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Edited version of your written advice

Authorisation Number: 1051427307429

Date of advice: 5 November 2018

Ruling

Subject: Subdivision and sale of land

Question 1

Are the activities arising in relation to the Taxpayer's land subdivision categorised as those of an entity carrying on a business of developing and selling property?

Answer

No

Question 2

Are the future net proceeds from the land subdivision assessable as ordinary income from a profit-making purpose?

Answer

No

Question 3

Are the future net proceeds from the land subdivision assessable under the capital gains tax (CGT) legislation?

Answer

Yes

This ruling applies for the following periods:

Year ending 30 June 2013

Year ending 30 June 2014

Year ending 30 June 2015

Year ending 30 June 2016

Year ending 30 June 2017

Year ending 30 June 2018

Year ending 30 June 2019

The scheme commences on:

1 July 2012

Relevant facts and circumstances

The Taxpayer and spouse (the Taxpayers) purchased a home on rural land in 1992 (the Property). The Property has, and continues to be, the Taxpayer's main residence.

In or about 2004, the area was re-zoned by the local council to rural residential with minimum lot sizes of 5,000m2.

The Taxpayers owned the land for over 12 years when the land was re-zoned to rural residential, and they continued to own it for a further eight years before Council approved a plan of subdivision for 16 lots.

Operational works were approved. However, no work was undertaken and a re-configured plan of subdivision was approved in 2015 for 15 lots.

The 15 lot subdivision was comprised of large rural blocks (5,000m2), which were to be completed in stages.

The purpose of the subdivision was to provide for the Taxpayer's retirement.

One of the lots will be retained by the Taxpayers in order to build their main residence, and remain on the land which they owned for some 26 years.

The Taxpayers had very little involvement in the subdivision because all dealings and negotiations with Council were completed by independent third party contractors, including surveyors and engineers.

AB Company Pty Ltd (AB) – a company previously owned by the Taxpayers - performed minimal earthworks on the Property in early 2018. This involved an additional two roads including channelling and kerbing. These works extended the existing driveway to allow access to the new lots following the subdivision configuration, and also involved re-vegetation (turf) of two common areas.

AB was also engaged to undertake electrical reticulation in or about mid-2016. AB engaged and paid independent third party contractors for telecommunication, and electrical reticulation.

Although the Taxpayers did own AB until approximately July 2018, their children carried out all the work on behalf of the company. AB engaged and paid contractors.

AB charged arm's length prices to the Taxpayers in respect of the cost of the roadworks undertaken on the Property, and the Taxpayers did not borrow any funds for the subdivision. Rather, they used their own funds to support these costs, and have pre-paid a significant amount to AB in anticipation of subdivision costs in the income year ended 2018.

The Taxpayers had no direct contractual relationship with ABs' contractors.

The Taxpayers were both Directors and Shareholders of AB. The Taxpayer was involved in the company operations up until 2016. They resigned as a Director and ceased to be a Shareholder of AB. The Taxpayer's child is a director of AB.

The Taxpayers have not borrowed any money for the subdivision and are not prepared to take risks associated with borrowing to fund the subdivision.

The Taxpayers will have no involvement in advertising or promoting the sale of the land. They intend to engage a Real Estate Agent to market and sell the lots.

The Taxpayers have adopted a passive role in respect of the subdivision.

The Taxpayers personally have not undertaken any similar subdivision activities in the past, and do not personally have any intention to undertake similar activities in the future.

A summary of costs for the land subdivision was provided.

No additional costs have been advised in respect of re-vegetation, as the re-vegetation was already completed by the Taxpayers over the years, and the park area was established prior to Council approval.

Subdivisions engaged in by associated entities

AB was a partner in a partnership with the children of the Taxpayers for a 9 lot subdivision project. The land was purchased for that project with a profit-making intention, and income from the subdivision was returned in the partnership tax return.

B Developments Pty Ltd (BD) acquired land, adjacent to the Property. This land was purchased with a profit-making intention for the subdivision into 5 lots. The profit is to be returned as income by the BD.

The Taxpayer and his wife are directors and shareholders of BD.

Relevant legislative provisions

Income Tax Assessment Act 1997 Part 3-1

Income Tax Assessment Act 1997 Part 3-3

Income Tax Assessment Act 1997 Section 6-5

Income Tax Assessment Act 1997 Section 104-10

Income Tax Assessment Act 1997 Section 108-5

Income Tax Assessment Act 1997 section 112-25

Income Tax Assessment Act 1997 Section 995-1

All legislative references are to the ITAA 1997, unless otherwise stated.

