive some or all of the proceeds
- the non-receipt is not due to anything you have done or failed to do, and
- you took all reasonable steps to get payment.

Provided you are not entitled to a tax deduction for the amount you repaid, your capital proceeds are also reduced by:

- any part of the proceeds that you repay, or
- any compensation you pay that can reasonably be regarded as a repayment of the proceeds.

If you are registered for goods and services tax (GST) and you receive payment when you dispose of a CGT asset, any GST payable is not part of the capital proceeds.

There are special rules for calculating the proceeds from a depreciating asset. For more information, see **CGT and depreciating assets** on page 20.

WHAT IS THE COST BASE?

The cost base of a CGT asset is generally the cost of the asset when you bought it; however, it also includes certain other costs associated with acquiring, holding and disposing of the asset.

For most CGT events, you need the cost base of the CGT asset to work out whether or not you have made a capital gain. If you may have made a capital loss, you need the reduced cost base of the CGT asset for your calculation. The capital gain and capital loss columns in the table at appendix 1 indicate whether the cost base and reduced cost base of an asset are relevant for a CGT event.

For those CGT events where the cost base and reduced cost base are not relevant, the explanation of the CGT event given in the table explains the amounts to use to work out your capital gain or capital loss. For example, if you enter into an agreement not to work in a particular industry for a set period of time, CGT event D1 specifies that you make a capital gain or capital loss by comparing the capital proceeds with the incidental costs (see **Second element** below).

Cost base is not relevant when working out a capital gain from a depreciating asset.

➤ There are special rules for calculating the cost of a depreciating asset. For details, see **CGT and depreciating assets** on page 20, and the *Guide to depreciating assets 2006* (NAT 1996–6.2006).

Elements of the cost base

The cost base of a CGT asset is made up of five elements. You need to work out the amount for each element, then add them together to work out the cost base of your CGT asset.

An amount paid in a foreign currency that is included in an element of the cost base is converted to Australian currency at the time of the relevant transaction or event. – for example, when the money is paid for the asset.

If you are registered for GST, you reduce each element of the cost base of your asset by any related GST net input tax credits.

First element: money or property given for the asset

The money paid (or required to be paid) for the asset and the market value of property given (or required to be given) to acquire the asset are included in the first element.

Second element: incidental costs of acquiring the CGT asset or of the CGT event

There are nine incidental costs you may have incurred in acquiring the asset or in relation to the CGT event that happens to it, including its disposal. They are:

- remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser (you can only include the cost of advice concerning the operation of the tax law as an incidental cost if the advice was provided by a recognised tax adviser and you incurred the cost after 30 June 1989)

- costs of transfer
- stamp duty or other similar duty
- costs of advertising or marketing (but not entertainment) to find a seller or buyer
- costs relating to the making of any valuation or apportionment to determine your capital gain or capital loss.
- search fees relating to an asset (such as fees to check land titles and similar fees, but not travel costs to find an asset suitable for purchase)
- the cost of a conveyancing kit (or a similar cost)
- borrowing expenses (such as loan application fees and mortgage discharge fees), and,
- expenditure that:
 - is incurred by the head company of a consolidated group to an entity that is not a member of the group; and
 - reasonably relates to a CGT asset held by the head company; and
 - is incurred because of a transaction that is between members of the group.

You do not include costs if you:

- have claimed a tax deduction for them in any year, or
- omitted to claim a deduction but can still claim it because the period for amending the relevant income tax assessment has not expired.

! NOTE

For CGT events that happened before 1 July 2005, marketing costs, search fees, the cost of a conveyancing kit and borrowing expenses were not included. If the CGT event (such as sale or disposal) happens on or after 1 July 2005, these costs are included in this cost element irrespective of whether they were incurred before or after that date.

Third element: costs of owning the asset

The costs of owning an asset include rates, land taxes, repairs and insurance premiums. Non-deductible interest on borrowings to finance a loan used to acquire a CGT asset and on loans used to finance capital expenditure you incur to increase an asset's value are also third element costs.

You do not include such costs if you acquired the asset before 21 August 1991. Nor do you include them if you:

- have claimed a tax deduction for them in any year, or
- omitted to claim a deduction but can still claim it because the period for amending the relevant income tax assessment has not expired.

You cannot include them at all in the cost base of collectables or personal use assets.

You cannot index these costs or use them to work out a capital loss. See **Indexation of the cost base** on the next page.

! NOTE

For CGT events that happened before 1 July 2005, the third element was non-capital costs associated with owning the asset. The effect of the change is to broaden the range of costs that are included in this element, including some capital expenditure that may not come within the other elements of the cost base. If the CGT event (such as sale or disposal) happens on or after 1 July 2005, costs that fall within the new description of this element are included irrespective of whether they were incurred before or after that date.

Fourth element: capital costs to increase or preserve the value of your asset or to install or move it

The fourth element is capital costs you incurred for the purpose or the expected effect of increasing or preserving the asset's value – for example, costs incurred in applying (successfully or unsuccessfully) for zoning changes. It also includes capital costs you incurred that relate to installing or moving an asset. However, it does not include capital expenditure incurred in relation to goodwill which may be deductible as a business-related cost. For details see *Guide to depreciating assets 2006*.

! NOTE

For CGT events that happened before 1 July 2005, the fourth element was capital costs associated with increasing the value of your asset that were reflected in the state or nature of the asset at the time of the CGT event – for example, if you paid for a carport to be built on your rental investment property. The effect of the change is to broaden the range of costs that are included in this element, including some expenditure that may not have been reflected in the state or nature of the asset when it was sold – for example, certain demolition costs. If the CGT event (such as sale or disposal) happens on or after 1 July 2005, costs that fall within the new description of this element are included irrespective of whether they were incurred before or after that date.

Fifth element: capital costs of preserving or defending your ownership of or rights to your asset

Capital expenses you incur to preserve or defend your ownership of or rights to the asset – for example, if you paid a **call on shares** – come under this element.

Assets acquired after 13 May 1997

If you acquired a CGT asset after 13 May 1997, the cost base of the asset also excludes:

- any expenditure in the first, fourth or fifth element for which you have claimed a tax deduction in any year, or have omitted to claim but can still claim a deduction because the period for amending the relevant income tax assessment has not expired, and

- heritage conservation expenditure and landcare and water facilities expenditure incurred after 12 November 1998 that give rise to a tax offset.

Special rules apply for land and buildings. See **Cost base adjustments for capital works deductions** on page 58.

Reversal of deduction: effect on cost base

In some cases, a deduction you have claimed on a CGT asset can be partly or wholly 'reversed' – that is, part or all of the deduction may be included in your assessable income in the year the CGT event happens. In this case, you increase the cost base of the CGT asset by the amount you have to include in your assessable income.

Indexation of the cost base

If a CGT event happened to a CGT asset you acquired before 11.45am (by legal time in the ACT) on 21 September 1999 and owned for at least 12 months, you can use either the **indexation method** or the **discount method** to calculate your capital gain.

If you use the indexation method, some of the cost base expenditure you incurred up to 11.45am (by legal time in the ACT) on 21 September 1999 may be indexed to account for inflation up to the September 1999 quarter. Only expenditure incurred before 11.45am (by legal time in the ACT) on 21 September 1999 may be indexed because changes to the law mean indexation was frozen at that date. See chapter 2 for more information on the indexation and discount methods.

WHAT IS THE REDUCED COST BASE?

When a CGT event happens to a CGT asset and you haven't made a capital gain, you need the asset's reduced cost base to work out whether you have made a capital loss. (Remember, you can only use a capital loss to reduce a capital gain – you cannot use it to reduce other income.)

Elements of the reduced cost base

The reduced cost base of a CGT asset has the same five elements as the cost base (see previous page), except for the third element:

- 1 money or property given for the asset
- 2 incidental costs of the CGT event or of acquiring the CGT asset
- 3 balancing adjustment amount – any amount that is assessable because of a balancing adjustment for the asset or that would be assessable if certain balancing adjustment relief were not available
- 4 capital costs to increase or preserve the value of your asset or to install or move it, and
- 5 capital costs of preserving or defending your title or rights to your asset.

These elements are not indexed.

You need to work out the amount for each element then add the amounts together to find out your reduced cost base for the relevant CGT asset.

If you are registered for GST, you reduce each element of the reduced cost base of the asset by the amount of any GST net input tax credits in relation to that element.

The reduced cost base does not include any costs you have incurred for which you have claimed a tax deduction or have omitted to claim, but can still claim, a deduction because the period for amending the relevant income tax assessment has not expired – for example, capital works deductions for capital expenditure.

EXAMPLE: Capital works deduction: effect on reduced cost base

Danuta acquired a new income-producing asset on 28 September 1999 for \$100,000. She sold it for \$90,000 in November 2005. During the period she owned it she claimed capital works deductions of \$7,500 for expenditure she incurred. Her capital loss is worked out as follows:

| | |
|-------------------------------|-----------------|
| Cost base | \$100,000 |
| less capital works deductions | \$7,500 |
| Reduced cost base | \$92,500 |
| less capital proceeds | \$90,000 |
| Capital loss | \$2,500 |

MODIFICATIONS TO THE COST BASE AND REDUCED COST BASE

In some cases, the general rules for calculating the cost base and reduced cost base have to be modified. For example, you substitute the market value for the first element of the cost base and reduced cost base if:

- you did not incur expenditure to acquire the asset
- some or all of the expenditure you incurred cannot be valued, or
- you did not deal at arm's length with the previous owner in acquiring the asset.

This is known as the **market value substitution rule for cost base and reduced cost base**.

There are exceptions to the market value substitution rule. One exception is where shares in a company, or units in a unit trust, are issued or allotted to you but you did not pay anything for them.

You do not include expenditure you subsequently recoup – such as an insurance pay-out you receive or an amount paid for by someone else – in the cost base and reduced cost of a CGT asset unless you include the recouped amount in your assessable income.

EXAMPLE: Recouped expenditure

John bought a building in 2000 for \$200,000 and incurred \$10,000 in legal costs associated with the purchase. As part of a settlement, the vendor agreed to pay \$4,000 of the legal costs. John did not claim as a tax deduction any part of the \$6,000 he paid in legal costs.

He later sells the building. As he received reimbursement of \$4,000 of the legal costs, in working out his capital gain he includes only the \$6,000 he incurred in the cost base.


If you acquire a CGT asset and only part of the expenditure relates to the acquisition of the CGT asset, you can only include that part of the expenditure that is reasonably attributable to the acquisition of the asset in its cost base and reduced cost base.

Apportionment is also required if you incur expenditure and only part of that expenditure relates to another element of the cost base and reduced cost base.

Similarly, if a CGT event happens only to part of your CGT asset, you generally apportion the asset's cost base and reduced cost base to work out the capital gain or capital loss from the CGT event.

Consolidated groups

The rules that apply to members of a consolidated group modify the application of the capital gains tax rules.

 For more information about the consolidation rules, visit our website or for technical enquiries, phone the Tax Reform Infoline on **13 24 78** (see also page 3).

General value shifting regime

Value shifting generally occurs when a dealing or transaction between two parties is not at market value and results in the value of one asset decreasing and (usually) the value of another asset increasing.

The general value shifting regime (GVSR) rules apply to:

- value shifts that arise because interests in a company or trust are issued or bought back at other than market value, or because their rights are varied so that the value of some interests increases while the value of others decreases (direct value shifts on interests)
- value shifts that arise because two entities under the same control or ownership conduct dealings or transactions that are neither at market value nor arm's length, so that the value of interests in one entity decreases while (usually) the value of interests in the other entity increases (indirect value shifting), and
- value shifts that arise from the creation of a right over a non-depreciating asset in favour of an associate for less than market value (direct value shifts by creating rights).

The rules on direct value shifts on interests target only equity or loan interests held by an individual or entity that controls the company or trust, the controller's associates and, if the company or trust is closely held, any active participants in the arrangement.

The indirect value shifting rules target only equity or loan interests held by an individual or entity that controls the two entities conducting the dealing or transaction and the controller's associates. But if the two entities are closely held, the rules also target equity or loan interests held by two or more common owners of those entities, the common owner's associates and any active participants in the arrangement.

There are also exclusions and safe harbours that limit the operation of the rules.

If the rules apply, you may need to:

- adjust the cost base and reduced cost base of equity and loan interests affected by the value shift, or
- adjust a realised loss or gain on the disposal of the relevant assets.

In some cases, there may also be an immediate capital gain.

➤ For more information on whether the GVSR rules apply to you, see *General value shifting regime in brief* (NAT 8933), available on our website. For detailed information on the operation of the rules, see *Guide to the general value shifting regime*, also available on our website.

Other special rules

There are other rules that may affect the cost base and reduced cost base of an asset. For example, they are calculated differently:

- if the asset is your main residence and you use it to produce income for the first time after 20 August 1996 (see chapter 6)
- if you receive the asset as a beneficiary or as the **legal personal representative** of a deceased estate (see chapter 9)
- for **bonus shares** or units, rights and options and convertible notes (see chapter 5)
- under a demerger (see chapter 5), and
- where you have been freed from paying a debt (see **Debt forgiveness** below).

Debt forgiveness

A debt is forgiven if you are freed from the obligation to pay it. Commercial **debt forgiveness** rules apply to debts forgiven after 27 June 1996. A debt is a commercial debt if part or all of the interest payable on the debt is, or would be, an allowable deduction.

Under the commercial debt forgiveness rules, a forgiven amount may reduce (in the following order) your:

- prior year revenue losses
- unapplied net capital losses from earlier years
- deductible expenditure, and
- assets' cost base and reduced cost base.

These rules do not apply if the debt is forgiven:

- as a result of an action under bankruptcy law
- in a deceased person's will, or
- for reasons of natural love and affection.

EXAMPLE: Applying a forgiven debt

On 1 July 2005, Josef had available net capital losses of \$9,000. On 3 January 2006, he sold shares he had owned for more than 12 months for \$20,000. They had a cost base (no indexation) of \$7,500. On 1 April 2006, a commercial debt of \$15,000 that Josef owed to AZC Pty Ltd was forgiven. Josef had no prior year revenue losses and no deductible capital expenditure.

Josef must use part of the forgiven commercial debt amount to wipe out his net capital losses and the rest to reduce the cost base of his shares. He works out what net capital gain to include in his assessable income as follows:

Adjust net capital losses:

| | |
|----------------------------------|------------|
| Available net capital losses | \$9,000 |
| less debt forgiveness adjustment | \$9,000 |
| Adjusted net capital losses | Nil |

Adjust cost base:

| | |
|-------------------------------------|----------------|
| Cost base of shares (no indexation) | \$7,500 |
| less debt forgiveness adjustment | \$6,000 |
| Adjusted cost base (no indexation) | \$1,500 |

Calculate net capital gain:

| | |
|---|----------------|
| Sale of shares | \$20,000 |
| less adjusted cost base (no indexation) | \$1,500 |
| less adjusted net capital losses | Nil |
| Capital gain (eligible for discount) | \$18,500 |
| less discount percentage (50%) | \$9,250 |
| Net capital gain | \$9,250 |

ACQUIRING CGT ASSETS

Generally, you acquire a CGT asset when you become its owner. You may acquire a CGT asset because:

- a CGT event happens to someone else (for example, the transfer of land to you under a contract of sale). If you acquired an asset because of a CGT event, you are generally taken to have acquired the asset at the time of the CGT event.
- for example, if you enter into a contract to purchase a CGT asset, the time of acquisition is when you enter into the contract. However, if you obtain an asset without entering into a contract, the time of acquisition is when you start being the asset's owner.
- other events or transactions happen that are not the result of a CGT event happening to someone else. For example, if a company issues or allots shares to you (which is not a CGT event), you acquire the shares when you enter into a contract to acquire them or, if there is no contract, at the time of their issue or allotment.

- other special CGT rules. For example, if a CGT asset passes to you as a beneficiary of someone who has died, you are taken to have acquired the asset on the date of the person's death. Also, if you start using your main residence to produce income for the first time after 20 August 1996, you are taken to have acquired it at its market value at the time it is first used to produce income.

Time of acquisition

The time a CGT asset is acquired is important for four reasons:

- CGT generally does not apply to assets acquired before 20 September 1985 (pre-CGT assets)
- different cost base rules apply to assets acquired at different times – for example, the costs of owning an asset (see **Third element: costs of owning the asset** on page 12) are not included in the cost base if you acquired it before 21 August 1991
- it determines whether the cost base can be indexed for inflation and the extent of that indexation (see chapter 2 page 23), and
- it determines whether you are eligible for the CGT discount – for example, one requirement is that you need to have owned the CGT asset for at least 12 months (see chapter 2 page 23).

COMPENSATION

There can be CGT consequences when you receive compensation.

You disregard some capital gains made as a result of you receiving compensation – for example, compensation for personal injury or compensation payable under certain government programs. For details of other compensation you disregard, see **Exemptions** on page 18. You may defer a capital gain made as a result of compensation for the loss, destruction or compulsory acquisition of an asset – see chapter 7.

A compensation payment may relate to the disposal of, or permanent damage to, an underlying asset. The underlying asset is the most relevant asset to which the compensation amount is most directly related. For example, if you receive compensation for damage to a rental property, the most relevant asset – the underlying asset – is the rental property.

If the payment relates to the disposal (in whole or part) of an underlying asset, the compensation is treated as additional capital proceeds for the disposal of that asset.

If the payment relates to permanent damage to, or permanent reduction in the value of, an underlying asset, the compensation is treated as a recoupment of all or part of the acquisition cost of the asset (that is, you reduce the cost base and reduced cost base by the amount of the compensation).

If the payment is not in relation to an underlying asset, it relates to the disposal of the right to seek compensation. The capital gain or capital loss will be the difference between the incidental costs and the compensation received.

➤ For more information about the CGT consequences of receiving compensation, see *Taxation Ruling TR 95/35 – Capital gains: treatment of compensation receipts*.

BECOMING A RESIDENT AND CEASING TO BE A RESIDENT

There are special CGT rules that apply when you become or cease being a resident of Australia for tax purposes. These rules do not affect pre-CGT assets.

Becoming a resident

If you become a resident you are taken to have acquired certain assets – specifically, those that do not have a necessary connection with Australia (see **Necessary connection with Australia** on page 17) – at the time you become a resident. You are taken to have acquired them for their market value at that time. This does not apply to assets you acquired before 20 September 1985 (pre-CGT assets) and assets that had the necessary connection within Australia.

The general rules apply to any assets that had the necessary connection with Australia (for example, land in Australia) when you became a resident.

Ceasing to be a resident

If you cease being an Australian resident for tax purposes, you are taken to have disposed of assets that don't have the necessary connection with Australia (see page 17) for their market value on the day you stopped being a resident.

Short-term resident

You disregard the capital gain or capital loss if you are an individual and were an Australian resident for less than five years during the 10 years before you stopped being one, and either:

- owned the asset before last becoming an Australian resident, or
- inherited the asset after last becoming an Australian resident.

Note: Changes have been made to the law affecting temporary residents. The changes apply to CGT events that happen on or after 1 July 2006. For more information, see **What's new** on our website.

Choosing to disregard making a capital gain or capital loss

If you are an individual, you can choose to disregard all capital gains and capital losses you made when you stopped being a resident. If you make this choice the assets are taken to have the necessary connection with Australia until the earlier of:

- a CGT event happening to the assets (for example, their sale or disposal)
- you again becoming an Australian resident.

The effect of making this choice is that the increase or decrease in value of the assets from the time you cease being a resident to the time of the next CGT event or you

again becoming a resident is also taken into account in working out your capital gains or capital losses on those assets. (For information about when and how you make a choice, see **Choices** below)

Non-residents

Generally, non-residents are only subject to capital gains tax on assets that have the 'necessary connection with Australia'. See **International tax reform** on page 5 about proposed changes affecting non-residents or visit our website.

Necessary connection with Australia

Assets you may own that have a necessary connection with Australia include:

- land or a building in Australia (or an interest in land or a building)
- a CGT asset you have used in carrying on a business through a permanent establishment in Australia
- a share in a private company that is an Australian resident company for the income year in which the CGT event happens
- a share, or an interest in a share, in a public company that is an Australian resident company and in which you and your associates have owned at least 10% of the value of the shares at any time during the five years before the CGT event happens
- a unit in a unit trust that is a resident trust and in which you and your associates have owned at least 10% of the issued units at any time during the five years before the CGT event happens
- an interest (other than a unit) in a trust that is a resident trust for CGT purposes for the income year in which the CGT event happens, and
- an option or right to acquire any of the preceding CGT assets.

Assets that do not fall within one of the above categories – for example, land or a building overseas or shares in a foreign company – do not have the necessary connection with Australia.

CHOICES

There are number of provisions in the capital gains tax (CGT) laws that allow you to make a choice.

Some of the provisions allow you to defer, or roll over, a capital gain you make when a CGT event (such as exchanging an asset for a replacement asset) happens until a later CGT event (such as selling the replacement asset).

When and how you make a choice

The general rule under CGT is that you must make a choice by the day you lodge your income tax return for the year in which the relevant CGT event happened.

The way you prepare your tax return is sufficient evidence of the making of your choice. However, there are some exceptions:

- companies must make some decisions about replacement asset rollovers earlier

- choices relating to the small business retirement exemption must be made in writing, and
- a longer period is allowed to choose the small business rollover.

Once you make a choice, it cannot be changed. Your choice is binding.

However, there are some circumstances when the Tax Office considers that you have not made a choice. These are if you lodge your tax return without being aware that:

- events have happened that required you to make a choice, or
- a choice was available.

In these circumstances, the Tax Office may allow you further time to make a choice.

Factors to be considered for an extension of time

To determine if further time should be allowed, the Tax Office considers factors such as whether:

- you have an acceptable explanation for not making the choice by the time it should have been made
- it would be fair and equitable in the circumstances to allow you further time to make a choice
- prejudice to the Commissioner of Taxation may result from additional time being allowed to you (note that the absence of prejudice by itself is not enough to justify the granting of an extension)
- it would be fair and equitable to people in similar positions and the wider public interest, and
- any mischief is involved.

Each case is decided on its own merits.

How to request an extension of time to make a choice

If you have lodged a tax return without knowing a choice was available to you under capital gains tax law and you want further time to make the choice, see *Choices you make under capital gains tax* on our website to find out how to make such a request.

Examples of choices available under capital gains tax

Examples of CGT choices you make include the choice:

- to use the indexation method rather than the CGT discount method if a CGT event happens to a CGT asset you acquired before 21 September 1999 (or are taken to have acquired before that date for the purpose of using those methods) – see **Choosing the indexation or discount method** on page 25
- to make a capital loss for the income year in which a liquidator or administrator declares in writing that shares or securities held in a company are worthless – see **Shares in a company in liquidation or administration** on page 39

- to rollover a capital gain if a company you hold shares in is taken over and you receive shares in the takeover company and the takeover meets certain conditions (this is known as scrip-for-scrip rollover). It can also apply if a trust or fund you hold units in is taken over and you receive units in the takeover trust or fund. The company, trust or fund will usually advise investors if the conditions for rollover are met – see **Scrip-for-scrip rollover** on page 40
- to roll over a capital gain if you hold shares in a company that demerges (or splits), you receive shares in the demerged company and the demerger meets certain conditions. Rollover can also apply if you hold units in a trust or fund that demerges and you receive units in the demerged trust or fund. The head company or head trust or fund will usually advise investors if the conditions for rollover are met – see **Demergers** on page 42
- to rollover a capital gain if you receive money or property (or both) as compensation for the loss or destruction of an asset or for the compulsory acquisition of property by an Australian government agency and certain conditions are met – see chapter 7 on page 83
- to treat a dwelling as your main residence even though:
 - you no longer live in it – see **Continuing main residence status after dwelling ceases to be your main residence** on page 72, or
 - you are yet to live in it but will do so as soon as practicable after it is constructed, repaired or renovated and will continue to live in it for at least 3 months – see **Constructing, renovating or repairing a dwelling on land you already own** on page 75
- for the main residence exemption, you make the choice when you prepare your income tax return for the income year in which you enter into the contract to sell the dwelling. If you own both:
 - the dwelling that you can choose to treat as your main residence for one of the periods above, and
 - the dwelling you actually lived in during that period
 you make the choice for the year you enter into the contract to sell the first of those dwellings.

EXEMPTIONS AND ROLLOVERS

There are exemptions and rollovers that may allow you to reduce, defer or disregard your capital gain or capital loss.

There is no rollover or exemption for a capital gain you make when you sell an asset and put the proceeds into a superannuation fund, use the proceeds to purchase an identical or similar asset or you transfer an asset into a superannuation fund. For example, if you sell a rental property and put the proceeds into a superannuation fund or use the proceeds to purchase another rental property, rollover is not available. However, an asset or the capital proceeds from the sale of an asset may be transferred into a superannuation fund in order to satisfy certain conditions under the small business retirement exemption. For more information about the CGT concessions for small business, see *Guide to capital gains tax concessions for small business*.

To find out when rollover is available – see **Rollovers** on the next page.

Exemptions

Generally, capital gains and capital losses from pre-CGT assets (that is, an asset you acquired before 20 September 1985) are exempt. However, CGT event K6 can result in capital gains if certain CGT events happen to pre-CGT shares in a company or to pre-CGT interests in a trust – see *Taxation Ruling TR 2004/18 – Capital gains: application of CGT event K6 (about pre-CGT shares and pre-CGT trust interests) in section 104-230 of the Income Tax Assessment Act 1997*.

Another important exemption is for a capital gain or capital loss you make from a CGT event relating to a **dwelling** that was your main residence. This rule can change, however, depending on how you came to own the dwelling and what you have done with it – for example, if you rented it out (see chapter 6 for more information).

The following capital gains and capital losses are also disregarded:

- a car (that is, a motor vehicle designed to carry a load of less than one tonne and fewer than nine passengers) or motor cycle or similar vehicle
- a decoration awarded for valour or brave conduct unless you paid money or gave any other property for it
- collectables acquired for \$500 or less
- a capital gain from a personal use asset acquired for \$10,000 or less
- any capital loss from a personal use asset
- CGT assets used solely to produce exempt income or some amounts of non-assessable non-exempt income
- a CGT asset that is your trading stock at the time of a CGT event
- shares in a pooled development fund
- compensation or damages you receive for any:
 - wrong or injury you suffer in your occupation
 - wrong, injury or illness you or your relatives suffer
- compensation you receive under the firearms surrender arrangements
- winnings or losses from gambling, a game or a competition with prizes
- a reimbursement or payment of your expenses under the General Practice Rural Incentives Program or the Sydney Aircraft Noise Insulation Project
- a reimbursement or payment made under the M4/M5 Cashback Scheme
- a re-establishment grant made under section 52A of the *Farm Household Support Act 1992*
- a dairy exit payment under the *Farm Household Support Act 1992*
- a sugar industry exit grant paid under the Sugar Industry Reform Program
- payments made under the German Forced Labour Compensation Programme (GFLCP), and certain payments or property received by Australian residents after 30 June 2001 as a result of persecution during the Second World War
- some types of testamentary gifts

- any capital gain or capital loss that would otherwise arise from the assignment to the Commonwealth of a right in relation to a general insurance policy held with an HII company, the trustee of the HII trust or a prescribed entity
- any capital gain or capital loss you make from rights being created in you or your rights ending in relation to the making of a superannuation agreement (as defined in the *Family Law Act 1975*), the termination or setting aside of such an agreement or such an agreement otherwise coming to an end
- any capital gain or capital loss that a complying superannuation entity makes from a CGT event happening in relation to a segregated current pension asset
- in certain circumstances, a general insurance policy, a life insurance policy or an annuity instrument
- the transfer of a superannuation interest in a small superannuation fund to another small superannuation fund on the breakdown of a legal (but not a de facto) marriage
- your gain on disposal of eligible venture capital investments, if you are a qualifying investor – see *Venture capital concessions (capital gains tax) – overview*, available on our website.

Other exemptions: capital gains

You may reduce your capital gain if, because of a CGT event, you have included an amount in your assessable income other than as a capital gain. For example, if you make a profit on the sale of land that is included in your assessable income as ordinary income, you don't also include that profit as a capital gain.

There are a range of concessions that allow you to disregard part or all of a capital gain made from an active asset you use in your small business. For more information, see *Guide to capital gains tax concessions for small business*.

Other exemptions: capital losses

You disregard any capital loss you make:

- from the expiry, forfeiture, surrender or assignment of a lease if the lease is not used solely or mainly for the purpose of producing assessable income
- from a payment to any entity of personal services income that is included in an individual's assessable income under the alienation of personal services income provisions, or any other amount attributable to that income
- as an exempt entity.

Rollovers

You may defer or disregard – that is, rollover – a capital gain or capital loss until a later CGT event happens. The types of rollover available are listed here but only the following four types are covered in this guide. If you would like information on the others, please contact the Tax Office.

Marriage breakdown

In certain cases where an asset or a share of an asset is transferred from one spouse to another after their marriage breaks down, any CGT is automatically deferred until a later CGT event happens (for example, when the former spouse sells the asset to someone else). For more examples of how CGT obligations are affected by marriage breakdown, see chapter 8.

Loss, destruction or compulsory acquisition of an asset

You may defer a capital gain in some cases where a CGT asset has been lost or destroyed or is compulsorily acquired (see chapter 7).

Scrip-for-scrip

You may be able to defer a capital gain if you dispose of your shares in a company or interest in a trust as a result of a **takeover** (see chapter 5).

Demergers

You may be able to defer a capital gain or capital loss if a CGT event happens to your shares in a company or interest in a trust as a result of a demerger (see chapter 5).

Other replacement asset rollovers

You may be able to defer a capital gain or capital loss when you replace an asset in the following circumstances (if you would like information on these rollovers, contact the Tax Office or your recognised tax adviser):

- an individual or trustee disposes of assets to, or creates assets in, a wholly owned company
- partners dispose of assets to, or create assets in, a wholly owned company
- a CGT event happens to small business assets and you acquire replacement assets
- your statutory licence is renewed or extended
- you are a financial service provider who had assets – for example, licences – replaced on transition to the financial services reform (FSR) regime
- your property is converted to strata title
- you exchange shares in the same company or units in the same unit trust
- you exchange rights or options to acquire shares in a company or units in a unit trust
- you exchange shares in one company for shares in an interposed company
- you exchange units in a unit trust for shares in a company
- a body is converted to an incorporated company
- you acquire a Crown lease
- you acquire a depreciating asset
- you acquire prospecting and mining entitlements
- you dispose of a security under a securities lending arrangement
- a trust restructure ends your ownership of units or interests.

Other same asset rollovers

You may be able to defer a capital gain or capital loss when you transfer or dispose of assets in the following circumstances (if you would like information on these rollovers, contact the Tax Office or your recognised tax adviser):

- an individual or trustee transfers a CGT asset to a wholly owned company
- a partner transfers their interest in a CGT asset to a wholly owned company
- a CGT asset is transferred between related companies
- a trust disposes of a CGT asset to a company under a trust restructure
- a CGT event happens because of a change to a trust deed of a complying approved deposit fund, a complying superannuation fund or a fund that accepts worker entitlement contributions
- a superannuation entity that merges with another superannuation entity between 1 July 2004 and 30 June 2006 inclusive because it does not satisfy requirements under the new superannuation safety arrangements, and
- a transfer of a CGT asset from one small superannuation fund to another because of a marriage breakdown.

CGT AND FOREIGN EXCHANGE GAINS AND LOSSES

A CGT asset can be denominated in a foreign currency and foreign currency cash itself can be a CGT asset. Gains or losses that you make during the period that you hold such assets will generally be taxed as a capital gain or capital loss respectively. However, if dealings with foreign currency denominated assets give rise to rights to receive or obligations to pay foreign currency, the rights or obligations may be subject to the foreign exchange (forex) provisions when a right or obligation ceases. For example, if a contract you enter into to sell an overseas rental property is denominated in foreign currency you will have a right to receive foreign currency (being the purchase price of the rental property) which ceases on payment of the foreign currency. Such rights and obligations will usually arise on the acquisition or disposal of a CGT asset.

A forex gain or loss commonly arises in relation to the acquisition or disposal of a CGT asset denominated in foreign currency where there is a currency exchange rate fluctuation between the date you entered into the contract and the date of settlement of the contract (when payment occurs). Currency fluctuations between the date of acquisition and date of disposal of a CGT asset are taken into account when the cost base and capital proceeds are translated into Australian currency.

It may be that the gain or loss you make on the ending of rights in relation to foreign currency, a disposal of foreign currency or a right to receive foreign currency is taxable under both CGT and the forex measures. Generally, to the extent that both the forex measures and CGT bring to account a forex gain or loss, the forex measures take precedence, such that the forex gain or loss is brought to account only under the forex provisions.

For more information, see *Foreign exchange (forex): overview* on our website.

Short-term forex gains and losses rules

Some short-term forex gains or losses which arise under transactions for the acquisition or disposal of certain CGT assets will be treated as capital gains or capital losses. In such cases, CGT events K10 or K11 will happen, which will result in the forex gain or loss being integrated into the tax treatment of the CGT asset, or matched to the character of the gain or loss that would arise from the disposal of the asset. For the short-term rules to apply, the due date for payment must be within 12 months of acquiring or disposing of the asset. For more information, see *Forex – the 12 month rule* on our website.

Translating (converting) foreign currency denominated CGT assets to Australian dollars

For information on what exchange rates to use in translating foreign currency amounts into Australian currency, see *Foreign exchange (forex): the general translation rule* available on our website.

Examples of application of forex rules to CGT assets

For examples of the application of the forex rules in respect of acquisitions and disposals of foreign currency denominated CGT assets, see the following fact sheets on our website:

- *Foreign exchange (forex): acquisition of a CGT asset*
- *Foreign exchange (forex): acquisition of a CGT asset (election out of 12 month rule)*
- *Foreign exchange (forex): disposal of CGT asset denominated in foreign currency—incidental costs (election out of 12 month rule)*
- *Foreign exchange (forex): disposal price of CGT asset denominated in foreign currency*
- *Foreign exchange (forex): disposal price of CGT asset denominated in foreign currency (election out of 12 month rule)*

CGT AND DEPRECIATING ASSETS

Under the uniform capital allowance (UCA) system, a capital gain or capital loss from the disposal of a depreciating asset will only arise to the extent that you have used the asset for a non-taxable purpose (for example, used for private purposes).

You calculate a capital gain or capital loss from a depreciating asset used for a non-taxable purpose using the UCA concepts of cost and termination value, not the concepts of capital proceeds and cost base found in the CGT provisions.

