Capital gains tax relief for taxpayers affected by natural disasters

Proposals Paper
October 2011

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ISBN 978-0-642-74747-1

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Consultation Process

Request for feedback and comments

We invite interested parties to lodge written submissions on the design of these measures.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law that may be relevant to the design of these measures. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Closing date for submissions: Friday 11 November 2011

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FOREWORD

I am very pleased to release this discussion paper on the Government's proposed capital gains tax (CGT) relief for taxpayers affected by natural disasters.

These changes recognise the difficulties faced by taxpayers that have been affected by a natural disaster. In particular, these changes remove CGT obstacles identified as restricting participation in Australian government agency replacement asset programs and make it easier for taxpayers to comply with their future CGT obligations.

This discussion paper sets out the implementation and design details of the proposed CGT relief and I encourage interested parties to participate in the consultation process.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

Summary

Taxpayers that are affected by a natural disaster may be eligible to participate in Australian government agency replacement asset programs or receive assistance in the form of a cash grant.

Taxpayers that receive cash grants or participate in such programs following a natural disaster may face CGT consequences or be unable to obtain pre-CGT status for their replacement asset. There are also technical issues in the CGT law that arise when a taxpayer's main residence dwelling is accidentally destroyed in certain circumstances.

To address these issues, the Government will:

- allow participating taxpayers to choose a CGT exemption for assets that are lost, destroyed or disposed of to an Australian government agency (Commonwealth, State, Territory or local) where they receive a replacement asset from that agency;
- ensure that taxpayers who are eligible to access the exemption but have pre-CGT status on their original asset obtain pre-CGT status for their replacement asset;
- provide a CGT exemption for any capital gains or capital losses on rights arising under a cash grant or an Australian government agency replacement asset program that assists taxpayers affected by natural disasters; and
- provide related CGT relief for taxpayers whose main residence dwelling is destroyed in particular circumstances.

1. Purpose

This proposals paper forms the basis for consultation on these changes and sets out, in broad terms, the way they may be implemented. The purpose of this proposals paper is to provide interested parties with an opportunity to comment on the policy design of these changes.

All legislative references in this paper refer to the *Income Tax Assessment Act 1997.*

2. CGT RELIEF FOR TAXPAYERS THAT PARTICIPATE IN AUSTRALIAN GOVERNMENT AGENCY REPLACEMENT ASSET PROGRAMS

2.1 CGT EXEMPTION FOR PARTICIPATING TAXPAYERS

Background and current treatment

Immediate CGT consequences for original asset

Under the CGT provisions, taxpayers affected by a natural disaster may face immediate CGT consequences when an asset they own is lost or destroyed, or if they dispose of the asset.

This CGT outcome applies even where they participate in an Australian government agency assistance program that provides replacement assets to taxpayers affected by natural disasters. Taxpayers that participate in such programs may not be able to access a CGT roll-over in order to defer any CGT consequences because the available roll-overs may not cover their circumstances.

- Even if a roll-over were available, taxpayers could face difficult compliance issues if their records have been lost or destroyed. Taxpayers would need these records in order to determine their cost base for the original asset, which would form part of the cost base for the replacement asset when it is dealt with at a later time.

Where a taxpayer receives a replacement asset under an Australian government agency assistance program and there is no CGT roll-over available, the taxpayer works out their capital gain or capital loss according to the difference between the cost base (or reduced cost base) of their original asset and the capital proceeds, which comprise the market value of the replacement asset (assuming nothing else is received).

CGT consequences for the replacement asset

Where the taxpayer disposes of their original asset in order to receive a replacement asset, the first element of the cost base of the replacement asset is the market value of what the taxpayer gave to receive the replacement asset — that is, the market value of the original asset.

- Where the market value of their original asset differs significantly from the value of the replacement asset, taxpayers may make an artificially high or low capital gain or capital loss on a later dealing with the replacement asset.

Compliance costs for taxpayers

Taxpayers may need to undertake valuations to determine both the market value of the original asset and the replacement asset. They will also need to find or reconstruct records in relation to their original asset to determine their capital gain or capital loss on the original asset.

Example 1(a): Current treatment where taxpayer makes a capital loss

William is eligible to participate in a land swap program run by his local Council because of a natural disaster. To participate, William must transfer the title of his property to the Council in March 2012 and the Council will provide him with title to a new parcel of land in return.

As William's records were destroyed in the natural disaster, he reconstructs them and determines that his cost base (and reduced cost base) for the original investment property is $140,000. William arranges a professional valuer to value the replacement land at the time he acquires the replacement land. The valuer values the land at $100,000. The value of the land is the capital proceeds for the disposal of his original investment property as he did not receive any other money or property for the disposal.

