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Tax and Property Development

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Property transactions are a tax office and state agency focus for income tax, GST and other (state) taxes. These agencies all share information. The risk of detection for underpaid tax with property is very high as the value of taxes and the easy access to data makes detection easy for all agencies.

The Australian fascination with property and investment in many forms means that the lines between an investor and a developer can be somewhat blurred. The complexity of interaction of numerous property taxes also means multiple points of taxation may arise, each with complexities and risks of errors or mistake. Due to the values involved errors are generally seen as avoidance and severe penalties apply.

This guide has been produced to explain to the property owner, developer or other interested parties the general tax principles so that they identify the key issues and seek and obtain appropriate guidance. This will assist them to pay no more and no less tax than they may expect to pay to comply.

By following the information in this guide tax payments will be minimised and therefore profit on projects will be maximised. Failure to seek advice and guidance may result in errors which can lead to over payment of tax or underpayment and errors in determining tax on profits.

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1. The ATO View – Enterprise

The Tax Office views on profits on isolated transactions is contained in Tax Ruling TR 92/3. An additional tax ruling TD 92/161 which describes the use of pre-CGT farming land in subdivisions, development or sale is also useful information that aligns with that same view involving change to how land is held and isolated transactions.

However a more relevant concept, that is also more recent, arises from GST law. GST law describes an *enterprise* rather than an entity, a structure (ie a company) or a business. The Tax Office views on what an enterprise is can be located in MT 2006/1. An enterprise is the doing of something.

MT 2006/1 is a generic ruling which has been written in a manner that describes actions rather than more specific transactions so that taxpayers may align their circumstances with that view. The ruling also contains many useful examples. The ruling has the purpose of assisting taxpayers determine if their venture is an enterprise. If it is, MT 2006/1 indicates that an ABN is required. A further tax office ruling GSTD 2006/6 aligns the views in MT 2006/1 about an ABN with GST law. Therefore, the combination of these ruling proposes that if a taxpayer meets with the views in MT 2006/1 an enterprise requires an ABN and that this may consequently require GST registration. These rulings clearly apply to isolated transactions as well as recurring one's.

Many taxpayers consider that repetition is required for tax and GST issues. This is certainly NOT the case and care should be taken to seek tax advice if you consider that position may apply.

Features of MT 2006/1 which relate to profits on isolated transactions and which the Commissioner considers an enterprise include :

(Paragraph no's are cited). The use of examples may assist readers to some degree.

265. From the Statham and Casimaty cases a list of factors can be ascertained that provide assistance in determining whether activities are a business or an adventure or concern in the nature of trade (a profit-making undertaking or scheme being the Australian equivalent, see paragraphs 233 to 242 of this Ruling). If several of these factors are present it may be an indication that a business or an adventure or concern in the nature of trade is being carried on. These factors are as follows:

- *there is a change of purpose for which the land is held;*
- *additional land is acquired to be added to the original parcel of land;*
- *the parcel of land is brought into account as a business asset;*
- *there is a coherent plan for the subdivision of the land;*
- *there is a business organisation - for example a manager, office and letterhead;*

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- *borrowed funds financed the acquisition or subdivision;*
- *interest on money borrowed to defray subdivisional costs was claimed as a business expense;*
- *there is a level of development of the land beyond that necessary to secure council approval for the subdivision; and*
- *buildings have been erected on the land.*

266. In determining whether activities relating to isolated transactions are an enterprise or are the mere realisation of a capital asset, it is necessary to examine the facts and circumstances of each particular case. This may require a consideration of the factors outlined above, however there may also be other relevant factors that need to be weighed up as part of the process of reaching an overall conclusion. No single factor will be determinative rather it will be a combination of factors that will lead to a conclusion as to the character of the activities.

Land bought with the intention of resale

270. In isolated transactions, where land is sold that was purchased with the intention of resale at a profit (which would be ordinary income) the Commissioner considers these activities to be an enterprise. This would be so whether the land was sold as it was when it was purchased or whether it was subdivided before sale. An enterprise would be carried on in this situation because the activities are business activities or activities in the conduct of a profit making undertaking or scheme and therefore an adventure or concern in the nature of trade.

Examples of subdivisions of land that are enterprises

Example 28

271. *Stefan and Krysia discover that the local council has recently changed its by-laws to allow for smaller lots in the area. They decide to take advantage of the by-law change. They purchase a block of land with the intention to subdivide it into two lots and to sell the lots at a profit. They carry out their plan and sell both lots of land at a profit.*

272. *Stefan and Krysia are entitled to an ABN in respect of the subdivision on the basis that their activities are an enterprise being an adventure or concern in the nature of trade. Their activities are planned and carried out in a businesslike manner.*

Example 29

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273. *Tobias finds an ocean front block of land for sale in a popular beachside town. He devises a plan to enable him to afford to live there. He decides to purchase the land and to build a duplex. He plans to sell one of the units and retain and live in the other. The object of his plan is to enable him to obtain private residential premises in an area that would otherwise be unaffordable for him.*

274. *Tobias carries out his plan. He purchases the land, and lodges the necessary development application with the local council. The development application is approved by the council, Tobias engages a builder and has the duplex built. He sells one unit, and lives in the other.*

275. *Tobias is entitled to an ABN. His intentions and activities have the appearance of a business deal. They are an enterprise.*

276. *Further, there is a reasonable expectation of profit or gain (see paragraphs 378 to 405 of this Ruling) as his plan has enabled him to be able to keep and live in one of the units.*

Example 30

277. *Steven buys a 100 hectare property. He believes that the property may be suitable to be developed as a resort. After investigation he decides that it would be more profitable to subdivide and sell the property. He decides to subdivide the property into one hectare lots and sell these.*

278. *He engages a town planner and a surveyor to survey the 100 hectare property and to establish how many hectare lots it can be subdivided into. Steven then approaches the local shire council and is advised that he may subdivide his property into 65 one hectare lots.*

279. *However, Steven must satisfy various shire council conditions if he wishes to obtain development approval. They are*:

- *the making of new sealed roads with kerbing and channelling within the subdivision*;
- *the provision of water, electricity and telephone services to the new lots*;
- *the provision of culverts and other storm water drainage works*; *and*
- *the transfer of certain areas of land to the shire council for parks, environmental and other public purposes.*

280. *Steven consults his accountant and legal advisers. Together they prepare a comprehensive business plan for the project. They approach a commercial lender to arrange a substantial loan, secured by the property, to cover all development costs and related expenses.*