If a balancing adjustment event occurs for a depreciating asset that you have at some time used for a non-taxable purpose, a CGT event happens (see CGT event K7 in appendix 1). The most common balancing adjustment event for a depreciating asset occurs when you stop holding it (for example, you sell, lose or destroy it) or stop using it.

Calculating a capital gain or capital loss for a depreciating asset

You make a capital gain if the termination value of your depreciating asset is greater than its cost. You make a capital loss if the reverse is the case and the asset's cost is more than its termination value.

You use different formulas to calculate a capital gain or capital loss depending on whether the asset is in a low-value pool or not.

Depreciating asset not in a low-value pool: capital gain

If your depreciating asset is not a pooled asset, you calculate the capital gain as follows:

$$(\text{Termination value} - \text{cost}) \times \frac{\text{sum of reductions}^1}{\text{total decline}^2}$$

Depreciating asset not in a low-value pool: capital loss

You calculate the capital loss from a depreciating asset that is not a pooled asset as follows:

$$(\text{Cost} - \text{termination value}) \times \frac{\text{sum of reductions}^1}{\text{total decline}^2}$$

EXAMPLE: Capital gain on depreciating asset

Larry purchased a truck in August 2004 for \$5,000 and sold it in June 2006 for \$7,000. He used the truck 10% for private purposes. The decline in value of the truck under the UCA system up to the date of sale was \$2,000. Therefore, the sum of his reductions relating to his private use is \$200 (10% of \$2,000). Larry calculates his capital gain from CGT event K7 as follows:

$$(\$7,000 - \$5,000) \times \frac{200}{2,000}$$

Capital gain from CGT event K7 = \$200 (before applying any discount).

Depreciating asset in a low-value pool: capital gain

You calculate the capital gain from a depreciating asset in a low-value pool as follows:

$$(\text{Termination value} - \text{cost}) \times (1 - \text{taxable use fraction}^3)$$

Depreciating asset in a low-value pool: capital loss

You calculate the capital loss from a depreciating asset in a low-value pool as follows:

$$(\text{Cost} - \text{termination value}) \times (1 - \text{taxable use fraction}^3)$$

1 The sum of the reductions in your deductions for the asset's decline in value that is attributable to your use of the asset, or having it installed ready for use, for a non-taxable purpose.

2 The decline in the value of the depreciating asset since you started to hold it.

3 Taxable use fraction is the percentage of the asset's use that is for producing your assessable income, expressed as a fraction. This is the percentage you reasonably estimate at the time you allocated the asset to the low-value pool.

Application of CGT concessions

A capital gain from a depreciating asset may qualify for the CGT discount if the relevant conditions are satisfied. If the CGT discount applies, there is no reduction of the capital gain under the indexation method, as detailed in chapter 2.

The small business CGT concessions do not apply to a capital gain made from the disposal of a depreciating asset – because a capital gain can only arise out of an asset's use for non-taxable purposes (for example, to the extent it is used for private purposes).

Do any CGT exemptions apply to a depreciating asset?

A number of exemptions may apply to a capital gain or capital loss made from the disposal of a depreciating asset:

- pre-CGT assets – you disregard a capital gain or capital loss from a depreciating asset if the asset was acquired before 20 September 1985
- simplified tax system (STS) assets – you disregard a capital gain or capital loss from a depreciating asset if you have elected to become an STS taxpayer and you can deduct an amount for the depreciating asset's decline in value under the STS provisions for the income year in which the balancing adjustment event occurred
- personal use asset – if a depreciating asset is a personal use asset (that is, one used or kept mainly for personal use and enjoyment), you disregard any capital loss from CGT event K7. You also disregard a capital gain under CGT event K7 from a personal use asset costing \$10,000 or less
- collectables – you disregard a capital gain or a capital loss from a depreciating asset that is a collectable costing \$500 or less
- balancing adjustment event and CGT event – you only include a balancing adjustment event that gives rise to a capital gain or capital loss under CGT event K7. However, capital proceeds received under other CGT events – for example, CGT event D1 – may still be relevant for a depreciating asset as CGT events are not the equivalent of balancing adjustment events.

Changed treatment of intellectual property

Intellectual property is a depreciating asset for the purposes of the UCA. Under this system, the former special treatment for partial realisations of intellectual property no longer applies.

If you grant or assign an interest in an item of intellectual property, you are treated as if you had stopped holding part of the item. You are also treated as if, just before you stop holding that part, you had split the original item of intellectual property into two parts, the part you stopped holding and the rest of the original item. You determine a first element of the cost for each part.

This treatment applies if a licence is granted over an item of intellectual property. To this extent, the treatment of intellectual property is different from other depreciating assets. The grant of a licence in respect of other depreciating assets would result in CGT event D1 (about creating contractual rights) happening.



NEED MORE INFORMATION?

For more information about depreciating assets, see the *Guide to depreciating assets 2006*.

WHERE TO NOW?

Chapter 2 in **part A** explains how to calculate a capital gain using one of the three methods (indexation, discount or 'other').

Chapter 4 in **part A** explains how to calculate your capital gain if a managed fund or trust has distributed a capital gain to you. You must take into account capital gains included in trust distributions in working out your net capital gain or capital loss.

For more specific directions on how to complete your tax return, please go to:

- **part B**, for individuals
- **part C**, for companies, trusts and funds (individuals who use the worksheets may find steps 1, 2 and 3 in part C useful – ignore the word 'entity').

HOW TO WORK OUT YOUR CAPITAL GAIN OR CAPITAL LOSS

02

This chapter explains how to work out each capital gain or capital loss you made during the year.

It does not explain how to work out your net capital gain or net capital losses carried forward to later income years. If you are completing a tax return for an individual and want more information on how to calculate your net capital gain for the year or net capital losses carried forward to later income years (including how to deduct any unapplied net capital losses from earlier years), see part B of this guide. For more information about companies, trusts and funds or about completing the CGT summary worksheet, see part C of this guide.

There are three methods that you can use to work out your capital gain. There is only one way to work out your capital loss.

The **Capital gain or capital loss worksheet** provided at the back of this guide shows the three methods of calculating a capital gain: the indexation method, the discount method and the **'other' method**. You are not obliged to use this worksheet but you may find it helps you calculate your capital gain or capital loss for each CGT event.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

THREE METHODS OF CALCULATING CAPITAL GAINS

The three methods of calculating capital gains are summarised and compared in the table **Capital gain calculation methods** on page 25. They are explained in more detail in the following pages. In some cases you may be able to choose either the discount method or the indexation method to calculate your capital gain. In this case you use the method that gives you the better result.

THE 'OTHER' METHOD

This is the simplest of the three methods. You must use the **'other' method** to calculate your capital gain if you have bought and sold your asset within 12 months or generally for CGT events that do not involve an asset. In these cases, the indexation and discount methods do not apply.

Generally, to use the 'other' method, you simply subtract your cost base (what the asset cost you) from your capital proceeds (how much you sold it for). The amount of proceeds left is your capital gain. For some types of CGT events, a cost base is not relevant. In these cases, the particular CGT event explains the amounts to use.

EXAMPLE: Calculating a capital gain using the 'other' method

Marie-Anne bought a property for \$250,000 under a contract dated 24 June 2005. The contract provided for the payment of a deposit of \$25,000 on that date, with the balance of \$225,000 to be paid on settlement on 5 August 2005.

Marie-Anne paid stamp duty of \$5,000 on 20 July 2005. On 5 August 2005, she received an account for solicitors fees of \$2,000 which she paid as part of the settlement process.

Marie-Anne sold the property on 15 October 2005 (the day the contracts were exchanged) for \$315,000. She incurred costs of \$1,500 in solicitors fees and \$4,000 in agents commission.

As she bought and sold her property within 12 months, Marie-Anne must use the 'other' method to calculate her capital gain.

| | |
|--|------------------|
| Deposit | \$25,000 |
| Balance | \$225,000 |
| Stamp duty | \$5,000 |
| Solicitors fees for purchase of property | \$2,000 |
| Solicitors fees for sale of property | \$1,500 |
| Agents commission | \$4,000 |
| Cost base (total) | \$262,500 |

Marie-Anne works out her capital gain as follows:

| | |
|---|-----------------|
| Capital proceeds | \$315,000 |
| less cost base | \$262,500 |
| Capital gain calculated using the 'other' method | \$52,500 |

Assuming Marie-Anne has not made any other capital losses or capital gains in the 2005–06 income year and does not have any unapplied net capital losses from earlier years, the net capital gain to be included at item **17** on her tax return (supplementary section) is \$52,500 (item **9** if she uses the tax return for retirees).

THE INDEXATION METHOD

Use the indexation method to calculate your capital gain if:

- a CGT event happens to an asset you acquired before 11.45am (by legal time in the ACT) on 21 September 1999, and
- you owned the asset for 12 months or more.

If you are not a company and you meet the 2 conditions above and you wish to use the indexation method, you must choose to do so, otherwise the discount method will apply. If you are a company (other than a listed investment company) and the capital gain meets the above conditions, you must use the indexation method to calculate the capital gain. Specific rules affect certain assets of a life insurance company.

Under the indexation method, you increase each amount included in an element of the cost base, (other than those in the third element – costs of owning the asset) by an **indexation factor**.

The indexation factor is worked out using the consumer price index (CPI) at appendix 2.

If the CGT event happened on or after 11.45am (by legal time in the ACT) on 21 September 1999 you can only index the elements of your cost base up to 30 September 1999. You use this formula:

$$\text{Indexation factor} = \frac{\text{CPI for quarter ending 30.9.99 (123.4)}}{\text{CPI for quarter in which expenditure was incurred}}$$

If the CGT event happened before 11.45am (by legal time in the ACT) on 21 September 1999, you use this formula:

$$\text{Indexation factor} = \frac{\text{CPI for quarter when CGT event happened}}{\text{CPI for quarter in which expenditure was incurred}}$$

Work out the indexation factor to three decimal places, rounding up if the fourth decimal place is five or more.

For most assets, you index expenditure from the date you incur it, even if you do not pay some of the expenditure until a later time. However, there is an exception for partly paid shares or units acquired on or after 16 August 1989. If the company or trust later makes a call on the shares or units, you use the CPI for the quarter in which you made that later payment.

There are some exceptions to the requirement that you must have owned an asset for at least 12 months for indexation to apply. For example, you can use the indexation method:

- if you acquire a CGT asset as a legal personal representative or a beneficiary of a deceased estate. The 12-month requirement is satisfied if the deceased acquired the asset 12 months or more before you disposed of it, or
- if you acquired an asset as the result of a marriage breakdown. You will satisfy the 12-month requirement if the combined period your spouse and you owned the asset is more than 12 months.

THE DISCOUNT METHOD

Use the discount method to calculate your capital gain if:

- you are an individual, a trust or a complying superannuation entity
- a CGT event happens to an asset you own
- the CGT event happened after 11.45am (by legal time in the ACT) on 21 September 1999
- you acquired the asset at least 12 months before the CGT event, and
- you did not choose to use the indexation method.

Generally the discount method does not apply to companies, although it can apply to a limited number of capital gains made by life insurance companies.

In determining whether you acquired the CGT asset at least 12 months before the CGT event, you exclude both the day of acquisition and the day of the CGT event.

Note that if:

- you acquire a property and construct a building or make improvements to it that are not separate assets (see **Separate assets** on page 10), and
 - you owned the property for at least 12 months (even if you did not construct the new building or improvements more than 12 months before the CGT event happened)
- you can use the discount method to work out your capital gain from the property.

EXAMPLE: Discount method

Sally acquired a CGT asset on 2 February 2005. She is entitled to apply the CGT discount if a CGT event happens to that asset on or after 3 February 2006.

In certain circumstances, you may be eligible for the CGT discount even if you have not owned the asset for at least 12 months. For example:

- if you acquire a CGT asset as a legal personal representative or as a beneficiary of a deceased estate. The 12-month requirement is satisfied if the asset was acquired by the deceased:
 - before 20 September 1985 and you disposed of it 12 months or more after they died, or
 - on or after 20 September 1985 and you disposed of it 12 months or more after they acquired it.
- if you acquired a CGT asset as the result of a marriage breakdown and rollover applies (see chapter 8). You will satisfy the 12 month requirement if the combined period your spouse and you owned the asset is more than 12 months.
- if a CGT asset is compulsorily acquired, lost or destroyed and you acquire a rollover replacement asset, you will satisfy the 12-month requirement for the replacement asset if the period of ownership of the original asset and the replacement asset is at least 12 months.

Certain capital gains are excluded

The CGT discount does not apply to capital gains from certain CGT events. The CGT discount does not apply to these CGT events:

- D1 Creating contractual or other rights

CAPITAL GAIN CALCULATION METHODS

| | Indexation method | Discount method | 'Other' method |
|--|--|---|--|
| Description of method | Allows you to increase the cost base by applying an indexation factor based on CPI up to September 1999 | Allows you to discount your capital gain | Basic method of subtracting the cost base from the capital proceeds |
| When to use the method | Use for an asset owned for 12 months or more if it produces a better result than the discount method. Use only for assets acquired before 11.45am (by legal time in the ACT) on 21 September 1999. | Use for an asset owned for 12 months or more if it produces a better result than the indexation method. | Use when the indexation and discount methods do not apply (for example, if you have bought and sold an asset within 12 months). |
| How to calculate your capital gain using the method | Apply the relevant indexation factor (see CPI table at appendix 2), then subtract the indexed cost base from the capital proceeds (see worked example for Val on page 27). | Subtract the cost base from the capital proceeds, deduct any capital losses, then reduce by the relevant discount percentage (see worked example for Val on page 27). | Subtract the cost base (or the amount specified by the relevant CGT event) from the capital proceeds (see worked example for Marie-Anne on page 23). |

- D2 Granting an option
- D3 Granting a right to income from mining
- E9 Creating a trust over future property
- F1 Granting a lease
- F2 Granting a long-term lease
- F5 Lessor receives payment for changing a lease
- H2 Receipt for an event relating to a CGT asset
- J2 Change in status of a CGT asset that was a replacement asset in a rollover under Subdivision 152-E
- J3 A change happens in circumstances where a share in a company or an interest in a trust was a replacement asset in a rollover under Subdivision 152-E.

The full list of CGT events is shown at appendix 1.

If you make a capital gain from a CGT event that creates a new asset – for example, receiving a payment for agreeing not to do something (entering into a restrictive covenant) – you cannot satisfy the 12-month ownership rule so your CGT event does not qualify for the CGT discount.

The CGT discount may be denied:

- if the CGT event that gave rise to the capital gain occurred under an agreement that was made within 12 months of the acquisition of the asset
- on the disposal of certain shares or trust interests in non-widely held companies and trusts – that is, those with fewer than 300 members, or
- if an arrangement was entered into for the purposes of claiming the CGT discount under which an 'income' asset was converted into a 'capital' asset (conversion of income to capital) (Part IVA of the *Income Tax Assessment Act 1936*).

If the 'home first used to produce income' rule (see page 70) applies and the period between when you first used the dwelling to produce income and the CGT event

happening is not at least 12 months, the discount method is not available.

Discount percentage

The discount percentage is the percentage by which you reduce your capital gain. You can reduce the capital gain only after you have applied all the capital losses for the year and any unapplied net capital losses from earlier years.

The discount percentage is 50% for individuals and trusts, and 33⅓% for complying superannuation entities and eligible life insurance companies.

CHOOSING THE INDEXATION OR DISCOUNT METHOD

For assets you acquired before September 1999 and have held for 12 months or more, you can choose to use the indexation method or the discount method to calculate your capital gain. There is no one factor to use as a basis to select the better option as it depends on the type of asset you own, how long you have owned it, the dates you owned it and past rates of inflation. Because capital losses must be offset against capital gains before the discount is applied, your choice may also depend on the amount of capital losses that you have available. For information about when and how, see **Choices** on page 17.

EXAMPLE

Justin sold some land and has a \$10,000 capital gain under the discount method (before applying the CGT discount) or a \$7,000 capital gain under the indexation method. If Justin has no capital losses the discount method will produce the smaller capital gain (that is, \$5,000).

However, Justin also made a capital loss of \$5,000 on the sale of some shares. He will be better off using the indexation method to work out the capital gain from the sale of his land. Under this method his net capital gain is \$2,000 (\$7,000 – \$5,000). If he used the discount method his net capital gain would be \$2,500 [(\$10,000 – \$5,000) × 50%].

The example below shows that applying one method to work out your capital gains on a whole parcel of shares you acquired before September 1999 may not be to your advantage if you have capital losses or net capital losses to apply.

In this situation, you will get a better result if you apply the indexation method to sufficient shares to absorb the capital loss (or as much of the capital loss as you can) and apply the discount method to any remaining shares.

EXAMPLE: Capital gains on shares where you also have capital losses

Clare sold a parcel of 500 shares in March 2006 for \$12,500 – that is, for \$25 each. She had acquired the shares in March 1995 for \$7,500 – that is, for \$15 each – including stamp duty and brokerage costs. There were no brokerage costs on the sale. Clare had no other capital gains or capital losses in 2005–06, although she has \$3,500 net capital losses carried forward from previous years.

Because Clare owned the shares for more than 12 months she can use the discount method or the indexation method to work out her capital gains – whichever gives her a better result. Clare decides to work out her net capital gain by applying both the discount method and the indexation method to the whole parcel of shares:

| | Using indexation method | Using discount method |
|-------------------------------------|-------------------------|-----------------------|
| Capital proceeds | \$12,500 | \$12,500 |
| Cost base | *\$8,070 | \$7,500 |
| Capital gain | \$4,430 | \$5,000 |
| /less capital losses | \$3,500 | \$3,500 |
| | \$930 | \$1,500 |
| CGT discount | Nil | \$750 |
| Net capital gain | \$930 | \$750 |
| * \$7,500 × (123.4 ÷ 114.7 = 1.076) | | |

However, because each share is a separate asset, Clare can use different methods to work out her capital gains for shares within the parcel. The lowest net capital gain would result from her applying the indexation method to the sale of 395** shares and the discount method to the remaining 105. She works out her net capital gain as follows:

| Indexation method (395 shares) | | Discount method (105 shares) | |
|--------------------------------|------------|------------------------------------|--------------|
| Capital proceeds (\$25 each) | \$9,875 | Capital proceeds (\$25 each) | \$2,625 |
| Cost base (395 × \$15 × 1.076) | \$6,375 | Cost base (105 × \$15) | \$1,575 |
| Capital gain | \$3,500 | Capital gain | \$1,050 |
| /less capital losses | \$3,500 | /less any remaining capital losses | nil |
| Capital gain/(loss) | nil | | \$1,050 |
| | | CGT discount | \$525 |
| | | Net capital gain | \$525 |

It is probably best to calculate your capital gain using both methods to find out which gives you the better result. This is shown for Val in the worked example on the next page and on the completed **Capital gain or capital loss worksheet** on page 28.

** To calculate this, Clare worked out the capital gain made on each share using the indexation method (\$4,430 ÷ 500 = 8.86) and divided the capital loss by this amount (\$3,500 ÷ 8.86 = 395).

EXAMPLE: Choosing the indexation or discount method

Val bought a property for \$150,000 under a contract dated 24 June 1991. The contract provided for the payment of a deposit of \$15,000 on that date, with the balance of \$135,000 to be paid on settlement on 5 August 1991.

She paid stamp duty of \$5,000 on 20 July 1991. On 5 August 1991, she received an account for solicitors fees of \$2,000, which she paid as part of the settlement process.

She sold the property on 15 October 2005 (the day the contracts were exchanged) for \$350,000. She incurred costs of \$1,500 in solicitors fees and \$4,000 in agents commission.

Val's capital gain calculated using the indexation method

| | |
|--|------------------|
| Deposit x indexation factor | |
| $\$15,000 \times (123.4 \div 106.0 = 1.164)$ | \$17,460 |
| Balance x indexation factor | |
| $\$135,000 \times (123.4 \div 106.0 = 1.164)$ | \$157,140 |
| Stamp duty x indexation factor | |
| $\$5,000 \times (123.4 \div 106.6 = 1.158)$ | \$5,790 |
| Solicitors fees for purchase of property x indexation factor | |
| $\$2,000 \times (123.4 \div 106.6 = 1.158)$ | \$2,316 |
| Solicitors fees for sale of property (indexation does not apply) | \$1,500 |
| Agents commission (indexation does not apply) | \$4,000 |
| Cost base (total) | \$188,206 |
| Val works out her capital gain as follows: | |
| Capital proceeds | \$350,000 |
| less cost base | \$188,206 |
| Capital gain (Val's total current year capital gain using this method) | \$161,794 |

Assuming Val has not made any other capital losses or capital gains in the 2005–06 income year and does not have any unapplied net capital losses from earlier years, her net capital gain using the **indexation method** is \$161,794.

Val's capital gain calculated using the discount method

| | |
|--|------------------|
| Deposit | \$15,000 |
| Balance | \$135,000 |
| Stamp duty | \$5,000 |
| Solicitors fees for purchase of property | \$2,000 |
| Solicitors fees for sale of property | \$1,500 |
| Agents commission | \$4,000 |
| Cost base (total) | \$162,500 |
| Val works out her capital gain as follows: | |
| Capital proceeds | \$350,000 |
| less cost base | \$162,500 |
| Capital gain before applying discount (Val's total current year capital gain using this method) | \$187,500 |
| less CGT discount (as Val has no capital losses) | \$93,750 |
| Net capital gain | \$93,750 |

As the **discount method** provides Val with the better result, she will show the amount worked out using the discount method on her tax return rather than the amount worked out using the indexation method.

The worksheet example on the next page shows how Val might complete the **Capital gain or capital loss worksheet** using both methods.

This worksheet helps you calculate a capital gain for each CGT asset or any other CGT event¹ using the indexation method², the discount method³ and/or the 'other' method. It also helps you calculate a capital loss.

| | Shares and units (in unit trusts) | Real estate |
|--|-----------------------------------|-------------------------------------|
| | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

| Other CGT assets and any other CGT events ⁴ | Collectables ⁵ |
|--|---------------------------|
| | |

Val's property at 15 Smith St, Oldtown

15/10/2005

| CAPITAL LOSS CALCULATION | |
|--|----|
| Capital loss | |
| Reduced cost base | \$ |
| /less: capital proceeds ¹¹ | \$ |
| Capital loss¹² | \$ |

| CAPITAL GAIN CALCULATION | | | |
|--------------------------------|------------|--------------------------------|--|
| Indexation method | | Discount method | 'Other' method (CGT asset held less than 12 months) |
| Capital proceeds ¹¹ | \$ 350,000 | Capital proceeds ¹¹ | Capital proceeds ¹¹ |
| less: cost base indexed | \$ 188,206 | less: cost base unindexed | less: cost base unindexed |
| Capital gain (a) | \$ 161,794 | Capital gain (b)* | Capital gain |

Transfer the capital loss to **part B** of the *CGT summary worksheet*, except for a capital loss from collectables which is transferred to **part A2** of that worksheet

FOOTNOTES
See the back of this worksheet.

Transfer the capital gain to **part A1** of the *CGT summary worksheet*, except for a capital gain from collectables which is transferred to **part A2** of that worksheet.

HOW TO CALCULATE A CAPITAL LOSS

Generally, you make a capital loss if your reduced cost base is greater than your capital proceeds. The excess is your capital loss.

EXAMPLE

Antonio acquired a new income-producing asset on 28 September 1999 for \$100,000, including stamp duty and legal costs. He sold it for \$90,000 in November 2005. During the period he owned it, he was allowed capital works deductions of \$7,500. Antonio works out his capital loss as follows.

| | |
|--------------------------------|----------------|
| Cost base | \$100,000 |
| /less capital works deductions | \$7,500 |
| Reduced cost base | \$92,500 |
| /less capital proceeds | \$90,000 |
| Capital loss | \$2,500 |

EXAMPLE

In July 1996, Chandra bought 800 shares at \$3 per share. He incurred brokerage and stamp duty of \$100. In December 2005, Chandra sold all 800 shares for \$2.50 per share. He incurred brokerage of \$75. He made a capital loss, calculated as follows.

CALCULATION OF REDUCED COST BASE

| Date expense incurred | Description of expense | Expense |
|-----------------------|-----------------------------|---------|
| July 1996 | Purchase price | \$2,400 |
| July 1996 | Brokers fees and stamp duty | \$100 |
| December 2005 | Brokers fees | \$75 |
| Reduced cost base | | \$2,575 |

CALCULATION OF CAPITAL LOSS

| | |
|--------------------------------------|---------|
| Reduced cost base | \$2,575 |
| Capital proceeds $800 \times \$2.50$ | \$2,000 |
| Capital loss | \$575 |

However, the reduced cost base is not relevant for some types of CGT events. In these cases, the particular CGT event explains the amounts to use (see appendix 1).



REDUCED COST BASE

You cannot index a reduced cost base.

You must keep records of everything that affects your capital gains and capital losses. There are penalties if you do not keep the records for at least five years after the relevant capital gains tax (CGT) event.

Keeping adequate records of all expenditure will help you correctly work out the amount of capital gain or capital loss you have made when a CGT event happens. It will also help to make sure you do not pay more CGT than is necessary. You should also keep records relevant to a net capital loss that you carry forward as part of unapplied net capital losses. You may be able to apply this net capital loss against a capital gain in a later year.

Keeping good records can help your beneficiaries reduce the impact of CGT after you die. If you leave an asset to another person, the asset may be subject to CGT when a CGT event happens to that asset in the future – for example, if your daughter (the beneficiary) sells the shares (the asset) you have left her in your will.

WHAT RECORDS DO YOU NEED TO KEEP?

You must keep records of every act, transaction, event or circumstance that may be relevant to working out whether you have made a capital gain or capital loss from a CGT event. It does not matter whether the CGT event has already happened or whether it may happen.

The records must be in English (or be readily accessible or translatable into English) and must show:

- the nature of the act, transaction, event or circumstance
- the day it happened
- who did the act or who were the parties to the transaction, and
- how the act, transaction, event or circumstance is relevant to working out the capital gain or capital loss.

The following are examples of records you may need to keep:

- receipts of purchase or transfer
- details of interest on money you borrowed relating to this asset
- records of agent, accountant, legal and advertising costs
- receipts for insurance costs, rates and land taxes
- any market valuations
- receipts for the cost of maintenance, repairs and modifications, and
- accounts showing brokerage on shares.

You should also keep records to establish whether you have claimed an income tax deduction for an item of expenditure. In many cases, if you have claimed a deduction for an amount it cannot be taken into account for CGT purposes.

Records relating to real estate

Real estate can include the family home, vacant blocks of land, business premises, rental properties, holiday houses and hobby farms.

Even though your family home is usually exempt, if you acquired it on or after 20 September 1985 try to keep all records relating to the home, just as you would for other items of real estate. If the home ceases to be fully exempt at some time in the future, you will need to know the full cost of the home so that you do not pay more CGT than necessary. If you do not have sufficient records, reconstructing them later could be difficult. See chapter 6 for details of when your home may not be fully exempt.

Keep a copy of the purchase contract and all receipts for expenses relating to the purchase of the property – for example, stamp duty, legal fees, survey and valuation fees. Also keep all records relating to the CGT event and all relevant expenses – for example, the sale contract and records of legal fees and stamp duty.

Keep a record of capital expenditure on improvements, costs of owning the property and capital expenditure on maintaining title or right to it that you incurred during your period of ownership. These costs may form part of the cost base in working out whether you have made a capital gain or capital loss at the time the CGT event happens.

Capital expenditure on improvements may include building an extension, addition or improvement, including initial repairs.

Examples of costs of owning real estate include interest, rates and land taxes, insurance premiums and cost of repairs – for example, replacing broken items. You only include such costs if you acquired the CGT asset on or after 21 August 1991 and if you have not claimed, and cannot claim, a tax deduction for them.

If the property is your home and you use it to produce income (for example, by renting out part or all of it), you will need to keep records of the period the home is producing income and the proportion of the home you have used to produce income.

If, after 20 August 1996, you use your home for income-producing purposes for the first time, you will be taken to have acquired your home at that time for its market value. You will use this as your acquisition cost for the purpose of calculating a capital gain or capital loss at the time the CGT event happens. You will still need to keep details of expenses relating to your home after the date that it started producing income.

Records relating to shares in companies and units in unit trusts

Most of the records you need to keep to work out your CGT when you dispose of shares in companies or units in unit trusts (including managed funds) will be given to you by the company, the unit trust manager or your stockbroker. It is important for you to keep everything they give you on your shares and units.

These records will generally provide the following important information:

- the date of purchase of the shares or units
- the amount paid to purchase the shares or units
- details of any non-assessable payments made to you during the time you owned the shares or units
- the date and amount of any calls if shares were partly paid
- the sale price if you sell them, and
- any commissions paid to brokers when you buy or sell them.

There are special CGT rules for certain shares and units which may affect the records you keep – for example, bonus shares and units, rights and options, and employee shares. See chapter 5 for more information.

Records relating to bonus shares

To be safe, if you have received any bonus shares on or after 20 September 1985, keep all the documents the company gives you.

For any bonus shares issued before 1 July 1987, you need to know when the original shares were acquired. If you acquired them on or after 20 September 1985, you will also need to know what they cost. Flowchart 1 in appendix 3 summarises the different rules applying to the treatment of bonus shares.

Keep a record of any amounts you paid to acquire the bonus shares and any amounts taxed as a dividend when they were issued.

Records relating to inheriting an asset

When you inherit an asset as a beneficiary of the estate of a person who died on or after 20 September 1985, you may need to obtain information from the executor or trustee.

If the deceased person acquired the asset before 20 September 1985, you need to know the market value of the asset at the date of the person's death and the amount of any relevant costs incurred by the executor or trustee. This is the amount that the asset is taken to have cost you. If the executor or trustee has a valuation of the asset, get a copy of that valuation report. Otherwise you will need to get your own valuation.

If the asset you inherit was acquired by the deceased person on or after 20 September 1985, you need to know full details of all relevant costs incurred by the deceased person and by the executor or trustee. Get those details from the executor or trustee.

Inheriting a main residence

If you inherit a house that was the deceased's main residence, any capital gain on its subsequent disposal may be exempt. However, until this is known, you should keep records of relevant costs incurred by you, the deceased or their trustee or executor.

You will not need to keep records of the deceased's costs if:

- you inherited the house after 20 August 1996
- the house was the deceased's main residence just before they died, and
- the house was not being used to produce income at the time of death.

In those circumstances, you will be taken to have acquired the house at its market value at the date of death. If the executor or trustee has a valuation of the asset, get a copy of that valuation report. Otherwise you will need to get your own valuation.

ASSET REGISTERS


You can choose to enter information from your CGT records into an asset register. If you keep an asset register, you may be able to discard records that you might otherwise need to keep for a long time.

If you choose to keep an asset register, transfer the following information to it from the records you generally need to keep for CGT purposes:

- the date the asset was acquired
- the cost of the asset
- a description, amount and date for each cost associated with the purchase of the asset (for example, stamp duty and legal fees)
- the date the CGT event happened to the asset, and
- the capital proceeds received when the CGT event happened.

This information must be certified by a registered tax agent or a person approved by the Commissioner of Taxation – for more information on who can approve, see *Taxation Ruling TR 2002/10 – Capital gains tax: asset register*, available on our website.

If you use an asset register, you must keep the documents from which you have transferred the information for five years from the date the relevant asset register entry is certified. You must keep the asset register entries for five years from the date the related CGT event happens. Keep the asset register for a longer period if you need to substantiate any carried forward net capital losses – for five years after any CGT event where you have applied any capital loss against capital gains.

 For more information about asset registers, see *Taxation Ruling TR 2002/10 – Capital gains tax: asset register*, available on our website.

EXCEPTIONS

You do not need to keep records if, for any CGT event, a capital gain or capital loss is disregarded. For example, you do not need to keep records for a motor vehicle as it is an exempt asset.

IT IS NEVER TOO LATE

If you acquired assets on or after 20 September 1985 and did not keep records, or your records have inadvertently been destroyed, you can still do something about it.

If you bought real estate, your solicitor or real estate agent may have copies of most of the records you need. You should be able to get copies if you ask for them.

If you made improvements to an investment property – for example, if you built an extension – ask for a copy of the builder's receipt for payment.

If you bought shares in a company or units in a unit trust, your stockbroker or investment adviser may be able to give you the information you need.

If you receive an asset as a gift and you did not get a market valuation at the time, a professional valuer can tell you what its market value was at the relevant date.

The main thing is to get as many details as possible so you can reconstruct your records. Make sure you keep sufficient records in the future.

This chapter explains how distributions from trusts (including managed funds) can affect your capital gains tax (CGT) position. Managed funds include property trusts, share trusts, equity trusts, growth trusts, imputation trusts and balanced trusts.

Distributions from trusts can include different amounts but the following two types of amounts are relevant for CGT purposes:

- capital gains, and
- non-assessable payments.

Distributions of trust capital gains are treated as capital gains that you have made.

Non-assessable payments mostly affect the cost base of units in a unit trust (including managed funds) but can in some cases create a capital gain. Non-assessable payments do not affect beneficiaries of a discretionary trust.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

Trustees, including fund managers, may use different terms to describe the methods of calculation and other terms used in this guide. For example, they may use the term 'non-discount gains' when they refer to capital gains worked out using the indexation and 'other' methods.

CAPITAL GAINS MADE BY A TRUST

STEP 1

Exclude net capital gains from trust income item

If you are a beneficiary of a trust, you may be entitled to (or may have received) a share of the net income of the trust which includes some of the trust's net capital gain. In this case, you do not include your share of the trust's net capital gain at item **12 Partnerships and trusts** on your tax return (supplementary section). Instead, you are treated as having a capital gain (or capital gains) worked out in the way explained in step 2.

! ITEM 12 ON TAX RETURN FOR INDIVIDUALS (SUPPLEMENTARY SECTION)

Question **12** in *TaxPack 2006 supplement* asks you to exclude net capital gains from the amount of trust income shown at **U** item **12** on your tax return (supplementary section). In your distribution statement, the trust should state the amount(s) of capital gain in your trust distribution.

If your statement shows that your share of the trust's net capital gain is more than the overall net amount of your share of the trust's net income, do **not** exclude all the capital gain component when you complete item **12** on your tax return (supplementary section). This is an exception to the instruction for item **12** that tells you not to include capital gains there. In this situation, you exclude instead only the overall net amount of your share of trust income. You also use only this lesser amount in working out your capital gains.

EXAMPLE: Capital gain greater than share of trust net income

Debra's trust distribution shows that she received \$2,000 as her share of the net income of a trust.

This is made up of a primary production loss of \$5,000, non-primary production income of \$2,000 and a net capital gain of \$5,000.

