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CAPITAL GAINS TAX

Capital gains tax (CGT) obligations will arise in the purchase and sale of capital assets, such as real estate, businesses and shares.

Other, less obvious areas in which CGT may arise is with family law property settlements, the drawing of wills and subsequent administration of estates, and re-arrangements of shareholdings or units in companies and trusts respectively.

It is therefore very important to be aware of and think about the CGT consequences of significant transactions prior to the event giving rise to the CGT liability, that is, at the time of purchasing or acquiring an asset.

What is Capital Gains Tax?
CGT is the income tax you pay on any net capital gain you make.

For example, when you dispose of a parcel of land as part of a CGT event, you are subject to CGT.

A *CGT event* occurs when a transaction takes place, such as the sale or acquisition of an asset. This is a very general definition and the *Income Tax Assessment Act 1997* (Cth) sets out the full list of CGT events.

How is CGT calculated?
The net capital gain is added to your income in the year derived, which is then taxed at the appropriate income threshold rates. After 21 September 1999 an investor (who has held the asset for over 12 months) has the choice to calculate the difference between the asset's *cost base* (indexed to 30/9/99) and the *capital proceeds*, or calculating the difference between the asset's *cost base* and the *capital proceeds*, without indexation, but applying a CGT discount for individuals (currently 50%) - which is now the only method for assets acquired after 21/9/99.

Cost base includes what was paid on the asset's acquisition, the incidental costs of acquisition and disposal such as legal costs and stamp duty, the non-capital costs of ownership such as rates and interest, and improvement costs such as renovations to a property.

Capital proceeds is the amount of the money received or entitled to be received at the time of sale of the asset (eg. market value).

We strongly recommend you contact your accountant, or tax planner, or investigate the ATO website www.ato.gov.au click on "Individuals" in left margin, then click "Capital Gains Tax" at the end of the list (or Tel: 13 28 61) for specific advice on calculating your gain.

Pre-CGT Assets and Post-CGT Assets
Not all assets will be subject to CGT on the happening of a CGT event.

Pre-CGT assets are those assets acquired prior to 20 September 1985. Usually, when these assets are disposed of, no CGT applies and thus the taxpayer can make a tax-free capital gain.

Post-CGT asset are those acquired on or after 20 September 1985. CGT will usually be payable on the disposal of these assets.

It is therefore important when considering investing in property, shares, or entering into family law property settlement negotiations or considering the terms of a will, for example, to identify which assets are *pre-CGT assets* and which are *post-CGT assets*, as the ultimate value of these may be significantly less than their face value if they are *post-CGT assets*.

Record Keeping
It is of vital importance that accurate records are kept regarding the cost base of an asset, including date of acquisition, cost, incidental costs, applicable rates and interest and improvement costs. Records of capital proceeds should also be kept.

Records must be kept for at least 5 years after the CGT event occurs.

Conveyancing

There are different issues to keep in mind when considering the purchase of and subsequent sale of a property.

Purchase
- In what *entity* (individuals, trust or company) will the property be purchased? Upon the sale of the property, different CGT rates and concessions apply to individuals and companies;
- *How will the property be used?* Concessions may apply if the property is used as a principal place of residence, and small business concessions may apply if the net value of the business' assets and related parties is less than $5 million;

Sale
Pre or post-CGT asset? CGT will only apply if the property is a post-CGT asset.
- *Sale price*: where the property is sold for less than its market value, the capital proceeds will be taken to be the property's market value at the time of sale;

- *Inclusions*: where the property includes depreciating assets for which you are entitled to claim a deduction, the expenditure may be deducted from the cost base. It is therefore important to apportion the various depreciating assets and the property in the Contract for Sale.

Wills and Estates

The consequences of CGT can affect the ultimate value of the assets which are left to beneficiaries.

Drawing Wills

- *Post-CGT assets* that are inherited by a beneficiary can result in the beneficiary inheriting a CGT liability;
- *Main-residence exemption and Right of Occupancy*: if the Will leaves a property being the testator's main residence, the main-residence exemption may not pass to the beneficiary unless a right of occupancy is also granted under the will;
- Record-keeping regarding the cost base is crucial as the beneficiaries inherit the testator's cost base.

Administration of Estates

- *Post-CGT assets*: a post-CGT asset is taken to be acquired by the testator's legal personal representative (eg. executor) and then the beneficiary, for the asset's market value at the date of death. Therefore valuations of such assets should be obtained at the date of death;
- *Main-residence*: apart from the exemption outlined above, if one of the assets was the deceased's main residence, an exemption will be available so long as the property is sold within 2 years of the testator's death.

Family Law

One common area where CGT implications should be carefully considered is when negotiating the terms of a property settlement with a former spouse.

- Roll-over of cost base: usually, where assets are transferred from one spouse to another following marriage breakdown, the receiving spouse may "inherit" the former spouse's cost base. This is usually automatic if the transfer occurs pursuant to a court order (including consent orders).
  This is an important factor to take into account where, for example, an investment property is being transferred to a spouse. In this case, if it is the receiving spouse's intention to sell the property, the net value of the property may be affected and reduced by a CGT liability and thus should be taken into account in settlement negotiations.
- Record keeping is crucial in order to ensure the receiving spouse does not inherit a greater CGT liability than what may be applicable.

Shares & Units

Company shares or units in a Unit Trust are also assets which may attract CGT consequences

Usually, where shares or units, being *post-CGT* assets, are sold/disposed of or are otherwise subject to a CGT event, CGT will be payable on the net capital gain made.

A CGT liability may arise regardless of whether the owner of the shares or units voluntarily participates in the distribution.

Certain shares and units have special CGT rules - for example, bonus shares and units, rights and options and employee shares.

Structure of Companies, Trusts and Businesses

The CGT implications should be considered when setting up a family company or trust and deciding on the structuring, shareholdings or unit entitlements of members or beneficiaries.

For example, consideration should be given to the differences between the corporate tax rate of 30% and the personal rate of 47%. Further, a CGT 50% discount is available only to individuals, but not companies. This may affect the structure of a new business or the purchasing entity of an existing business.

For more in depth analysis on CGT implications of any proposed transaction, we always strongly recommend that you obtain advice from your accountant, or tax advisor, who can give you specific advice on the amount of capital gains tax (for sales) and the correct purchasing entity for your existing financial structure (for purchases).

You may also consider reviewing the ATO website www.ato.gov.au and entering "capital gains tax" in the search box, or calling them 13 28 61.

If you require further information, please don't hesitate to contact us.

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