Reasons for decision

Question 1

Summary

The Taxpayers are not considered to be engaged in activities which constitute the carrying on of a business of property development and sale.

Detailed reasoning

There are three ways profits from property sales can be treated for taxation purposes:

1. As ordinary income under section 6-5, on revenue account, as a result of carrying on a business of property development, involving the sale of land as trading stock;

2. As ordinary income under section 6-5, on revenue account, as a result of entering into a profit-making undertaking or scheme (including an isolated transaction); or

3. As statutory income under the CGT legislation.

Section 995-1(1) defines 'business' as including any profession, trade, employment, vocation or calling, but does not include occupation as an employee.

The question of whether a business is being carried on is a question of fact and degree. Over the years the courts have developed a series of indicators to determine if a business is being carried on.

Taxation Ruling TR 97/11 *Income Tax: Am I carrying on a business of primary production?* (TR 97/11) sets out the Commissioner's view of the indicators used to determine whether an entity is carrying on a business.

Paragraph 13 of TR 97/11 explains that the courts have held that the following indicators are relevant:

- whether the activity has a significant commercial purpose or character; this indicator comprises many aspects of the other indicators;
- whether the taxpayer has more than just an intention to engage in business;
- whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity;
- whether there is repetition and regularity of the activity;
- whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;
- whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
- the size, scale and permanency of the activity; and
- whether the activity is better described as a hobby, a form of recreation or a sporting activity

In determining whether a taxpayer is carrying on a business, and having regard to paragraph 16 of TR 97/11, it becomes evident that no one indicator will be decisive. Whether a business is being carried on depends on the large or general impression gained from looking at all the indicators, and whether these factors provide the operations with a commercial flavour.

The comments of Mason J in in *Whitfords Beach* at p. 4047 where he refers to the comments of Dean J in the Federal Court are presently relevant:

> 'However, apart altogether from this factor, the facts previously mentioned show that there was involved more than mere realisation of an asset. *Deane* J. was right in pointing to the circumstance that the asset was divided and improved in the course of a business of dividing and improving the asset. In this respect I do not agree with the proposition which appears to be founded on remarks in some of the judgments that sale of land which has been subdivided is necessarily no more than the realisation of an asset merely because it is an enterprising way of realizing the asset to the best advantage. That may be so in the case where an area of land is merely divided into several allotments. But it is not so in a case such as the present where the planned subdivision takes place on a massive scale, involving the laying-out and construction of roads, the provision of parklands, services and other improvements. All this amounts to development and improvement of the land to such a marked degree that it is impossible to say that it is mere realisation of an asset. We need to bear in mind that the subdivision of broad acres into marketable residential allotments involves much more in the way of planning, development and improvement than was formerly the case. '

Further, the comments of Wilson J. in *Whitfords Beach*, where he refers to the comments of Justice Brennan in the Federal Court are also relevant:

> 'It remains a question of degree whether the proceeds of that business constitute income according to ordinary concepts, and the answer depends, in my opinion, whether what happens to the subject land in the course of conducting that business is such as to take the process beyond what may properly be described as mere realisation' (at p. 4057).

In your application reference is made to the similarities of the Taxpayer's case with *Statham & Anor* where it is explained that the Taxpayers had very little involvement in the subdivision and had no site office or building on the land, in order to claim that the development, just like *Statham's* was a mere realisation. Through this approach you are implying that the Full Federal court case of *Statham* provides legal precedent to support a view that if you contract out the activities of property development to other entities, you cannot be held to be in the business of property development. However this view seems to ignore the Full High Court Case of *Whitfords Beach*, whereby in that case the entity, *Whitfords Beach,* had no employees, nor did it have a building from which to conduct the property development business from. Therefore in the case of *Whitfords Beach,* the taxpayer had to in fact contract out the role of the Project Manager and the role of selling the properties to other entities, namely Martindale and G.D.C in order to undertake the property development project on *Whitfords Beach's* behalf. Therefore in many respects, the case of *Whitfords Beach* is similar to the facts in your case. Notably in *Whitfords Beach,* the Full High Court had no qualms in holding that Whitfords *Beach* was in the business of property development despite the activities of the property development in fact being undertaken by other entities.