Calculating the capital gain or capital loss on the original asset:

William makes a capital loss of $40,000 on the disposal of his property to the Council, being the difference between the property's reduced cost base of $140,000 and capital proceeds of $100,000.

Cost base for the replacement asset:

William must use the market value of what he gave to receive the land as the first element of the cost base for his replacement land— that is, the market value of his original investment property.

William arranges for the professional valuer to value his damaged investment property. According to the valuation, the market value of the investment property is $30,000 at the time William disposes of it to the Council. Therefore, the first element of William's cost base for the replacement land is $30,000.

Assuming the replacement land increases in value and William does not incur any other costs in relation to the land, William will make a capital gain on any increase in value above $30,000 when the replacement land is sold, even though the market value at the time he acquired it was $100,000.

Proposed treatment

Taxpayers will be able to choose a CGT exemption for assets that are lost, destroyed or disposed of to an Australian government agency (Commonwealth, State, Territory or local), as a consequence of a natural disaster where they receive a replacement asset from the Australian government agency.

Where taxpayers choose the exemption, they will also obtain a market value cost base (and reduced cost base) for the replacement asset.

Taxpayers may choose not to access the exemption if they wish to realise a capital loss and have the relevant records or can reconstruct them. Taxpayers that choose not to access the exemption will not obtain a market value cost base (or reduced cost base) for the replacement asset.

This exemption is proposed to apply to CGT events happening on or after 1 July 2011.

Example 1(b): Taxpayer chooses CGT exemption

Assume the same facts as example 1(a), except that William expects that he will make a capital gain on the property. His records relating to the property have been lost in the natural disaster and he is not confident that he can reconstruct them accurately.

Because of his circumstances and his participation in the land swap program, William chooses the CGT exemption for his investment property when he disposes of it to the Council.

The first element of the cost base for the replacement asset (the new land) is its market value at the time William acquires it ($100,000). Therefore, assuming that the land increases in value and William does not incur any additional costs in relation to the land, William will make a capital gain on any increase in value above $100,000 on a later disposal of the land.

2.2 PRE-CGT STATUS FOR REPLACEMENT ASSETS

Background and current treatment

Taxpayers with pre-CGT assets that participate in an Australian government agency assistance program that provides replacement assets to taxpayers affected by natural disasters do not need to choose the CGT exemption outlined above in 2.1 because a capital gain or capital loss on a pre-CGT asset is already disregarded.

However, if these taxpayers do not obtain a CGT roll-over when they participate in the Australian government agency replacement asset program, they will not be able to obtain pre-CGT status for their replacement asset. As noted above, existing roll-overs may not cover a taxpayer's particular circumstances.

Proposed treatment

Taxpayers that are eligible to choose the exemption but have pre-CGT status on their original asset will obtain pre-CGT status for the replacement asset.

This will ensure that taxpayers with pre-CGT assets are not disadvantaged in tax terms by participating in an Australian government agency replacement asset program to assist taxpayers affected by natural disasters.

Example 2: Obtaining pre-CGT status for a replacement asset

Assume the same facts as example 1(b), but that William's investment property is a pre-CGT asset. He disregards the capital gain on his investment property when he disposes of it to the Council because the asset is a pre-CGT asset. Therefore, he does not choose the exemption in 2.1.

Because William is eligible for the CGT exemption in 2.1 but does not choose to access it because his original property is pre-CGT, he obtains pre-CGT status for the replacement land he receives from the Council.

2.2.1 Pre-CGT status where a taxpayer builds a dwelling on replacement land

Background and current treatment

Pre-CGT land transferred to an Australian government agency in a land swap program to assist taxpayers affected by a natural disaster will fall into one of three categories immediately before the relevant natural disaster:

- land that had a dwelling on it that was considered part of the land for tax law purposes (and was covered by the pre-CGT status of the land);
- land that had a post-CGT dwelling that was treated as a separate asset from the land for tax law purposes; or
- land without a dwelling on it.

Following the relevant natural disaster, taxpayers that transfer pre-CGT land to an Australian government agency in the land swap program and choose to rebuild a dwelling on the new land would have to treat the new land and dwelling as two separate assets — with the new dwelling being a post-CGT asset. This disadvantages taxpayers whose land fits within the first category, as they do not have pre-CGT status on the new dwelling.

Proposed treatment

Taxpayers that treated a dwelling as part of pre-CGT land just before the relevant natural disaster will turn off the separate asset rule where they build a dwelling on the new land they receive under an Australian government agency land swap program that assists taxpayers affected by natural disasters. This ensures that the new dwelling is not treated as a separate post-CGT asset but is covered by the pre-CGT status of the land (as achieved under the treatment proposed under 2.2).