At item **12** on her tax return (supplementary section), Debra will show \$5,000 loss from primary production at **L** and \$5,000 non-primary production income at **U** (that is, \$2,000 non-primary production income plus sufficient net capital gain [\$3,000] to offset the loss from primary production).

Debra takes her remaining \$2,000 net capital gain (\$5,000 – \$3,000) from the trust into account in working out her net capital gain at **A** item **17** on her tax return (supplementary section).

STEP 2

Capital gain you are taken to have made

If you are a beneficiary who is entitled to a share of a trust's net capital gain you are taken to have made extra capital gains in addition to those you have made from CGT events.

The trustee may have advised you what your share is or you may need to contact them to obtain details.

Investors in managed funds and other unit trusts

If you are a unit holder in a managed fund and have received a distribution from a trust that includes a capital gain, you take that amount into account in working out your net capital gain for the year.

Trust distributions to which the CGT discount or the small business 50% active asset reduction apply

You may be a beneficiary who is entitled to a share of the income of a trust that includes a net capital gain reduced by the CGT discount or the small business 50% active asset reduction. In this case, you need to **gross up** the capital gain by multiplying it by two. This grossed-up amount is an extra capital gain.

You multiply by four your share of any part of the net capital gain from a trust that the trust has reduced by both the CGT discount and the small business 50% active asset reduction. This grossed-up amount is an extra capital gain.

If you are entitled to any part of the net capital gain from a trust that the trust has not reduced by one of these concessions, that amount is an extra capital gain.

! NO DOUBLE TAXATION

You are not taxed twice on these extra capital gains because you did not include your capital gains from the trust at item **12** on your tax return (supplementary section). You can apply the CGT discount to trust gains calculated using the discount method after you have applied your capital losses.

These extra capital gains are taken into account in working out your net capital gain for the income year. You include them at step 2 in **part B** or **part C**.

If you are a unit holder in a managed fund, the trustee or manager will generally advise you of your share of the trust's net capital gain, together with details of your share of any other income distributed to you.

In other cases, the trustee may inform you or you may need to contact them to obtain details.

EXAMPLE: Distribution where the trust claimed concessions

Serge is a beneficiary in the Shadows Unit Trust. He receives a distribution of \$2,000 from the trust. This distribution includes \$250 of net income remaining after a \$1,000 capital gain made by the trustee was reduced by the CGT discount and the small business 50% active asset reduction.

Serge has also made a capital loss of \$100 from the sale of shares.

He calculates his net capital gain as follows:

| | |
|--|--------------|
| Gross up the share of the trust's net capital gain (\$250) by multiplying by 4 | \$1,000 |
| Deduct capital losses | \$100 |
| Capital gains before applying discounts | \$900 |
| Apply the CGT discount of 50% | \$450 |
| Apply the 50% active asset reduction | \$225 |
| Net capital gain | \$225 |

Serge will show \$1,000 at **H** item **17** on his tax return (supplementary section), which is his total current year capital gain. His net capital gain to be shown at **A** item **17** on his tax return (supplementary section) is \$225. He will show a trust distribution of \$1,750 (\$2,000 – \$250) at **U** item **12** on his tax return (supplementary section).

! APPLYING THE CONCESSIONS

Remember that you must use the same method as the trust to calculate your capital gain.

This means you cannot apply the CGT discount to capital gains distributed to you from the trust calculated using the indexation method or 'other' method.

Also, you can only apply the small business 50% active asset reduction to grossed-up capital gains to which the trust applied that concession.

NON-ASSESSABLE PAYMENTS FROM A TRUST

Trusts often make non-assessable payments to beneficiaries.

If a profit made by the trust is not assessable, any part of that profit distributed to a beneficiary will also be non-assessable in most cases – for example, a share of a profit made on the sale of property acquired by the trust before 20 September 1985.

However, if you receive non-assessable payments from a trust, you may need to make cost base adjustments to your units or trust interest. Those adjustments will affect the amount of any capital gain or capital loss you make on the unit or interest (for example, when you sell it). If certain amounts exceed your cost base, you may also make a capital gain equal to that excess in the year it is paid to you.

! NOTE

As a result of recent stapling arrangements, some investors in managed funds have received units which have a very low cost base. The payment of certain non-assessable amounts in excess of the cost base of the units will result in these investors making a capital gain.

! NON-ASSESSABLE PAYMENTS UNDER A DEMERGER

If you receive a non-assessable payment under an eligible demerger, you do not deduct the payment from the cost base and the reduced cost base of your units or trust interest. Instead you adjust your cost base and reduced cost base according to the demerger rules.

You may make a capital gain on the non-assessable payment if it exceeds the cost base of your original unit or trust interest, although you will be able to choose CGT rollover.

An eligible demerger is one that happens on or after 1 July 2002 and satisfies certain tests. The trust making the non-assessable payment will normally advise unit or trust interest holders if this is the case.

For more information about demergers, see chapter 5.

! CAPITAL LOSS

You cannot make a capital loss from a non-assessable payment.

The cost base adjustments you need to make (if any) depend on the category of non-assessable payment you receive.

Non-assessable payments may be shown on your distribution statement as:

- **tax-exempted amounts** – generally made up of exempt income and non-assessable non-exempt income of the trust, amounts on which the trust has already paid tax or income you had to repay to the trust
- **tax-free amounts** – where certain tax concessions allowed to the trust mean it can pay greater distributions to its unit holders
- **tax-deferred amounts** – other non-assessable payments, including indexation allowed to the trust on its capital gains and accounting differences in income, or
- **CGT-concession amounts** – the trust's CGT discount and capital losses components of any actual distribution.

Tax-exempted amounts do not affect your cost base and reduced cost base. However, if your statement shows any tax-deferred or tax-free amounts, you adjust the cost base and reduced cost base as follows:

- cost base – deduct the tax-deferred amounts from the cost base
- reduced cost base – deduct both the tax-deferred amounts and the tax-free amounts.

Before 1 July 2001, a payment of an amount associated with building allowances was treated as a tax-free amount. Payments on or after that date are treated as tax-deferred amounts.

A CGT-concession amount received before 1 July 2001 was treated in the same way as a tax-deferred amount. However, from this date, CGT-concession amounts no longer require a cost base and reduced cost base adjustment.

Generally, you make any adjustment to the cost base and reduced cost base of your unit or trust interest at the end of the income year. However, if some other CGT event happens to the unit or trust interest during the year (for example, you sell your units) you must adjust the cost base and reduced cost base just before the time of that CGT event. The amount of the adjustment is based on the amount of non-assessable payments paid to you up to the date of sale. You use the adjusted cost base and reduced cost base to work out your capital gain or capital loss (see chapter 2 for more information).

The cost base and reduced cost base adjustments are more complex if you deducted capital losses from a grossed-up capital gain where a capital gain made by the trust was reduced by the small business 50% active asset reduction. If this applies to you, you may need to seek advice from the Tax Office on how to make the adjustments.

If the tax-deferred amount is greater than the cost base of your unit or trust interest, you include the excess as a capital gain. You can use the indexation method if you bought your units or trust interest before 11.45am (by legal time in the ACT) on 21 September 1999. However, if you do so, you cannot use the discount method to work out your capital gain when you later sell the units or trust interest.

EXAMPLE: Bob has received a non-assessable amount

Bob owns units in OZ Investments Fund which distributed income to him for the year ending 30 June 2006. The fund gave him a statement showing his distribution included the following capital gains:

- \$100 calculated using the discount method (grossed-up amount \$200)
- \$75 calculated using the indexation method, and
- \$28 calculated using the 'other' method.

These capital gains add up to \$203.

The statement shows Bob's distribution did not include a tax-free amount but it did include:

- \$105 tax-deferred amount.

From his records, Bob knows that the cost base and reduced cost base of his units are \$1,200 and \$1,050 respectively.

Bob has no other capital gains or capital losses for the 2005–06 income year and no unapplied net capital losses from earlier years.

Bob follows these steps to work out the amounts to show on his tax return.

As Bob has a capital gain which the fund reduced under the CGT discount of 50% (\$100), he includes the grossed-up amount (\$200) in his total current year capital gains.

Bob adds the grossed-up amount to his capital gains calculated using the indexation method and 'other' method to work out his total current year capital gains:

$$\$200 + \$75 + \$28 = \$303$$

As Bob has no other capital gains or capital losses, and he must use the discount method for the capital gains calculated using the discount method from the trust, his net capital gain is equal to the amount of capital gain included in his distribution from the fund (\$203).

Bob completes item 17 on his tax return (supplementary section) as follows:

| | | | | |
|-------------------------|--|---|--|---|
| 17 Capital gains | Did you have a capital gains tax event during the year? | G NO <input type="checkbox"/> | YES <input checked="" type="checkbox"/> | You must also print <input checked="" type="checkbox"/> in the YES box at G if you received a distribution of a capital gain from a trust. |
| | Net capital gain A <input type="text" value="203"/> | | | |
| | Total current year capital gains H <input type="text" value="303"/> | Net capital losses carried forward to later income years V <input type="text" value="00"/> | | |

Records Bob needs to keep

The tax-deferred amount Bob received is not included in his income or his capital gains but it affects the cost base and reduced cost base of his units in OZ Investments Fund for future income years.

Bob deducts the tax-deferred amount from both the cost base and reduced cost base of his units as follows:

| | |
|------------------------------|----------------|
| Cost base | \$1,200 |
| less tax-deferred amount | \$105 |
| New cost base | \$1,095 |
| Reduced cost base | \$1,050 |
| less tax-deferred amount | \$105 |
| New reduced cost base | \$945 |

EXAMPLE: Ilena's capital loss is greater than her non-discounted capital gain

Ilena invested in XYZ Managed Fund. The fund made a distribution to Ilena for the year ending 30 June 2006 and gave her a statement that shows her distribution included:

- \$65 **discounted capital gain**, and
- \$90 non-discounted capital gain.

The statement shows Ilena's distribution also included:

- \$30 tax-deferred amount, and
- \$35 tax-free amount.

Ilena has no other capital gains but made a capital loss of \$100 on some shares she sold during the year. Ilena has no unapplied net capital losses from earlier years.

From her records, Ilena knows the cost base and reduced cost base of her units are \$5,000 and \$4,700 respectively.

Ilena has to treat the capital gain component of her fund distribution as if she made the capital gain. To complete her tax return, Ilena must identify the capital gain component of her fund distribution and work out her net capital gain.

Ilena follows these steps to work out the amount to show at **H** item 17 on her tax return (supplementary section).

As Ilena has a \$65 capital gain which the fund reduced by the CGT discount of 50%, she must gross up the capital gain. She does this by multiplying the amount of the discounted capital gain by two:

$$\$65 \times 2 = \$130$$

Ilena adds her grossed-up and non-discounted capital gains to work out her total current year capital gains:

$$\$130 + \$90 = \$220$$

She shows her total current year capital gains (\$220) at **H** item 17 on her tax return (supplementary section).

After Ilena has grossed up the discounted capital gain received from the fund, she subtracts her capital losses from her capital gains.

Ilena can choose which capital gains she subtracts the capital losses from first. In her case, she gets the better result if she:

- 1 subtracts as much as possible of her capital losses (which were \$100) from her non-discounted capital gains (\$90).

$$\$90 - \$90 = \$0 \text{ (non-discounted capital gains)}$$

- 2 subtracts her remaining capital losses after step 1 (\$10) from her discounted capital gains (\$130).

$$\$130 - \$10 = \$120 \text{ (discounted capital gains)}$$

- 3 applies the CGT discount to her remaining discounted capital gains:

$$(\$120 \times 50\%) = \$60 \text{ (discounted capital gains)}$$

Finally, Ilena adds up the capital gains remaining to arrive at her net capital gain:

$$\begin{aligned} &\$0 \text{ (non-discounted)} + \$60 \text{ (discounted)} \\ &= \$60 \text{ net capital gain.} \end{aligned}$$

Ilena completes item 17 on her tax return (supplementary section) follows:

| | | |
|-------------------------|--|---|
| 17 Capital gains | Did you have a capital gains tax event during the year? G NO <input type="checkbox"/> YES <input checked="" type="checkbox"/> | You must also print <input checked="" type="checkbox"/> in the YES box at G if you received a distribution of a capital gain from a trust. |
| | Net capital gain A <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> | |
| | Total current year capital gains H <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> | |
| | Net capital losses carried forward to later income years V <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> <input type="text"/> | |

Records Ilena needs to keep

The tax-deferred and tax-free amounts Ilena received are not included in her income or her capital gain but the tax-deferred amount affects the cost base and reduced cost base of her units in XYZ Managed Fund for future income years. The tax-free amount affects her reduced cost base.

Ilena reduces the cost base and reduced cost base of her units as follows:

| | |
|---|----------------|
| Cost base | \$5,000 |
| less tax-deferred amount | \$30 |
| New cost base | \$4,970 |
| Reduced cost base | \$4,700 |
| less (tax-deferred amount + tax-free amount) (\$30 + \$35) | \$65 |
| New reduced cost base | \$4,635 |

This chapter explains your capital gains tax (CGT) obligations if you sold or otherwise disposed of any shares or units in a unit trust (including a managed fund) in 2005–06. It also explains what happens when you have a CGT event under a demerger. For information about distributions from a unit trust (other than under a demerger) in 2005–06, see chapter 4.

! MANAGED FUND

A managed fund is a unit trust. Where we refer to a unit trust in this guide we are also referring to a managed fund.

! SOME MAJOR SHARE TRANSACTIONS

For information about some major share transactions, see appendix 4.

HOW CAPITAL GAINS TAX AFFECTS SHARES AND UNITS

For CGT purposes, shares in a company or units in a unit trust are treated in the same way as any other assets.

As a general rule, if you acquire any shares or units on or after 20 September 1985, you may have to pay tax on any capital gain you make when a CGT event happens to them. This would usually be when you sell or otherwise dispose of them. It also includes where you redeem units in a managed fund by switching them from one fund to another. In these cases, CGT event A1 happens. There is a list of all CGT events at appendix 1.

Profits on the sale of shares held in carrying on a business of share trading are included as ordinary income rather than as capital gains. For more information, see the fact sheet *Carrying on a business of share trading*, available on our website.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

A CGT event might happen to shares even if a change in their ownership is involuntary – for example, if the company in which you hold shares is taken over or merges with another company. This may result in a capital gain or capital loss.

This chapter also deals with the receipt of non-assessable payments from a company (CGT event G1) while chapter 4 deals with non-assessable payments from a trust (CGT event E4). If you own shares in a company that has been placed in liquidation or administration, CGT event G3

explains how you can choose to make a capital loss when the liquidator or administrator declares the shares (or other financial instruments) worthless.

There are a number of special CGT rules if you receive such things as bonus shares, **bonus units**, rights, options or non-assessable payments from a company or trust. Special rules also apply if you buy convertible notes or participate in an **employee share scheme** or a dividend reinvestment plan.

The rest of this chapter explains these rules and has examples showing how they work in practice. The flowcharts at appendix 3 will also help you work out whether the special rules apply to you.

➤ If you need more information about how other income tax provisions affect your share investments, see *You and your shares 2006* (NAT 2632–6.2006).

IDENTIFYING SHARES OR UNITS SOLD

Sometimes taxpayers own shares or units that they may have acquired at different times. This can happen as people decide to increase their investment in a particular company or unit trust. A common question people ask when they dispose of only part of their investment is how to identify the particular shares or units they have disposed of.

This can be very important because shares or units bought at different times may have different amounts included in their cost. In calculating the capital gain or capital loss when disposing of only part of an investment, you need to be able to identify which ones you have disposed of. Also, when you dispose of any shares or units you acquired before 20 September 1985, any capital gain or capital loss you make is generally disregarded.

If you have the relevant records (for example, share certificates), you may be able to identify which particular shares or units you have disposed of. In other cases, the Commissioner of Taxation will accept your selection of the identity of shares disposed of.

Alternatively, you may wish to use a ‘first in, first out’ basis where you treat the first shares or units you bought as being the first you disposed of.

In limited circumstances, the Tax Office will also accept an average cost method to determine the cost of the shares disposed of. You can only use this average cost method when:

- the shares are in the same company
- the shares are acquired on the same day
- the shares have identical rights and obligations, and
- you are not required to use market value for cost base purposes.

EXAMPLE: Identifying when shares or units were acquired

Boris bought 1,000 shares in WOA Ltd on 1 July 1997. He bought another 3,000 shares in the company on 1 July 2002.

In December 2002, WOA Ltd issued Boris with a CHES statement for his 4,000 shares. When he sold 1,500 of the shares on 1 January 2006, he was not sure whether they were the shares he bought in 2002 or whether they included the shares bought in 1997.

Because Boris could not identify when he bought the particular shares he sold, he decided to use the 'first in, first out' method and nominated the 1,000 shares bought in 1997 plus 500 of the shares bought in 2002.

DEMUTUALISATION OF INSURANCE COMPANIES

If you hold a policy in an insurance company that **demutualises**, you may be subject to CGT either at the time of the demutualisation or when you sell your shares (or another CGT event happens). A company demutualises when it changes its membership interests to shares (for example, AMP, IOOF and NRMA). There are similar rules if you are a member of a non-insurance organisation which demutualises.

The insurance company may give you an option either to keep your share entitlement or to take cash by selling the shares under contract through an entity set up by the company.

If it is an Australian insurance company and you choose to keep the shares, you will not be subject to CGT until you sell them or another CGT event happens. If you elect to sell your share entitlement to the company and take cash, you need to include any capital gain on your tax return in the income year in which you entered into the contract to sell the shares, even though you may not receive the cash until a later income year.

The demutualising company will write to all potential 'shareholders' and advise them of the acquisition cost in each instance, sometimes referred to as the 'embedded value'. Even though you did not pay anything to acquire the shares, they have a value that is used as the cost base and reduced cost base for CGT purposes.

If you sell your shares before the insurance company is listed on the stock exchange and you make a capital loss, you disregard the loss.

If you hold a policy in an overseas insurance company that demutualises, you may be subject to CGT at the time of the demutualisation. You should contact the Tax Office for advice if this applies to you.

SHARE BUY-BACKS

As a shareholder, you may have received an offer from a company to buy back some or all of your shares in the company. If you disposed of shares back to the company under a **share buy-back** arrangement, you may have made a capital gain or capital loss from that CGT event.

You compare the capital proceeds with your cost base and reduced cost base to work out whether you have made a capital gain or capital loss.

The time you make the capital gain or capital loss will depend on the conditions of the particular buy-back offer. It may be the time you lodge your application to participate in the buy-back or, if it is a conditional offer of buy-back, the time you accept the offer.

If shares in a company:

- are not bought back by the company in the ordinary course of business of a stock exchange – for example, the company writes to shareholders offering to buy their shares (commonly referred to as 'off-market share buy-back'), and
- the buy-back price is less than what the market value of the share would have been if the buy-back hadn't occurred and was never proposed

the capital proceeds are taken to be the market value the share would have been (if the buy-back hadn't occurred and was never proposed) *minus* the amount of any dividend paid under the buy-back. In this situation, the company may provide you with that market value or, if the company obtained a class ruling from the Tax Office, you can find out the amount by visiting our website at www.ato.gov.au.

Under other off-market buy-backs where a dividend is paid as part of the buy-back, the amount paid excluding the dividend is your capital proceeds for the share.

EXAMPLE: Buy-back

Sam bought 4,500 shares in Company A in January 1994 at a cost of \$5 per share. In February 2006, Sam applied to participate in a buy-back offer to dispose of 675 shares (15%). Company A approved a buy-back of 10% (450) of the shares on 15 June 2006. The company sent Sam a cheque on 5 July 2006 for \$4,050 (450 shares × \$9). No part of the payment is a dividend.

Sam works out his capital gain for 2005–06 as follows.

If he chooses to use the indexation method:

| | |
|--|----------------|
| Capital proceeds | \$4,050 |
| Cost base 450 shares × \$5 ($\$2,250 \times 1.118$ including indexation) | \$2,515 |
| Capital gain | \$1,535 |

If he chooses to use the discount method:

| | |
|--|----------------|
| Capital proceeds | \$4,050 |
| Cost base | \$2,250 |
| Capital gain (before applying any discount) | \$1,800 |

Sam has no capital losses to apply against this capital gain and decides that the discount method will provide him with the better result. He takes \$900 ($\$1,800 \times 50\%$) into account in working out his net capital gain for the year.

EXAMPLE: Off-market buy-back including dividend

Ranjini bought 10,000 shares in Company M in January 2003 at a cost of \$6 per share, including brokerage.

In January 2006, the company wrote to its shareholders advising them it was offering to buy-back 10% of their shares for \$9.60 each. The buy-back price was to include a franked dividend of \$1.40 per share (and each dividend was to carry a franking credit of \$0.60).

Ranjini applied to participate in the buy-back to sell 1,000 of her shares.

Company M approved the buy-back on 1 May 2006 on the terms anticipated in its earlier letter to shareholders.

The market value of Company M shares at the time of the buy-back (if the buy-back did not occur and was never proposed) is \$10.20.

Ranjini received a cheque for \$9,600 (1,000 shares × \$9.60) on 8 June 2006.

Because it was an off-market share buy-back and the buy-back price was less than what the market value of the share would have been if the buy-back hadn't occurred, Ranjini works out her capital gain for 2005–06 as follows.

Capital proceeds:

| | | |
|---|-----------------------|---------|
| Market value | \$10.20 | |
| less Dividend | \$1.40 | |
| | \$8.80 × 1,000 shares | \$8,800 |
| Cost base: | \$6 × 1,000 shares | \$6,000 |
| Capital gain (before applying any discount) | | \$2,800 |

Ranjini takes her capital gain into account in completing item **17** on her tax return (supplementary section). She also includes her dividend at item **11** on her tax return (\$1,400 at **T** and \$600 at **U**).

SHARES IN A COMPANY IN LIQUIDATION OR ADMINISTRATION

If a company is placed in liquidation or administration, company law restricts the transfer of shares in the company. This means that, in the absence of special CGT rules, you may not be able to realise a capital loss on shares that have become worthless unless you declare a trust over them.

In certain circumstances, you can choose to realise a capital loss on worthless shares before dissolution (if you acquired the shares on or after 20 September 1985). This

applies if you own shares in a company and a liquidator declares in writing that there is no likelihood you will receive any further distribution in the course of winding up the company. The liquidator's declaration can still be made after you receive a distribution during the winding-up.

The law (CGT event G3) has been changed so that you can now choose to make a capital loss if a company administrator declares in writing after 21 March 2005 that shares are worthless. Under the changes, financial instruments relating to a company (not just shares) can also be declared worthless by a liquidator or administrator after 21 March 2005.

Financial instruments include (but are not limited to) convertible notes, debentures, bonds, promissory notes, loans to the company, futures contracts, forward contracts and currency swap contracts relating to the company, and rights or options to acquire any of these (including rights or options to acquire shares in a company). Many financial instruments may be referred to as securities.

If you make this choice, you will make a capital loss equal to the reduced cost base of the shares (or financial instruments) at the time of the liquidator's or administrator's declaration. The cost base and reduced cost base of the shares (or financial instruments) are reduced to nil just after the liquidator or administrator makes the declaration.

These rules do not apply:

- to a financial instrument where any profit made on the disposal or redemption of it would be included in your assessable income or any loss would be deductible – such as a traditional security or qualifying security
- to a right acquired under an employee share scheme
- to a share acquired under an employee share scheme if it is a qualifying share, you did not make a section 139E election in relation to the share under the employee share rules, and the declaration by the liquidator or administrator was made no later than 30 days after the 'cessation time' for the share (for more information about employee share schemes, see *Employee share schemes – answers to frequently asked questions by employees*, available on our website), or
- to units in unit trusts or financial instruments relating to trusts.

➤ For general information about capital losses on worthless shares and a list of declarations made in relation to major companies in the last three years, see our fact sheet *Shares and securities that become worthless*, available on our website. For more detailed information, see our fact sheet *Worthless shares and financial instruments relating to a company*, also available on our website.

EXAMPLE: Liquidator's declaration that shares are worthless

The administrators of Pasminco Ltd made a written declaration on 31 March 2005 that they had reasonable grounds to believe that there was no likelihood that the shareholders of Pasminco would receive any distribution from their shares.

Hillary purchased shares in Pasminco Ltd in March 1998 for \$1.70, including brokerage costs. Following the administrators' declaration, Hillary chose to make capital losses equal to the reduced cost bases of her shares as at 31 March 2005. She claimed the capital losses in her 2005 tax return.

If no declaration is made by a liquidator or administrator or you have not chosen to make a capital loss following a declaration by a liquidator or administrator (for information about when and how you make a choice, see **Choices** on page 17), you may make a capital loss on your shares or financial instruments when a court order is given to dissolve the company. Also, if a company is wound up voluntarily, shareholders may realise a capital loss either three months after a liquidator lodges a tax return showing that the final meeting of the company has been held, or on another date declared by a court. The cancellation of shares as a result of the dissolution of the company is an example of CGT event C2.

TAKEOVERS AND MERGERS

If a company in which you own shares is **taken over or merges** with another company, you may have a CGT obligation if you are required to dispose of your existing shares or they are cancelled.

In certain circumstances, if you acquire new shares in the takeover or merged company, you may be able to defer paying CGT until a later CGT event happens. For more information, see **Scrip-for-scrip rollover** in the next column.

Some takeover or merger arrangements involve an exchange of shares. In these cases, when you calculate your capital gain or capital loss, your capital proceeds will be the market value of the shares received in the takeover or merged company at the time of disposal of your original shares.

If you receive a combination of money and shares in the takeover or merged company, your capital proceeds are the total of the money and the market value of the shares you received at the time of disposal of the shares.

The cost of acquiring the shares in the takeover or merged company is the market value of your original shares at the time you acquire the other shares, reduced by any cash proceeds.

To correctly calculate the capital gain or capital loss for your original shares, you will need to keep records (in addition to the usual records) showing the parties to the arrangement, the conditions of the arrangement and the capital proceeds.

As each takeover or merger arrangement will vary according to its own particular circumstances, you need to get full details of the arrangement from the parties involved.

EXAMPLE: Takeover

We are assuming with this example that **scrip-for-scrip rollover** does not apply (see below).

In October 2000, Desiree bought 500 shares in ABC Ltd. These shares are currently worth \$2 each. Their cost base is \$1.50.

XYZ Ltd offers to acquire each share in ABC Ltd for one share in XYZ Ltd and 75 cents cash. The shares in XYZ Ltd are valued at \$1.25 each. Accepting the offer, Desiree receives 500 shares in XYZ Ltd and \$375 cash.

The capital proceeds received for each share in ABC Ltd is \$2 (\$1.25 market value of each XYZ Ltd share plus 75 cents cash). Therefore, as the cost base of each ABC Ltd share is \$1.50, Desiree will make a capital gain of 50 cents (\$2 – \$1.50) on each share, a total of \$250.

The cost base of the newly acquired XYZ Ltd shares is the market value of the shares in ABC Ltd (\$2) less the cash amount received (\$0.75) – that is, \$1.25 each or a total of \$625 (500 × \$1.25).

SCRIP-FOR-SCRIP ROLLOVER

If a company in which you owned shares was taken over and you received new shares in the takeover company, you may be entitled to scrip-for-scrip rollover. You may also be eligible for this rollover if you exchange a unit or other interest in a fixed trust, for a similar interest in another fixed trust.

Scrip-for-scrip rollover is not available if a share is exchanged for a unit or other interest in a fixed trust, or if a unit or other interest in a fixed trust is exchanged for a share.

You can only choose the rollover if you have made a capital gain from such an exchange on or after 10 December 1999. Rollover does not apply to a capital loss.

Rollover is only available if the exchange is in consequence of an arrangement that results in the acquiring entity (or the wholly owned group of which it is a member) becoming the owner of 80% or more of the original company or trust.

For companies, the arrangement must be one in which all owners of voting shares in the original entity can participate. For trusts, this means all owners of trust voting interests in the original entity or, if there are no voting interests, all owners of units or other fixed interests can participate.

There are special rules if a company or trust has a small number of shareholders or beneficiaries or there is a significant common stakeholder. If the company or trust does not let you know, you will need to seek information from them about whether the conditions have been satisfied.

The rollover allows you to disregard the capital gain made from the original shares, units or other interest. You are taken to have acquired the replacement shares, units or other interest for the cost base of the original interest.

You can apply the CGT discount when you dispose of new shares providing the combined period that you owned the original shares and the new shares is at least 12 months. The same applies to units in a trust. Note that you have to deduct any capital losses (including unapplied net capital losses from earlier years) from your capital gains before applying the CGT discount.

You may only be eligible for partial rollover if you exchange shares, units or interests for similar interests in another entity (replacement interest) plus something else, usually cash.

This is because rollover applies only to the replacement interest. You will need to apportion the cost base of the original interest between the replacement interest and the cash (or other proceeds not eligible for rollover).

If your original shares, units or other interests were acquired before 20 September 1985 (pre-CGT), you are not eligible for scrip-for-scrip rollover. Instead, you acquire the replacement interest at the time of the exchange and the replacement interest is no longer a pre-CGT asset. However, if the arrangement is one that would otherwise qualify for scrip-for-scrip rollover, the cost base of the replacement interest is its market value just after the acquisition.

EXAMPLE: Partial scrip-for-scrip rollover

Gunther owns 100 shares in Windsor Ltd, each with a cost base of \$9. He accepts a takeover offer from Regal Ltd which provides for Gunther to receive one Regal share plus \$10 cash for each share in Windsor. Gunther receives 100 shares in Regal and \$1,000 cash. Just after Gunther is issued shares in Regal, each share is worth \$20.

Gunther has received \$10 cash for each of his Windsor shares and so has \$1,000 to which rollover does not apply.

In this case, it is reasonable to allocate a portion of the cost base of the original shares having regard to the proportion that the cash bears to the total proceeds. That is:

$$\begin{array}{ccccccc}
 \$1,000 & \div & \$3,000 & \times & \$900 & = & \$300 \\
 \text{(cash)} & & \text{(total proceeds} & & \text{(cost base of} & & \text{(proportion of} \\
 & & \text{– cash and} & & \text{original shares)} & & \text{cost base for} \\
 & & \text{value of shares} & & & & \text{which cash was} \\
 & & \text{received)} & & & & \text{received)}
 \end{array}$$

Gunther's capital gain is as follows:

$$\begin{array}{ccc}
 \$1,000 & - & \$300 \\
 \text{(cash)} & & \text{(cost base)} \\
 & & \text{(capital gain)}
 \end{array}
 = \$700$$

Gunther calculates the cost base of each of his Regal shares as follows:

$$\$900 - \$300 \div 100 = \$6$$

EXAMPLE: Scrip-for-scrip rollover

Stephanie owns ordinary shares in Reef Ltd. On 28 February 2006, she accepted a takeover offer from Starfish Ltd under which she received one ordinary share and one preference share for each Reef share. The market value of the Starfish shares just after Stephanie acquired them was \$20 for each ordinary share and \$10 for each preference share.

The cost base of each Reef share just before Stephanie ceased to own them was \$15.

The offer made by Starfish Ltd satisfied all the requirements for scrip-for-scrip rollover.

If rollover did not apply, Stephanie would have made a capital gain per share of:

$$\begin{array}{ccccccc}
 \$30 & - & \$15 & = & \$15 \\
 \text{(capital proceeds)} & & \text{(cost base)} & & \text{(capital gain)}
 \end{array}$$

Scrip-for-scrip rollover allows Stephanie to disregard the capital gain. The cost base of the Starfish shares is the cost base of the Reef Ltd shares.

Apportioning the cost base

As the exchange is one share in Reef Ltd for two shares in Starfish Ltd, Stephanie needs to apportion the cost base of the Reef Ltd share between the ordinary share and the preference share.

Cost base of ordinary share:

$$\$20 \div 30 \times \$15 = \$10$$

Cost base of preference share:

$$\$10 \div 30 \times \$15 = \$5$$

DEMERGERS

A demerger involves the restructuring of a corporate or fixed trust group by splitting its operations into two or more entities or groups. Under a demerger the owners of the head entity of the group (that is, the shareholders of the company or unit holders of the trust) acquire a direct interest (shares or units) in an entity that was formerly part of the group (the demerged entity).

EXAMPLE: Demerger

Peter owns shares (his original interest) in Company A. Company B is a wholly owned subsidiary of Company A. Company A undertakes a demerger by transferring all of its shares in Company B to its shareholders. Following the demerger, all of the shareholders in Company A, including Peter, will own all of the shares in Company B (their new interests) in the same proportion that they hold their shares in Company A.

New rules for demergers

There are new rules that apply to eligible demergers that happen on or after 1 July 2002. The following are major demergers which are subject to these new rules – you will find specific details in appendix 4:

- BHP Billiton Ltd demerger of BHP Steel Ltd (now known as BlueScope)
- WMC Ltd (renamed Alumina) demerger of WMC Resources Ltd, and
- CSR Ltd demerger of Rinker Group Ltd.

Demergers that happen on or after 1 July 2002

If you received new interests in a demerged entity under an eligible demerger that happened on or after 1 July 2002, you need to be aware of the following CGT consequences:

- you may be entitled to choose rollover for any capital gain or capital loss you make under the demerger, and
- you must calculate the cost base and reduced cost base of your interests in the head entity and your new interests in the demerged entity immediately after the demerger.

! NOTE

The head entity will normally advise you whether it has undertaken an eligible demerger. The Tax Office may have provided advice to the head entity in the form of a class ruling.

Rollover available

To choose rollover, the demerger must be an eligible demerger. The head entity will usually advise you of this.

If you choose rollover:

- you disregard any capital gain or capital loss made under the demerger, and

- your new interests in the demerged entity are acquired on the date of the demerger. However, if a proportion of your original interests was acquired before 20 September 1985 (pre-CGT), the same proportion of your new interests in the demerged entity is treated as pre-CGT assets.

If you do not choose rollover:

- you cannot disregard any capital gain or capital loss made under the demerger, and
- all your new interests in the demerged entity are acquired on the date of the demerger.

Cost base calculations

You must recalculate the first element of the cost base and reduced cost base of your remaining **original** interests in the head entity and of your **new interests** in the demerged entity. You must make these calculations whether you choose rollover or not, or if no CGT event happens to your original interests under the demerger.

The calculation will depend on whether you have pre-CGT original interests in the head entity.

Cost base calculations where you do not have pre-CGT interests

You work out the cost base and reduced cost base of your remaining **post-CGT** original interests and your post-CGT new interests immediately after the demerger. You do this by spreading the total cost base of your post-CGT original interests (immediately **before** the demerger) over both your remaining post-CGT original interests and your post-CGT new interests. The following steps explain how to do this.