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281. *After gaining development approval from the council, Steven then engages a project manager who arranges for all the survey and subdivisional works to be carried out. Contractors are engaged to put in the roads, complete all the necessary drainage works and install the water, electricity and telephone services.*

282. *Steven also investigates a marketing strategy that will provide the best return for his project. Sales agents are retained to carry out the marketing program which involves a comprehensive advertising campaign using a promotional estate name, 'Bush Turkey Hill'.*

283. *Steven is entitled to an ABN on the basis that the subdivision is an enterprise and it is more than a mere realisation of a capital asset. Significant factors that are relevant which lead to this conclusion are as follows*:

- *there is a change of purpose for which the whole property is held*;
- *there is a comprehensive plan for the development of the property*;
- *the subdivision is developed in a businesslike manner for example there is a project manager, significant development costs, a comprehensive marketing campaign including an estate name for the land*; *and*
- *a substantial loan has been taken out to finance the development.*

Example 31

284. *Prakash and Indira have lived in the same house on a large block of land for a number of years. They decide that they would like to move from the area and develop a plan to maximise the sale proceeds from their land.*

285. *They consider their best course of action is to demolish their house, subdivide their land into two blocks and to build a new house on each block.*

286. *Prakash and Indira lodge the necessary development application with the local council and receive approval for their plan. They arrange for*:

- *their house to be demolished*;
- *the land to be subdivided*;
- *a builder to be engaged*;
- *two houses to be built*;
- *water meters, telephone and electricity to be supplied to the new houses*; *and*
- *a real estate agent to market and sell the houses.*

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287. *Prakash and Indira carry out their plan and make a profit. They are entitled to an ABN in respect of the subdivision on the basis that their activities go beyond the minimal activities needed to sell the subdivided land. The activities are an enterprise as a number of activities have been undertaken which involved the demolition of their house, subdivision of the land and the building of new houses.*

Features of MT 2006/1 which relate to subdivisions and which the Commissioner considers are NOT an enterprise are also contained in this ruling. Taxpayers must be very careful that they do not attempt to "solution-shop" where they seek to apply their circumstances by stretching the examples or over-simplifying their case to fit. Professional guidance may be recommended as penalties for evasion can be held against a taxpayer.
Examples in the ruling include :

Example 32

288. *Astrid and Bruno live on a large suburban block. The council has recently changed their by-laws to allow for smaller lots in their area. They decide to subdivide their land to allow their only child, Greta, to build a house in which to live.*

289. *They arrange for the approval of the subdivision through the council, for the land to be surveyed and for the title of the new block to be transferred to Greta. She pays for all the costs of the subdivision and the cost of her new house.*

290. *Astrid and Bruno have not carried on an enterprise and are not entitled to an ABN in respect of the subdivision. It is a subdivision without any commercial aspects and is part of a private or domestic arrangement to provide a house for their daughter.*

Example 33

291. *Ursula and Gerald live on a 2.5 hectare lot that they have owned for 30 years.*

292. *They decide to sell part of the land and apply to subdivide the land into two 1.25 hectare lots. The survey and subdivision are approved. They retain the subdivided lot containing their house and the other is sold.*

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293. *Ursula and Gerald are not carrying on an enterprise and are not entitled to an ABN in respect of the subdivision as the subdivision and sale are a way of disposing of some of the land on which their home is situated. It is the mere realisation of a capital asset.*

Example 34

294. *A number of years ago Elsie and Karin purchased some acreage on which to keep their horses, which they rode on weekends. Karin now accepts a job overseas and they decide to sell the land.*

295. *They put the land on the market with little success. The local real estate agent then advises that it would be easier to sell the land if it was subdivided into smaller lots. They arrange for a development application to be lodged with the local council and obtain approval to subdivide the land into nine lots. Elsie and Karin arrange for the land to be surveyed. The land has a road running along its boundary and has some existing services such as electricity. Only minimal activity is required to subdivide the land.*

296. *Elsie and Karin are not entitled to an ABN. The sale is not considered to be an enterprise and is the mere realisation of a capital asset.*

Example 35

297. *Oliver and Eloise have lived on a rural property, Flat Out for the last 30 years. They live a self-sufficient lifestyle. As a result of a number of circumstances including their advancing years, Oliver's deteriorating health, growing debt and drought conditions they decide to sell.*

298. *Oliver and Eloise put Flat Out on the market and are unable to find any buyers. They then receive advice from the real estate agent that they may be able to sell smaller portions of it. They initially arrange for council approval to subdivide part of Flat Out into 13 lots. They undertake the minimal amount of work necessary and sell the lots. They continue to live on the remaining part of their property.*

299. *A few years later Oliver and Eloise decide to sell some more land to meet their increasing debt obligations. They arrange for council approval to subdivide another part of Flat Out into four lots. Again they undertake the minimal amount of work necessary to enable the lots to be subdivided and arrange for the real estate agent to sell these lots.*

300. *Three years later Oliver's and Eloise's personal and financial circumstances are such that they again decide to sell some more land. They arrange for further council approval to subdivide part of their*

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remaining property into three lots. Again they undertake the minimal amount of work necessary to enable the lots to be sold and arrange for the real estate agent to sell the lots.

301. *Over the years involved Oliver and Eloise have subdivided 30% of Flat Out. They continue to live on the remaining part of their property.*

302. *Oliver and Eloise are not entitled to an ABN as they are not carrying on an enterprise. They are merely realising a capital asset. In this example the following factors are relevant*:

- *There is no change of purpose or object with which the land is held - it has remained their home.*
- *There is no coherent plan for the subdivision of the land - the subdivision has been undertaken in a piecemeal fashion as circumstances change.*
- *A minimal amount of work has been undertaken in order to prepare the land for sale. There has been no building on the subdivided land. The only work undertaken was that necessary to secure approval by the council for the subdivision.*

Determination of whether a venture is or is not likely to be an enterprise is not generally something that is always straight forward. Professional advice may assist a taxpayer later to argue that their view was not reckless where they seek professional advice.

Failure to obtain this advice could may also create a difficulty to later defend an allegation of fraud and evasion and remission of penalties and interest.