The position in *Whitfords Beach* finds support in the case of *Abeles and Anor* where Justice O'Loughlin states:

> 'But, in these particular circumstances, they cannot hide behind Mr. Markham. He was their agent and his conduct was their conduct. Through Mr. Markham, the brothers went beyond a mere simple subdivision and sale of their 10 acres; they entered into an arrangement that was in the nature of a joint venture; sharing costs and expenses rateably; they even participated in variations to the boundaries of their land in order to present and participate in, the best plan of subdivision. Their financing commitment was heavy, their established line of credit was $90,000 more than they paid for the land five years earlier, they allowed for the subdivision being a lengthy project and arranged with the finance company to accrue interest on the borrowed moneys. Although the size of a project is not a conclusive factor, it is one of numerous matters that are to be weighed in the balance. In this case the readiness of the brothers to involve themselves with the other owners was more consistent with a

> business enterprise than a private realisation. The taxpayers, through their agent, Mr. Markham, chose to embark upon a business-like and efficient program of subdivision.'

The Commissioner considers that the circumstances in *Statham & Anor* can be distinguished from the Taxpayer's case simply by the fact that you are hiring the services of commercial operators to undertake the subdivision on your behalf, as opposed to leaving the subdivision works to the local city council to undertake and complete in an un-business like way.

In the case of *Statham & Anor,* in addition to facts such as *limited clearing and earthworks* undertaken on the land, the court emphasised the fact that the subdivision was not conducted in a business-like manner as having a bearing on making their final decision. Therefore the Commissioner does not consider the simple fact that the Taxpayer hired a contractor to undertake the works on their behalf as having a bearing on the final decision of whether the subdivision amounts to a mere realisation or not.

Application to your situation

On the basis of the facts provided, the Taxpayer's primary intention at the time of acquiring the rural property in 1992 was for domestic purposes as a principal place of residence. The property has been held for a substantial period of time, and the Taxpayers intend to retain one of the lots so that they can remain on the land which they purchased in 1992, and build their main residence.

The rural nature of the property is to be retained. The subdivision is to be comprised of large rural blocks (5,000m2), with no water or sewerage reticulation. No amount has been expended on parkland, and no clearing of the land was required. A minimal amount of work was undertaken to prepare the land for sale.

The Taxpayers have not borrowed any money, and are not prepared to take risks associated with borrowing to fund the subdivision. The amount expended to date on the subdivision has not been excessive. Therefore these facts help distinguish the Taxpayer's case from the case of *Abeles and Anor.*

The Taxpayer's circumstances can also be distinguished from *Whitfords*

Beach in that subdivision has not been undertaken on a massive scale, and has not changed the Property to such a marked degree that it has gone beyond the point of a mere realisation. It appears that the subdivision of the land is *merely dividing the land into several allotme*nts, rather than embarking on a large scale development of the likes of *Whitfords Beach*.

Further, the subdivisions engaged in by associated entities were undertaken at a point in time which occurred after Council approved a plan of subdivision in 2012 in respect of the Property. There is no history of similar developments that the Taxpayers individually, or together with their associated entities were engaged in. Rather, the two subdivisions engaged in by associated entities occurred subsequent to the Property's subdivision, and were entered into with a profit making intention and thus the proceeds were returned on revenue account. Also there is nothing to suggest that these subsequent subdivisions were done in conjunction with the subdivision subject to this ruling, in order to support the Commissioner making a proposition that this subdivision was part of this subsequent property subdivision business. It would appear from the facts presented that this development is distinct and mutually exclusive from the later business of property subdivision.

The indicators of business when considered in combination do not provide the operations with a commercial flavour, and do not support a view that a business of property subdivision, development and sale will be conducted. Merely realizing the Property is not considered to be trading.

Question 2

Summary

A profit making intention was not a significant factor in the decision making process to acquire the Property, and the land subdivision is not considered to constitute a business operation or commercial transaction.

Detailed reasoning

Under section 6-5, the assessable income of an Australian resident includes ordinary income derived both in and out of Australia during an income year. Ordinary income is defined as income according to ordinary concepts.

In *Myer Emporium*, the Full High Court expressed the view that profits made by a taxpayer who enters into an isolated transaction with a profit making purpose can be assessable income.

Taxation Ruling TR 92/*3 Income Tax: whether profits on isolated transactions are income* (TR 92/3), sets out the Commissioner's view of the general principles and factors that have been considered in determining whether an isolated transaction is of a revenue nature.

Paragraph 6 of TR 92/3 provides that a profit from an isolated transaction will be ordinary income when:

> a) the intention or purpose of a 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 course of carrying on a business operation or commercial transaction.

In accordance with paragraph 9 of TR 92/3 it is usually, but not always, necessary that the taxpayer has the purpose of profit-making at the time of acquiring the property.