The steps and example below work out your new cost bases using an 'averaging method'. You may be able to use other methods if they are reasonable. For more information, visit www.ato.gov.au/demergers

STEP 1 Add the cost bases of your post-CGT original interests immediately before the demerger. (Do not reduce your total cost base by any capital amounts returned to you under the demerger and do not include indexation.)

STEP 2 Use the relevant percentages to apportion the step 1 amount between:

- your post-CGT original interests in the head entity, and
- your post-CGT new interests in the demerged entity.

The head entity should advise you of the relevant percentages to use.

STEP 3 Divide the cost base apportioned to the head entity interests (from step 2) by the number of remaining post-CGT original interests you own.

STEP 4 Divide the cost base apportioned to the demerged entity interests (from step 2) by the number of post-CGT new interests you own.

These amounts will form the first element of the cost base and reduced cost base of your post-CGT original interests and post-CGT new interests.

EXAMPLE: No pre-CGT interests

Under the BHP Billiton Ltd demerger of BHP Steel Ltd, shareholders received one BHP Steel share for every five BHP Billiton shares they owned at the date of the demerger.

Anita owned 280 BHP Billiton shares (all post-CGT) with a cost base of \$2,500 immediately before the demerger. Under the demerger, Anita received 56 BHP Steel shares. Anita works out the cost base and reduced cost base of her BHP Billiton shares and BHP Steel shares as follows:

STEP 1 The total cost base of the BHP Billiton shares immediately before the demerger was \$2,500.

STEP 2 BHP Billiton advised shareholders to apportion 94.937% of the total cost base from step 1 to BHP Billiton shares and 5.063% to BHP Steel shares:

(a) BHP Billiton:
 $94.937\% \times \$2,500 = \$2,373.43$

(b) BHP Steel:
 $5.063\% \times \$2,500 = \126.58

STEP 3 Divide the step 2(a) amount by the 280 BHP Billiton shares:
 $\frac{\$2,373.43}{280} = \8.48 per share

STEP 4 Divide the step 2(b) amount by the 56 BHP Steel shares
 $\frac{\$126.58}{56} = \2.26 per share

Cost base calculations where you have pre-CGT interests

If you choose rollover

If you choose rollover and a proportion of your original interests are pre-CGT, the same proportion of your new interests will be treated as pre-CGT interests. It is not necessary to calculate the cost base and reduced cost base for your pre-CGT interests.

You calculate the cost base and reduced cost base of your remaining post-CGT original interests and your post-CGT new interests in the same way as shown in the example above.

There is no change to the acquisition date of your original interests.

If you do not or cannot choose rollover

If you do not or you cannot choose rollover (for example, because a CGT event did not happen to your original interests), the new interests that you receive for your pre-CGT original interests are treated as post-CGT interests.

You work out the cost base of these new interests under the ordinary cost base rules (this will generally be equal to the capital return and dividend distributed from the head entity that is applied to acquire those new interests).

NOTE

It may be to your advantage not to choose rollover for new interests you receive for your pre-CGT original interests – for example, where the reduced cost bases of those new interests calculated under the ordinary cost base rules mean you will make a capital loss when you dispose of them.

You calculate the cost base and reduced cost base of your remaining post-CGT original interests and your post-CGT new interests (other than those received for pre-CGT original interests) in the same way as shown in the example above – except that you ignore the new interests received for pre-CGT original interests in the calculation.

There is no change to the acquisition date of your original interests.

EXAMPLE: With pre-CGT interests

Anita owned 400 BHP Billiton shares immediately before the demerger:

- 120 pre-CGT shares, and
- 280 post-CGT shares (the cost base of which, immediately before the demerger, was \$2,500).

(i) If Anita chose rollover, the 24 BHP Steel shares she received for the 120 pre-CGT BHP Billiton shares will also be pre-CGT. It is not necessary to work out the cost base and reduced cost base for your pre-CGT interests.

Immediately after the demerger, she calculates the cost base and reduced cost base of her 280 post-CGT BHP Billiton shares and the 56 BHP Steel shares she received for those BHP Billiton shares in the same way as shown in the example in the previous column.

(ii) If Anita did not choose rollover, the 24 BHP Steel shares she received for the 120 pre-CGT BHP shares are post-CGT shares acquired on the date of demerger. Immediately after the demerger, the cost base and reduced cost base of the 24 BHP Steel shares are \$3.45 per share (the capital return of \$0.69 per share \times 5).

Immediately after the demerger, she calculates the cost base and reduced cost base of her 280 post-CGT BHP Billiton shares and the 56 BHP Steel shares she received for those BHP Billiton shares in the same way as shown in the example in the previous column.

In either case, there is no change to the pre-CGT status of Anita's 120 BHP Billiton shares.

Using the discount method if you sell your shares after the demerger

If you sell your new interests in the demerged entity after the demerger, you must have owned those interests for at least 12 months from the date you acquired the corresponding original interests in the head entity in order to use the discount method.

EXAMPLE

You received BHP Steel Ltd shares under the demerger on 22 July 2002. They related to shares you acquired in BHP Billiton Ltd on 15 August 2001. You can only use the discount method to work out your capital gain on these shares if you dispose of them after 15 August 2002 – that is, more than 12 months after the date you acquired the BHP Billiton shares.

However, you calculate the 12 months from the date of demerger if you:

- did not choose rollover and you received new interests in the demerged entity which relate to pre-CGT interests in the head entity, or
- acquired your new interests without a CGT event happening to your original interests.

EXAMPLE

You received BHP Steel Ltd shares under the demerger where you calculated the cost base as \$3.45 per share (because they related to pre-CGT shares you owned in BHP Billiton Ltd and you did not choose rollover). You can only use the discount method to work out your capital gain on these shares if you disposed of them after 22 July 2003 – that is, more than 12 months after the demerger.

▶ DEMERGERS CALCULATOR AND OTHER PRODUCTS AND INFORMATION

We have a **demergers calculator** on our website to help you make these calculations.

We also have other products to assist you, such as question and answer sheets for some demergers undertaken by major listed entities.

You can access these from the demergers homepage on our website at **www.ato.gov.au/demergers**

DIVIDEND REINVESTMENT PLANS

Some companies ask their shareholders whether they would like to participate in a **dividend reinvestment plan**. Under these plans, shareholders can choose to use their dividend to acquire additional shares in the company instead of receiving a cash payment. These shares are usually issued at a discount on the current market price of the shares in the company.

For CGT purposes, if you participate in a dividend reinvestment plan you are treated as if you had received a cash dividend and then used the cash to buy additional shares.

Each share (or parcel of shares) acquired in this way – on or after 20 September 1985 – is subject to CGT. The cost base of the new shares includes the price you paid to acquire them – that is, the amount of the dividend.

EXAMPLE: Dividend reinvestment plans

Natalie owns 1,440 shares in PHB Ltd. The shares are currently worth \$8 each. In November 2005, the company declared a dividend of 25 cents per share.

Natalie could either take the \$360 dividend as cash ($1,440 \times 25$ cents) or receive 45 additional shares in the company ($360 \div 8$).

Natalie decided to participate in the dividend reinvestment plan and received 45 new shares on 20 December 2005. She included the \$360 dividend in her 2005–06 assessable income.

For CGT purposes, she acquired the 45 new shares for \$360 on 20 December 2005.

BONUS SHARES

Bonus shares are additional shares a shareholder receives for an existing holding of shares in a company. If you dispose of bonus shares received on or after 20 September 1985, you may make a capital gain. You may also have to modify the cost base and reduced cost base of your existing shares in the company if you receive bonus shares.

The cost base and reduced cost base of bonus shares depend on whether the bonus shares are assessable as a dividend.

As a result of changes to company and taxation laws, the paid-up value of bonus shares is now generally not assessable as a dividend. An exception to this rule is where you have the choice of being paid a cash dividend or of being issued shares under a dividend reinvestment plan. These shares are treated as dividends and the amount of the dividend is included in your assessable income.

The following table explains how the time of issue of your bonus shares affects whether the paid-up value of the bonus shares is assessed as a dividend.

| Date | Implications of timing of bonus shares |
|--|---|
| From 20 September 1985 to 30 June 1987 inclusive | Many bonus shares issued were paid out of a company's asset revaluation reserve or from a share premium account. These bonus shares are not usually assessable dividends. |
| From 1 July 1987 to 30 June 1998 inclusive | The paid-up value of bonus shares issued is assessed as a dividend unless paid from a share premium account. |
| From 1 July 1998 | The paid-up value of bonus shares issued is not assessed as a dividend unless part of the dividend was paid in cash or paid as part of a dividend reinvestment plan. |

There are other, less common, circumstances where bonus shares will be assessed as a dividend – for example, where:

- the bonus shares are being substituted for a dividend to give a tax advantage, or
- the company directs bonus shares to some shareholders and dividends to others to give them a tax benefit.

Flowchart 1 in appendix 3 summarises the different rules applying to different bonus shares issued on or after 20 September 1985.

➤ For more information about bonus shares, see the sources of further information listed at the back of this guide.

Bonus shares issued where no amount is assessed as a dividend

Original shares acquired on or after 20 September 1985

If your bonus shares relate to other shares that you acquired on or after 20 September 1985 (referred to as your original shares) your bonus shares are taken to have been acquired on the date you acquired your original shares. If you acquired your original shares at different times, you will have to work out how many of your bonus shares are taken to have been acquired at each of those times.

Calculate the cost base and reduced cost base of the bonus shares by apportioning the cost base and reduced cost base of the original shares over both the original and the bonus shares. Effectively, this results in a reduction of the cost base and reduced cost base of the original shares. You also include any calls paid on partly paid bonus shares as part of the cost base and reduced cost base that is apportioned between the original and the bonus shares.

Original shares acquired before 20 September 1985

Your CGT obligations depend on when the bonus shares were issued and whether they are fully paid or partly paid. For more information, see flowchart 1 in appendix 3.

EXAMPLE: Fully paid bonus shares

Chris bought 100 shares in MAC Ltd for \$1 each on 1 June 1985. He bought 300 more shares for \$1 each on 27 May 1986. On 15 November 1986, MAC Ltd issued Chris with 400 bonus shares from its capital profits reserve, fully paid to \$1. Chris did not pay anything to acquire the bonus shares and no part of the value of the bonus shares was assessed as a dividend.

For CGT purposes, the acquisition date of 100 of the bonus shares is 1 June 1985 (pre-CGT). Therefore, those bonus shares are not subject to CGT.

The acquisition date of the other 300 bonus shares is 27 May 1986. Their cost base is worked out by spreading the cost of the 300 shares Chris bought on that date over both those original shares and the remaining 300 bonus shares. As the 300 original shares cost \$300, the cost base of each share will now be 50 cents.

EXAMPLE: Partly paid bonus shares

Klaus owns 200 shares in MAC Ltd which he bought on 31 October 1984, and 200 shares in PUP Ltd which he bought on 31 January 1985.

On 1 January 1987, both MAC Ltd and PUP Ltd made their shareholders a one-for-one bonus share offer of \$1 shares partly paid to 50 cents. Klaus elected to accept the offer and acquired 200 new partly paid shares in each company. No part of the value of the bonus shares was taxed as a dividend.

On 1 April 1989, PUP Ltd made a call for the balance of 50 cents outstanding on the partly paid shares, payable on 30 June 1989. Klaus paid the call payment on that date. MAC Ltd has not yet made any calls on its partly paid shares.

For CGT purposes, Klaus is treated as having acquired his bonus PUP Ltd shares on the date he became liable to pay the call (1 April 1989). The cost base of the bonus shares in PUP Ltd includes the amount of the call payment (50 cents) plus the market value of the shares immediately before the call was made.

The MAC Ltd bonus shares will continue to have the same acquisition date as the original shares (31 October 1984) and are therefore not subject to CGT. However, this will not be the case if Klaus makes any further payments to the company on calls made by the company for any part of the unpaid amount on the bonus shares. In this case, the acquisition date of the bonus shares will be when the liability to pay the call arises and the bonus shares will then be subject to CGT.

Bonus shares issued where the paid-up value is assessed as a dividend

If the paid-up value of bonus shares is assessed as a dividend, you may have to pay CGT when you dispose of the bonus shares, regardless of when you acquired the original shares.

Original shares acquired on or after 20 September 1985

If your bonus shares relate to original shares that you acquired on or after 20 September 1985, the acquisition date of the bonus shares is the date they were issued. Their cost base and reduced cost base includes the amount of the dividend, plus any call payments you made to the company if they were only partly paid.

EXCEPTION – BONUS SHARES RECEIVED BEFORE 1 JULY 1987

The exception to this rule is bonus shares you received before 1 July 1987. They are taken to be acquired on the date you acquired your original shares. Their cost base is calculated as if the amount was not taxed as a dividend (see **Bonus shares issued where no amount is assessed as a dividend** on the previous page).

Original shares acquired before 20 September 1985

The rules that apply where you acquired your original shares before 20 September 1985 depend on when the bonus shares were issued and whether they were partly paid or fully paid. For further details, see flowchart 1 in appendix 3.

EXAMPLE: Cost base of bonus shares

Mark owns 1000 shares in RIM Ltd, which he bought on 30 September 1984 for \$1 each.

On 1 February 1997, the company issued him with 500 bonus shares partly paid to 50 cents. The paid-up value of bonus shares (\$250) is an assessable dividend to Mark.

On 1 May 1997, the company made a call for the 50 cents outstanding on each bonus share, which Mark paid on 1 July 1997.

The total cost base of the bonus shares is \$500, consisting of the \$250 dividend received on the issue of the bonus shares on 1 February 1997 plus the \$250 call payment made on 1 July 1997.

The bonus shares have an acquisition date of 1 February 1997. If Mark holds the bonus shares for 12 months from that date, when he sells them he can use the indexation method to calculate his capital gain. Amounts payable to a company on shares in the company can be indexed only from the date of actual payment. In Mark's case, he can only index the \$250 call payment from the date he paid it (1 July 1997).

However, indexation on the \$250 dividend included in his assessable income on the issue of the bonus shares was available from 1 February 1997. This is different from the indexation treatment of amounts paid to acquire assets in other circumstances where indexation is available from the time the liability to make the payment arises. The indexation rules are explained in more detail in chapter 2.

If Mark disposes of the shares after 11.45am (by legal time in the ACT) on 21 September 1999, he can calculate his capital gain using either the indexation method or the discount method.

BONUS UNITS

If you have received bonus units on or after 20 September 1985, you may make a capital gain when you dispose of them.

The CGT rules for bonus units are similar to those for bonus shares. However, the rules do not apply if the bonus units are issued by a corporate unit trust or a public trading trust.

When the unit trust issues the bonus units, they will generally tell you what amount (if any) you have to include in your assessable income. You need to keep a record of that information to work out your CGT obligation when you dispose of them.

Flowchart 2 in appendix 3 summarises the rules applying to bonus units issued on or after 20 September 1985.

Bonus units issued where no amount is included in assessable income

Original units acquired on or after 20 September 1985

If your bonus units relate to other units that you acquired on or after 20 September 1985, your bonus units are taken to have been acquired on the date you acquired your original units. If you have original units that you acquired at different times, you will have to work out how many of your bonus units are taken to have been acquired at each of those times.

Calculate the cost base and reduced cost base of the bonus units by apportioning the cost base and reduced cost base of the original units over the original units and the bonus units. Effectively, this results in a reduction of the cost base and reduced cost base of the original units. You also include any calls paid on partly paid bonus units that are apportioned between the original units and the bonus units as part of the cost base and reduced cost base.

Original units acquired before 20 September 1985

The rules that apply if you acquired your original units before 20 September 1985 depend on when the bonus units were issued and whether they were partly paid or fully paid. For further details, see flowchart 2 in appendix 3.

EXAMPLE: Unit trusts

Sarah is a unit holder in the CPA Unit Trust. She bought 1,000 units on 1 September 1985 for \$1 each and 1,000 units on 1 July 1996 for \$2 each. On 1 March 1997, the unit trust made a one-for-one bonus unit issue to all unit holders. Sarah received 2,000 new units. She did not include any amount in her assessable income as a result.

The 1,000 new units issued for the original units she acquired on 1 September 1985 are also treated as having been acquired on that date and are therefore not subject to CGT.

However, the 1,000 new units issued for the original units she acquired on 1 July 1996 are subject to CGT. Their cost base is worked out by spreading the cost of the original units (\$2,000) acquired on that date over both the original units and the bonus units. Each of the units therefore has a cost base of \$1.

Bonus units issued where an amount is included in assessable income

If you include any amount in your assessable income as a result of the issue of bonus units, their acquisition date is the date they were issued, regardless of when you acquired the original units.

The cost base and reduced cost base of the bonus units is the amount included in your assessable income as a result of the issue of those units, plus any calls you made if they were only partly paid.

If the bonus units were issued before 20 September 1985, any capital gain or capital loss is disregarded as they are pre-CGT assets.

RIGHTS OR OPTIONS TO ACQUIRE SHARES OR UNITS

If you own shares or units, you may be issued rights or options to acquire additional shares or units at a specified price.

Rights and options issued directly to you from a company or trust for no cost

You are taken to have acquired the rights and options at the same time as you acquired the original shares or units. Therefore, if you acquired the original shares or units before 20 September 1985, you disregard any capital gain or capital loss you make when the rights or options expire or are sold as they are pre-CGT assets.

If you acquired the original shares or units on or after 20 September 1985, you make a capital gain if the capital proceeds on the sale or expiry of the rights or options are more than their cost base. You make a capital loss if the reduced cost base of the rights or options is more than those capital proceeds.

Rights and options you paid to acquire from a company or trust – or that you acquired from another person

If you acquired your rights or options on or after 20 September 1985, they are treated much like any other CGT asset and are subject to CGT.

Flowcharts 3, 4 and 5 in appendix 3 summarise the different rules applying to the treatment of rights or options to acquire shares or units.

EXERCISING RIGHTS OR OPTIONS TO ACQUIRE SHARES OR UNITS

Many people decide to exercise their rights or options to acquire new shares or units rather than sell them. In most cases, no CGT is payable at the time you exercise the rights or options.

The acquisition date of the shares or units is the date of exercise of the rights or options to acquire the shares or units.

If you exercise the rights or options on or after 20 September 1985, some special rules apply for calculating the cost base and reduced cost base of shares or units acquired as a result.

The rules outlined below do not apply to rights or options to acquire shares under an employee share scheme.

Rights or options issued directly to you for no cost from a company or trust in which you are a shareholder or unit holder

The amount included in the cost base and reduced cost base of the shares or units you acquire on exercise of the rights or options depends on when you acquired your original shares or units. The following rules do not apply to rights or options to acquire units issued before 29 January 1988.

Original shares or units acquired before 20 September 1985

The first element of the cost base and reduced cost base for the shares or units you acquire on exercising your rights or options is:

- the market value of the rights or options at the time you exercised them, plus
- the amount you paid to exercise the rights or options, plus
- if the rights or options were exercised on or after 1 July 2001 and, as a result, an amount was included in your assessable income – that amount.

Original shares or units acquired on or after 20 September 1985

The first element of the cost base and reduced cost base for the shares or units you acquire on exercising your rights or options is:

- the cost base of the rights or options at the time you exercised them, *plus*
- the amount you paid to exercise the rights or options (except to the extent that the amount is represented in the cost base of the rights or options at the time of exercise), *plus*
- if the rights or options were exercised on or after 1 July 2001 and, as a result, an amount was included in your assessable income – that amount.

Flowchart 3 in appendix 3 summarises the rules relating to the treatment of such options and rights.

Rights or options you acquired from an individual or entity that received them as a shareholder in the company or as a unit holder in the trust

The amount included in the cost base and reduced cost base of the shares or units you acquire depends on when you acquired your rights or options. The following rules do not apply to rights or options to acquire units issued before 29 January 1988.

Rights or options acquired before 20 September 1985

If the rights or options were exercised on or after 20 September 1985 the first element of the cost base and reduced cost base for the shares is:

- the market value of the rights or options at the time you exercised them, *plus*
- the amount you paid to exercise the rights or options, *plus*
- if the rights or options were exercised on or after 1 July 2001 and, as a result, an amount was included in your assessable income – that amount.

Rights or options acquired on or after 20 September 1985

The first element of the cost base and reduced cost base for the shares or units you acquire on exercising your rights or options is:

- the cost base for the rights or options (including any amount you paid for them), *plus*
- the amount you paid for the shares or units on exercising the rights or options (except to the extent that the amount is represented in the cost base of the rights or options at the time of exercise), *plus*
- if the rights or options were exercised on or after 1 July 2001 and, as a result, an amount was included in your assessable income – that amount.

Flowchart 4 in appendix 3 summarises the rules relating to the treatment of such options and rights.

Rights or options you paid for that were issued directly to you from the company or trust or that you acquired from an individual or entity that was not a shareholder or unit holder

For rights or options to acquire units, these rules apply to rights or options exercised on or after 27 May 2005.

The amount included in the cost base and reduced cost base of the shares or units you acquire depends on when you acquired your rights or options.

Rights or options acquired before 20 September 1985

This includes rights or options last renewed or extended after that date if they were exercised before 27 May 2005.

If the rights or options were exercised on or after 20 September 1985 the first element of the cost base and reduced cost base for the shares or units is:

- the market value of the rights or options at the time you exercised them, *plus*
- the amount you paid for the shares or units on exercising the rights or options.

Rights or options acquired on or after 20 September 1985

This includes rights or options you acquired before 20 September 1985 which were last renewed or extended after that date and were exercised before 27 May 2005.

The first element of the cost base and reduced cost base for the shares or units you acquire on exercising your rights or options is:

- the amount you paid for the rights or options, *plus*
- the amount you paid for the shares or units on exercising the rights or options.

Flowchart 5 in appendix 3 summarises the rules relating to the treatment of such options and rights.

NOTE

Previous editions of this publication stated that these rules (now covered in Flowchart 5 in appendix 3) may apply not only to the rights or options for the issue of shares but also to rights or options for the issue of units. However, these rules only apply to rights or options for the issue of units by the grantor of the rights or options which are exercised on or after 27 May 2005. To confirm the way in which the tax law applies to rights or options for the issues of units that you exercised before 27 May 2005, you may seek a private binding ruling from the Tax Office – see *How to apply for a private ruling* on our website.

EXAMPLE: Sale of rights

Shanti owns 2,000 shares in ZAC Ltd. She bought 1,000 shares on 1 June 1985 and 1,000 shares on 1 December 1996.

On 1 July 1998, ZAC Ltd granted each of its shareholders one right for each four shares owned to acquire shares in the company for \$1.80 each. Shanti therefore received 500 rights in total. At that time, shares in ZAC Ltd were worth \$2. Each right was therefore worth 20 cents.

Shanti decided that she did not wish to buy any more shares in ZAC Ltd, so she sold all her rights for 20 cents each – a total amount of \$100. Only those rights issued for the shares she bought on 1 December 1996 are subject to CGT. As Shanti did not pay anything for the rights, she has made a \$50 taxable capital gain on their sale.

The \$50 Shanti received on the sale of her rights for the shares she bought on 1 June 1985 is not subject to CGT as those rights are taken to have been acquired at the same time as the shares – that is, before 20 September 1985.

EXAMPLE: Rights exercised

Assume that, in the previous example, Shanti wished to acquire more shares in ZAC Ltd. She therefore exercised all 500 rights on 1 August 1998 when they were still worth 20 cents each.

There are no CGT consequences arising from the exercise of the rights.

However, the 500 shares Shanti acquired on 1 August 1998 when she exercised the rights are subject to CGT and are acquired at the time of the exercise.

When Shanti exercised the rights issued for the shares she bought on 1 December 1996, the cost base of the 250 shares Shanti acquired is the amount she paid to exercise each right – \$1.80 for each share.

When she exercised the rights for the shares she bought before 20 September 1985, Shanti's cost base for each of the 250 shares she acquired includes not only the exercise price of the right (\$1.80) but also the market value of the right at that time – 20 cents. The cost base of each share is therefore \$2.

CGT discount on shares or units acquired from exercise of rights or options

You can only use the discount method to calculate your capital gain from an asset if you own it for at least 12 months. In calculating any capital gain on shares or units you acquire from the exercise of a right or option, the 12-month period applies from the date you acquire the shares or units (not the date you acquired the right or option).

CONVERTIBLE INTERESTS

Convertible notes

A convertible note (which is one type of convertible interest) is another type of investment you can make in a company or unit trust. A convertible note earns interest on the amount you pay to acquire the note until the note's expiry date. On expiry of the note, you can either ask for the return of the money paid or convert that amount to acquire new shares or units.

Convertible notes you acquired after 10 May 1989 will generally not be subject to CGT if you sold or disposed of them before they were converted into shares. Instead, you include any gain you make on your tax return as ordinary income and any loss you make is included as a deduction.

➤ For more information, see *You and your shares 2006*.

➤ If you have sold or disposed of a convertible note that you acquired before 11 May 1989, phone the Business Infoline on **13 28 66**. When you phone, make sure you know the date you acquired the convertible note as this may affect the tax treatment.

Conversion of notes to shares

The tax treatment that applies when your convertible notes are converted to shares depends on when you acquired the convertible notes, the type of convertible note, when the conversion occurred and when the convertible note was issued.

Shares acquired by the conversion of a convertible note on or after 20 September 1985 will be subject to CGT when they are sold or disposed of as the shares are taken to be acquired when the conversion happens.

You may have acquired the convertible note on or after 20 September 1985 and, as a traditional security or qualifying security, you have already included the gain you made on the conversion of the note on your tax return as income (or as a deduction if you made a loss). The way you calculate the cost base of the shares varies depending on whether the notes converted to shares before 1 July 2001 or on or after that date. Table 1 on the next page provides a summary.

Convertible notes issued after 14 May 2002

If you have convertible notes that are traditional securities and were issued by a company after 14 May 2002:

- any gains you make when these notes are converted or exchanged for ordinary shares in a company will not be ordinary income at the time of conversion or exchange, and any losses you make will not be deductible
- instead, any gains or losses you make on the later sale or disposal of the shares (incorporating any gain or loss that would have been made on the conversion or exchange of the notes) will be:
 - subject to CGT if you are an ordinary investor, or
 - ordinary income (or deductible, in the case of a loss) if you are in the business of trading in shares and other securities.

TABLE 1: Treatment of convertible notes acquired after 10 May 1989

| Convertible note | Converted before 1 July 2001 | Converted on or after 1 July 2001 |
|---|--|--|
| The note is a traditional security* that was issued before 15 May 2002. | You include gain on conversion as income (or loss on conversion is deducted). Cost base of shares includes their market value at the date the convertible notes were converted. | You include gain on conversion as income (or loss on conversion is deducted). Cost base of shares includes cost base of the convertible note, any amount paid on conversion and any amount included in your assessable income on conversion. |
| The note is a traditional security* that was issued after 14 May 2002. | | You disregard gain (or loss) on conversion. Cost base of shares includes cost base of the convertible note and any amount paid on conversion. |
| The note is a qualifying security**. | You include accrued gains as income and include any gain on conversion as income (or deduct any loss on conversion). Cost base of shares includes amounts paid to acquire the note and any amount paid on conversion. | You include accrued gains as income and include any gain on conversion as income (or deduct any loss on conversion). Cost base of shares includes cost base of the convertible note, any amount paid on conversion and any amount included in your assessable income on conversion. |
| <p>* A traditional security is one that is not issued at a discount of more than 1.5%, does not bear deferred interest and is not capital indexed. It may be, for example, a bond, a deposit with a financial institution, or a secured or unsecured loan.</p> <p>** A qualifying security is one that has a deferred income element – that is, it is issued under terms such that the investor's return on investment (other than periodic) will be greater than 1.5% per annum.</p> | | |

If you are an individual who is an ordinary investor, this change means you will be able to get the benefit of the CGT discount if you own the shares for more than 12 months. The table above sets out how you calculate the cost base.

Conversion of notes to units

Convertible notes – converted before 1 July 2001

If the convertible note is a traditional security, the first element of the cost base and reduced cost base of the units is their market value at the time of conversion. You disregard any capital gain or capital loss made on their conversion to units in the unit trust.

If the convertible note is not a traditional security and was issued by the unit trust after 28 January 1988, the first element of the cost base and reduced cost base of the units includes both the cost of the convertible note and any further amount payable on the conversion. You disregard any capital gain or capital loss made on their conversion to units in the unit trust.

Convertible notes – converted after 1 July 2001

If the convertible note is a traditional security the first element of the cost base and reduced cost base of the units includes:

- the cost base of the convertible note, *plus*
- any amount paid on conversion, *plus*
- any amount included in your assessable income on conversion.

You disregard any capital gain or capital loss made on their conversion to units in the unit trust.

Similarly, if the convertible note is not a traditional security and was issued by the unit trust after 28 January 1988, the first element of the cost base and reduced cost base of the units includes:

- the cost base of the convertible note, *plus*
- any amount paid on conversion, *plus*
- any amount included in your assessable income on conversion.

You disregard any capital gain or capital loss made on their conversion to units in the unit trust.

EXAMPLE: Converting notes to shares

David bought 1,000 convertible notes in DCS Ltd on 1 July 1997 (that is, notes that were issued before 15 May 2002). The notes cost \$5 each. Each convertible note is convertible into one DCS Ltd share. On expiry of the notes on 1 July 2000, shares in the company were worth \$7 each. David converted the notes to shares, which are subject to CGT. No further amount was payable on conversion of the notes. David sold the shares on 4 December 2005 for \$10 each.

The \$2 (\$7 – \$5) gain David made on the conversion of each of the notes to shares was assessable to David as ordinary income at the time of conversion – that is, in the 2000–01 income year. As such, David has no capital gain in that year.

The \$3 (\$10 – \$7) gain David made on the sale of each of the shares is subject to CGT. The \$7 cost base is the market value per share on the date the notes converted to shares. Because he sold the shares after 11.45am (by legal time in the ACT) on 21 September 1999 and owned them for at least 12 months, David can claim the CGT discount. David calculates his capital gain as follows:

| | |
|--------------------------------|----------------|
| \$3 per share × 1,000 shares = | \$3,000 |
| less CGT discount of 50% | \$1,500 |
| Net capital gain | \$1,500 |

David includes the capital gain on his 2006 tax return.

EMPLOYEE SHARE SCHEMES

Some companies encourage employees to participate in employee share schemes by offering them discounted shares or rights (including options) to acquire shares. Employee share scheme income tax rules (ESS tax rules) apply to this discount.

If the employee acquires 'qualifying shares or rights' (those that satisfy certain ESS tax rules), the employee can choose when they include the discount given on the shares or rights in their assessable income.

The employee includes the discount in their assessable income:

- in the income year they acquire shares or rights, if the employee makes an election under the ESS tax rules. The discount is calculated at the date the shares or rights were acquired, or
- in the income year that 'cessation time' of the shares or rights occurs. For shares, the cessation time is usually the earlier of employment ceasing or when the disposal restrictions cease and forfeiture conditions expire on the shares. For rights, the cessation time is usually the earlier of employment ceasing or the exercise of the rights to acquire the shares. The discount is calculated at the date of cessation time.

If the employee acquires shares or rights that are not qualifying shares or rights, the employee includes the discount, calculated at the date the shares or rights were acquired, in their assessable income for the income year in which they acquired them.

The first element of the cost base of the shares or rights is their market value as determined under the ESS tax rules at the date the discount was calculated. If a CGT event happens to, or in relation to, the shares or rights, the capital gain or capital loss is calculated under the rules that apply to that event.

If an arm's length CGT event A1 (sale or disposal of a CGT asset), C2 (cancellation, surrender or similar ending), E1 (creating a trust over a CGT asset), E2 (transferring a CGT asset to a trust) or E5 (beneficiary becoming entitled to a trust asset) happens to the shares or rights (or any shares

acquired as a result of exercise of the rights) within 30 days of cessation time, the capital gain or capital loss is disregarded.

If an employee makes an election under the ESS tax rules, special rules apply if the employee acquires a beneficial interest in the shares or rights – that is, the shares or rights were acquired on their behalf by the trustee of an employee share trust but, due to restrictions, the trustee is unable to dispose of them on behalf of the employee.

If the employee acquired their beneficial interest before 5.00pm (by legal time in the ACT) on 27 February 2001, the cost base of the shares or rights is either:

- their market value at the date the employee became absolutely entitled to the shares or rights (the date the disposal restrictions are lifted and the trustee can sell them on behalf of, or transfer them to, the employee), or
- if the employee chooses, their market value at the date the employee acquired the beneficial interest.

However, the 12-month ownership requirement for the 50% CGT discount commences from the date the employee acquired absolute entitlement in the shares or rights.

If the employee acquired the beneficial interest after 5.00pm (by legal time in the ACT) on 27 February 2001, the cost base of the shares or rights is their market value at the date the employee acquired the beneficial interest. The 12-month ownership requirement for the 50% CGT discount commences from the date the employee acquired the beneficial interest in the shares or rights.

For cost base purposes, the market value of the shares or rights is established under the ESS tax rules.

Elections under the ESS tax rules must be made by the employee in writing and should be kept with their tax return for the relevant income year.

If a liquidator or administrator declares that rights acquired under an employee share scheme are worthless, no capital loss is available. For employee shares that are declared worthless, a capital loss is only available in certain circumstances – see **Shares in a company in liquidation or administration** on page 39.

➤ For more general information on employee share schemes, see *Employee share schemes – answers to frequently asked questions by employees*, available on our website.

CGT implications for employee shares and rights under a corporate restructure

If employee shares or rights are exchanged for replacement shares or rights in a new company under a corporate restructure that happens on or after 1 July 2004, rollover may be available so that there is no taxing point under the ESS tax rules. Corporate restructures affected include mergers, demergers (in limited circumstances) and 100% takeovers. Any capital gain or capital loss made on the employee shares or rights because of the restructure will be disregarded where this rollover applies.

➤ For more information, see our fact sheet *Employee share schemes – rollover relief on a corporate restructure*, available on our website.

Changing residence or working in multiple countries

There are new income and CGT rules relating to ESS shares or rights held by employees who become or cease to be Australian residents, or who work in Australia and also in one or more other countries. The changes apply from 26 June 2005.

For more information, visit our website or phone the Personal Tax Infoline on **13 28 61**.

STAPLED SECURITIES

Stapled securities are created when two or more different securities are legally bound together so that they cannot be sold separately. Many different types of securities can be stapled together. For example, many property trusts have their units stapled to the shares of companies with which they are closely associated.