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2. The ATO View in TR 92/3 and TD 92/161

Tax Ruling TR 92/3 is the leading ATO view on the distinction between revenue or capital. (Basically if an amount may be dealt with as income tax or CGT taxation rules). Following the decision in *FCT v Myer Emporium Ltd [1987] ATC 4363* the ATO adopts the view that profits from isolated transactions of taxpayer ***not carrying on a business*** will be income according to ordinary concepts (ie revenue in nature) where :

a) The *intention* and purpose of the taxpayer in entering into the transaction was to *make a profit or gain*; **and**
b) The transaction was entered into and the profit was made in the *carrying out of a business operation **or** commercial transaction.*

Emphasis has been given to key elements of this view. The ruling states that is usually, but not always, necessary that the taxpayer has a profit making intention when the property is acquired.

The ATO generally seeks to determine that if a transaction has a business or commercial character. They may consider :

- The nature of the entity;
- The nature and scale of other activities undertaken by the taxpayer;
- The amount of money involved and the magnitude of profit sought or obtained;
- The nature, scale and complexity of the operation or transaction;
- The manner in which the operation or transaction was entered into or carried out;
- The nature of any connection between the relevant taxpayer and any other party to the operation or transaction;
- If the transaction involves the acquisition and disposal of property, the nature of that property; and
- The timing of the transaction and the various steps in the transaction.

TR 92/3 takes the view that a profit from the sale will be of a revenue nature (ie NOT a CGT event) if:

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1. There was a profit making intention on the part of the taxpayer when entering into the transaction; and
2. The transaction was entered into, and profit made, in the course of either carrying on a business or carrying out a business operation or commercial transaction.
   Where a property transaction is neither :
   a) Part of a taxpayers normal business; nor
   b) Commercial in nature,

   Then unless the property was acquired with a view to a profit making intention, any subsequent disposal of the property is likely to be a “mere realisation” of the asset and on capital account.

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3. How Profits are to be Taxed

It is essential to consider the intent of the taxpayer at the time the property is purchased to determine how income or profit is to be taxed. It is necessary to consider actions at that time, and after.

Common indicators of intent can include finance applications, council submissions, meeting with advisers etc. Where these demonstrate intentions to resell, build and resell, improve and resell then it may be later alleged that a profit making intention arises. A good example may be buying land and then soon after drawing up plans to subdivide and build townhouses and arranging finance that is based on sale of the properties including discussions with local agents on likely sales values. It would be difficult to form the view that the taxpayer intended to build these premises for rental income.

Case law includes examples of taxpayers who acquire residential land intending to knockdown and develop who never adopt their plans perhaps as the market declined or finance became difficult. They then passively rent the property and later are denied the CGT discount on sale as the Commissioner considers their intent was to profit. The fact a business like or commercial operation never occurred is not relevant. A profit making intention may prevent sale on capital account, and access to a CGT discount.

3.1 Tax when sale of property is on revenue account

Income from sale of property is usually taxed as ordinary income where the taxpayer enhances the property or develops with a view to generating a profit from their activities. The size, scale and nature of these changes to the property to enhance value must be considered.

The costs of developing and the cost of the land and its acquisitions costs are generally held as trading stock. This defers the cost of the land, infrastructure costs and development costs until such time that the land is sold. This accumulation of costs is referred to as trading stock. Each “lot” of land comprises an element of trading stock. It is necessary to apportion total trading stock on a reasonable basis for each lot’s carrying value.

The gross proceeds on sale (after excluding any GST included in the sale price or costs) are offset against the specific lot of trading stock so that net profit is determined.

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3.2 Timing of When Land Becomes Trading Stock

In some instances land may be held by a taxpayer on revenue account prior to it becoming trading stock. A common example may be a residential home that has an existing tenancy. The tenancy may continue for some time prior to the use of the land in an activity that is (later?) intended to generate profit through development.

In TD 92/124 the ATO considers there are two limbs that must be met before land may be held as trading stock.

a) The land is acquired for the purposes or resale; and
b) A business activity which involves dealing in land has commenced.

Section 70-10(a) of the 1997 Tax Act no longer requires that land be acquired for the purpose of a sale to be held as trading stock. It only has to be held. This means that a CGT asset can convert into trading stock where the land is later held for a development, subdivision and sale.

A example of this may include buying a residential house site with a old dwelling. Later the tenancy is ended and the building demolished. The land is then sold. This would trigger a GST concern in two ways.

1. The land is held for resale and
2. The property is not an existing residential property when sold. It is subject to GST.

3.3 Valuation Basis for Trading Stock

Section 70-45 of the 1997 Tax Act allows land to be valued as trading stock at the end of the income year at :

a) Cost
b) Market selling value ; or
c) Replacement value

Use of a method other than Cost, may result in profit being bought to account for income tax prior to disposal. The nature of how the trading stock first becomes trading stock must be determined.

3.4 Land Held on Revenue Account – A CGT event (Post CGT property)

Complex issues arise when a taxpayer owns a property which has been held on capital account and the taxpayer proposes to commence a development activity with an expectation of profit.

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The land may become trading stock. Trading stock and CGT law permits a taxpayer to treat a CGT asset that moves to trading stock based on the value of the CGT event at either cost or market value.

It is important to note that this choice provides some issues each taxpayer must consider:

a) Choosing market value may trigger a CGT event that is exempt (ie a former home) or at a CGT discount. This will increase the amount of profit subject to CGT discount and reduce the extent of ordinary income. However, the CGT event may occur in the year/s prior to the final completion of the development and unless it is a small development with exceptional timing it is unlikely that the CGT event and the sale of trading stock would both occur in the same tax period. The CGT event may become a cashflow concern. The CGT event occurs at the time the land is first held as trading stock. This may be when demolition and site clearing occurs.

   This cashflow concern can be addressed by using a poorly understood tax concession. The ATO allow an administrative concession that allows a taxpayer to defer the CGT event until the settlement for the sale occurs. The taxpayer may then amend the relevant year to include the CGT event and pay the CGT on a deferred basis. Tax advice is recommended to use this concession.

   A professional valuation should be obtained. The method of valuation can use a valuation basis that assumes the BEST USE of the land to enhance the discounted or exempt gain.

b) Choosing cost as the trading stock valuation method defers the profit that would have been attributable to the change in land value to the time of sale however it is then subject to ordinary income provisions.

3.5 Land Held on Revenue Account – A CGT event (Pre CGT property)

As previously noted above, when the land is held as trading stock the taxpayer may choose either cost or market value as the basis for valuation of the trading stock. Where a taxpayer owns pre-CGT land the issue of land first held as trading stock ends the pre-CGT nature of the property. The trading stock must be valued using cost or market value.