Paragraph 13 of TR 92/3 identifies the following matters which may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction:

> a) the nature of the entity undertaking the operation or transaction;
>
> b) the nature and scale of other activities undertaken by the taxpayer;
>
> c) the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;
>
> d) the nature, scale and complexity of the operation or transaction;

e) the manner in which the operation or transaction was entered into or carried out;

f) the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;

g) if the transaction involves the acquisition and disposal of property, the nature of that property; and

h) the timing of the transaction or the various steps in the transaction.

Paragraph 36 of TR 92/3 explains that the courts have often said that a profit on the mere realisation of an investment is not income, even if the taxpayer goes about the realisation in an enterprising way. The expression 'mere realisation' is used to contradistinguish a business operation or a commercial transaction carrying out a profit-making scheme.

If a transaction satisfies the elements set out in paragraph 6 of TR 92/3, it is generally not considered to be a mere realisation.

Paragraph 41 of TR 92/3 also provides that a taxpayer must have the requisite purpose at the time of entering into the relevant transaction or operation. If the transaction or operation involves the sale of property, it is usually necessary that the taxpayer has the purpose of profit-making at the time of acquiring the property. However, as the High Court decisions in *White*[1] and *Whitfords Beach* demonstrate, that is not always the case.

The comments expressed by *Barwick* C.J in White, (at p. 216) provide the following guidance:

> ``In cases such as the present, where the line has to be drawn between the proceeds of the realisation of an asset not acquired for resale and the income of a business, the discrimen, in my opinion, is whether the asset has produced the money claimed to be income in the course of its realisation or whether the asset has become the capital of a business which has produced the money. With every respect to some of the reasons given in *Official Receiver v. F.C. of T. (Fox's case)* ((1956) 96 C.L.R. 370), it is not enough, in my opinion, to make the proceeds of the realisation taxable income, that the taxpayer in realizing his capital asset has taken steps to increase the amount it will realise, even if those steps are clearly commercial steps, and even if they are of an organized or repetitive nature. It seems to me that it is not the circumstance that the taxpayer has endeavoured to improve the realizable value of his capital asset which provides the criterion but the circumstance that he has in reality put his capital asset to work as the whole or part of the capital of a business upon which he has ventured. Merely to realise a capital asset may involve money making as distinct from profit making but a business in the relevant sense of necessity involves the earning of or the intention to earn profits."

Further, the comments of Jacobs J. in *St. Hubert's Island*[2] at p. 4118 provide:

> ``... the intention to develop and sell off an asset not acquired for the purpose of so doing or the activity of development and sale of such an asset is not the carrying on of a business of trading in that asset. The asset must at least have been acquired for the purpose of resale before the question can arise whether the activities are trading activities."

Application to your situation

Making an overall assessment of the factors set out in TR 92/3, and for the reasons already provided in relation to Question 1, it is the Commissioner's view that the land was not acquired by the Taxpayers with the intention of profit making by sale. The main driver for the acquisition of the Property

was for domestic purposes as a main residence. The Taxpayers owned the Property for a long period of time before it was re-zoned to rural residential, and for some 20 years before Council approval was obtained for the plan of subdivision.

The subdivision and sale of the lots will be a realisation of a capital asset. The Taxpayers will sell parts of their capital asset – improved and subdivided – but not changed in substance from what was initially purchased. The taxpayers are merely seeking to realise the Property in the most advantageous way, and not to venture the Property into a profit making scheme or undertaking.

Question 3

Summary

The sale of the subdivided lots will constitute no more than the realisation of a capital asset, and any realised gains will be assessable under the CGT provisions.

Detailed reasoning

Parts 3-1 and 3-3 contain the CGT provisions. Broadly, the provisions include in your assessable income any assessable gain or loss made when a CGT event happens to a CGT asset that you own.

Section 108-5 provides that a CGT asset is any kind of property, or a legal or equitable right that is not property.

The splitting of a CGT asset without a change in beneficial ownership, such as when land is subdivided, does not give rise to a CGT event (section 112-25).

CGT event A1 under section 104-10 will happen to the Taxpayer when each subdivided lot is sold to another entity resulting in a change of ownership. The time of the event is when the contract to dispose of the subdivided lot is entered into. Alternatively, if no contract is entered into, the time of the event will be when the change of ownership occurs.

Application to your situation

The circumstances in the present case can be distinguished from those in *Witfords Beach*, on the basis of the nature, size and scale of the subdivision undertaken by the Taxpayers. The proceeds from sale are neither part of a business of property development or a profit making undertaking as previously discussed in Questions 1 and 2.

The subdivision of land and any profit made on the sale of each subdivided lot will constitute a mere realisation of a capital asset which will be subject to tax under section 104-10.