The effect of stapling depends on the specific terms of the stapling arrangement. The issuer of the stapled security will be able to provide you with detailed information on their particular stapling arrangement. However, in general the effect of stapling is that each individual security retains its character and there is no variation to the rights or obligations attaching to the individual securities.

Although a stapled security must be dealt with as a whole, the individual securities that are stapled are treated separately for tax purposes. For example, if a share in a company and a unit in a unit trust are stapled, you:

- continue to include separately on your tax return dividends from the company and trust distributions from the trust, and
- work out any capital gain or capital loss separately for the unit and the share.

Because each security that makes up your stapled security is a separate CGT asset, you must work out a cost base and reduced cost base for each separately.

If you acquired the securities after they were stapled (for example, you bought the stapled securities on the ASX), you do this by apportioning, on a reasonable basis, the amount you paid to acquire the stapled security (and any other relevant costs) between the various securities that are stapled. One reasonable basis of apportionment is to have regard to the portion of the value of the stapled security that each security represented. The issuer of the stapled security may provide assistance in determining these amounts.

EXAMPLE: Apportionment of cost base and reduced cost base to the separate securities

On 1 September 2002 Cathy acquired 100 ABC stapled securities which comprised a share in ABC Ltd and a unit in the ABC Unit Trust. She paid \$4.00 for each stapled security, and on the basis of the information provided to her by the issuer of the stapled securities she determined that 60% of the amount paid was attributable to the value of the share and 40% to the value of the unit. On this basis, the first element of the cost base and reduced cost base of each of Cathy's shares in ABC Ltd will be \$2.40 ($\$4.00 \times 60\%$). The first element of the cost base and reduced cost base of each of Cathy's units in ABC Unit Trust will be \$1.60 ($\$4.00 \times 40\%$).

If you acquired your stapled securities as part of a corporate restructure you will, during the restructure, have owned individual securities that were not stapled. The way you work out the cost base and reduced cost base of each security depends on the terms of the stapling arrangement.

The stapling does not result in any CGT consequences for you, because the individual securities are always treated as separate securities. However, there may be other aspects of the whole restructure arrangement which will result in CGT consequences for you.

EXAMPLE: CGT consequences associated with the stapling of securities

Jamie acquired 100 units in the Westfield America Trust (WFA) in January 2003. Immediately before the merger of Westfield America Trust with Westfield Holdings Ltd and Westfield Trust (July 2004), the cost base of each of his units was \$2.12 (total cost base = \$212 ($\2.12×100)).

Under the arrangement, Jamie's original units in WFA were firstly consolidated in the ratio of 0.15 consolidated WFA unit for each original WFA unit. After the consolidation, Jamie held 15 consolidated WFA units with a cost base of \$14.13 ($\$212 \div 15$) each. There are no CGT consequences for Jamie as a result of the consolidation of his units in WFA.

Jamie then received a capital distribution of \$1.01 for each consolidated unit he held.

CGT event E4 happens as a result of the capital distribution. Consequently, Jamie must reduce the cost base of each of his consolidated WFA units by \$1.01 to \$13.12.

The capital distribution was compulsorily applied to acquire a share in Westfield Holdings Ltd (WSF) for \$0.01 and a unit in the Westfield Trust (WFT) for \$1.00. The first element of the cost base and reduced cost base of each of Jamie's new shares in WSF will be \$0.01 and for each new WFT unit \$1.00.

The units and shares were then stapled to form a Westfield Group Security. There are no CGT consequences for Jamie as a result of the stapling of each consolidated WFA unit to each new WFT unit and WSF share.

Following the arrangement, Jamie holds 15 Westfield Group Securities with the following CGT attributes:

| Element | WFA unit | WFT unit | WSF share | Total |
|---------------------|----------|----------|-----------|---------|
| Cost base (initial) | \$13.12 | \$1.00 | \$0.01 | \$14.13 |

When you dispose of your stapled securities you must divide the capital proceeds (on a reasonable basis) between the securities that make up the stapled security and then work out whether you have made a capital gain or capital loss on each security.

! NOTE

Other tax provisions may apply upon disposal of some securities – for example, you include a gain made on a traditional security in your assessable income under other tax provisions.

EXAMPLE: Apportioning the capital proceeds between the separate securities

On 1 August 1983 Kelley purchased 100 shares in XYZ Ltd for \$4.00 per share. In August 2002, Kelley was allocated 100 units in XYZ Unit Trust under a corporate reorganisation of the XYZ Group. The units were acquired for \$1.00 each, with the funds to acquire the units coming from a capital reduction made in respect of her shares. At that same time Kelley's shares in XYZ Ltd and units in XYZ Unit Trust were stapled and became known as XYZ stapled securities.

Kelley disposed of all of her XYZ stapled securities on 1 March 2006 for \$8.00 per security. On the basis of the information provided by the issuer of the stapled securities, Kelley determined that of this amount 70% or \$5.60 per share ($\$8.00 \times 70\%$) was attributable to the value of her XYZ Ltd shares and 30% or \$2.40 per unit ($\$8.00 \times 30\%$) to the value of her units in the XYZ Unit Trust.

Kelley must account for the sale of each share and unit (that make up the stapled security) separately.

As Kelley acquired her XYZ Ltd shares before 20 September 1985, she disregards any capital gain or capital loss she makes on the disposal of these shares.

Kelley will make a capital gain of \$1.40 per unit ($\$2.40 - \1.00) on the disposal of her units in the XYZ Unit Trust. As Kelley owned those units for more than 12 months she can reduce her capital gain by the CGT discount of 50% after applying any capital losses.

➤ For more information on stapled securities, see our fact sheet *Stapled securities and capital gains tax*, available on our website.

NON-ASSESSABLE PAYMENTS

You may need to adjust the cost base of shares or units for CGT calculations if you receive a non-assessable payment without disposing of your shares or units. A payment or distribution can include money and property.

You need to keep accurate records of the amount and date of any non-assessable payments on your shares and units.

! NON-ASSESSABLE PAYMENTS AFTER A RECENT RESTRUCTURE

As a result of recent stapling arrangements, some investors in managed funds have received units which have a very low cost base. The payment of certain non-assessable amounts in excess of the cost base of the units will result in these investors making a capital gain.

Non-assessable payments from a company (CGT event G1)

Non-assessable payments to shareholders are not very common and would generally be made only if a company has shareholder approval to reduce its share capital – for example, to refund part of the paid-up value of shares to shareholders. Before 1 July 1998, a company needed court approval to reduce its share capital.

If you receive a non-assessable payment from a company (that is, a payment that is not a dividend), you need to adjust the cost base of the shares at the time of the payment. If the amount of the non-assessable payment is not more than the cost base of the shares at the time of payment, you reduce the cost base and reduced cost base by the amount of the payment.

You make a capital gain if the amount of the non-assessable payment is more than the cost base of the shares. The amount of the capital gain is equal to the excess. If you make a capital gain, you reduce the cost base and reduced cost base of the shares to nil. You cannot make a capital loss from the making of a non-assessable payment.

Interim liquidation distributions that are not dividends can be treated in the same way as other non-assessable payments under CGT event G1.

The exception is if the payment is made to you by a liquidator after the declaration and the company is dissolved within 18 months of such a payment. In that case, you include the payment as capital proceeds on the cancellation of your shares (rather than you making a capital gain at the time of the payment). In preparing your tax return, you may delay declaring any capital gain until your shares are cancelled unless you are advised by the liquidator in writing that the company will not cease to exist within 18 months of your receiving the payment.

EXAMPLE: Non-assessable payments

Rob bought 1,500 shares in RAP Ltd on 1 July 1994 for \$2 each. On 30 November 2005, as part of a shareholder-approved scheme for the reduction of RAP's share capital, he received a non-assessable payment of 50 cents per share. At that date, the cost base of each share (without indexation) was \$2.20.

As the amount of the payment is not more than the cost base (without indexation), he reduces the cost base of each share at 30 November 2005 by the amount of the payment to \$1.70 (\$2.20 – 50 cents). As Rob has chosen not to index the cost base, he can claim the CGT discount if he disposes of the shares in the future.

Non-assessable payments from a unit trust (CGT event E4)

Unit trusts often make non-assessable payments to unit holders. Your CGT obligations in this situation are explained in chapter 4.

When you sell the units, you must adjust their cost base and reduced cost base. The amount of the adjustment is based on the amount of non-assessable payments you received during the income year up to the date of sale. You use the adjusted cost base and reduced cost base to work out your capital gain or capital loss.

! NON-ASSESSABLE PAYMENTS UNDER A DEMERGER

If you receive a non-assessable payment under an eligible demerger, you do not deduct the payment from the cost base and the reduced cost base of your shares or units. Instead you adjust your cost base and reduced cost base under the demerger rules. You may make a capital gain on the non-assessable payment if it exceeds the cost base of your original share or unit, although you will be able to choose CGT rollover.

An eligible demerger is one that happens on or after 1 July 2002 and satisfies certain tests. The head entity will normally advise shareholders or unit holders if this is the case.

For more information about demergers, see **Demergers** on page 42.

INVESTMENTS IN FOREIGN HYBRIDS

If you have an investment in a foreign hybrid, the tax treatment from 1 July 2003 or optionally from 1 July 2002 has changed. A foreign hybrid is an entity that was taxed in Australia as a company but taxed overseas as a partnership. This can include a limited partnership, a limited liability partnership and a US limited liability company. Investors in these entities are now treated for Australian tax purposes as having a partnership interest. Previously, the investors were treated as shareholders and distributions they received were taxed as dividends. Further information is available on our website.

GENERAL VALUE SHIFTING REGIME (GVSR)

If you own shares in a company or units (or other fixed interests) in a trust, you may be affected by value shifting rules. The value shifting rules may apply to you if:

- you have interests in a company or trust in which equity or loan interests have been issued or bought back at other than market value, or varied such that the values of some interests have increased while others have decreased (direct value shifts on interests), or
- you have interests in an entity whose dealings (such as providing loans or other services, or transferring assets) with another entity are neither at market value nor arm's length and both entities are under the same control or ownership (indirect value shifting).

➤ For more information on whether the GVSR rules apply to you, see *General value shifting regime in brief*, available on our website. For detailed information on the operation of the rules, see the *Guide to the general value shifting regime*, also available on our website.

USING THE CAPITAL GAIN OR CAPITAL LOSS WORKSHEET FOR SHARES

In the example on the next page, Tony uses the indexation method, the discount method and the 'other' method to calculate his capital gain so he can decide which method gives him the best result. This example shows you how to complete the **Capital gain or capital loss worksheet** at the back of this guide to calculate your capital gain when you acquire or dispose of shares.

See chapter 2 for a description of each method and when you can use each one.

Remember that if you bought and sold your shares within 12 months, you must use the 'other' method to calculate your capital gain. If you owned your shares for 12 months or more, you may be able to use either the discount method or the indexation method, whichever gives you the better result.

Because each share in a parcel of shares is a separate CGT asset, you can use different methods to work out the amount of any capital gain for shares within a parcel. This may be to your advantage if you have capital losses to apply. See the example of Clare on page 26.

EXAMPLE: Using all three methods to calculate a capital gain

On 1 July 1993, Tony bought 10,000 shares in Kimbin Ltd for \$2 each. He paid stockbrokers fee of \$250 and stamp duty of \$50.

On 1 July 2005, Kimbin Ltd offered each of its shareholders one right for each four shares owned to acquire shares in the company for \$1.80 each. The market value of the shares at the time was \$2.50. On 1 August 2005, Tony exercised all rights and paid \$1.80 per share.

On 1 December 2005, Tony sold all his shares in Kimbin Ltd for \$3.00 each. He incurred stockbrokers fee of \$500 and stamp duty of \$50.

! SEPARATE RECORDS

Tony has two parcels of shares – those he acquired on 1 July 1993 and those he acquired at the time he exercised all rights, 1 August 2005. He needs to keep separate records for each parcel and apportion the stockbrokers fee of \$500 and stamp duty of \$50.

The completed **Capital gain or capital loss worksheets** on the following pages show how Tony can evaluate which method gives him the best result.

He uses the 'other' method for the 2,500 shares he owned for less than 12 months, as he has no choice:

| | | | | |
|------------------|---|-----------|---|--------------|
| \$7,500 | – | \$4,610 | = | \$2,890 |
| capital proceeds | | cost base | | capital gain |

For the 10,000 shares he has owned for 12 months or more, his capital gain using the indexation method would be:

| | | | | |
|------------------|---|-----------|---|--------------|
| \$30,000 | – | \$23,257 | = | \$6,743 |
| capital proceeds | | cost base | | capital gain |

This means his net capital gain would be:

| | | | | |
|----------------|---|-------------------|---|------------------|
| \$2,890 | + | \$6,743 | = | \$9,633 |
| 'other' method | | indexation method | | net capital gain |

If Tony uses the discount method instead (assuming he has no capital losses), his capital gain would be:

$\$30,000 - \$20,740 = \$9,260$

He applies the CGT discount of 50%:

$\$9,260 \times 50\% = \$4,630$

This means his net capital gain would be:

| | | | | |
|----------------|---|-----------------|---|------------------|
| \$2,890 | + | \$4,630 | = | \$7,520 |
| 'other' method | | discount method | | net capital gain |

In this case he would choose the discount method rather than the indexation method, as it gives him the better result (a lower net capital gain).

Dividends paid by listed investment companies (LIC) that include LIC capital gain

If a LIC pays a dividend to you that includes a **LIC capital gain amount**, you may be entitled to an income tax deduction.

You can claim a deduction if:

- you are an individual
- you were an Australian resident when a LIC paid you a dividend
- the dividend was paid to you after 1 July 2001, and
- the dividend included a LIC capital gain amount.

The amount of the deduction is 50% of the LIC capital gain amount. The LIC capital gain amount will be shown separately on your dividend statement.

You do not show the LIC capital gain amount at item **17** on your tax return (supplementary section) – or item **9** if you use the tax return for retirees.

EXAMPLE: LIC capital gain

Ben, an Australian resident, was a shareholder in XYZ Ltd, a LIC. For the 2005–06 income year, Ben received a fully franked dividend from XYZ Ltd of \$70,000 including a LIC capital gain amount of \$50,000. Ben includes on his tax return the following amounts:

| | |
|--|------------------|
| Franked dividend (shown at T item 11 in his tax return) | \$70,000 |
| plus franking credit (shown at U item 11 in his tax return) | \$30,000 |
| | \$100,000 |
| less deduction for LIC capital gain (shown as deduction at item D7 on his tax return) | \$25,000 |
| Net amount included in taxable income | \$75,000 |

! NOTE

If Ben uses the tax return for retirees, he shows the amounts as follows: franked dividend at **T** item **8**, franking credit at **U** item **8** and deduction for LIC capital gain at item **12**.

CAPITAL GAIN OR CAPITAL LOSS WORKSHEET

This worksheet helps you calculate a capital gain for each CGT asset or any other CGT event¹ using the indexation method², the discount method³ and/or the 'other' method. It also helps you calculate a capital loss.

CGT asset type or CGT event

Shares and units (in unit trusts) ☒
 Real estate ☐

Other CGT assets and any other CGT events⁴ ☐
 Collectables⁵ ☐

Description of CGT asset or CGT event

Tony's 2,500 shares in Kimbin Ltd - Exercise of rights, given 1/7/2005, exercised 1/8/2005

Date of acquisition

01/08/2005

Date of CGT event

01/12/2005

ELEMENTS OF THE COST BASE OR REDUCED COST BASE

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|-------------------|---|---------------------------|---------------------------------|---------------------------|
| Amount | Amounts to be deducted for cost base ⁹ | Cost base (1 - 2) | Amounts to be deducted for reduced cost base ⁹ | Reduced cost base (1 - 4) | Indexation factor ¹⁰ | Cost base indexed (3 x 6) |
| Acquisition or purchase cost of the CGT asset ⁶ | 0 | 4,500 | | | | |
| Incidental costs to acquire the CGT asset | 0 | 110 | | | | |
| Incidental costs that relate to the CGT event ⁷ | | | | | | |
| Costs of owning the CGT asset ⁸ | | | | | | |
| Capital expenditure to increase or preserve the asset's value or install or move it | | | | | | |
| Capital costs to establish, preserve or defend title to, or a right over, the CGT asset | | | | | | |
| Cost base unindexed | | \$ 4,610 | | | | |
| Reduced cost base | | | | \$ | | |
| Cost base indexed | | | | | | \$ |

CAPITAL GAIN CALCULATION

| Indexation method | Discount method | 'Other' method (CGT asset held less than 12 months) |
|--------------------------------|--------------------------------|---|
| Capital proceeds ¹¹ | Capital proceeds ¹¹ | Capital proceeds ¹¹ |
| \$ | \$ | \$ 7,500 |
| less: cost base indexed | less: cost base unindexed | less: cost base unindexed |
| \$ | \$ | \$ 4,610 |
| Capital gain (a) | Capital gain (b)* | Capital gain |
| \$ | \$ | \$ 2,890 |

* In choosing between capital gain (a) or (b), remember that the CGT discount will not apply to (a) but it will reduce the amount of capital gain remaining after capital losses are deducted from (b).

FOOTNOTES

See the back of this worksheet.

Transfer the capital gain to **part A1** of the CGT summary worksheet, except for a capital gain from collectables which is transferred to **part A2** of that worksheet.

Transfer the capital loss to **part B** of the CGT summary worksheet, except for a capital loss from collectables which is transferred to **part A2** of that worksheet.

CAPITAL LOSS CALCULATION

| Capital loss |
|--------------------------------------|
| Reduced cost base |
| \$ |
| less: capital proceeds ¹¹ |
| \$ |
| Capital loss ¹² |
| \$ |

CAPITAL GAIN OR CAPITAL LOSS WORKSHEET

This worksheet helps you calculate a capital gain for each CGT asset or any other CGT event³ using the indexation method², the discount method³ and/or the 'other' method. It also helps you calculate a capital loss.

CGT asset type or CGT event

Shares and units (in unit trusts) ☒
 Real estate ☐

Other CGT assets and any other CGT events⁴ ☐
 Collectables⁵ ☐

Description of CGT asset or CGT event

Tony's 10,000 shares in Kimbin Ltd

Date of acquisition

01/07/1993

Date of CGT event

01/12/2005

ELEMENTS OF THE COST BASE OR REDUCED COST BASE

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|-------------------|---|---------------------------|---------------------------------|---------------------------|
| Amount | Amounts to be deducted for cost base ⁹ | Cost base (1 - 2) | Amounts to be deducted for reduced cost base ⁹ | Reduced cost base (1 - 4) | Indexation factor ¹⁰ | Cost base indexed (3 × 6) |
| Acquisition or purchase cost of the CGT asset ⁶ | 0 | 20,000 | | | 1.124 | 22,480 |
| Incidental costs to acquire the CGT asset | 0 | 300 | | | 1.124 | 337 |
| Incidental costs that relate to the CGT event ⁷ | 0 | 440 | | | 1 | 440 |
| Costs of owning the CGT asset ⁸ | | | | | | |
| Capital expenditure to increase or preserve the asset's value or install or move it | | | | | | |
| Capital costs to establish, preserve or defend title to, or a right over, the CGT asset | | | | | | |
| Cost base unindexed | | \$ 20,740 | | | | |
| Reduced cost base | | | | \$ | | |
| Cost base indexed | | | | | | \$ 23,257 |

CAPITAL GAIN CALCULATION

| Indexation method | Discount method | 'Other' method (CGT asset held less than 12 months) |
|--------------------------------|--------------------------------|---|
| Capital proceeds ¹¹ | Capital proceeds ¹¹ | Capital proceeds ¹¹ |
| \$ 30,000 | \$ 30,000 | \$ |
| less: cost base indexed | less: cost base unindexed | less: cost base unindexed |
| \$ 23,257 | \$ 20,740 | \$ |
| Capital gain (a) | Capital gain (b)* | Capital gain |
| \$ 6,743 | \$ 9,260 | \$ |

* In choosing between capital gain (a) or (b), remember that the CGT discount will not apply to (a) but it will reduce the amount of capital gain remaining after capital losses are deducted from (b).

! FOOTNOTES

See the back of this worksheet.

Transfer the capital gain to **part A1** of the CGT summary worksheet, except for a capital gain from collectables which is transferred to **part A2** of that worksheet.

Transfer the capital loss to **part B** of the CGT summary worksheet, except for a capital loss from collectables which is transferred to **part A2** of that worksheet.

CAPITAL LOSS CALCULATION

| Capital loss |
|--------------------------------------|
| Reduced cost base |
| \$ |
| less: capital proceeds ¹¹ |
| \$ |
| Capital loss ¹² |
| \$ |

This chapter explains your capital gains tax (CGT) obligations for real estate. Real estate includes vacant blocks of land, business premises, rental properties, holiday houses and hobby farms. The CGT exemption for a **main residence** is also explained in this chapter.

Apart from the main residence rules, capital gains and capital losses on real estate are worked out under the rules set out earlier in this guide.

Land is a CGT asset. In some cases improvements made to land are treated as separate CGT assets – see **Separate assets** on page 10. A depreciating asset that is found in a building (for example, carpet or a hot water system) is also taken to be a separate CGT asset from the building. When a CGT event happens to your property you must work out a capital gain or capital loss for each CGT asset it comprises (or balancing adjustment in the case of **depreciating assets** sold with the property).

The most common CGT event that happens to real estate is its sale or disposal – **CGT event A1**. The time of the event is:

- when you enter into the contract for the disposal
- if there is no contract – when the change of ownership occurs, or
- if the asset is compulsorily acquired by an entity – the earliest of:
 - when you received compensation from the entity
 - when the entity became the asset's owner
 - when the entity entered it under a power of compulsory acquisition, or
 - when the entity took possession under that power.

If land is disposed of under a contract, it is taken to have been disposed of when the contract is entered into – not the settlement date. The fact that a contract is subject to a condition, such as finance approval, will generally not affect this date.

You are not required to include any capital gain or capital loss on your tax return for the relevant year until an actual change of ownership occurs. When settlement occurs, you must include any capital gain or capital loss in the year of income in which the contract was made. If an assessment has already been made for that year of income, you may need to have that assessment amended. Where an assessment is amended to include a net capital gain and a liability for shortfall interest charge (SIC) arises, remission of that interest charge will be considered on a case by case basis. Generally, it would be expected that the shortfall interest charge would be remitted in full where requests for amendment are lodged within a reasonable time after the

date of settlement – which, in most cases, is considered to be one month. If you consider that the shortfall interest charge should be remitted, you should provide reasons why when you request the amendment to your assessment. More information about SIC is available on our website.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

RULES TO KEEP IN MIND

There are a few rules to keep in mind when you calculate your capital gain or capital loss from real estate, in particular rules relating to:

- the costs of owning, and
- cost base adjustments for capital works deductions.

Costs of owning

You do not include rates, insurance, land tax, maintenance and interest on money you borrowed to buy the property or finance improvements to it in the reduced cost base. You only include them in the cost base if:

- you acquired the property under a contract entered into after 20 August 1991 (or if you didn't acquire it under a contract, you became the owner after that date), and
- you could not claim a deduction for the costs because you did not use the property to produce assessable income – for example, it was vacant land, your main residence or a holiday home during the period.

Cost base adjustments for capital works deductions

In working out a capital gain for property that you used to produce assessable income – such as a rental property or business premises – you may need to exclude from the cost base and reduced cost base capital works deductions you have claimed in any year (or omitted to claim but can still claim because the period for amending the relevant income tax assessment has not expired).

For information on when property (for example, a building, structure or other capital improvement to land) is treated for CGT purposes as a CGT asset separate from the land, see chapter 1, and **Major capital improvements to a dwelling acquired before 20 September 1985** on page 78.

You must exclude from the cost base of a CGT asset (including a building, structure or other capital improvement to land that is treated as a separate asset for CGT purposes) the amount of capital works deductions you claimed (or omitted to but can still claim because the period for amending the relevant income tax assessment has not expired) for the asset if:

- you acquired the asset after 7.30pm (by legal time in the ACT) on 13 May 1997, or
- you acquired the asset before that time and the expenditure that gave rise to the capital works deductions was incurred after 30 June 1999.

However if you omitted to claim capital works deductions because you did not have sufficient information to determine the amount and nature of the construction expenditure, there is no need to exclude the amount of such deductions from the cost base of the CGT asset.

Reduced cost base

You exclude the amount of the capital works deductions you claimed (or omitted to claim but can still claim because the period for amending the relevant income tax assessment has not expired) from the reduced cost base. However if you omitted to claim capital works deductions because you did not have sufficient information to determine the amount and nature of the construction expenditure, there is no need to exclude the amount of such deductions from the reduced cost base of the CGT asset.

EXAMPLE: Capital works deduction

Zoran acquired a rental property on 1 July 1997 for \$200,000. Before disposing of the property on 30 June 2006, he had claimed \$10,000 in capital works deductions.

At the time of disposal, the cost base of the property was \$210,250. Zoran must reduce the cost base of the property by \$10,000 to \$200,250.

Rollover

There is no rollover or exemption for a capital gain you make when you sell an asset and put the proceeds into a superannuation fund or use the proceeds to purchase an identical or similar asset or you transfer an asset into a superannuation fund. For example, if you sell a rental property and put the proceeds into a superannuation fund or use the proceeds to purchase another rental property, rollover is not available. However, rollover may be available in special circumstances – in particular for destruction or compulsory acquisition of property (see chapter 7) or marriage breakdown (see chapter 8). However, an asset or the capital proceeds from the sale of an asset may be transferred into a superannuation fund in order to satisfy certain conditions under the small business retirement exemption. For more information about the CGT concessions for small business, see *Guide to capital gains tax concessions for small business*.

Keeping records

Keep appropriate records – see **Records relating to real estate** on page 30.

SALE OF A RENTAL PROPERTY

The example on the next page shows how you would calculate your capital gain on the sale of your rental property.

The sample worksheet on page 61 shows how you would complete the **Capital gain or capital loss worksheet** for this example.

EXAMPLE: Sale of a rental property

Brett travelled interstate in February 1997 to inspect a number of properties and incurred travel and accommodation costs. He purchased one of the properties, a residential rental property, on 1 July 1997. The price he paid was \$150,000 of which \$6,000 was attributable to depreciating assets. He also paid \$20,000 in total for pest and building inspections, stamp duty and solicitors fees.

In the next few years, Brett incurred the following expenses on the property:

| | |
|----------------------------------|-----------------|
| Interest on money borrowed | \$10,000 |
| Rates and land tax | \$8,000 |
| Deductible (non-capital) repairs | \$15,000 |
| Total | \$33,000 |

Brett cannot include the expenses of \$33,000 in the cost base as he was able to claim a deduction for them. Nor can he include the travel and accommodation costs incurred before he acquired the property as they do not come within any of the five elements of cost base, see **Elements of the cost base** page 12.

When Brett decided to sell the property, a real estate agent advised him that if he spent around \$30,000 on major structural improvements, the property would be valued at around \$500,000. The major structural improvements were completed on 1 October 2005 at a cost of \$30,000.

On 1 April 2006, he sold the property for \$500,000 (of which \$4,000 was attributable to depreciating assets).

Brett's real estate agents fees and solicitors fees for the sale of the property totalled \$12,500.

Brett could not claim any capital works deductions for the original construction costs as construction of the property began before 18 July 1985. However, he could claim a capital works deduction of \$375 ($\$30,000 \times 2.5\% \times 183 \div 365$) for the major structural improvements. For information about capital works that qualify for a deduction, see *Rental properties 2006* (NAT 1729-6.2006). For information about how capital works deductions affect the CGT cost base, see page 58.

This is Brett's only capital gain for the year – and he has no capital losses to offset from this year or previous years.

Brett works out his cost base as follows:

| | |
|---|------------------|
| Purchase price of property (not including depreciating assets) | \$144,000 |
| <i>plus</i> | |
| Pest and building inspections, stamp duty and solicitors fees on purchase of the property | \$20,000 |
| Capital expenditure (major structural improvements) \$30,000 less capital works deduction (\$375) | \$29,625 |
| Real estate agents fees and solicitors fees on sale of the property | \$12,500 |
| Cost base unindexed | \$206,125 |

Brett deducts his cost base from his capital proceeds (sale price):

| | |
|---|------------------|
| Proceeds from selling the house (not including depreciating assets) | \$496,000 |
| <i>less</i> | |
| Cost base unindexed | \$206,125 |
| | \$289,875 |

He decides the discount method will give him the best result, so he uses this method to calculate his capital gain:

$$\$289,875 \times 50\% = \$144,937$$

Brett shows \$144,937 at **A** item **17** on his tax return (supplementary section) – or item **9** if he uses the tax return for retirees.

Brett shows \$289,875 at **H** Total current year capital gains at item **17** on his tax return (supplementary section) – or at item **9** if he uses the tax return for retirees. Brett must also make balancing adjustment calculations for his depreciating assets. Because he used the property 100% for taxable purposes he will not make a capital gain or capital loss from the depreciating assets.

CAPITAL GAIN OR CAPITAL LOSS WORKSHEET

This worksheet helps you calculate a capital gain for each CGT asset or any other CGT event³ using the indexation method², the discount method³ and/or the 'other' method. It also helps you calculate a capital loss.

CGT asset type or CGT event

Shares and units (in unit trusts) ☐
Real estate ☒

Other CGT assets and any other CGT events⁴ ☐
Collectables⁵ ☐

Description of CGT asset or CGT event

Brett's property at 30 Jones St. Oldtown

Date of acquisition Date of CGT event

ELEMENTS OF THE COST BASE OR REDUCED COST BASE

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|-------------------|---|---------------------------|---------------------------------|---------------------------|
| Amount | Amounts to be deducted for cost base ⁹ | Cost base (1 – 2) | Amounts to be deducted for reduced cost base ⁹ | Reduced cost base (1 – 4) | Indexation factor ¹⁰ | Cost base indexed (3 × 6) |
| Acquisition or purchase cost of the CGT asset ⁶ | 0 | 144,000 | | | 123.4 ÷ 119.7 = 1.031 | 148,464 |
| Incidental costs to acquire the CGT asset | 0 | 20,000 | | | 1.031 | 20,620 |
| Incidental costs that relate to the CGT event ⁷ | 0 | 12,500 | | | 1 | 12,500 |
| Costs of owning the CGT asset ⁸ | 33,000 | 0 | | | | 0 |
| Capital expenditure to increase or preserve the asset's value or install or move it | 375 | 29,625 | | | 1 | 29,625 |
| Capital costs to establish, preserve or defend title to, or a right over, the CGT asset | | | | | | |
| Cost base unindexed | | \$ 206,125 | | | | |
| Reduced cost base | | | | \$ | | |
| Cost base indexed | | | | | | \$ 211,209 |

CAPITAL GAIN CALCULATION

| Indexation method | Discount method | 'Other' method (CGT asset held less than 12 months) |
|--------------------------------|--------------------------------|---|
| Capital proceeds ¹¹ | Capital proceeds ¹¹ | Capital proceeds ¹¹ |
| \$ 496,000 | \$ 496,000 | \$ |
| less: cost base indexed | less: cost base unindexed | less: cost base unindexed |
| \$ 211,209 | \$ 206,125 | \$ |
| Capital gain (a) | Capital gain (b)* | Capital gain |
| \$ 284,791 | \$ 289,875 | \$ |

* In choosing between capital gain (a) or (b), remember that the CGT discount will not apply to (a) but it will reduce the amount of capital gain remaining after capital losses are deducted from (b).

FOOTNOTES

See the back of this worksheet.

Transfer the capital loss to **part B** of the CGT summary worksheet, except for a capital loss from collectables which is transferred to **part A2** of that worksheet.

Transfer the capital gain to **part A1** of the CGT summary worksheet, except for a capital gain from collectables which is transferred to **part A2** of that worksheet.

Other CGT events affecting real estate

CGT event B1 happens to real estate if you enter into an agreement where the new owner is entitled to possession of the land or the receipt of rents and profits before becoming entitled to a transfer or conveyance of the land.

Where this happens under a contract, it is known as a terms contract and the new owner usually completes the purchase by paying the balance of the purchase price and receiving the instrument of transfer and title deeds.

It may also happen where an agreement is made with a relative or other party to use and enjoy the property for a specified period, after which title to the property passes to them. It will not happen where, under an arrangement, title to a property may pass at an unspecified time in the future.

CGT event B1 happens when use and enjoyment of the land is first obtained by the new owner. Use and enjoyment of the land from a practical point of view takes place at the time the new owner gets possession of the land or the date the new owner becomes entitled to the receipt of rents and profits.

If the agreement falls through before completion and title to the land does not pass to the new owner, you may be entitled to amend your assessment for the year in which CGT event B1 happened.

CGT event C1 happens if an asset is lost or destroyed. This event may happen if, for example, a building on your land is destroyed by fire. Your capital proceeds for CGT event C1 happening include any insurance proceeds you may receive for the loss or destruction. The market value substitution rule for capital proceeds that generally applies if you receive no capital proceeds does not apply if CGT event C1 happens. For more information, see chapter 7.

CGT event D1 happens if you give someone a right to reside in a dwelling. The capital proceeds include money (but not rent) and the value of any property you receive.

The market value substitution rule for capital proceeds (see **Definitions** on page 132) applies if:

- the amount of capital proceeds you receive is more or less than the market value of the right, and
- you and the person you granted the right to were not dealing with each other at arm's length in connection with the event.

CGT event D2 happens if you grant an option to a person or an entity, or renew or extend an option that you had granted.

The amount of your capital gain or capital loss from CGT event D2 is the difference between what you receive for granting the right and any expenditure you incurred on it. The CGT discount does not apply to CGT event D2.

EXAMPLE: Granting of an option

You were approached by Colleen who was interested in buying your land. On 30 June 2005, you granted her an option to purchase your land within 12 months for \$200,000. Colleen pays you \$10,000 for the grant of the option. You incur legal fees of \$500. You made a capital gain in the 2004–05 income year of \$9,500.

Exercise of an option

If the option you granted is later exercised, you ignore any capital gain or capital loss you made from the grant, renewal or extension. You may have to amend your income tax assessment for an earlier income year.

Similarly, any capital gain or capital loss that the grantee would otherwise make from the exercise of the option is disregarded.

The effect of the exercise of an option depends on whether the option was a call option or a put option. A call option is one that binds the grantor to dispose of an asset. A put option binds the grantor to acquire an asset.

EXAMPLE: Granting of an option (cont)

On 1 February 2006, Colleen exercised the option. You disregard the capital gain that you made in 2005 and you request an amendment of your income tax assessment to exclude that amount. The \$10,000 you received for the grant of the option is considered to be part of the capital proceeds for the sale of your property in the 2005–06 income year. Your capital gain or capital loss from the property is the difference between its cost base/reduced cost base and \$210,000.