Taxpayers with pre-CGT land generally choose to value trading stock at market value. This results in no CGT but a higher value for trading stock meaning that the taxable ordinary income will be less than if original cost is chosen.

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A professional valuation should be obtained. The method of valuation can use a valuation basis that assumes the BEST USE of the land to enhance the discounted or exempt gain.

3.6 Apportioning costs in a development

As previously indicated almost all costs of a development are accumulated and held as an increase in trading stock. From an accounting perspective this constitutes a single number however for a developer they would identify each "lot" as a distinct article of trading stock. (ie $1.2m of trading stock may comprise 4 units each identical that cost $$300,000 each)

Some costs are NOT incorporated into trading stock. Tax Ruling TD 92/132 considers that interest (after acquisition), rates and land taxes do not form an element of the cost of trading stock. These are accounted for as an expenses and result in a tax loss if the sales have not yet occurred. The loss may carry forward to future tax periods.

In addition to the land, all other development costs are included as trading stock. This includes construction costs, council fees etc.

The difficulty is that the developer must become the accountant in order to ensure that the records are satisfactory for all the following purposes:

a) Summarise *absolutely every cost* incurred, the date incurred and who was paid. Omission would increase profit and impose onerous tax outcomes. ;
b) Indicate the amount of each cost and the extent of GST included in any cost in a manner that enables this to be determined each quarter possibly;
c) Accounting for GST in aggregate so that deferred claiming of GST is managed to comply with ATO requirements and adjusted in future tax periods so that a 100% claim is made;
d) Allow costs (after GST has been excluded) to be apportioned on a reasonable basis. Further discussion of this concerns follows.
e) Allow the carrying cost to be determined for each lot as this, together with land, would be the trading stock and be used to determine profit on each allotment. Failure to account for any costs would result in excessive tax and under-claimed GST;
f) Act as the primary records for GST compliance when audited

Accounting software such as Xero, MYOB and the like are completely unsuitable for these purposes in most instances.

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Price Accounting Services Pty Ltd provides a suitable excel based support tool capable of being used by its developer clients. The accountant will configure this software in a manner that assists with reasonable apportionment for each client's specific development. This method greatly reduces error and assists with cost-effective outcomes v's traditional accounting processes.

Contact Price Accounting Services Pty Ltd if you are interested in this service.

Reasonable apportionment concerns

When a developer builds a duplex the apportionment is generally very straight forward as each lot of the duplex may be identical is size. In such cases total trading stock can be divided by two.

However, not all developments are that straight forward. Some will include a mix of different sized land, irregularly shaped land, different sized property (2br, 3br etc), different carpark configurations and sizes, different values based on street proximity, water view v's no water views etc.

Where 100% are being sold this generally poses little concern where a crude but "reasonable" basis of apportionment is made. One profit may be under-stated and other/s would be equally over-stated. However, where less than 100% is being sold or where an "associate sale" occurs then a higher level of ATO diligence can be expected to identify and ***penalise a tax scheme*** that seeks to shift profit, defer profit or tax and overclaim GST:

- Deferring profit from unsold units to those being "kept". Ie a form of evasion
- Enhancing profit on sales and minimising cost allocations on those kept to inflate future CGT in some instances
- Errors in GST claimed
- A scheme to obtain a tax benefit
- A "value shift" if a sale is made to a third party associate

Warning : Almost all developers propose or enquire about utilising such schemes and the detection risk is very high.

Generally speaking, there is no consistent definition of a *reasonable apportionment*. The true and final test is if the ATO accept it during an audit. The onus is always on the taxpayer to comply. We generally recommend that each developer carefully consider a uniform approach and that once this is determined that it is strictly adopted and not altered. ***Your Price Accounting Services Pty Ltd tax adviser would be able to confirm or provide advice if it is required.***

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Apportionment *never* means that some costs are included and the residual costs are left for the final site (being kept). Apportionment means an actual cost is identified and applied to each site or costs are split based on a sound and logical basis.

Example of reasonable apportionments:

3 villa site. 2 x 3br with double garage + 1 x 2br with single garage
Square meterage could be used. Alternatively apportionment of total costs based upon final consolidated selling prices. If the villa's have any special characteristics (ie one is water front) then a valuer may need to provide guidance and also apportion the land cost.

6 villa's across two lots. 5 x 3br and 1 x 2br.
Likely different costs for each lot die to land apportionment. Valuer may be needed to apportion respective land lots. Thereafter, use square meterage unless special characteristics apply. Alternatively, apportion based on selling prices eg 3br $450,000 and 2br $390,000 might be 17.05% each and 14.75% respectively.

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4. Subdividing – Capital Account

It is important that this section be read with an important issue in mind. If you are buying land or own land with an intention to profit from subdivision, development and sale etc the revenue approach may prevail.

This section addresses a situation where land is acquired and held on capital account. This may be a rental investment property owned for a time. You consider subdivision of the land and its sale. There may be limited avenues for the sale of this subdivided land to be taxed under the CGT provisions rather than revenue account as ordinary income in *very limited instances*.

Firstly, subdividing land is not a CGT event. A taxpayer can own land and subdivide it and there are no tax consequences. They may end up with two CGT assets and merely need to apportion the original cost based on a reasonable basis (s112-25(3) 1997 Act.)

A sale of land with an existing tenancy which has been subdivided by the taxpayer for the buyer to complete the development of the site may attract a higher value than un-subdivided land. The sale may be taxed as a CGT event rather than as ordinary income where there is a "mere realisation" of the asset. It would be important that the taxpayer do very little to actively enhance the value. The more that is done, the more likely the issue is a revenue concern. For example merely obtaining a DA and then selling an existing tenancy property would be unlikely to be more than a mere realisation. However, where the buyer and selling are associates and further planning has occurred then a concern can occur.

A mere-realisation would not include a related party transfer where that associate is intended to develop the site. Demolition and clearing of the site will also pose a concern and may expose the seller to further GST concerns as the item being sold is not input-taxed. Vacant land is a GST concern.

Can I develop then live in one property for a while and then sell it and claim the main residence exemption ?

This issue is highly misunderstood and care must be taken. It's an area where initial tax advice may be required.

The misunderstanding arises since the main residence exemption (Div 118-B ITAA97) contains section 118-150(3)(b) which imposes a three month main residence requirement where a property "you are building, repairing or renovating". Many accountants who are not property savvy mis-interpret this rule as permission for the main residence exemption to apply in all circumstances where a property is newly constructed.

Tax Ruling TD 92/135 however considers ATO view on the question of if the CGT main residence exemption can apply when the proceeds of sale are ordinary income arising from

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the business of a developer OR an isolated profit-making transaction. The ATO view is the s6-5 ordinary income prevails and that the proceeds are not CGT proceeds and that this prevents a main residence exemption from being claimed.

Importantly, this position is not always clear. A developer may intend to build and construct one residence as their own home. The holding of the asset on capital account would require an extended period of ownership. How long may that be ?? The answer is, we do not know. But the period should be a considerable number of years of continuous occupation. It may be necessary for the taxpayer to seek a binding private tax ruling specific to their position. The ATO may take the position that the notional developer profit at the time the home commenced to become a main residence remains assessable and a reasonable basis for determining that is needed.

All these issues indicate important reasons why all property investors and developers should retain personal tax advisers who are property savvy. Care should be taken that some good tax advisers have poor experience in the area of development activities and taxes.

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5. Developing – When it is not a development

Many property investors acquire a site and rent this long term and then one day decide to improve and develop the site. However their intention is not to sell. Whether they build a replacement single dwelling, a duplex or a number of properties the key concern revolve around the intention to sell.

Where they intend to complete the development and hold the properties indefinitely then the term developer doesn't really apply. They merely improved their property. Enhanced rental income, enhanced deductions (interest, depreciation and capital allowances) will follow.

What this style of improvement does is change many tax aspects. These include:

a) The taxpayer may qualify for a scrapping deduction of the residual value of the pooled assets, plant and equipment and building costs remaining on the quantity survey report at the final date the property is tenanted.

   A scrapping deduction effectively writes off the remaining assets as the effective life has ended. Any scrap recovery or proceeds from sale of these redundant items or materials reduces that deduction which can range between a few hundred dollars up to many tens of thousands of dollars.

   It is essential all investors contemplating such a project obtain a Quantity Surveyor opinion of the scraping value prior to demolition.

b) During development, the taxpayer may claim interest deductions (only) under the principles in Steele's decision contained in TR 2000/17 if they intend to hold all of the completed property.

c) As the property (now comprising land and improvements only) has not become trading stock the costbase of the property will continue to be based upon the former costs of acquisition (duty, legals etc) and any improvements. This is then reduced for the value of the scrapping deduction claimed and the value of depreciation and capital allowances claimed since acquisition. The former QS report and any scrapping advice from the QS may assist this.

d) During development, the taxpayer will not claim any deductions (beyond interest) for the period of construction through and up to the date the property again becomes available for rent. These costs will add to the costbase for the reconstructed property. The costbase will also be increased to include the costs to design, construct, landscape and complete the property incl of council and other charges.

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e) Following development, new Quantity Surveyor report/s will be obtained.

f) For cost base purposes the new costbase should be recorded and documented with a reasonable basis for apportioning between the completed lots.

A word of caution must be expressed at this time. The taxpayer has chosen to build to rent and if that is the position then no further tax concerns may arise. However for the next five OR MORE years this basis must remain consistent. If the taxpayer changes their mind and chooses to sell then two tax concerns could occur:

1. The CGT basis of sale may require review. Where sale is in proximity to the end of the development then it's possible that the ordinary income basis may occur. Especially if some or most are sold. The greater the number of lots sold will trigger a concern about using the CGT basis of taxation.
2. GST may be involved in the sale of the newly constructed premises. We have earlier explored MT 2006/1 and the nature of an enterprise. The scale and nature of the development and reasons for the sale must be re-reviewed. If a concern is noted, then an ABN may be required and the sale may be considered "new residential premises" which requires that GST be paid to the tax office on the sale.

   GST concerns for the property remain for up to five years or even longer. Many people read about the 5 year rule and consider it is just 5 years. The 5 years must be carefully determined as even one day error in determining when that period starts and ends can result in full GST becoming liable. The tax office consider that after five COMPLETE and continuous of rental income production years a property constructed by a taxpayer will no longer satisfy the definition of "new residential premises" under GST law.

   GST payable on the sale may be reduced by the extent of GST included in the development (for that % of the development being sold). However after four years the entitlement to the GST credits may lapse. For sales within the four year window we encourage that investors who develop ALWAYS retain identical records to developers so that all costs that are inclusive of GST can be identified and a reasonable basis for apportioning used. It is very common for sites to be developed and records are poorly retained assuming property will not be sold however if that view changes it may prevent GST adjustments to be made in favour of the taxpayer.

   This is a complex area. For example, if the property was available for sale and then due to market factors it is rented for six months and then sold there is a calculations needed to REDUCE some of the GST credits on the build. Unless a property is build and sold at completion a scale-back of GST may be required.

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The Developer Toolkit contains a developer accounting spreadsheet which can be customised by Price Accounting Services Pty Ltd specifically to each development to assist those who build to keep to retain quality records which are needed for CGT in any event. Your Price Accounting Services Tax Adviser can configure the toolkit to suit each specific development.

Personal tax advice should be obtained if the taxpayer is considering sale of any or all of the properties.

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5.1 Features of Developers v's Investors

1. **Developer** : Acquires, subdivides and sells land. Many also renovate some elements of property as a part of a site where an existing property is retained and a new property built. Features :
    - Land acquired intending to make a gain on resale
    - Likely seeks to repeat venture as a part of a plan alone or with others
    - Highly organised with substantial planning and personal involvement
    - Business like.
    - Financing is more complex
    - Often involved with town planning, DA issues, approvals and design etc
    - Can be first time or repetitive
    - Scale may be small or very large (business)
    - GST registered or required to be

    Income is on a revenue basis. Income tax is payable on profits assessed in year when vendor loses dispositive power

    Taxation : Trading stock basis of gross profit determination. Land is trading stock. Valuation methodology choice. Outgoings acquiring land and selling costs are incurred during year. Interest, rates and land tax deductible when incurred.