CGT event D4 happens if you enter into a conservation covenant after 15 June 2000 over land that you own and if you receive capital proceeds for entering into the covenant.

From 1 July 2002, CGT event D4 also happens if you receive no capital proceeds for entering into the covenant and you can claim a tax deduction for entering into the covenant. One of the conditions for a tax deduction is that the covenant is entered into with a deductible gift recipient or an Australian government agency (that is, the Commonwealth, a state, a territory or one of their authorities).

A 'conservation covenant' is a covenant that:

- restricts or prohibits certain activities on the land that could degrade the environmental value of the land
- is permanent and binding on current and future land owners (by way of registration on the title to the land where possible), and
- is approved by the Minister for the Environment and Heritage (including those entered into under a program approved by that Minister).

If CGT event D4 happens, you calculate your capital gain by comparing your capital proceeds from entering into the covenant with the portion of the cost base of the land that is attributable to the covenant.

Similarly, you calculate your capital loss by comparing your capital proceeds from entering into the covenant with the portion of the reduced cost base of the land that is attributable to the covenant.

NOTE

The market value substitution rule for capital proceeds that generally applies if you receive no consideration for a CGT event does not apply if CGT event D4 happens. Instead, the capital proceeds are equal to the amount you can claim as a tax deduction for entering into the covenant.

Calculate the relevant portion of the cost base and reduced cost base attributable to the covenant using this formula:

$$\text{Cost base (reduced cost base)} \times \frac{\text{capital proceeds from entering into the covenant over land}}{\text{those capital proceeds plus the market value of the land just after you enter into the covenant}}$$

As the conservation covenant will affect the value of the entire land you must use the cost base of the entire land in calculating the cost base apportioned to the covenant. This is the case even if the covenant specifically states within its terms that the restrictions as to use only apply to part of the land.

CGT event D4 will not happen if you receive no capital proceeds and the conditions for a tax deduction for entering into the covenant are not satisfied. In that case, CGT event D1 will apply.

CGT events involving leases

There are a number of CGT events that might apply to the lease of land.

CGT event F1 happens if you grant a lease to a person or entity or if you extend or renew a lease that you had previously granted. In the case of a long-term lease (one that may be expected to continue for at least 50 years), you can choose to treat the grant (renewal or extension) of the lease as a part disposal of the underlying leased property.

EXAMPLE: Receiving an amount for granting a lease

Elisabeth operates a profitable footwear retailing business, and wishes to lease some shop space in a prestigious location in the Sydney CBD. However, the demand for shop space in the locality is great, and competition between prospective tenants is fierce. In order to ensure that she secures the lease of the particular shop space that she wants, Elisabeth pays John Rich (the owner of the shop space) a premium of \$6,000 in consideration for the grant of that particular lease.

She enters into the lease on 6 September 2005, and John Rich incurs stamp duty of \$300 and solicitors fees of \$500 on the grant of the lease.

John makes a capital gain of \$5,200 from CGT event F1

| | |
|---|---------|
| Capital proceeds: | \$6,000 |
| Incidental costs: (that is, stamp duty of \$300 and solicitors fees of \$500) | \$800 |

Note: For Elisabeth, this transaction results in CGT event C2 when the lease expires.

The amount of your capital gain or capital loss from CGT event F1 is the difference between any premium you got for granting the lease and the expenditure you incurred in granting it. The CGT discount does not apply to CGT event F1. The market value substitution rule for capital proceeds that generally applies if you receive no consideration for a CGT event does not apply if CGT event F1 happens.

You can choose for CGT event F2 to apply (rather than CGT event F1) when you grant, renew or extend a long-term lease. It can apply if you are the owner of the underlying land or if you grant a sub-lease.

Your capital proceeds if CGT event F2 happens are the greatest of:

- the market value of the freehold or head lease (at the time you grant, renew or extend the lease)
- the market value if you had not granted, renewed or extended the lease, and
- any premium from the grant, renewal or extension.

There are special cost base rules that apply if you choose for CGT event F2 to apply.

For any later CGT event that happens to the land or the lessor's lease of it, its cost base and reduced cost base (including the cost base and reduced cost base of any building, part of a building, structure or improvement that is treated as a separate CGT asset) excludes:

- any expenditure incurred before CGT event F2 happens, and
- the cost of any depreciating asset for which the lessor has deducted or can deduct an amount for its decline in value.

The fourth element of the property's cost base and reduced cost base includes any payment by the lessor to the lessee to vary or waive a term of the lease or for the forfeiture or surrender of the lease, reduced by the amount of any input tax credit to which the lessor is entitled for the variation or waiver.

CGT event F3 happens if you make a payment to a lessee to vary a lease. You can only make a capital loss from this CGT event. Your capital loss is equal to the expenditure you incurred to change the lease.

CGT event F4 happens if you (as lessee) receive a payment from the lessor for agreeing to vary or waive a term of the lease.

You cannot make a capital loss from this CGT event. You will only make a capital gain from CGT event F4 if the amount of the payment you received exceeds the cost base of your lease at the time when the term is varied. In other cases, you will be required to adjust the cost base of your lease.

The market value substitution rule for capital proceeds that applies if you do not receive market value for a CGT event does not apply if CGT event F4 happens.

EXAMPLE: Payment to lessee for change in lease

Sam is the lessor of a commercial property. His tenant, Peter, currently holds a three-year lease over the property, which has another 26 months to run. A business associate of Sam's wishes to lease the property from Sam for a 10-year period, beginning in six months' time, for twice the rent that Peter is currently paying. Sam approaches Peter with an offer of \$5,000 cash for Peter to agree to vary the terms of the lease so that the lease will expire in six months' time. Peter agrees to vary the terms on 10 August 2005.

Sam will make a capital loss of \$5,000 from CGT event F3 happening:

| | |
|--|---------|
| Capital proceeds: | \$0 |
| Incidental costs/expenditure incurred: | \$5,000 |

For Peter this transaction results in CGT event F4 happening. The cost base of Peter's lease at the time of the variation was \$500. He makes a capital gain of \$4,500 (\$5,000 – \$500).

! NOTE

You disregard any capital loss you make from the expiry, forfeiture, surrender or assignment of a lease (except one granted for 99 years or more) if you did not use it solely or mainly for the purpose of producing assessable income – for example, if you used it for private purposes.

CGT event F5 happens if you as lessor receive a payment for changing a lease.

The amount of your capital gain or capital loss from CGT event F5 is the difference between what you receive for changing the lease and any expenditure you incurred on it. The CGT discount does not apply to CGT event F5.

SUBDIVISION OF LAND

If you subdivide a block of land, each block that results is registered with a separate title. For CGT purposes, the original land parcel is divided into two or more separate assets. Subdividing land does not result in a CGT event if you retain ownership of the subdivided blocks. Therefore, you do not make a capital gain or a capital loss at the time of the subdivision.

However, you may make a capital gain or capital loss when you sell the subdivided blocks. The date you acquired the subdivided blocks is the date you acquired the original parcel of land and the cost base of the original land is divided between the subdivided blocks on a reasonable basis.

! WHEN THE PROFIT IS ORDINARY INCOME

You may have made a profit from the subdivision and sale of land which occurred in the ordinary course of your business or which involved a commercial transaction or business operation entered into with the purpose of making a profit. In this case, the profit is ordinary income (see *Taxation Ruling TR 92/3 – Whether profits on isolated transactions are income*). You reduce any capital gain from the land by the amount otherwise included in your assessable income.

EXAMPLE: Land purchased before 20 September 1985, land subdivided after that date and house built on subdivided land

In 1983, Mike bought a block of land that was less than 2 hectares. He subdivided the land into two blocks in May 2005 and began building a house on the rear block, which he finished in August 2005. He sold the rear block (including the house) in October 2005 for \$250,000. Mike got a valuation from a qualified valuer who valued the rear block at \$150,000 and the house at \$100,000. The construction cost of the house was \$85,000.

Mike acquired the rear block before 20 September 1985, so it is not subject to CGT. As the new house was constructed after 20 September 1985 on land purchased before that date, the house is taken to be a separate asset from the land. Mike is taken to have acquired the house in May 2005 when he began building it. Mike made a capital gain of \$15,000 (\$100,000 – \$85,000) when he sold the house because he did not use it as his main residence.

As Mike had owned the house for less than 12 months, he used the 'other' method to calculate his capital gain.

EXAMPLE: Dwelling purchased on or after 20 September 1985 and land subdivided after that date

Kym bought a house on a 0.2 hectare block of land in June 2005 for \$350,000. The house was valued at \$120,000 and the land at \$230,000. Kym lived in the house as her main residence. She incurred \$12,000 in stamp duty and legal fees purchasing the property.

Kym found the block was too big for her to maintain. In January 2006, she subdivided the land into two blocks of equal size. She incurred \$10,000 in survey, legal and subdivision application fees and \$1,000 to connect water and drainage to the rear block. In March 2006, she sold the rear block for \$130,000.

As Kym sold the rear block of land separately, the **main residence exemption** does not apply to that land. She contacted several local real estate agents who advised her that the value of the front block was \$15,000 higher than the rear block. Kym apportioned the \$230,000 original cost base into \$107,500 for the rear block (46.7%) and \$122,500 for the front block (53.3%). Kym incurred \$3,000 legal fees on the sale.

The cost base of the rear block is calculated as follows:

| | |
|--|------------------|
| Cost of the land | \$107,500 |
| 46.7% of the \$12,000 stamp duty and legal fees on the purchase | \$5,604 |
| 46.7% of the \$10,000 cost of survey, legal and application fees | \$4,670 |
| Cost of connecting water and drainage | \$1,000 |
| Legal fees on sale | \$3,000 |
| Total | \$121,774 |

The capital gain on the sale of the rear block is \$8,226. She calculates this by subtracting the cost base (\$121,774) from the sale price (\$130,000). As Kym had owned the land for less than 12 months, she uses the 'other' method to calculate her capital gain.

Kym will get the full exemption for her house and the front block if she uses them as her main residence for the full period she owns them.

AMALGAMATION OF TITLE

The amalgamation of the titles to various blocks of land that you own does not result in a CGT event happening.

Land you acquire before 20 September 1985 that is amalgamated with land acquired on or after that date retains its pre-CGT status.

EXAMPLE: Amalgamation of title

On 1 April 1984, Robert bought a block of land. On 1 June 1999, he bought another block adjacent to the first one. Robert amalgamated the titles to the two blocks into one title.

Robert is taken to have two separate assets. The first block continues to be treated as a pre-CGT asset.

Examples of CGT calculations affecting real estate

There are a number of other examples in this guide that explain how to calculate your capital gain or capital loss on the sale of real estate:

- calculation of capital gain (including worksheet) where a person can choose the indexation or discount method to calculate their capital gain – see example of Val on page 27
- calculation of capital gain on property owned for 12 months or less – see example of Marie-Anne on page 23
- recoupment of expenditure affecting CGT cost base calculation – see example of John on page 14
- deductions affecting CGT cost base calculations – see example of Zoran on page 59.

MAIN RESIDENCE

Generally, if you are an individual – not a company or trust – you can ignore a capital gain or capital loss from a CGT event that happens to your **ownership interest** in a dwelling that is your main residence (also referred to as 'your home').

To get full exemption from CGT:

- the dwelling must have been your home for the whole period you owned it
- you must not have used the dwelling to produce assessable income, and
- any land on which the dwelling is situated must be 2 hectares or less.

If you inherited a dwelling or a share of a dwelling and it was not the deceased's main residence, you may not get full exemption (see flowchart 6 in appendix 3, and **Inherited main residence** on page 80).

If you are not fully exempt, you may be partially exempt if:

- the dwelling was your main residence during only part of the period you owned it
- you used the dwelling to produce assessable income, or
- the land on which the dwelling is situated is more than 2 hectares.

Short absences from your home – for example, annual holidays, do not affect your exemption.

If a dwelling was not your main residence for the whole time you owned it, some special rules may entitle

you to a full exemption or extend the part exemption you would otherwise get. These rules can apply to land or a dwelling if:

- you choose to treat the dwelling as your main residence, even though you no longer live in it (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72)
- you moved into the dwelling as soon as practicable after its purchase (see **Moving into a dwelling** on page 67)
- you are changing main residences (see **Moving from one main residence to another** on page 72)
- you are yet to live in the dwelling but will do so as soon as practicable after it is constructed, repaired or renovated and you will continue to live in it for at least three months (see **Constructing, renovating or repairing a dwelling on land you already own** on page 75), or
- you sell vacant land after your main residence is accidentally destroyed (see **Destruction of dwelling and sale of land** on page 76).

Special rules

There are some special CGT rules that are not covered in this chapter that may affect you if your home was:

- destroyed and you receive money or another asset as compensation or under an insurance policy (see chapter 7)
- transferred to you as a result of its conversion to strata title, or
- compulsorily acquired by an Australian government agency (see chapter 7).

If you own more than one dwelling during a particular period, only one of them can be your main residence at any one time.

The exception to this rule is if you move from one main residence to another. In this case you can treat two dwellings as your main residence for a limited time (see page 72 for more information). Special rules apply if you have a different main residence from your spouse or dependent children (see page 76).

WHAT IS A DWELLING?

A dwelling is anything that is used wholly or mainly for residential accommodation. Certain mobile homes can also be a dwelling. Examples of a dwelling are:

- a home or cottage
- an apartment or flat
- a strata title unit
- a unit in a retirement village, and
- a caravan, houseboat or other mobile home.

Any land the dwelling is on is included as part of the dwelling but it only qualifies for the main residence exemption if the land and the dwelling are sold together. Also, the exemption applies to a maximum of 2 hectares of land (including the land on which the dwelling is built). Any excess is subject to capital gains tax. Land adjacent to the dwelling may also qualify for exemption (see page 68 for more information).

WHAT IS AN OWNERSHIP INTEREST?

In the case of a flat or home unit, you have an ownership interest if you have:

- a legal or equitable interest in a strata title in the flat or home unit
- a licence or right to occupy the flat or home unit, or
- a share in a company that owns a legal or equitable interest in the land on which the flat or home unit is constructed and that share gives you a right to occupy the flat or home unit.

In the case of a dwelling that is not a flat or home unit, you have an ownership interest if you have:

- a legal or equitable interest in the land on which it is constructed, or
- a licence or right to occupy it.

In the case of land, you have an ownership interest if you have:

- a legal or equitable interest in it, or
- a right to occupy it.

An equitable interest may include life tenancy of a dwelling that you acquire – for example, under a deceased's will.

When do you acquire an ownership interest?

For the purposes of the main residence exemption, you have an ownership interest in a dwelling or land you acquire under a contract from the time you get legal ownership (unless you have a right to occupy it at an earlier time).

You have legal ownership of a dwelling or land from the date of settlement of the contract of purchase (or if you have a right to occupy it at an earlier time, that time) until the date of settlement of the contract of sale. This period is called your ownership period. If the dwelling is on 2 hectares of land or less, is your main residence for the whole of the ownership period and you do not use it to produce assessable income, the home is fully exempt.

EXAMPLE: Full exemption

Frank signed a contract on 14 August 1999 to purchase 0.1 hectare of land from a developer and to have a house constructed on the land. Under the contract, settlement did not occur until construction was completed on 26 October 2000.

Frank moved into the house immediately upon settlement of the contract he had with the developer – that is, on 26 October 2000. He did not have a right to occupy the house at an earlier time under the purchase contract. He signed the contract to sell it on 25 May 2006 and settlement occurred on 20 July 2006. The house was Frank's main residence for the full period he owned it and he did not use any part of it to produce income.

For CGT purposes, Frank is taken to have acquired the land on which the house was constructed on the date he entered into the contract – 14 August 1999. However, because the house was Frank's main residence for the whole period between settlement of the purchase contract and settlement of the sale contract, it is fully exempt.

The period between when Frank entered into the purchase contract and started to live in the house – 14 August 1999 to 25 October 2000 – is ignored. This is because the relevant dates for the main residence exemption are the settlement dates or, if you had a right under the purchase contract to occupy the dwelling at an earlier time, that time until settlement of the sale contract.

Even though the settlement dates are used to calculate the period for which the main residence exemption applies, the dates you enter into the purchase and sale contracts are important.

A CGT event occurs when you enter into the sale contract. You include any capital gain on your tax return for the year of income in which the CGT event occurs. The dates you enter into the purchase and sale contracts are also relevant for determining what method you can use to work out your capital gain from your main residence.

EXAMPLE: Part exemption

The facts are the same as in the previous example except that Frank rented out the house from 26 October 2000 – the date of settlement of the purchase contract – until 2 March 2002.

Frank makes a capital gain of \$90,000 on the house. To work out the part of the capital gain that is not exempt, Frank must determine how many days in his ownership period the dwelling was not his main residence.

Frank had an ownership interest in the property from settlement of the purchase contract (26 October 2000) until settlement of the sale contract (20 July 2006) – a total of 2,094 days.

The period between the dates the purchase contract was signed (14 August 1999) and settled (25 October 2000) is ignored. Because the house was not Frank's main residence from 26 October 2000 to 2 March 2002 (493 days), he does not get the exemption for this period.

Frank calculates his capital gain as follows:

$$\begin{array}{rcl} \$90,000 & \times & \frac{493 \text{ days}}{2,094 \text{ days}} \\ \text{capital gain} & & \\ & = & \$21,189 \\ & & \text{taxable portion} \end{array}$$

Because Frank entered into the purchase contract before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the sale contract after this time (and he owned the house for at least 12 months), he can choose either the indexation or the discount method to calculate his capital gain. Frank decides to reduce his capital gain by the CGT discount of 50% after applying any capital losses.

Because Frank signed the sale contract on 25 May 2006, the CGT event occurred in the 2005–06 income year, even though settlement occurred in the next income year. Frank shows the capital gain on his 2006 tax return.

IS THE DWELLING YOUR MAIN RESIDENCE?

The following factors may be relevant in working out whether a dwelling is your main residence:

- the length of time you live there – there is no minimum time a person has to live in a home before it is considered to be their main residence
- whether your family lives there
- whether you have moved your personal belongings into the home
- the address to which your mail is delivered
- your address on the electoral roll
- the connection of services (for example, phone, gas or electricity)
- your intention in occupying the dwelling.

A mere intention to construct or occupy a dwelling as your main residence – without actually doing so – is not sufficient to get the exemption.

In certain circumstances, you may choose to treat a dwelling as your main residence even though:

- you no longer live in it (for more information, see **Continuing main residence status after dwelling ceases to be your main residence** on page 72), or
- you are yet to live in it but will do so as soon as practicable after it is constructed, repaired or renovated and you will continue to live in it for at least three months (for more information, see **Constructing, renovating or repairing a dwelling on land you already own** on page 75).

MOVING INTO A DWELLING

A dwelling is considered to be your main residence from the time you acquired your ownership interest in it if you moved into it as soon as practicable after that time. If you purchased the dwelling, this would generally be the date of settlement of the purchase contract. However if there is a delay in moving in because of illness or other unforeseen circumstances the exemption may still be available from the time you acquired your ownership interest in the dwelling.

If you could not move in because the dwelling was being rented to someone, you are not considered to have moved in as soon as practicable after you acquired your ownership interest.

As mentioned earlier, there is a special rule that allows you to treat more than one dwelling as your main residence for a limited time if you are changing main residences (see **Moving from one main residence to another** on page 72).

EXAMPLE: Moving in as soon as practicable

Mary signs a contract to buy a townhouse on 1 March 2006. She is to take possession when settlement occurs on 30 April 2006.

On 11 March 2006, Mary is directed by her employer to go overseas on an assignment for four months, leaving on 25 March 2006. Mary moves into the townhouse on her return to Australia in late July 2006.

Mary's overseas assignment was unforeseen at the time of purchasing the property. As she moved in as soon as practicable after settlement of the contract occurred, Mary can treat the townhouse as her main residence from the date of settlement until she moved in.

LAND ADJACENT TO THE DWELLING

The land adjacent to a dwelling is also exempt if:

- during the period you owned it, the land is used mainly for private and domestic purposes in association with the dwelling, and
- the total area of the land around the dwelling, including the land on which it stands, is not greater than 2 hectares (4.94 acres). If the land used for private purposes is greater than 2 hectares, you can choose which 2 hectares are exempt.

Land is adjacent to your dwelling if it is close to, near, adjoining or neighbouring the dwelling.

If you sell any of the land adjacent to your dwelling separately from the dwelling, the land is not exempt. It is only exempt when sold with the dwelling. There is an exception if the dwelling is accidentally destroyed and you sell the vacant land (see **Destruction of dwelling and sale of land** on page 76).

Any part of the land around a dwelling used to produce income is not exempt, even if the total land is less than 2 hectares. However, the dwelling and any buildings and other land used in association with it remain exempt if you do not use them to produce income.

EXAMPLE: Land used for private purposes

Tim bought a home with 15 hectares of land in November 2000. He uses 10 hectares of the land to produce income and 5 hectares for private purposes. Tim can get the main residence exemption for the home and 2 hectares of land he selects out of the 5 hectares that are used for private purposes.

Tim gets a valuation which states that the home and 2 hectares of land that he has selected are worth two-thirds of the total value of the property. The relative values of the different parts of the property remained the same between the time of purchase and the time of sale.

Tim entered into a contract to sell the property on 8 May 2006. The capital gain from the property is \$150,000. Tim may claim the main residence exemption on the two-thirds of the capital gain attributable to the house and 2 hectares of land – that is, \$100,000.

Because he entered into the contract to acquire the property after 11.45am (by legal time in the ACT) on 21 September 1999 and owned it for at least 12 months, Tim reduces his remaining \$50,000 gain (attributable to the land) by the CGT discount of 50% after applying any capital losses.

OTHER STRUCTURES ASSOCIATED WITH THE DWELLING

A flat or home unit often includes areas (for example, a laundry, storeroom or garage) that are physically separate from the flat or home unit. As long as you use these areas primarily for private or domestic purposes in association with the flat or home unit for the whole period you own it, they are exempt on the same basis that the flat or home unit is exempt.

However, if you dispose of one of these structures separately from the flat or home unit, they are not exempt.

PART EXEMPTION

Main residence for only part of the period you owned it

If a CGT event happens to a dwelling you acquired on or after 20 September 1985 and that dwelling was not your main residence for the whole time you owned it, you get only a part exemption.

You calculate the part of the capital gain that is taxable as follows:

$$\text{Total capital gain made from the CGT event} \times \frac{\text{number of days in your ownership period when the dwelling was not your main residence}}{\text{total number of days in your ownership period}}$$

EXAMPLE: Main residence for part of the ownership period

Andrew bought a house on 1 hectare of land under a contract that was settled on 1 July 1990 and moved in immediately. On 1 July 1993, he moved out and began to rent out the house. He did not choose to treat the house as his main residence for the period after he moved out, although he could have done this under the 'continuing main residence status after dwelling ceases to be your main residence' rule (see page 72). The 'home first used to produce income' rule (explained on page 70) does not apply because Andrew used the home to produce income before 21 August 1996.

The contract for the sale of the house was settled on 1 July 2005 and Andrew made a capital gain of \$100,000. As he is entitled to a part exemption, Andrew's capital gain is as follows:

$$\$100,000 \times \frac{4,384 \text{ days}}{5,480 \text{ days}} = \$80,000$$

As Andrew entered into the contract to acquire the house before 11.45am (by legal time in the ACT) on 21 September 1999 but the CGT event occurred after this date and he had owned the house for at least 12 months, Andrew can choose to use the discount method or the indexation method to calculate his capital gain.

If a dwelling was not your main residence for the whole time you owned it, some special rules may entitle you to a full exemption or extend the part exemption you would otherwise get. These rules apply to land or a dwelling if:

- you choose to treat the dwelling as your main residence, even though you no longer live in it (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72)
- you moved into the dwelling as soon as practicable after its purchase (see **Moving into a dwelling** on page 67)
- you are changing main residences (see **Moving from one main residence to another** on page 72)
- you are yet to live in the dwelling but will do so as soon as practicable after it is constructed, repaired or renovated and you will continue to live in it for at least three months (see **Constructing, renovating or repairing a dwelling on land you already own** on page 75), or
- you sell vacant land after your main residence is accidentally destroyed (see **Destruction of dwelling and sale of land** on page 76).

DWELLING USED TO PRODUCE INCOME

Usually you cannot get the full main residence exemption if you:

- acquired your dwelling on or after 20 September 1985 and used it as your main residence
- used any part of it to produce income during all or part of the period you owned it, and

- would be allowed a deduction for interest had you incurred it on money borrowed to acquire the dwelling (interest deductibility test).

The interest deductibility test applies regardless of whether you actually borrowed money to acquire your dwelling. You must apply it on the assumption that you did borrow money to acquire the dwelling.

If you rent out part of your home, you would be entitled to deduct part of the interest if you had borrowed money to acquire the dwelling.

If you run a business or professional practice in part of your home, you would be entitled to deduct part of the interest on money you borrowed to acquire the dwelling if:

- part of the dwelling is set aside exclusively as a place of business and is clearly identifiable as such, and
- that part of the home is not readily adaptable for private use – for example, a doctor's surgery located within the doctor's home.

You would not be entitled to deduct any interest expenses if, for convenience, you use a home study to undertake work usually done at your place of work. Similarly, you would not be entitled to deduct interest expenses if you do paid child-minding at home (unless a special part of the home was set aside exclusively for that purpose). In these situations, you could still get a full main residence exemption.

EXAMPLE: Renting out part of a home

Thomas purchased a home under a contract that was settled on 1 July 1998 and sold it under a contract that was settled on 30 June 2006. The home was his main residence for the entire eight years.

Throughout the period Thomas owned the home, a tenant rented one bedroom, which represented 20% of the home. Both Thomas and the tenant used the living room, bathroom, laundry and kitchen which represented 30% of the home. Only Thomas used the remainder of the home. Therefore Thomas would be entitled to a 35% deduction for interest if he had incurred it on money borrowed to acquire his home. The 'home first used to produce income' rule (explained on the next page) does not apply because Thomas used the home to produce income from the date he purchased it.

Thomas made a capital gain of \$120,000 when he sold the home. Of this total gain, the following proportion is not exempt:

| Capital gain | × | percentage of floor area | = | taxable portion |
|--------------|---|--------------------------|---|-----------------|
| \$120,000 | × | 35% | = | \$42,000 |

As Thomas entered into the contract to acquire the home before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and held it for at least 12 months, he can use either the indexation or the discount method to calculate his capital gain.

If you set aside and use part of the dwelling exclusively as a place of business, you cannot get a CGT exemption for that part of the dwelling by not claiming a deduction for the interest. Nor can you include interest in the cost base if you are entitled to a deduction but do not claim it.

You can still get a full main residence exemption if someone else uses part of your home to produce income and you receive no income from that person.

When a CGT event happens to the home, the proportion of the capital gain or capital loss that is taxable is an amount that is reasonable according to the extent to which you would have been able to deduct the interest on money borrowed to acquire the home.

In most cases this is the proportion of the floor area of the home that is set aside to produce income and the period you use the home to produce income. This includes if the dwelling is available (for example, advertised) for rent.

EXAMPLE: Running a business in part of a home for part of the period of ownership

Ruth bought her home under a contract that was settled on 1 January 1999. She sold it under a contract that was entered into on 1 November 2005 and was settled on 31 December 2005. It was her main residence for the entire seven years.

From the time she bought it until 30 June 2002, Ruth used part of the home to operate her photographic business. She modified the rooms for that purpose and they were no longer suitable for private and domestic use. They represented 25% of the total floor area of the home.

When she sold the home, Ruth made a capital gain of \$80,000. The following proportion of the gain is taxable:

| Capital gain | × | percentage of floor area not used as main residence | × | percentage of period of ownership that that part of the home was not used as main residence | = | taxable portion |
|--------------|---|---|---|---|---|-----------------|
| \$80,000 | × | 25% | × | 50% | = | \$10,000 |

As Ruth entered into the contract to acquire the home before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and held it for at least 12 months, she can use either the indexation or discount method to calculate her capital gain.

The 'home first used to produce income' rule (explained on this page) does not apply because Ruth used the home to produce income from the date she purchased it.

➤ For more information on rental properties (for example, negative gearing and deductions), see *Rental properties 2006*.

Home first used to produce income

If you start using part or all of your main residence to produce income for the first time after 20 August 1996, a special rule affects the way you calculate your capital gain or capital loss.

In this case, you are taken to have acquired the dwelling at its market value at the time you first used it to produce income if all of the following apply:

- you acquired the dwelling on or after 20 September 1985
- you first used the dwelling to produce income after 20 August 1996
- when a CGT event happens to the dwelling, you would get only a part exemption because you used the dwelling to produce assessable income during the period you owned it, and
- you would have been entitled to a full exemption if the CGT event happened to the dwelling immediately before you first used it to produce income.

If all of the above apply, you **must** work out your capital gain or capital loss using the market value of the dwelling at the time you first used it to produce income. You do not have a choice.

If a deceased's main residence passed to you as a beneficiary or as trustee of their estate on or after 20 September 1985, you are taken to have acquired the dwelling at its market value at the time you first used it to produce your income only if:

- you first used the dwelling to produce income after 20 August 1996
- when a CGT event happens to the dwelling, you would get only a part exemption because you used the dwelling to produce assessable income during the period you owned it
- you would have been entitled to a full exemption if the CGT event happened to the dwelling immediately before you first used it to produce income, and
- the CGT event did not happen to the dwelling within two years of the person's date of death.

! FULL EXEMPTION

You may have made the choice to treat a dwelling as your main residence after the dwelling ceases to be your main residence (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72). In this case, if the dwelling is fully exempt, the 'home first used to produce income' rule does not apply.

In working out the amount of capital gain or capital loss, the period before the dwelling is first used by you to produce income is not taken into account. The extent of the exemption depends on the period after that time and the proportion of the home used to produce income. The example on the next page explains this.

If the 'home first used to produce income' rule applies and the period between when you first used the dwelling to produce income and the CGT event happening is less than 12 months, the CGT discount method is not available.

EXAMPLE: Home becomes a rental property after 20 August 1996

Erin purchased a home on 0.9 hectares of land in July 2000 for \$280,000. The home was her main residence until she moved into a new home on 1 August 2003. On 2 August 2003 she commenced to rent out the old home. At that time the market value of the old home was \$450,000.

Erin does not want to treat the old home as her main residence (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72) as she wants the new home to be treated as her main residence from when she moved into it.

On 14 April 2006 Erin sold the old home. Erin is taken to have acquired the old home for \$450,000 on 2 August 2003 and calculates her capital gain to be \$46,000.

Because Erin is taken to have acquired the old home on 2 August 2003 and has held it for more than 12 months, she can use the discount method to calculate her capital gain. As Erin has no capital losses she includes a capital gain of \$23,000 on her 2006 tax return.

EXAMPLE: Part of home first used to produce income after 20 August 1996

Louise purchased a home in December 1991 for \$200,000. The home was her main residence. On 1 November 2004, she started to use 50% of the home for a consultancy business. At that time the market value of the house was \$320,000.

She decided to sell the property in August 2005 for \$350,000. As Louise was still living in the home, she could not get a full exemption under the 'continuing main residence status after dwelling ceases to be your main residence' rule (see the next page). The capital gain is 50% of the proceeds less the cost base.

| | | | | |
|-------------------|---|-------------------------|---|--------------|
| Percentage of use | × | (proceeds – cost base) | = | capital gain |
| 50% | × | (\$350,000 – \$320,000) | = | \$15,000 |

Louise is taken to have acquired the property on 1 November 2004 at a cost of \$320,000. Because she is taken to have acquired it at this time, Louise is taken to have owned it for less than 12 months and must use the 'other' method to calculate her capital gain.

If you make the choice to continue to treat a dwelling as your main residence after it ceases to be your main residence (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72) and you do **not** get a full exemption, the 'home first used to produce income' rule may apply.

EXAMPLE: Dwelling used to produce income for more than six years and first used to produce income after 20 August 1996

Roya purchased an apartment in Australia for \$280,000 under a contract that was settled on 15 September 1994 and immediately started using the apartment as her main residence.

On 29 September 1996 she moved overseas and began renting out the apartment. During the time she was overseas she did not acquire another dwelling and continued to rent out the apartment. After she returned to Australia in July 2005, she sold the apartment for \$555,000. Settlement occurred in September 2005 and she incurred \$15,000 in agent's and solicitor's costs.

As Roya rented out the apartment she is only entitled to choose to continue to treat the dwelling as her main residence during her absence for a maximum of 6 years – that is, for the period 29 September 1996 to 29 September 2002.

As Roya is only entitled to a part CGT exemption, she first used the property to produce income after 20 August 1996 and she would have been entitled to a full CGT exemption for the dwelling immediately before she started renting it out, she may treat the dwelling as having been acquired on 29 September 1996 at the market value at that time, which was \$340,000.

Roya works out her capital gain as follows:

| | |
|--------------------|-----------|
| Capital proceeds | \$555,000 |
| Cost base: | \$340,000 |
| | \$15,000 |
| | \$355,000 |
| Total capital gain | \$200,000 |

$$\$200,000 \times \frac{1,097 \text{ days}}{3,288 \text{ days}} = \$66,727$$

Roya chooses to use the discount method and, because she has no other capital gains or capital losses, she includes a net capital gain of \$33,363 (\$66,727 × 50%) on her 2006 tax return.

MOVING FROM ONE MAIN RESIDENCE TO ANOTHER

If you acquire a new home before you dispose of your old one, both dwellings are treated as your main residence for up to six months if:

- the old dwelling was your main residence for a continuous period of at least three months in the 12 months before you disposed of it
- you did not use the old dwelling to produce assessable income in any part of that 12 months when it was not your main residence, and
- the new dwelling becomes your main residence.

If you dispose of the old dwelling within six months of acquiring the new one, both dwellings are exempt for the whole period between when you acquire the new one and dispose of the old one.

If you disposed of your old home before 1 July 1998, both homes are exempt for a maximum of three months.

EXAMPLE: Exemption for both homes

Jill and Norman bought their new home under a contract that was settled on 1 January 2006 and moved in immediately. They sold their old home under a contract that was settled on 15 April 2006. Both the old and new homes are treated as their main residence for the period 1 January to 15 April even though they did not live in the old home during that period.

If it takes longer than six months to dispose of your old home, both homes are exempt only for the last six months before you dispose of the old one. You get only a part exemption when a CGT event happens to your old home.