2. **Investor :** Acquires land with view to earning assessable income from rent. Ideally investors seek to maximise yield however capital appreciation concerns can guide this. Where they develop land they intend to hold. Features :
    - Property acquired with expectations of rent, cashflow and negative / positive gearing tax issues.
    - Likely to buy and hold. Features of holding can include refinancing property equity to access equity release to buy more. May even enhance yield be adding dual or multiple income sources ie granny flat.
    - Seeks to repeat with concerns about LVR and servicing over time
    - Simple records – Often summarising agent and personal transactions
    - Generally seek capital appreciating property with capital base stability (ie capital city rather than regional areas)
    - May require to register for GST if Commercial Property

    Income tax is on a revenue basis with negative gearing permitted for individuals although some advanced investors may choose other structures that address land tax, asset protection etc. Negative gearing is a frequent issue. Sale of property is a CGT event.

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3. **Flipper :** (US Slang). A taxpayer who seeks to buy property and perform minimal cosmetic and structural improvements necessary to obtain an improved selling price. Sells to realise profits quickly to minimise holding costs. Sometimes encounters issues with market prices and is forced to hold. Features :
    - Often a business alone or with others. These can be called a joint venture but is a business intention.
    - Very high entry costs (duty etc) make this venture difficult in Australia without an aggressive approach to it as a business eg may advertise seeking sellers desperate to sell (due to poor property state and lack of money to improve themselves)
    - Seeks to repeat. Often with key elements
    - Business like. Often follows approach learned from other notable flippers

    Income : Flippers seek to avoid ordinary income seeking CGT treatment if possible especially when commencing. Frequently they misrepresent occupation of the premises as a main residence when it may be uninhabitable or factually incorrect. They may fail to re-occupy the premises for a minimum period which may be fatal to the main residence exemption in any event. Often lack compliance eg GST. Income tax is on a revenue basis. Rarely do flippers own property for 12months + but some seek to argue the CGT concessions when they may not be genuinely available.

Where a taxpayer may encompass more than any one of the above arrangements there can be severe tax outcomes where one behaviour may taint the tax position of other activities. Eg An investor who also develops.

It is generally recommended in such cases that the taxpayer consider structuring arrangements which isolate activities to limit this effect. The most common effect of this problem is that loss of CGT discounting may be placed at risk or GST concerns cross-over.

6. Developing – Occupancy

It is common for taxpayers who develop land and build multiple properties to consider moving into one. They generally seek advice on the main residence exemption and how this affects a development.

Firstly, income tax, GST and CGT are only ever triggered when a sale occurs. If the taxpayer retains ownership than no immediate concern occurs.

Some important issues to consider:

1. For a property to be classified as a main residence it must be occupied by the taxpayer. This should occur as *soon as practicable* after occupancy is permitted for it to be valid (s118-150(3)). s118-110 of the 1997 Act contains the requirement that it

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must be your "*main* residence". You must fully occupy the property together with your spouse and your family or a partial exemption may only apply.

Retaining rented accommodation or not moving fully into the property may taint the main residence claim. They are numerous issues that can be checked to verify if taxpayers don't occupy a site. Eg : connection of services and use of the services, redirected mail, license details, voting roll, etc

2. The property must satisfy a *minimum* requirement that it is your main residence for at least three months AFTER completion. Taxpayers who merely seek to satisfy that minimum three months expose themselves to review to identify sham arrangements. A example of this is sale of the property after 60days. This can render the property as taxable as the main residence exemption renovation and construction rule for occupancy may not have been met.

   Despite the three month minimum, this is not permission for a taxpayer to then sell the property seeking to avoid tax and GST. The tax office would not accept such a position and cases indicate they go the lengths to deny such claims. Penalties and costly defences can result.

The taxpayer could cease to reside in the new property after a suitable period and utilise the 6 year absence rule if they choose.

The asset must be capable of meeting the requirements of a mere-realisation. Generally speaking, the proximity to completion and sale must be remote. *This period of time should be years, not months*. In such cases no tax on the development element of profit may be payable. Care musts till be taken that the views in TD 92/135 are not met ie by a builder.

The key concern that remains is GST. For the first five + years a property owned by the taxpayer would still be classified as new-residential premises remaining liable for GST when sold. All sales within 5.5 years should seek personal tax advice before contracting to sell to confirm their personal tax position.

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7. GST on Property

We considered earlier, the requirements which may require a taxpayer, taxpayers or an entity to hold an Australian Business Number (ABN) expressed in MT 2006/1.

A taxpayer who is required to hold an ABN may be required to hold (or may choose to register) for GST. The turnover threshold for taxable supplies made by an enterprise is $75,000 which means property transactions will be easily caught by the turnover threshold.

Selling new property generally involves GST. Personal advice may be required if special circumstances apply which may include where land is sold and GST will not apply.

An example of this would be a long term landowner who owns a 5 acre home where he lives. Modern developments have reached his door and Fred considers selling off a large part of his land as he is old and finds the maintenance difficult. Fred may not be required to hold an ABN and GST may not apply.

Taxpayers should always seek personal tax advice to ensure evasion cannot be argued later.

7.1 What Property is subject to GST ?

Commercial property is a taxable supply. New Residential premises are a taxable supply. New residential property generally means property that has been sold for the first time provided that time does not exceed 5 years. However existing residential premises are not taxed.

Developers are generally concerned with GST as it applies to the sale of all new premises.

7.2 How much is GST ?

GST is a 10% tax added to the value of the supply. The reality is that 1/11th of the price of the supply of property may be GST. It does not matter if there is GST included in this price. If the ATO later review a transaction and consider GST should have been paid they would assess 1/11th of the value of the supply as the sum of GST.

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7.3 How does GST affect a developer ?

GST is a tax collected by a developer and given to the Australian Taxation Office when it sells and GST is included in the price. GST reduces profit. For each dollar of GST profit falls by $1. The developer remains liable for GST if it is underpaid. Criminal offences may occur if schemes to defeat the ATO through winding up an entity is used.

Example :
Devco Pty Ltd builds a 4 bedroom house in a Sydney suburb and lists it for sale. The price is $1,100,000. The GST is 1/11th x $1.1m = $100,000. Devco will pay $100,000 to the tax office on this sale. Devco will base its profit on the GST exclusive sale price of $1m.

Mary owns a 4 bedroom house next door to Devco's property. She sells for $1,100,000. Mary is not registered for GST and she has no requirement to hold an ABN. Mary keeps all $1.1m.

It is important to remember that GST does not make property cost more. Buyers will pay the same price. Therefore, GST reduces Developer profit.

7.4 But this isn't fair on the Developer is it ?

A developer can claim GST it pays on its costs. So let's assume Devco Pty Ltd paid $352,000 for ABC Constructions to build the new home. Devco could claim a refund of GST of 1/11th x $352,000 = $32,000

Devco would reduce its payment to the ATO from $100,000 to $68,000

7.5 What is the Margin Scheme ? – I heard it helps developers

The Margin Scheme is a special way some people such as developers can use to reduce the GST on their projects. <u>This increases their profit.</u>

The margin scheme allows a developer to use a special method to calculate the GST when they sell. To use the margin scheme Devco Pty Ltd chooses to include a clause in its sale contract that chooses the margin scheme. *This is their right, not that of the buyer*. Since the home buyer is not registered for GST they don't care how the GST is calculated or if there is GST in the price. Its still $1,100,000. So choosing the margin scheme normally doesn't impact anyone. We will explore later how it can harm another developer however.

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Let's assume that Devco Pty Ltd buys its land from John Newman. John owns an old former farmhouse. It's dilapidated but still home and John wants to move out to an age care facility. He sells his land to Devco Pty Ltd for $500,000. There is no GST.

The margin scheme allows Devco Pty Ltd to reduce its GST payable on the sale. Instead of 1/11th x$1.1m = $100,000 the GST payable will be based on the *margin* it makes on the property.

Devco Pty Ltd will reduce the sale price of $1.1m by the $500,000 land cost. The margin is $600,000. The GST will be 1/11th x $600,000 or $54,545. Previously GST was $100,000 less the $32,000 on construction to be $68,000. Now it is $54,545 less $32,000 = $22,545

Profit has been increased by $45,455 through paying less GST under the margin scheme. Think of it this way – Developers can effectively claim 1/11th of the GST on land that doesn't have GST in its cost !!

7.6 So the margin scheme always saves developers ?

No. The margin scheme comes with a catch. It can only be used once on any land. In the example above Devco Pty Ltd bought from a seller not registered for GST. If Deco Pty Ltd buys from anyone who is registered they need to check the contract.

There will be one of two situations:

a) The land seller will be using the margin scheme themselves. This normally only occurs if the land vendor is a land developer. If this occurs, Devco Pty Ltd cannot use the margin scheme when they sell. This may reduce the profit for Devco Pty Ltd. Devco Pty Ltd also cannot claim any GST paid if the margin scheme is used.

   The reason GST cannot be claimed is that only the land vendor will know what the margin is and how much GST has actually been paid. Devco Pty Ltd will not be given a tax invoice for the land if it is bought using the margin scheme. If it does receive a tax invoice it still cannot claim the GST. The contract clause prevails and the claim would be disallowed and subject to penalties.

   Tip : developers should avoid buying land from GST registered providers who choose the margin scheme. Check the contract carefully.

b) The seller will be registered for GST and the land will include GST. Devco Pty Ltd should request a tax invoice. Before they sign the contract they should ensure this fact is ascertained. Most solicitors would add special GST clauses if the contract does not already contain them. A solicitor and not a conveyancer should always be used for such acquisitions. Solicitors can give tax advice. Conveyancers

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cannot. If Devco Pty Ltd does obtain a tax invoice they will be able to claim a refund of the GST paid on the land on a Business Activity Statement. The profit will be identical to the use of the margin scheme. However it may take time for the GST to be claimed. (The ATO usually audits such large refunds delaying the refund)

Devco Pty Ltd could also ask the land developer if they will sell at a price where ordinary GST is calculated in place of the margin scheme. The land developer could then provide a tax invoice and Devco Pty Ltd could claim the GST paid.

7.7 So how much GST did Devco Pty Ltd pay ?

Using the margin scheme example above Devco Pty Ltd has paid GST of $45,455 instead of $100,000.

This has reduced the GST from 9.09% to 4.13% of the sale price. Savings in the order of 15-40% are normal with the margin scheme. This can double profits on some developments.

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8. Determining Profit

We will explore how Devco Pty Ltd may be taxed on profit made in its development and the sale of the property.

We will assume that Devco Pty Ltd has used the excel accounting resources contained in the Developer Toolkit in arriving in the above examples. For comparison purposes we will consider two alternative scenario's.

1. Sale using the margin scheme
2. Sale without the margin scheme
3. Sale without margin scheme – Normal GST basis

	Margin Scheme	**No Margin Scheme**	**Normal GST Method**
Cost of Land	$500,000	$500,000	$500,000
Less : GST claimed on land			($45,454)
Net Cost of Land	$500,000	$500,000	$454,545
DA costs, Building costs and all project related costs incl selling costs	$352,000	$352,000	$352,000
Less : GST claimed on building costs	($32,000)	($32,000)	($32,000)
Total Trading Stock Value	**$820,000**	**$820,000**	**$774,545**
Selling Price	$1,100,000	$1,100,000	$1,000,000
Less : GST on sale	($ 54,545)	($100,000)	($100,000)
Income for Tax Purposes	$1,045,455	$1,000,000	$1,000,000
Less : Trading Stock	($820,000)	($820,000)	($774,545)
Taxable Income	**$225,455**	**$180,000**	**$225,455**

The benefit of the margin scheme v's the normal GST method is the Devco Pty Ltd does not have to finance or fund the GST claimed on the land under the normal method. Also if the seller of the land is unregistered (ie an existing home or a deceased estate etc) that method is unavailable.

Where it is available the margin scheme is generally preferred. Profit using the margin scheme has been increased by 20.16% in the above scenario

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9. When will Profit be Taxed ?

There are two varying positions in most cases.

1. Sales of CGT assets are triggered when a contract is made.
2. Sales of non-CGT property (ie a developer) are accounted for when settled.

Individual tax advice would apply and is recommended. GST in #2, above may also become due and would be reported in the tax period when the settlement occurs. It is very unusual for property sales to settle on a accruals basis and if a taxpayers is registered for GST on a accruals basis they should obtain personal tax advice.

10. Is there a way to reduce tax on profit ?

Yes. So far in this guide we have considered either a sole taxpayer or a company taxpayer which undertakes a development. There are many alternatives to this. **This guide does not seek to provide guidance on this.**

It is essential that the developer or investor seek appropriate legal and tax advice well before acquiring any land on the structure that will benefit that precise project. Several issues should be considered in advance of the final decision and include:

10.1 Who are the parties involved ?

Unrelated persons will have more complex arrangements than related persons. Related persons such as spouses etc have more simple matters to consider.