EXAMPLE: Part exemption for a first home

Jeneen and John bought their first home under a contract that was settled on 1 January 1998 and moved in immediately. It was their main residence until they bought their second home under a contract that was entered into on 2 November 2004 and settled on 1 January 2005.

They retained the first home after moving into the new one but did not use it to produce income. They sold the first home under a contract that was settled on 1 October 2005. They owned this home for a total period of 2,831 days.

Both homes are treated as their main residence for the period 1 April 2005 to 1 October 2005, the last six months that Jeneen and John owned their first home. Therefore, their first home is treated as their main residence only for the period before settlement of their new home and during the last six months before settlement of the sale of the old home.

The 90 days from 1 January 2005 to 31 March 2005, when the old home was not their main residence, are taken into account in calculating the proportion of their capital gain that is taxable ($90 \div 2,831$).

Because they entered into the contract to acquire their old home before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and held it for at least 12 months, Jeneen and John can use either the indexation or the discount method to calculate their capital gain.

CONTINUING MAIN RESIDENCE STATUS AFTER DWELLING CEASES TO BE YOUR MAIN RESIDENCE

In some cases you can choose to treat a dwelling as your main residence even though you no longer live in it. You cannot make this choice for a period before a dwelling first becomes your main residence – see **Is the dwelling your main residence?** on page 67.

EXAMPLE: Not main residence until you move in

Therese bought a house and rented it out immediately. Later she stopped renting it out and moved in.

Therese cannot choose to treat the house as her main residence during the period she was absent under the continuing main residence rule because the house was not her main residence before she rented it out. She will only be entitled to a part exemption if she sells the dwelling.

This choice needs to be made only for the income year that the CGT event happens to the dwelling – for example, the year that you enter into a contract to sell it. If you own both:

- the dwelling that you can choose to treat as your main residence after you no longer live in it, and
 - the dwelling you actually lived in during that period
- you make the choice for the year you enter into the contract to sell the first of those dwellings.

If you make this choice, you cannot treat any other dwelling as your main residence for that period (except for a limited time if you are changing main residences, see **Moving from one main residence to another** on page 72).

If you do not use it to produce income – for example, you leave it vacant or use it as a holiday home – you can treat the dwelling as your main residence for an unlimited period after you stop living in it.

If you do use it to produce income – for example, you rent it out or it is available for rent – you can choose to treat it as your main residence for up to six years after you stop living in it. If you make this choice and as a result of it the dwelling is fully exempt, the ‘home first used to produce income’ rule (explained on page 70) does not apply.

You can choose when you want to stop the period covered by this choice.

For information about when and how you make a choice, see **Choices** on page 17.

EXAMPLE: Choosing to stop the period covered by the choice early

James bought his home in Brisbane on 1 July 2002 and moved in immediately. On 31 July 2003 he moved to Perth and rented out his Brisbane home. James bought a new residence in Perth on 31 January 2005. He sold the property in Brisbane on 31 July 2005. In completing his 2006 tax return, James decided to continue to treat the Brisbane property as his main residence after he moved out of it but only until 31 January 2005 – when he purchased his new main residence in Perth.

If you rent out the dwelling for more than six years, the ‘home first used to produce income’ rule may apply, which means you are taken to have acquired the dwelling at its market value at the time you first used it to produce income, see **Home first used to produce income** on page 70.

If you are absent more than once during the period you own the home, the six-year maximum period that you can treat it as your main residence while you use it to produce income applies separately to each period of absence.

EXAMPLE: One period of absence of 10 years

Home ceases to be the main residence and is used to produce income for one period of six years

Lisa bought a house after 20 September 1985 but stopped using it as her main residence for the 10 years immediately before she sold it. During this period, she rented it out for six years and left it vacant for four years.

Lisa chooses to treat the dwelling as her main residence for the period after she stopped living in it, so she disregards any capital gain or capital loss she makes on the sale of the dwelling. The maximum period the dwelling can continue to be her main residence while she used it to produce income is six years. However, while the house is vacant, the period is unlimited, which means the exemption applies for the whole 10 years.

In addition to this, as the dwelling is fully exempt because Lisa made this choice, the ‘home first used to produce income’ rule (explained on page 70) does not apply.

Home used to produce income for more than one period totalling six years

In the 10-year period after Lisa stopped living in the dwelling she rented it out for three years, left it vacant for two years, rented it out for the next three years, then once more left it vacant for two years.

If she chooses to treat the dwelling as her main residence for the period after she stopped living in it, she again disregards any capital gain or capital loss she makes on selling it. This is because the period she used the home to produce income during each absence is not more than six years. (See the example on the next page for more detail.)

EXAMPLE: Home ceases to be the main residence and is used to produce income for more than six years during a single period of absence

1 July 1991

Ian settled a contract to buy a home in Sydney on 0.9 hectares of land and used it as his main residence.

1 January 1993

Ian was posted to Brisbane and settled a contract to buy another home there.

1 January 1993 to 31 December 1997

Ian rented out his Sydney home during the period he was posted to Brisbane.

31 December 1997

Ian settled a contract to sell his Brisbane home and the tenant in his Sydney home left.

The period of five years from 1993 to 1997 is the first period the Sydney home was used to produce income for the purpose of the six-year test.

1 January 1998

Ian was posted from Brisbane to Melbourne for three years and settled a contract to buy a home in Melbourne. He did not return to his Sydney home at this time.

1 March 1998

Ian again rented out his Sydney home – this time for two years.

28 February 2000

The tenant of his Sydney home left.

The period of two years from 1998 to 2000 is the second period the Sydney home was used to produce income under the six-year test.

31 December 2000

Ian sold his home in Melbourne.

31 December 2001

Ian returned to his home in Sydney and it again became his main residence.

28 February 2006

Ian settled a contract to sell his Sydney home.

Ian chooses to treat the Sydney home as his main residence for the period after he stopped living in it. The effect of making this choice is that any capital gains Ian made on the sale of both his Brisbane home in 1997–98 and his Melbourne home in 2000–01 are not exempt.

Ian cannot get the main residence exemption for the whole period of ownership of the Sydney home because the combined periods he used it to produce income (1 January 1993 to 31 December 1997 and 1 March 1998 to 28 February 2000) during his one absence were more than six years.

As a result, the Sydney house is not exempt for the period it was used to produce income that exceeds the six-year period – that is, one year.

If the capital gain on the disposal of the Sydney home is \$250,000, he calculates the amount of the gain that is taxable as follows:

| Period of ownership of the Sydney home: | |
|--|-------------------|
| 1 July 1991 to 28 February 2006 | 5,357 days |
| Periods the Sydney home was used to produce income after Ian stopped living in it: | |
| 1 January 1993 to 31 December 1997 | 1,826 days |
| 1 March 1998 to 28 February 2000 | 730 days |
| | 2,556 days |
| First six years the Sydney home was used to produce income: | |
| 1 January 1993 to 31 December 1997 | 1,826 days |
| 1 March 1998 to 28 February 1999 | 365 days |
| | 2,191 days |
| Income producing for more than six years after Ian stopped living in it: | 365 days |

Proportion of capital gain taxable in 2005–06

$$\$250,000 \times \frac{365}{5,357} = \$17,033$$

Because Ian entered into the contract to acquire the house before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and owned it for at least 12 months, he can use either the indexation or the discount method to calculate his capital gain.



21 AUGUST 1996 IMPORTANT

The 'home first used to produce income' rule explained on page 70 does not apply because the home was first used by Ian to produce income before 21 August 1996.

HOME USED TO PRODUCE INCOME AND THEN YOU STOP LIVING IN IT

If you use any part of your home to produce income before you stop living in it, you cannot apply the 'continuing main residence status after dwelling ceases to be your main residence' rule (see page 72) to that part. This means you cannot get the main residence exemption for that part of the dwelling either before or after you stop living in it.

EXAMPLE: Ceasing to live in a home after part of it is used to produce income

Helen purchased a home under a contract that was settled on 1 July 1993 and she moved in immediately. She used 75% of the home as her main residence and the remaining 25% as a doctor's surgery, which she used until 30 June 2000.

On 1 July 2000, she moved out and rented out the home until it was sold under a contract that was settled on 30 June 2006. Helen chose to treat the dwelling as her main residence for the six years she rented it out. She made a capital gain of \$100,000 when she sold the home.

As 25% of the home was not used as her main residence during the period before Helen stopped living in it, part of the capital gain is taxable, calculated as follows:

$$\$100,000 \times 25\% = \$25,000$$

Because Helen entered into the contract to acquire the house before 11.45am (by legal time in the ACT) on 21 September 1999 and sold it after that time, and owned it for at least 12 months, she can use either the indexation or the discount method to calculate her capital gain.

The 'home first used to produce income rule' does not apply because she used it to produce income from the time she purchased it.

CONSTRUCTING, RENOVATING OR REPAIRING A DWELLING ON LAND YOU ALREADY OWN

Generally, if you build a dwelling on land you already own, the land does not qualify for exemption until the dwelling becomes your main residence. However, you can choose to treat land as your main residence for up to four years before the dwelling becomes your main residence in certain circumstances.

You can choose to have this exemption apply if you acquire an ownership interest (other than a life interest) in land and you:

- build a dwelling on the land
- repair or renovate an existing dwelling on the land, or
- finish a partly constructed dwelling on the land.

There are a number of conditions that you must satisfy before you can claim the exemption. You must first finish building, repairing or renovating the dwelling and then:

- move into the dwelling as soon as practicable after it is finished, and
- continue to use the dwelling as your main residence for at least three months after it becomes your main residence.

The land, including the dwelling that is being built, renovated, repaired or finished on it, is exempt for the shorter of the following periods:

- the four-year period immediately before the date the dwelling becomes your main residence, or
- the period between the date you acquired the land and the date the dwelling becomes your main residence.

However, if after you acquired the land you or someone else occupied a dwelling that was already on the land, the period of exemption starts from the date that dwelling was vacated.

If a newly constructed dwelling is built to replace a previous dwelling that was demolished or destroyed, you can get a full exemption when you dispose of the property if:

- the original dwelling was your main residence for the full period you owned it, you did not use it to produce assessable income and it was on land covering an area of 2 hectares or less
- the new dwelling becomes your main residence as soon as practicable after it is completed, it continues to be your main residence until you dispose of it and that period is at least three months
- you make a choice to treat the vacant land and new dwelling as your main residence in the period starting when you stopped occupying the previous dwelling and ending when the new dwelling becomes your main residence, and this period is four years or less, and
- you dispose of the land and new dwelling together.

If you make this choice, you cannot treat any other dwelling as your main residence for the period, except for a limited time under the 'moving from one main residence to another' rule (explained on page 72).

Therefore, if you have a dwelling you acquired on or after 20 September 1985 and you live in it while you build your new home, you must decide whether to:

- maintain the exemption for your old home, or
- have the exemption apply to the land (including the dwelling that is being built, renovated, repaired or finished on it) for the shorter of:
 - the time from when you acquire the land until the new home becomes your main residence, or
 - the four-year period immediately before the date on which the new home becomes your main residence.

If you acquired your old main residence before 20 September 1985, it is fully exempt. (The exception is if you made major capital improvements after that date and did not use them exclusively as your main residence – see **Major capital improvements to a dwelling acquired before 20 September 1985** on page 78). This means you

will benefit from choosing to treat the land on which your new dwelling is to be built, renovated, repaired or finished as your main residence for the relevant dates above.

You cannot choose to have a shorter period of exemption for the new home in order to exempt the old home for part of the construction period.

For information about when and how you make a choice, see **Choices** on page 17.

EXAMPLE: Choosing to claim exemption for the land from the date of construction

Grant bought vacant land on which he intended to build a new home under a contract that was settled on 3 September 2002. He bought his previous home under a contract that was settled on 3 November 1991.

Grant finished building his new home on 8 September 2005. He moved into it on 7 October 2005, which was as soon as practicable after completion. He sold his previous home under a contract that was settled on 1 October 2005.

If Grant wants to, he can:

- treat the new home as his main residence from 3 September 2002, and
- claim the exemption for his previous home from 3 November 1991 to 2 September 2002.

Both homes are also exempt from 1 April 2005 to 1 October 2005, the date Grant disposed of the old home. This is because the maximum six-month exemption outlined in the section **Moving from one main residence to another** on page 72 also applies.

If you were to die at any time between entering into contracts for the construction work and the end of the first three months of residence in the new home, this exemption can still apply.

If you owned the land as a joint tenant and you die, the surviving joint tenant (or if none, the trustee of your estate) can choose to treat the land and the dwelling as your main residence for the shorter of:

- four years before your death, or
- the period starting when you acquired the land and ending when you die.

If there was already a dwelling on the land when you acquired it and someone else occupied it after that time, the surviving joint tenant (or if none, the trustee of your estate) can choose to treat the land and the dwelling as your main residence for the shorter of:

- four years before your death, or
- the period starting when the dwelling stopped being occupied so that it could be repaired or renovated and ending when you die.

DESTRUCTION OF DWELLING AND SALE OF LAND

If your home is accidentally destroyed and you then dispose of the vacant land on which it was built, you can choose to apply the main residence exemption as if the home had not been destroyed and continued to be your main residence.

You can get a full exemption for the land if you used it solely for private purposes in association with your home and it does not exceed 2 hectares. You cannot claim the main residence exemption for this period for any other dwelling, except for a limited time if you are changing main residences (see **Moving from one main residence to another** on page 72).

HAVING A DIFFERENT HOME FROM YOUR SPOUSE OR DEPENDENT CHILD

If you and a dependent child under 18 years old have different homes for a period, you must choose one of the homes as the main residence for both of you for the period.

If you and your spouse have different homes for a period, you and your spouse must either:

- choose one of the homes as the main residence for both of you for the period, or
- nominate the different homes as your main residences for the period.

If you nominate different homes for the period and you own 50% or less of the home you have nominated, you qualify for an exemption for your share. If you own more than 50%, your share is exempt for half the period you and your spouse had different homes.

The same applies to your spouse. If your spouse owns 50% or less of the home they have nominated, they qualify for an exemption for their share. However, if your spouse owns more than 50% of the home, their share is exempt for only half the period you had different homes.

This rule applies to each home the spouses own whether they have sole ownership or own the home jointly (either as joint tenants or tenants in common).

This rule applies also if you choose to treat a dwelling as your main residence when you no longer live in it (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72), and this choice results in your having a different main residence from your spouse or a dependent child for a period.

For information about when and how you make a choice, see **Choices** on page 17.

EXAMPLE: Spouses with different main residences

Under a contract that was settled on 1 July 1997, Kathy and her spouse Grahame purchased a townhouse where they lived together. Grahame owns 70% of the townhouse while Kathy owns the other 30%.

Under a contract that was settled on 1 August 1999, they purchased a beach house which they own in equal shares. From 1 May 2000, Kathy lives in their beach house while Grahame keeps living in the townhouse. Grahame nominated the townhouse as his main residence and Kathy nominated the beach house as her main residence.

Kathy and Grahame sold the beach house under a contract that was settled on 15 April 2006. As it was Kathy's main residence and she owned 50% of it, she disregards her share of any capital gain or capital loss for the period she and Grahame had different homes (1 May 2000 – 15 April 2006).

As Grahame did not live in the beach house or nominate it as his main residence when he and Kathy had different homes, he does not ignore his share of any capital gain or capital loss for any of the period he owned it.

Grahame and Kathy also sold the townhouse under a contract that was settled on 15 April 2006.

Because Grahame owns more than 50% of the townhouse, it is taken to have been his main residence for half of the period when he and Kathy had different homes.

If the total capital gain on the sale of the townhouse is \$100,000, Grahame's share of the capital gain is \$70,000 (reflecting his 70% ownership interest). The portion of the gain that Grahame disregards under the main residence exemption is:

$$\$70,000 \times \frac{1,035 \text{ days}^*}{3,211 \text{ days}^{**}} = \$22,563$$

plus

$$\$70,000 \times 50\% \times \frac{2,176 \text{ days}^{***}}{3,211 \text{ days}^{**}} = \$23,718$$

* townhouse was Grahame's home and he and Kathy did not have different homes

** total ownership period

*** when Grahame and Kathy had the different homes

The total amount disregarded by Grahame is:

$$\$22,563 + \$23,718 = \$46,281$$

As Grahame bought the townhouse before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and owned his share for at least 12 months, he can use either the indexation or the discount method to calculate his capital gain.

Kathy's share of the \$100,000 capital gain on the townhouse is \$30,000, reflecting her 30% ownership interest. The portion she disregards is:

$$\$30,000 \times \frac{1,035 \text{ days}^*}{3,211 \text{ days}^{**}} = \$9,670$$

* period before 1 May 2000 when the townhouse was Kathy's home

** total ownership period

As Kathy entered into the contract to buy the townhouse before 11.45am (by legal time in the ACT) on 21 September 1999 and entered into the contract to sell it after that time, and owned her share for at least 12 months, she uses the discount method to calculate her capital gain unless she chooses to use the indexation method.

EXAMPLE: Different main residences

Anna and her spouse Mark jointly purchased a townhouse under a contract that was settled on 5 February 1999 and both lived in it from that date until 29 April 2006, when the contract of sale was settled. Anna owned more than 50% of the townhouse.

Before 5 February 1999, Anna had lived alone in her own flat which she rented out after moving to the townhouse. She then sold her flat and settled the sale on 11 March 2000. Anna chose to treat the flat as her main residence from 5 February 1999 until she sold it under the 'continuing main residence status after dwelling ceases to be your main residence' rule (see page 72).

Because of Anna's choice, Mark had a different main residence from Anna for the period 5 February 1999 to 11 March 2000. Therefore, Mark must either:

- treat Anna's flat as his main residence for that period, or
- nominate the townhouse as his main residence for that period.

If he chooses to treat Anna's flat as his main residence, a part of any gain Mark makes when he sells the townhouse will be taxable. He will not get an exemption for the townhouse for the period that he nominated Anna's flat as his main residence (that is, 5 February 1999 – 11 March 2000).

If Mark nominates the townhouse as his main residence, he qualifies for a full exemption on any capital gain he makes when it is sold because he owned 50% or less of it. However, because Mark and Anna have different main residences as a result of Mark's choice, and Anna owns more than 50% of the flat, her gain on the flat will only qualify for a 50% exemption for the period from 5 February 1999 to 11 March 2000.

Any capital gain Anna makes on the townhouse is taxable except for the period from 12 March 2000 to 29 April 2006 and the part that is ignored under the 'moving from one main residence to another' rule (see page 72).

MAJOR CAPITAL IMPROVEMENTS TO A DWELLING ACQUIRED BEFORE 20 SEPTEMBER 1985

If you acquired a dwelling before 20 September 1985 and you make major capital improvements after that date, part of any capital gain you make when a CGT event happens to the dwelling could be taxable. Even though you acquired the dwelling before CGT started, major capital improvements are considered to be separate CGT assets from the original asset and may therefore be subject to CGT in their own right if you make them on or after 20 September 1985.

If the dwelling is your main residence and you use the improvements as part of your home, they are still exempt. This includes improvements on land adjacent to the dwelling (for example, installing a swimming pool) if the total land, including the land on which the home stands, is 2 hectares or less.

However, if the dwelling is not your main residence or you used the improvements to produce income for any period, the part of any gain that is attributable to the improvements for that period is taxable.

A capital improvement to an existing structure, such as a renovation to your house, is taken to be major if its original cost (indexed for inflation if the improvements were made under a contract entered into before 11.45am (by legal time in the ACT) on 21 September 1999) is:

- more than 5% of the amount you receive when you dispose of the dwelling, and
- is greater than a certain threshold. The threshold increases every year to take account of inflation. Improvement thresholds for 1985–86 to 2005–06 are shown in the table on page 11.

When you dispose of the dwelling, you calculate the capital gain or capital loss on the major improvements by taking away the cost base of the improvements from the proceeds of the sale that are reasonably attributable to the improvements:

| | | | | |
|--|---|---|---|------------------------------|
| Capital gain on major improvements | = | proceeds of sale attributable to improvements | – | cost base of improvements |
|--|---|---|---|------------------------------|

You can choose to calculate the capital gain made on the improvements using either the indexation or the discount method if:

- the improvements were made under a contract entered into before 11.45am (by legal time in the ACT) on 21 September 1999
- the dwelling was sold after that time, and
- you owned the improvements for at least 12 months.

If you entered into the contract to make the improvements after 11.45am (by legal time in the ACT) on 21 September 1999 and you owned them for more than 12 months, you can calculate your capital gain using the CGT discount of 50%.

In calculating the amount of capital proceeds to be attributed to the improvements, you must take whatever steps are appropriate to work out their value. If you make an estimate of this amount, it must be reasonable and you must be able to show how you arrived at the estimated amount.

EXAMPLE: Improvement on land acquired before 20 September 1985

Martin bought a home in 1984. On 1 December 1993, he undertook major renovations to his home costing \$100,000. He sold the home for \$500,000 under a contract that was settled on 1 December 2005. At the date of sale, the indexed cost base of the improvements was \$112,200.

Of the \$500,000 he received for the home, \$200,000 could be attributed to the improvements. Martin used the improvements to produce income from the time they were finished until the time he sold them with the home.

The 'home first used to produce income' rule (explained on page 70) does not apply to the improvements because they were first used to produce income before 21 August 1996.

Test 1 Is the cost base of the improvements more than 5% of \$500,000 – that is, \$25,000? **Yes**

Test 2 Is the cost base of the improvements more than the 2005–06 threshold of \$109,447? **Yes**

(Because the improvements were made under a contract entered into before 11.45am (by legal time in the ACT) on 21 September 1999 the indexed cost base is used for the purpose of these tests.)

As the answer to both questions is YES and the improvements were used to produce income, the capital gain on the improvements is taxable.

As Martin acquired the improvements before 11.45am (by legal time in the ACT) on 21 September 1999 and sold the home after that time, and had held the improvements for at least 12 months, he could use either the indexation method or the discount method to calculate his capital gain on the improvements.

Martin calculates his capital gain using the indexation method as follows:

| | |
|---|-----------------|
| Amount of proceeds attributable to the improvements | \$200,000 |
| /less cost base of improvements indexed for inflation | \$112,200 |
| Taxable capital gain | \$87,800 |

Martin's capital gain using the discount method (assuming he has no capital losses or capital gains in the 2005–06 income year and does not have any unapplied net capital losses from earlier years) is:

| | |
|--|-----------------|
| Amount of proceeds attributable to the improvements | \$200,000 |
| /less cost base of improvements (without indexation) | \$100,000 |
| Capital gain | \$100,000 |
| /less 50% discount | \$50,000 |
| Net capital gain | \$50,000 |

Martin chooses the discount method because this gives him a lower capital gain.

Note: If the improvements had been used as part of Martin's main residence, this gain would be exempt. However, if the home (including the improvements) had been rented out for one-third of the period, one-third of the capital gain made on the improvements would have been taxable.

If construction of the improvements started after 13 May 1997 and they were used to produce income, Martin would also reduce the cost base by the amount of any capital works deductions he claimed or can claim (see **Cost base adjustments for capital works deductions** on page 58). If Martin makes a capital loss, the reduced cost base of the improvements is reduced by the amount of any capital works deductions irrespective of when construction started.

Buildings or structures constructed on land acquired before 20 September 1985

Buildings or structures constructed on or after 20 September 1985 on land acquired before that date are also considered to be separate CGT assets from the original land. The major capital improvement threshold and 5% of capital proceeds rules (see page 78) do not apply to them. Therefore, they may be subject to CGT if you use them other than as your main residence.

ACQUISITION OF A DWELLING FROM A COMPANY OR TRUST UPON MARRIAGE BREAKDOWN

If a dwelling or an interest in a dwelling was transferred to you from a company or trustee of a trust as a result of your marriage breakdown, and marriage breakdown rollover applied to the transfer, you are treated as having owned the dwelling while it was owned by the company or trustee. However, you cannot get the main residence exemption during any part of the period that the company or trustee owned it (even if you lived in the dwelling during that time).

Therefore, if a dwelling is transferred to you by a company or trustee as a result of your marriage breakdown, you will be entitled to the exemption only for the period after it was transferred when it was your main residence. You calculate this by dividing the period after the transfer that it was your main residence by the combined period you and the company or trustee owned it.

For more information about CGT assets and marriage breakdown, see chapter 8.

INHERITED MAIN RESIDENCE

If you inherit a deceased person's dwelling, you may be exempt or partially exempt when a CGT event happens to it. The same exemptions apply if a CGT event happens to a deceased's estate of which you are the trustee. Flowchart 6 in Appendix 3 sets out the full exemption rules if you inherit a dwelling. Alternatively, the rules are set out below.

If you are a joint tenant and another joint tenant dies, their interest in the dwelling is taken to pass in equal shares to you and any other surviving joint tenants on that date.

For the purpose of the main residence exemption, you are treated as if that interest in the dwelling has passed to you as beneficiary of the deceased estate – which means the following rules apply to that interest. (For more information about other rules affecting joint tenants, see **Joint tenants** on page 92.)

Full exemption

Deceased died before 20 September 1985

As you acquired the dwelling before 20 September 1985, any capital gain you make is exempt. However, major capital improvements you make to the dwelling on or after 20 September 1985 may be taxable (see **Major capital improvements to a dwelling acquired before 20 September 1985** on page 78).

Deceased died on or after 20 September 1985

a) *The deceased acquired the dwelling before 20 September 1985 (it does not matter whether the dwelling was the main residence of the deceased person).*

You may have an ownership interest in a dwelling that passed to you as a beneficiary in a deceased estate or you may have owned it as trustee of a deceased estate. In either case, you disregard any capital gain or capital loss you make from a CGT event that happens to the dwelling if either of the following applies:

- 1 You disposed of your ownership interest within two years of the person's death – that is, if the dwelling was sold under a contract, settlement occurred within two years. This exemption applies whether or not you used the dwelling as your main residence or to produce income during the two-year period. The Tax Office has no discretion to extend the two-year period.

OR

- 2 From the deceased's death until you disposed of your ownership interest, the dwelling was not used to produce income and was the main residence of one or more of:
 - a person who was the spouse of the deceased immediately before the deceased's death (but not a spouse who was permanently separated from the deceased)
 - an individual who had a right to occupy the home under the deceased's will, or
 - you, as a beneficiary, if you disposed of the dwelling as a beneficiary.

The dwelling can be the main residence of one of the above people (even though they may have stopped living in it) if they choose to treat it as their main residence under the 'continuing main residence status after dwelling ceases to be your main residence' rule (explained on page 72).

b) *The deceased acquired the dwelling on or after 20 September 1985.*

You disregard any capital gain or capital loss you make when a CGT event happens to the dwelling or your ownership interest in the dwelling if:

- Condition 2 in (a) above is met and the dwelling passed to you as beneficiary or trustee on or before 20 August 1996. For this to apply, the deceased must have used the dwelling as their main residence from the date they acquired it until their death and they must not have used it to produce income.

OR

- One of the conditions in (a) above is met and the dwelling passed to you as beneficiary or trustee after 20 August 1996, and just before the date the deceased died it was their main residence and was not being used to produce income.

A dwelling can still be regarded as the deceased's main residence even though they stopped living in it – see **Continuing main residence status** on page 82.

EXAMPLE: Full exemption

Rodrigo was the sole occupant of a home he bought in April 1990. He did not live in or own another home.

He died in January 2005 and left the house to his son, Petro. Petro rented out the house and then disposed of it 15 months after his father died.

Petro is entitled to a full exemption from CGT as he acquired the house after 20 August 1996 and disposed of it within two years of his father's death.

Part exemption

If you do not qualify for a full exemption from CGT for the home you may be entitled to a part exemption.

You calculate your capital gain or capital loss as follows:

$$\text{Capital gain or capital loss amount} \times \frac{\text{non-main residence days}}{\text{total days}}$$

Non-main residence days

'Non-main residence days' is the number of days that the dwelling was not the main residence.

- a) If the deceased acquired the dwelling before 20 September 1985, non-main residence days is the number of days in the period from their death until settlement of your contract for sale of the dwelling when it was not the main residence of one of the following:
 - a person who was the spouse of the deceased (except a spouse who was permanently separated from the deceased)
 - an individual who had a right to occupy the dwelling under the deceased's will, or
 - you, as a beneficiary, if you disposed of the dwelling as a beneficiary.
- b) If the deceased acquired the dwelling on or after 20 September 1985, non-main residence days is the number of days calculated under (a) plus the number of days in the deceased's period of ownership when the dwelling was not their main residence.

Total days

- a) If the deceased acquired their ownership interest before 20 September 1985, 'total days' is the number of days from their death until you disposed of your ownership interest.
- b) If the deceased acquired the ownership interest on or after 20 September 1985, total days is the number of days in the period from when the deceased acquired the dwelling until you disposed of your ownership interest.

! NOTE

A further adjustment may be required if the dwelling was a main residence but was partly used to produce income – for example, if for a period, part of it was rented out or used as a place of business.

EXAMPLE: Part exemption

Vicki bought a house under a contract that was settled on 12 February 1995 and she used it solely as a rental property. When she died on 17 November 1998, the house became the main residence of her beneficiary, Lesley. Lesley sold the property under a contract that was settled on 27 November 2005.

As Vicki had never used the property as her main residence, Lesley cannot claim a full exemption from CGT. However, as Lesley used the house as her main residence, she is entitled to a part exemption from CGT.

Vicki owned the house for 1,375 days and Lesley then lived in the house for 2,568 days, a total of 3,943 days. Assuming Lesley made a capital gain of \$100,000, the taxable portion is:

$$\$100,000 \times \frac{1,375}{3,943} = \$34,872$$

In working out her capital gain, Lesley can use either the discount method or the indexation method. This is because for the purposes of using those methods she is taken to have acquired the property on 12 February 1995 (when Vicki acquired it) and this is before 11.45am (by legal time in the ACT) on 21 September 1999 and more than 12 months before Lesley entered into the contract to sell it.

If you dispose of your ownership interest in a dwelling within two years of the person's death, you can ignore the main residence days and total days in the period from the person's death until you dispose of the dwelling if this lessens your tax liability.

You also ignore any non-main residence days before the deceased's death in calculating the capital gain or capital loss if:

- you acquired the dwelling after 20 August 1996
- the dwelling was the deceased's main residence just before their death, and
- the dwelling was not being used to produce income at the time of their death.

Cost to you of acquiring the dwelling

If you acquire a dwelling the deceased had owned, there are special rules for calculating your cost base.

These rules apply in calculating any capital gain or capital loss when a CGT event happens to the dwelling.

The first element of the cost base and reduced cost base of a dwelling – its acquisition cost – is its market value at the date of death if either:

- the dwelling was acquired by the deceased before 20 September 1985, or
- the dwelling passes to you after 20 August 1996 (but not as a joint tenant) and it was the main residence of the deceased immediately before their death and was not being used to produce income at that date.

In any other case, your acquisition cost is the deceased's cost base and reduced cost base on the day they died. You may need to contact the trustee or the deceased's recognised tax adviser to obtain the details. If that cost base includes indexation you must recalculate it to exclude the indexation component if you prefer to use the discount method to work out your capital gain from the property.

If you are a beneficiary, the cost base and the reduced cost base also include amounts that the trustee of the deceased's estate would have been able to include in the cost base and reduced cost base.

Continuing main residence status

If the deceased was not living in the home at the date of their death, they or their trustee may have chosen to continue to treat it as their main residence. You may need to contact the trustee or the deceased's recognised tax adviser to find out whether this choice was made. If it was, the dwelling can still be regarded as the deceased's main residence:

- for an indefinite period – if the dwelling was not used to produce income after the deceased stopped living in it, or
- for a maximum of six years after they stopped living in it – if it was used to produce income after they stopped living in it.

EXAMPLE: Continuing main residence status

Aldo bought a house in March 1995 and lived in it.

He moved into a nursing home in December 2001 and left the house vacant. He chose to treat the house as his main residence after he stopped living in it under the 'continuing main residence status after dwelling ceases to be your main residence' rule (explained on page 72).

Aldo died in February 2006 and the house passed to his beneficiary, Con, who uses the house as a rental property.

As the house was Aldo's main residence immediately before his death and was not being used to produce income at that time, Con can get a full exemption for the period Aldo owned it.

If Con rented out the house and sold it more than two years after Aldo's death, the capital gain for the period from the date of Aldo's death until Con sold it is taxable.

If Con had sold the house within two years of Aldo's death, he could have ignored the main residence days and total days between Aldo's death and him selling it – which would have given him exemption for this period.

If Aldo had rented out the house after he stopped living in it he could also have chosen to continue to treat it as his main residence (see **Continuing main residence status after dwelling ceases to be your main residence** on page 72). The house would be considered to be his main residence until his death because he rented it out for less than six years.

If this choice had been made, Con would get an exemption for the period Aldo owned the house.

INHERITING A DWELLING FROM SOMEONE WHO INHERITED IT THEMSELVES

The formula for calculating the partial main residence exemption is adjusted if the deceased individual also acquired the interest in the dwelling on or after 20 September 1985 as a beneficiary (or trustee) of a deceased estate. The main residence exemption

is calculated having regard to the number of days the dwelling was the main residence of yourself and the previous beneficiaries.

EXAMPLE:

Ahmed acquired a dwelling after 20 September 1985.

The dwelling was his main residence from the date of settlement of the contract for purchase until he died. The number of days Ahmed owned the dwelling after 19 September 1985 was 3,700.

Under his will, Ahmed left the dwelling to his son, Fayeze. Fayeze was the sole beneficiary of Ahmed's estate. No other individual had a right to occupy the dwelling under Ahmed's will.

Some years later, Fayeze died. He had owned the dwelling for 2,600 days and it wasn't his main residence at any time during this period.

The dwelling was left to Mardianah under Fayeze's will.

Mardianah sold the dwelling in 2005–06 and made a capital gain of \$100,000. She owned the dwelling for 750 days and it wasn't her main residence at any time during that period.

The taxable proportion of Mardianah's \$100,000 capital gain is \$47,518. This is worked out as follows:

$$\$100,000 \times \frac{2,600 + 750}{2,600 + 750 + 3,700} = \$47,518$$

Because the combined period that Ahmed, Fayeze and Mardianah owned the dwelling was more than 12 months, Mardianah can reduce her \$47,518 capital gain by the 50% discount (after deducting any capital losses).

Because Mardianah gets an exemption for the period the dwelling was Ahmed's main residence, her capital gain is less than it otherwise would have been.

For more information about deceased estates, see chapter 9.

DEATH DURING CONSTRUCTION

If an individual entered into a contract to construct, repair or renovate a home on land they already owned, and they die before certain conditions are met, the trustee may choose that the home and land be treated as the deceased's main residence for up to four years before the home became (or was to become) their main residence.

The trustee can make this choice if the deceased dies:

- before the home is finished
- before it was practicable for the home to be their main residence, or
- before they had lived in the home for three months.

If the trustee makes this choice, no other dwelling can be treated as the deceased's main residence during that time.

LOSS, DESTRUCTION OR COMPULSORY ACQUISITION OF AN ASSET

07

This chapter explains your capital gains tax (CGT) obligation if your CGT asset is lost, destroyed or compulsorily acquired.

Generally, there is no CGT obligation for assets acquired before 20 September 1985 (pre-CGT).

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

There may be a situation where you receive money or another CGT asset (or both) as compensation when you dispose of an asset involuntarily (or under an insurance policy against the risk of such an event happening). In this case, you may be able to choose to:

- defer your liability to pay tax on any capital gain arising on the disposal, or
- get a CGT exemption for any replacement asset if you acquired the original asset before 20 September 1985.

This concession is known as rollover. It may be available if one of the following events happens:

- all or part of your CGT asset is lost or destroyed
- your CGT asset is compulsorily acquired by an Australian government agency (that is, the Commonwealth, a state, a territory or one of their authorities)
- you dispose of your CGT asset to an Australian government agency after a notice is served on you inviting you to negotiate a sale agreement. You must have been informed that, if the negotiations are unsuccessful, the asset will be compulsorily acquired, or
- a lease that had been granted to you by an Australian government agency under a Commonwealth, state or territory law expires and is not renewed.

! NOTE

A Bill has been introduced into Parliament to extend rollover to the disposal of CGT assets (and depreciating assets) compulsorily acquired by a private acquirer under a statutory power.

Under the changes, rollover will also apply where a landowner whose land is compulsorily subject to a mining lease sells the land to the lessee and acquires a replacement asset. Rollover will only apply if the lease would significantly affect the landowner's use of the land.

The changes are expected to apply to disposals made on or after 11 November 1999. For more information, visit our website.

This rollover is not available for plant disposed of after 11.45am (by legal time in the ACT) on 21 September 1999 and other depreciating assets from 1 July 2001. Instead, if a depreciating asset is lost or destroyed or an Australian government agency acquires it compulsorily or by forced negotiation, the capital allowances provisions may allow for a balancing charge offset.

This means that rather than including an amount in your assessable income by way of a balancing adjustment, you can offset that amount against the cost of a replacement asset (or assets).

If you choose to take rollover, you do not need to lodge a written election stating your choice – it will be clear from the way you prepare your tax return.

You cannot choose to defer a capital loss but you can use it to reduce any capital gain made in the current income year or a later year.

For rollover relief to apply, the replacement asset you receive cannot be a car, motorcycle or similar vehicle.

Further, from 1 July 2001, for rollover relief to apply, the replacement asset you receive cannot become an item of your trading stock nor can it be a depreciating asset.

TIME OF THE CGT EVENT

You need to know the time of a CGT event to work out in which income year a capital gain or capital loss affects your income tax.

If an asset is lost or destroyed and you receive compensation, the time of the CGT event is when you first receive the compensation.

If you do not receive any compensation, the time of the CGT event is when the loss is discovered or the destruction occurred.

If an Australian government agency compulsorily acquires your asset, the time of the CGT event is when:

- you first received compensation from the agency, or
- the agency enters the asset (for example, land) or takes possession of it.

If an Australian government agency acquires your asset following negotiation (rather than compulsorily acquiring it), the time of the CGT event is:

- the date the contract to acquire it is made, or
- the date of the change of ownership if there is no contract.

If a lease that had been granted to you by an Australian government agency expires and is not renewed, the time of the CGT event is when the lease expires.

IF YOU RECEIVE MONEY

If you receive money because a CGT event happens, you can choose rollover only if:

- you incur expenditure in acquiring another CGT asset that is used:
 - in your business for a reasonable period if the original asset was a business asset, or
 - otherwise, for a reasonable period for the same or a similar purpose as the original asset, or
- part of the original asset is lost or destroyed and you incur expenditure of a capital nature in repairing or restoring it.

You must incur at least some of the expenditure:

- no earlier than one year before the event happens, or
- within one year after the end of the income year in which the event happens.

This period may be extended in special circumstances.

EXAMPLE: Rollover applies

Trish paid for the repair of an asset for which she was compensated after part of it was destroyed on 1 September 2004. Trish's expenditure qualifies for the rollover concession if it was incurred any time during the period 1 September 2003 to 30 June 2006.

The replacement asset need not be identical to the one it is replacing. However, for rollover to apply, you must use it in the same business or for the same (or a similar) purpose as the one for which you used the original asset. Also, your replacement asset cannot become an item of trading stock nor can it be a depreciating asset.

EXAMPLE: Rollover does not apply

Denise receives money when her manufacturing business premises are destroyed. She buys a rental property with this money.

Denise cannot access the rollover concession because she does not use the rental property for the same or similar purpose as her old business premises.

Consequences of receiving money

If you receive money and choose to take a rollover, the consequences depend on whether:

- you acquired the original asset before 20 September 1985
- you acquired the original asset on or after 20 September 1985, and
 - the money received for the asset is more than the cost of repair or replacement
 - the money received does not exceed the cost of repair or replacement.

Original asset acquired before 20 September 1985

If you acquired the original asset before 20 September 1985, you are taken to have acquired the repaired or replacement asset before that day if:

- you repair or restore the original asset, or
- you replace the original asset:
 - at a cost of no more than 120% of its market value at the time of the event, or
 - at any cost, provided it (or part of it) was lost or destroyed by a natural disaster and the replacement asset is substantially the same.

This means you disregard any capital gain or capital loss you make when a later CGT event happens to the repaired or replacement asset.

Original asset acquired on or after 20 September 1985

If you acquired the original asset on or after 20 September 1985, the way rollover applies will depend on whether the money you received is more or less than the cost of repairing or replacing the asset. If it is more, it also depends on whether the capital gain you make when the event happens is:

- more than that excess, or
- less than or equal to that excess.

Money received is more than the cost of repair or replacement

If you do not use all of the money you received to repair or replace the original asset, this affects your CGT obligation. The amount of capital gain you include on your tax return depends on whether the capital gain is more or less than the difference between the amount you received and the cost of the repair or replacement.

If the capital gain is more than that difference, you reduce your capital gain to the amount of the excess. Include this amount on your tax return in the year the event happens. This gain may be eligible for the CGT discount (see chapter 2 for more information).

When a later CGT event happens, you reduce the expenditure to include in the cost base of the asset by the difference between the capital gain before it is reduced and the excess. This enables you to defer part of your CGT liability until a later CGT event happens.

If the capital gain is less than or equal to the excess (the compensation amount less the cost of the repair or replacement), you do not reduce the capital gain and the expenditure on the repair or replacement (see the example on page 85).

Money received does not exceed the cost of repair or replacement

If the amount of money you received is less than or equal to the expenditure you incurred to repair or replace the original asset, you disregard any capital gain. You reduce the expenditure you include in the cost base of the asset when a later CGT event happens by the amount of the gain (see the example on page 85).

EXAMPLE: Money received is less than expenditure incurred

Gerard's business premises were destroyed by fire on 15 March 2006. He received \$246,000 in compensation from his insurance company.

It cost him \$257,000 to reconstruct the premises, \$11,000 more than the amount of compensation he received.

Gerard made a capital gain of \$2,000 because his cost base apportioned to the building was \$244,000 at the time of the fire.

| | |
|-------------------------|-----------|
| Money received | \$246,000 |
| Cost base | \$244,000 |
| Capital gain | \$2,000 |
| Money received | \$246,000 |
| Replacement expenditure | \$257,000 |
| Shortfall | \$11,000 |

As the compensation money does not exceed the repair expenditure, Gerard disregards the capital gain.

However, the amount of expenditure that Gerard can include in the cost base of the repaired building is reduced by the amount of the capital gain (\$2,000) to \$255,000.

EXAMPLE: Money received is more than the expenditure incurred

Assume that in the above example, Gerard incurred only \$240,000 for repairs and the cost attributed to the building was \$230,000.

| | |
|-------------------------|-----------|
| Money received | \$246,000 |
| Cost base | \$230,000 |
| Capital gain | \$16,000 |
| Money received | \$246,000 |
| Replacement expenditure | \$240,000 |
| Excess | \$6,000 |

The compensation money (\$246,000) is \$6,000 more than the replacement expenditure (\$240,000). The capital gain (\$16,000) is \$10,000 more than the excess of \$6,000. The capital gain is reduced to the excess amount of \$6,000.

Gerard's capital gain (before applying the CGT discount of 50%) is \$6,000. Therefore, assuming he has not made any other capital losses or capital gains in the 2005–06 income year (and does not have any unapplied net capital losses from earlier years) Gerard includes \$3,000 ($\$6,000 \times 50\%$) as his net capital gain for the 2005–06 income year.

Also, he reduces the expenditure he incurred on the replacement asset by the balance of the capital gain (\$10,000) to \$230,000. This means \$10,000 of the capital gain is deferred.

IF YOU RECEIVE AN ASSET

If you receive a replacement asset when the event happens, you can choose a rollover only if:

- the replacement asset is not a depreciating asset or held as trading stock when you acquire it, and
- the market value of the replacement asset is more than the cost base of the original asset just before the event happened.

Consequences of receiving an asset

If you choose to take a rollover when you receive a replacement asset, you disregard any capital gain you make from the original asset. The other consequences are outlined below.

Original asset acquired before 20 September 1985

If you acquired the original asset before 20 September 1985, you are taken to have acquired the new asset before that day.

Original asset acquired on or after 20 September 1985

If you acquired the original asset on or after 20 September 1985, the first element of the cost base and reduced cost base of the replacement asset is taken to be the cost base and reduced cost base of the original asset at the time of the event.

However, you may have to recalculate the first element of the cost base of your replacement asset if the cost base of the original asset included an amount of indexation and you are seeking to apply the CGT discount to a capital gain from the replacement asset.

EXAMPLE: Asset received

Jon acquired land after 19 September 1985 which the state government compulsorily acquired on 14 July 2005. The cost base of the land at the time it was compulsorily acquired was \$180,000. As compensation, Jon received another piece of land with a market value of \$200,000.

Because the market value of the replacement land was greater than the cost base of the original land just before it was compulsorily acquired, Jon disregards the capital gain made on the disposal of the original land. Jon is taken to have paid \$180,000 to acquire the replacement land (that is, the cost base of the original land at the time it was compulsorily acquired).

IF YOU RECEIVE BOTH MONEY AND AN ASSET

If you receive both money and an asset and choose to take a rollover, the requirements and consequences are different for each part of the compensation.

EXAMPLE: Money and an asset received as compensation

The state government compulsorily acquires land Kris bought in 2002. Its cost base at the time was \$150,000 but Kris received compensation worth \$160,000.

Half of the total compensation is money (\$80,000) and half is replacement land (market value \$80,000).

Therefore, the cost base of the original land attributable to each part of the compensation is \$75,000 ($50\% \times \$150,000$). Kris bought additional replacement land for \$82,000.

The total capital gain is \$10,000 which is capital proceeds of cash and property totalling \$160,000 less the cost base of \$150,000. Half of this capital gain can be attributed to the money and half to the asset (the replacement land).

The money Kris received as compensation is less than the amount he paid to buy the additional land. He can therefore disregard the \$5,000 of the capital gain that is attributable to the money compensation. He reduces the expenditure on the additional land by \$5,000, so the first element of its cost base is only \$77,000.

As the market value of the replacement land is more than that part of the cost base of the original land, Kris can choose to take rollover relief and disregard the capital gain of \$5,000 relating to the land.

As a result, the value of the replacement land (\$75,000) forms the first element of its cost base, not its market value (\$80,000) when he acquired it.

Consequences of receiving both money and an asset

You need to separately determine what happens to the replacement asset and the money, having regard to the proportion of the original asset attributable to each type of compensation.

The rules are then applied separately to the money and to the asset.

INDEXATION OR CGT DISCOUNT

If a CGT event happens to the replacement asset (for example, a later disposal), you may be able to use the indexation method or the discount method to calculate your capital gain. This applies only if the periods of ownership of the original asset and the replacement asset add up to at least 12 months. For indexation to apply, you must have acquired the asset before 11.45am (by legal time in the ACT) on 21 September 1999.

Read this chapter if your legal or de facto marriage ended on or after 20 September 1985 and:

- you transfer an asset or a share of an asset to your spouse
- you receive an asset or a share of an asset from your spouse, or
- a company or trustee of a trust transfers an asset to you or your spouse.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

When we talk about ‘your spouse’, this includes your de facto spouse. ‘Transfer’ of an asset includes disposing of an asset to the transferee spouse or ‘creating’ an asset in their favour (such as a right to use property). Where we talk about ‘an asset’, this includes a share of an asset.

The term ‘transferee spouse’ refers to the spouse to whom an asset is transferred, while the ‘transferor’ is the person (or a company or the trustee of a trust) who transfers an asset to the transferee spouse.

As a general rule, capital gains tax (CGT) applies to all changes of ownership of assets on or after 20 September 1985. However, if you transfer an asset to your spouse as a result of a marriage breakdown, there is automatic rollover in certain cases (you cannot choose whether or not it applies).

This rollover ensures the transferor spouse disregards a capital gain or capital loss that would otherwise arise. In effect, the one who receives the asset (the transferee spouse) will make the capital gain or capital loss when they dispose of the asset. If you are the transferee spouse, the cost base and other attributes of the asset are transferred to you.

You must keep all relevant records, as explained in chapter 3.

CONDITIONS FOR MARRIAGE BREAKDOWN ROLLOVER

For the rollover conditions to be met, the CGT event must have happened because of:

- an order of a court or court order made by consent under the *Family Law Act 1975* or a similar law of a foreign country

- a maintenance agreement approved by a court under section 87 of that Act or a similar agreement under a foreign law, or
- a court order under a state, territory or foreign law relating to de facto marriage breakdowns.

Rollover is not available to couples in same-sex relationships.

Note that from 27 December 2000 maintenance agreements are no longer approved under section 87 of the *Family Law Act 1975*. Therefore, rollover does not apply to maintenance agreements entered into after this date unless a court order (including a consent order) has been obtained. CGT events happening because of maintenance agreements registered under section 86 of the *Family Law Act 1975* have never qualified for rollover.

On 10 May 2005, as part of the 2005 Budget, the Government announced proposed changes that will extend the scope of the marriage breakdown CGT rollover to assets transferred to a spouse or former spouse under a binding financial agreement or arbitral award under the *Family Law Act 1975* or a similar agreement or award under a corresponding foreign law. The rollover will also apply to assets transferred under a written agreement under a state, territory or foreign law relating to de facto marriage breakdowns where the agreement is similar to a binding financial agreement. (Amendments will also be made to ensure that the main residence exemption interacts more appropriately with the marriage breakdown rollover relief and ensure that marriage breakdown cash settlements do not give rise to CGT liabilities.) The Government’s intention is that the changes will apply to CGT events that happen after the date of Royal Assent of the amending legislation.

If you transfer assets under a private or informal arrangement that does not meet any of these conditions, rollover is not available. (See **If there is no court approval** on page 89.)

Relevant CGT events

For rollover to apply, one of the following events must happen. The transferor:

- disposes of an asset to the transferee spouse (CGT event A1)
- enters into an agreement with the transferee spouse under which:
 - the right to use and enjoy a CGT asset passes to the transferee spouse
 - title in the asset will or may pass to the transferee spouse at the end of the agreement (CGT event B1). There is no rollover if title in the CGT asset does not pass to the transferee spouse when the agreement ends

- creates a contractual or other right in favour of the transferee spouse (CGT event D1)
- grants an option to the transferee spouse or renews or extends an option granted to them (CGT event D2)
- owns a prospecting or mining entitlement, or an interest in one, and grants the transferee spouse a right to receive income from operations carried on by the entitlement (CGT event D3), or
- is a lessor and grants, renews or extends a lease to the transferee spouse (CGT event F1).

There is no rollover for the transfer of trading stock.

CONSEQUENCES OF ROLLOVER

You transfer the asset

If you transfer the asset, the consequences of rollover are:

- you disregard any capital gain or capital loss for assets acquired before 20 September 1985 and
- for assets acquired on or after 20 September 1985 marriage breakdown rollover ensures you disregard any capital gain or capital loss you make from the CGT event that involves you and the transferee spouse.

The asset is transferred to you

Assets acquired before 20 September 1985

If a CGT asset, including a share of a jointly owned asset, was transferred to you because of the breakdown of your marriage and it was acquired by the transferor before 20 September 1985, you are also taken to have acquired the asset before that date. You disregard any capital gain or capital loss you make when you later dispose of the asset.

However, if you make a major capital improvement to that asset after 20 September 1985, you may be subject to CGT when a CGT event happens to that asset (see **Other capital improvements to pre-CGT assets** on page 11).

Assets acquired on or after 20 September 1985

The rules are different if the asset was acquired by the transferor on or after 20 September 1985. In this case, if you receive the CGT asset (or a share of a jointly owned asset) and there is a marriage breakdown rollover, you are taken to have acquired the asset (or share of the asset) at the time it was transferred from your spouse (or the company or trustee).

To calculate your capital gain or capital loss when a later CGT event happens, the first element of your cost base and reduced cost base will be the same as the cost base and reduced cost base of your spouse (or the company or trustee) at the time of the transfer.

If the transferor's cost base includes an amount of indexation, you may later have to recalculate the first element of your cost base to exclude that amount if you want to apply the CGT discount to your capital gain.

You include transfer costs incurred by your spouse (or the company or trustee) – for example, conveyancing fees and stamp duty – in the cost base.

If you acquired the asset from your spouse (or the company or trustee) before 11.45am (by legal time in the ACT) on 21 September 1999, you may be able to use the indexation method when calculating your capital gain. This can only apply if your and your spouse's combined period of ownership is 12 months or more (or your and the company's or trustee's combined period of ownership is 12 months or more).

If you acquired the asset after 11.45am (by legal time in the ACT) on 21 September 1999, you cannot use the indexation method when calculating your capital gain but you may be able to use the discount method. You can use the discount method to calculate your capital gain if your and your spouse's combined period of ownership is 12 months or more. If the period is less than 12 months, you use the 'other' method.

Collectables or personal use assets remain collectables or personal use assets when they are transferred from your spouse (or the company or trustee) in the case of a marriage breakdown rollover.

For information about collectables and personal use assets, see **What is a CGT asset?** on page 9.

As explained earlier, there are several instances where your spouse (or a company or trustee) may create an asset in your favour. The table below explains how to calculate the first element of your cost base and reduced cost base of that asset in each case.

| CGT event | First element of cost base and reduced cost base |
|---|---|
| Creating contractual or other rights (D1) | Incidental costs incurred by the transferor that relate to the event |
| Granting an option (D2) | Expenditure incurred by the transferor to grant the option |
| Granting a right to income from mining (D3) | Expenditure incurred by the transferor to grant the right |
| Granting a lease (F1) | Expenditure incurred by the transferor on the grant renewal or extension of the lease |

You are taken to have acquired the asset at the time specified by the CGT event. For example, for CGT event D1, you acquire the asset at the time you enter into the contract or if there is no contract, at the time the right is created. For more information, see appendix 1.

CGT ASSETS TRANSFERRED BY A COMPANY OR TRUST

If a company or a trustee of a trust transfers a CGT asset to a spouse, adjustments are required to the relevant cost base and reduced cost base of interests in the company or trust. These may be shares (or indirect interests in shares)

in the company, units in a unit trust and other interests in the trust. They are reduced in value by an amount that reasonably reflects the fall in their market value as a result of the transfer of the CGT asset.

EXAMPLE: Transfer of assets from a legal or a de facto marriage

Danny and Claudia jointly owned the following assets immediately before their marriage breakdown:

| Asset | When purchased | Cost |
|---------------------|----------------|----------|
| The family home | January 1985 | \$75,000 |
| Holiday house | December 1988 | \$65,000 |
| Shares in a company | March 1999 | \$35,000 |

On their divorce in October 2005, the Family Court approved the couple's agreement and made an appropriate court order by consent.

Claudia received the family home. Because it was acquired by the couple before 20 September 1985, she is taken to have acquired both her original interest in the home and Danny's share before that date. Claudia will not have to pay tax on capital gains when she sells the home.

Danny has no CGT obligation on the transfer to Claudia of his share in the family home.

Danny received the shares and the holiday house which did not become his home.

Although the couple acquired these assets after 20 September 1985, Claudia's capital gain from the transfer of her share of these assets to Danny is disregarded under the marriage breakdown rollover.

Danny is taken to have acquired Claudia's share of these assets at the time of transfer for her relevant cost base. If he were to sell the holiday house or the shares, he would calculate his capital gain or capital loss in respect of his original interest and the interest he acquired from Claudia.

When he sells the assets, Danny can choose to apply the indexation method or the discount method to work out the amount of any capital gain from his original interests because they were acquired before 21 September 1999.

Because he acquired Claudia's interests after that date, he can only choose the discount method to work out any capital gain on them. However, in applying the 12-month ownership test for the purposes of the CGT discount, he can take into account the period that Claudia owned the interest.

Danny will have to ensure that the cost base of the interest that he acquired from Claudia does not include any amount of indexation.

Special rules apply to marriage breakdown rollovers involving a controlled foreign corporation or certain non-resident trusts.

If these rules apply to you please seek help from the Tax Office or a recognised tax adviser.

SUPERANNUATION INTERESTS

CGT rollover may apply if an interest in a small superannuation fund is subject to a payment split on the breakdown of a legal (but not a de facto) marriage and a CGT asset of a small superannuation fund is transferred to another small superannuation fund.

A small superannuation fund is one that is a complying fund and has fewer than five members.

The consequences of rollover are the same as for transfers between spouses.

MAIN RESIDENCE

If the CGT asset transferred to you in a marriage breakdown rollover is your home, you may be entitled to an exemption from CGT for the period the home was your main residence. Special rules apply if the dwelling is transferred to you from a company or trust (see **Acquisition of a dwelling from a company or trust upon marriage breakdown** on page 79 for more information).

IF THERE IS NO COURT APPROVAL

If you and your spouse divide your property by some means other than by a court order or an agreement approved by the court, normal CGT rules apply – not the rules explained earlier in this chapter. You must include on your tax return for that year any capital gain or capital loss you make on the transfer of a CGT asset.

The spouse to whom the asset is transferred is taken to have acquired the asset at the time of transfer.

Special rules may apply if the amount paid by one spouse for property owned by the other is greater or less than the market value of the property and they are not dealing at arm's length – see market value substitution rule for capital proceeds and market value substitution rule for cost base and reduced cost base in **Definitions** on page 132. In these cases, for CGT purposes, they are taken to have paid or received the market value of the property.

If you are a deceased person's legal personal representative or a beneficiary of a deceased estate, read this chapter to find out about the special capital gains tax (CGT) rules that apply.

! NEW TERMS

We may use some terms that are new to you. These words are printed in **red** the first time they are used and explained in **Definitions** on page 132. Generally they are also explained in detail in the section where they first appear.

When a person dies, the assets that make up their estate can:

- pass directly to a beneficiary (or beneficiaries), or
- pass directly to their legal personal representative (for example, their executor) who may dispose of the assets or pass them to the beneficiary (or beneficiaries).

A beneficiary is a person entitled to assets of a deceased estate. They can be named as a beneficiary in a will or they can be entitled to the assets as a result of the laws of intestacy (when the person does not make a will).

A legal personal representative can be either:

- the executor of a deceased estate (that is, a person appointed to wind up the estate in accordance with the will), or
- an administrator appointed to wind up the estate if the person does not leave a will.

CAPITAL GAIN OR CAPITAL LOSS ON DEATH IS DISREGARDED

There is a general rule that CGT applies to any change of ownership of a CGT asset, unless the asset was acquired before 20 September 1985 (pre-CGT).

There is a special rule that allows any capital gain or capital loss made on a post-CGT asset to be disregarded if, when a person dies, an asset they owned passes:

- to their legal personal representative or to a beneficiary, or
- from their legal personal representative to a beneficiary.

Exceptions to this rule

A capital gain or capital loss is not disregarded if a post-CGT asset owned at the time of death passes from the deceased to a **tax-advantaged entity** or to a non-resident. In these cases, a CGT event is taken to have

happened to the asset just before the person died. The CGT event will result in:

- a capital gain if the market value of the asset on the day the person died was more than the cost base of the asset, or
- a capital loss if the market value was less than the asset's reduced cost base.

These capital gains and losses should be taken into account in the deceased person's 'date of death return' (the tax return for the period from the start of the income year to the date of the person's death).

However, any capital gain or capital loss from a testamentary gift of property can be disregarded if:

- the gift is made under the Cultural Bequests Program (which applies to certain gifts of property – not land or buildings – to a library, museum or art gallery), or
- the gift is made to a deductible gift recipient or a registered political party and the gift would have been income tax deductible if it had not been a testamentary gift.

The condition that testamentary gifts of property must be valued at greater than \$5,000 before the CGT exemption applies does not apply to gifts made on or after 1 July 2005.

Tax-advantaged entity

A tax-advantaged entity is:

- a tax-exempt entity (for example, a church or charity), or
- the trustee of:
 - a complying superannuation fund
 - a complying approved deposit fund, or
 - a pooled superannuation trust.

Non-resident beneficiary

If a non-resident is a beneficiary of a deceased's post-CGT asset, any capital gain or capital loss is not disregarded if:

- the deceased was an Australian resident when they died, and
- the asset does not have the necessary connection with Australia.

Examples of assets that do not have the necessary connection with Australia include:

- real estate located overseas
- shares in a non-resident company, and
- shares in an Australian public company if the total number of shares owned is less than 10% of the value of shares in the company.

ASSETS WHICH PASS TO THE BENEFICIARY OR LEGAL PERSONAL REPRESENTATIVE

Main residence

Special rules apply if the asset was the deceased person's or beneficiary's main residence (see **Inherited main residence** on page 80 and flowchart 6 on page 125).

Other real estate

Even if the property was not the deceased person's main residence, special rules may mean you qualify for a full or part exemption when you dispose of it (see **Inherited main residence** on page 80 and flowchart 6 on page 125).

Other assets

In administering and winding up a deceased estate, a legal personal representative may need to dispose of some or all of the assets of the estate. Assets disposed of in this way are subject to the normal rules and any capital gain the legal personal representative makes on the disposal is subject to CGT.

Similarly, it may be necessary for the legal personal representative to acquire an asset (for example, to satisfy a specific legacy made). Any capital gain or capital loss they make on disposal of that asset to the beneficiary is subject to the normal CGT rules.

If a beneficiary sells an asset they have inherited, the normal CGT rules also apply.

Acquisition of asset

If you acquire an asset owned by a deceased person as their legal personal representative or beneficiary you are taken to have acquired the asset on the day the person died. If that was before 20 September 1985, you disregard any capital gain or capital loss you make from the asset.

Cost base of asset

Assets acquired by the deceased person before 20 September 1985

If the deceased person acquired their asset before 20 September 1985, the first element of your cost base and reduced cost base (that is, the amount taken to have been paid for the asset) is the market value of the asset on the day the person died.

If, before they died, a person made a major improvement to a pre-CGT asset on or after 20 September 1985, the improvement is not treated as a separate asset.

The beneficiary or legal personal representative is taken to have acquired the improved asset when the person died. Although the deceased used to treat the asset and the improvement as separate assets, the beneficiary or legal personal representative now treats them as one asset.

Assets acquired by the deceased person on or after 20 September 1985

If a deceased person acquired their asset on or after 20 September 1985, the first element of your cost base and reduced cost base is taken to be the cost base and reduced cost base of the asset on the day the person died.

There is an exception if the asset is a dwelling and certain conditions are met. See **Cost to you of acquiring the dwelling** on page 81.

If the deceased person died before 21 September 1999, and you choose the indexation method to work out the capital gain when you dispose of the asset (or when another CGT event happens), you index the first element of the cost base from the date the deceased person acquired it up until 21 September 1999.

If the deceased person died on or after 21 September 1999, you cannot use the indexation method and, when you dispose of the asset, you must recalculate the first element of your cost base to leave out any indexation that was included in the deceased's cost base.

Expenditure incurred by a legal personal representative

As a beneficiary, you can include in your cost base (and reduced cost base) any expenditure the legal personal representative (for example, the executor) would have been able to include in their cost base if they had sold the asset instead of distributing it to you. You can include the expenditure on the date they incurred it.

For example, if an executor incurs costs in confirming the validity of the deceased's will, these costs form part of the cost base of the estate's assets.

CHOOSING THE INDEXATION METHOD OR THE DISCOUNT METHOD

If the deceased died before 11.45am (by legal time in the ACT) on 21 September 1999 and you dispose of the asset (as legal personal representative or beneficiary) after that date, there are two ways of calculating your capital gain. You can use either the indexation method or the discount method, whichever gives you the better result. However, the CGT discount is only available if you are an individual, a trust or a complying superannuation entity.

Elements of an asset's cost base can be indexed only if you own the asset for at least 12 months before disposing of it. For the purposes of this 12-month ownership test you are taken to have acquired the asset when the deceased acquired it, not from the date of their death.

For the CGT discount to apply, you must have acquired the asset at least 12 months before disposing of it. For the purposes of this 12-month ownership test, you are taken to have acquired the asset at one of the following times:

- for pre-CGT assets, the date the deceased died, and
- for post-CGT assets, the date the deceased acquired it.

EXAMPLE: Transfer of an asset from the executor to a beneficiary

Maria died on 13 October 2000 leaving two assets: a parcel of 2,000 shares in ABC Ltd and a vacant block of land. Giovanni was appointed executor of the estate (the legal personal representative).

When the assets are transferred to Giovanni, he disregards any capital gain or capital loss. Giovanni disposes of (sells) the shares to pay Maria's outstanding debts. As the shares are not transferred to a beneficiary, any capital gain or capital loss on this disposal must be included on the tax return for Maria's deceased estate.

When all debts and tax have been paid, Giovanni transfers the land to Maria's beneficiary, Antonio, and pays the conveyancing fee of \$5,000. As the land is transferred to a beneficiary, any capital gain or capital loss is disregarded. The first element of Antonio's cost base is taken as Maria's cost base on the date of her death. Antonio is also entitled to include in his cost base the \$5,000 Giovanni spent on the conveyancing.

EXAMPLE: Indexation and CGT discount

Leonard acquired a property on 14 November 1998 for \$126,000. He died on 6 August 1999 and left the property to Gladys. She sold the property on 6 July 2005 for \$240,000. The property was not the main residence of either Leonard or Gladys.

Although Gladys acquired the property on 6 August 1999, for the purpose of determining whether she had owned the property for at least 12 months, she was taken to have acquired it on 14 November 1998 (the day Leonard acquired it).

At the time of disposal, Gladys had owned the property for more than 12 months. As she acquired it before 11.45am (by legal time in the ACT) on 21 September 1999 and disposed of it after that date, Gladys could choose to index the cost base. However, if the discount method gave her a better result, she could choose to claim the CGT discount.

If Gladys chose the discount method she would have to exclude from the first element of her cost base the amount that represented indexation that had accrued to Leonard up until the time he died.

Collectables and personal use assets

A post-CGT collectable or personal use asset is still treated as such when you receive it as a beneficiary or the legal personal representative of the estate.

JOINT TENANTS

If two or more people acquire a property asset together, it can be either as tenants in common or as joint tenants.

If a tenant in common dies, their interest in the property is an asset of their deceased estate. This means it can be transferred only to a beneficiary of the estate or be sold (or otherwise dealt with) by the legal personal representative of the estate.

If one of the joint tenants dies, their interest in the property passes to the surviving joint tenant(s). It is not an asset of the deceased estate.

For CGT purposes, if you are a joint tenant you are treated as if you are a tenant in common owning equal shares in the asset. However, if you are a joint tenant and another joint tenant dies, on that date their interest in the asset is taken to pass in equal shares to you and any other surviving joint tenants, as if their interest is an asset of their deceased estate and you are beneficiaries.

This means that if the dwelling was the deceased's main residence, you may be entitled to the main residence exemption (see **Inherited main residence** on page 80) for the interest you acquired from them.

If the joint tenant who dies acquired their interest in the asset on or after 20 September 1985, the first element of the cost base of the interest you acquire from them is the cost base of their interest on the day they died, divided by the number of joint tenants (including you) who acquire it. The first element of the reduced cost base of the interest you acquire from them is worked out similarly.

EXAMPLE: Surviving joint tenants

In 1999, Ming and Lee buy a residential property for \$250,000 as joint tenants. Each one is taken to have a 50% interest in it. On 1 May 2001 Lee dies.

On 1 May 2001 Ming is taken to have acquired Lee's interest for an amount equal to Lee's cost base on that day.

If Ming uses the property as his main residence after Lee dies, he may be entitled to the main residence exemption (see chapter 6) for the interest he acquired from Lee as well as for his original interest.

If the joint tenant who dies acquired their interest in the asset before 20 September 1985, the first element of the cost base of the interest you acquire from them is the market value of their interest on the day they died, divided by the number of joint tenants (including you) who acquire it. The first element of the reduced cost base of the interest you acquire from them is worked out similarly.

For the indexation and discount methods to apply, you must have owned the asset (or your share of it) for at least 12 months. As a surviving joint tenant, for the purposes of this 12-month test, you are taken to have acquired the deceased's interest in the asset (or your share of it) at the time the deceased person acquired it.

EXAMPLE: CGT and joint tenants

Trevor and Kylie acquired land as joint tenants before 20 September 1985. Trevor died in October 2005. For CGT purposes, Kylie is taken to have acquired Trevor's interest in the land at its market value at the date of his death.

Kylie holds her original 50% interest as a pre-CGT asset, and the inherited 50% interest as a post-CGT asset which she is taken to have acquired at its market value at the date of Trevor's death.

If Kylie sold the land within 12 months of Trevor's death, she would qualify for the CGT discount on any capital gain she makes on her post-CGT interest. She qualifies for the CGT discount because, for the purposes of the 12-month ownership test, she is taken to have acquired Trevor's interest at the time he acquired it, which was before 20 September 1985.

UNAPPLIED NET CAPITAL LOSSES

If the deceased had any unapplied net capital losses when they died, these cannot be passed on to you as the beneficiary or legal personal representative for you to offset against any net capital gains.

LIFE AND REMAINDER INTERESTS

There may be CGT consequences on the creation, surrender, expiry or disposal of a life interest or remainder interest.

The Tax Office has issued a Taxation Ruling to explain these. For more information, visit our website or seek advice from a recognised tax adviser.