Unrelated persons need to deal with issues of trust and may seek a fixed entitlement or share of profits. An example of a concern using a company which has fixed shareholdings is that the Directors of the company may choose to defer dividends (a share of profit) or refuse to pay dividends. A fixed trust however may impose a obligation on the trustee company to share profits however this may impose an unexpected tax concern on the unitholders.

Unrelated parties may seek a unitholder or shareholder agreement or for less complex affairs a partnership agreement. Partnerships come with a serious concern that each Partner may become jointly and severally liable for the partnership debts. Also the partnership cannot actually own land – Only a partner or partners can.

10.2 What are the marginal tax rates of the parties involved ?

The highest marginal tax rate applicable to profit in Australia is around 49%. However income tax scales are progressive and range from 0% for up to $18,200 per annum of

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income. This position can be attractive for structures which allow income to be split especially where a spouse may not be working and is involved in the project.

Companies are often attractive to developers as the company rate rate is 30% (or 27.5% for a small business). However this may not be the full and final tax rate which applies to profits. The company may pay 30% tax but in order to pass the profits to a shareholder the full and final tax rate may exceed 50%.

A discretionary trust may allow family members to apportion annual taxable income in a manner which is flexible. In families with adult children this may be flexible but frequently the concern is that the beneficiaries of the profit may be confined to merely two spouses. In NSW a discretionary trust which owns land may pay more land tax.

10.3 What is the planned profit expected to be ?

The greater the expected profit then the greater the need for prior tax planning. A single development expected to produce $100K of profit may desire a far simpler structure than a three stage unit development expected to produce $2m in profits.

Tax advice and structuring advice should always consider expected profits and expected outcomes based on a budget.

10.4 What is the expected timing of profits ?

Most taxpayers pay income tax on the profit earned during that financial year. A company does permit tax to be initially restricted to a 30% rate with greater tax planning opportunity allowing deferred treatment of profits to shareholders. For example, a company could have human shareholders or a discretionary trust. The company could defer passing profit to the shareholder/s. If a discretionary trust is the shareholder there may be capacity to apportion that income in a flexible manner that minimises tax.

10.5 Do the parties have spouses or other business interests ?

We have already explored the possibility of income splitting arrangements whether by way of partnership, trust or company. In some instances profits may be distributed to secondary entities such as a family trust which may hold other financial interest or activities.

10.6 Is there a structure which may save land tax ?

In NSW a discretionary trust has a $0 threshold for land tax. Compared to other land owners this can impose around $6,000 a year more land tax than other land owner

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options. Land tax generally applies to a specific date of the year. Where a development is held over that date land tax may result.

In QLD use of a trust may allow multiple trusts to each own a property accessing multiple (lower) thresholds.

A company may be used to access a further threshold (or more than one) in some states. However care must be taken as multiple companies may be considered a single group and allowed just one threshold.

The annual cost of land tax should be considered in each instance as the savings may add to profit. The tax residency and citizenship of parties may also affect land txa and stamp duties even where an entity is involved.

10.7 What asset protection issues need to be considered ?

Asset protection risks include personal risk. Co-borrowers are generally jointly and severally liable meaning that the bank won't care which one pays for a loss. Unrelated persons should be aware of this risk. This is the position with partners in a joint venture. A land owner may be exposed to claims and personal guarantees and indemnities may further broaden this risk.

The other significant asset protection risk occurs when the land owner also is the same entity as the builder. A workplace death or injury or financial difficulty could expose the asset to claims. Many advisers advocate that ownership is separate from construction in some types of development.

10.8 Do the parties want a fixed agreed share or not ?

Financing partners or unrelated parties may agree on a specific profit share arrangement. The structure must comply with that position. Some entities offer a rigid fixed share. Other structures may allow a financing partner to access an agreed rate of return in preference to other investors. Other structures may provide 100% flexibility.

10.9 How will the project be financed ?

The lender will impose rigid requirements to provide financing. This generally means that the borrowers and the ownership must be identical. However this is not always the case. Using a broker who is expert in *commercial and residential finance options* will be a distinct advantage and they may guide the required structure to ensure finance approval is not complicated. Using branch based lending staff should be avoided. A good broker will deal directly with credit approval policies and staff and will be aware of each requirement well in advance.

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Price Accounting Services Pty Ltd offers taxation advice in respect of structure/s to suit each taxpayer and caution that no two projects are ever alike. We also work with and can refer specialist lawyers where this is required. For projects involving Self Managed Superannuation Funds and SMSF interests our related entity, Price Financial Intelligence Pty Ltd offers financial advice and services under an Australian Financial Services License (AFSL).

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DEVELOPER SERVICES

Pricing for developer services is needs based. These are typical developer services and a guide to pricing. Where the developer accounting template we provide is not used additional costs may be incurred. The developer accounting template has been designed to minimise errors and simplify all project accounting. If Price Accounting Services Pty Ltd has not customised your template, additional costs may be expected for us to validate the data.

If you require a copy contact our office on 02 9875-2444

Initial consultation. Phone, video conference or face-to-face.
Approx 60-90 mins. Discuss about project specific issues and will address parties, financing issues, basic structure and income tax on profits, GST and GST claiming strategies, use of margin scheme, accounting process and records. **$350-$550**

Customisation of accounting template.
Customisation of our accounting and tax template (Excel) for your project to determine total costs, GST and apportionment specific to project parameters. Also serves as a single record for ATO audit and record keeping review, BAS preparation and contractor payment reporting (annual) requirements to the ATO. **$440+**

Structure advice
While the initial consultation will address structure for your project this is project specific advice that addresses profit share and finance issues specific to your project including setup where required. May include sole trader, partnership, company, unit trust, discretionary trust, class discretionary trust, hybrid trust. Note that legal advice relating to legal issues such as liability, indemnities and other issues is not given and you will be encouraged to seek legal advice prior to proceeding. ***Quoted***

BAS preparation
Using the customised accounting template we will check and review entries and reconcile and adjust the template for prior claims and payments. Preparation of BAS included.
Slightly additional cost can be expected in quarters where sales have been made.
$350+

Income Tax and Profit
Diligent review and checking and adjustment for margin scheme, where applicable, and reconciliation and review of your customised accounting template to determine cost of construction and resulting profit for each unit sold / kept. Information will be used as the basis for income tax return preparation and financial reporting as applicable.
Entity or personal income tax and financial report preparation (as applicable) ***Quoted***

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