The separate asset rule for the new dwelling is turned off in these circumstances if the transfer of land would have been eligible for the CGT exemption in 2.1 — which means the transfer would have to have occurred on or after 1 July 2011.

- Taxpayers that had a post-CGT dwelling or no dwelling on their original land immediately before the relevant natural disaster are unaffected, and will treat any dwelling built on their new land as a separate post-CGT asset.

2.3 Separate CGT taxing point for participating taxpayers if their dwelling is destroyed as a result of the natural disaster

Background and current treatment

Taxpayers that participate in an Australian government agency's land swap program may face a separate CGT taxing point (CGT event C1) for their dwelling if it is destroyed as a result of the natural disaster, even if the taxpayer chooses the proposed CGT exemption in 2.1 in relation to their land.

Taxpayers would need to calculate a capital gain or capital loss on the CGT event happening to the dwelling. This involves apportioning the cost base for the original property between the land and the dwelling, using the rules in section 112-30. This CGT event happening on the destruction of the dwelling results in similar record keeping and compliance issues as outlined above, as taxpayers would need to rely on records relating to their original dwelling and a market valuation in relation to the land.

Proposed treatment

Taxpayers will obtain a CGT exemption for a capital gain or capital loss arising on the destruction of a dwelling as a result of a natural disaster, if the relevant land is subsequently transferred to an Australian government agency, and the taxpayer chooses the CGT exemption outlined in 2.1 in relation to the transfer of the land.

If the taxpayer chooses the CGT exemption in 2.1 (which means the transfer would have to occur on or after 1 July 2011), this further exemption applies in relation to the destruction of the dwelling, regardless of when the destruction occurred.

3. CGT EXEMPTION FOR RIGHTS ARISING UNDER ASSISTANCE PROGRAMS FOR TAXPAYERS AFFECTED BY NATURAL DISASTERS

BACKGROUND AND CURRENT TREATMENT

Taxpayers that participate in an Australian government agency replacement asset program that assists taxpayers affected by a natural disaster may receive rights under that program, which are CGT assets. Taxpayers that are affected by a natural disaster that apply for a cash grant (whether from a government agency or another entity) may also receive rights under that cash grant program.

Therefore, a taxpayer may realise a capital gain or capital loss when a CGT event happens to their rights under a cash grant program, or their rights under an Australian government agency replacement asset program.

PROPOSED TREATMENT

To reduce complexity and remove uncertainty about how the tax law operates in these circumstances, any capital gains or capital losses on rights arising under a cash grant or an Australian government agency replacement asset program that assists taxpayers affected by natural disasters will be disregarded.

This will apply to CGT events happening in relation to such rights on or after 1 July 2011.

Example 3

Shirley, a small business owner, is affected by a flood during a natural disaster. She applies for a grant of $5,000 under a community organisation's cash grant program for small businesses affected by the flood.

Prior to receiving the $5,000 grant, Shirley has a right to receive the grant. She incurs costs of $20 in applying for the grant. This is the cost base for her right to receive the grant.

When Shirley receives the grant, her right to receive the grant comes to an end. This ending is a CGT event. The capital proceeds on the right to receive the grant ending is the amount of the grant ($5,000).

Apart from this proposed change, Shirley would make a capital gain of $4,980 on the ending of her right to receive the grant.

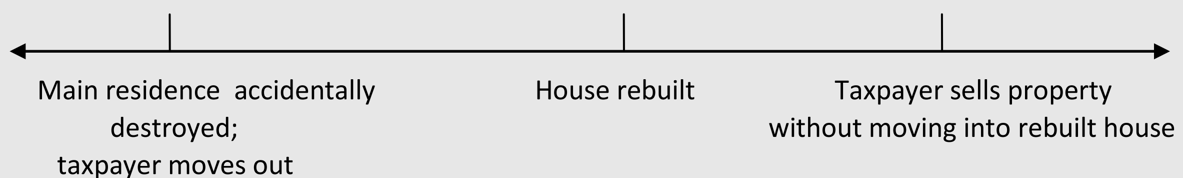
However, the grant may still be assessable income even if the capital gain on the right is disregarded.

4. Extending the CGT main residence exemption in certain circumstances when a taxpayer's main residence dwelling is destroyed

Background and current treatment

Taxpayers may be unable to apply the CGT main residence exemption to their land and a new dwelling, in circumstances where their original main residence dwelling is accidentally destroyed and a subsequent CGT event happens to the property after they have rebuilt a new dwelling on the land but have not established the new dwelling (and its adjacent land) as their main residence.

Sequence of events leading to loss of CGT main residence exemption



This outcome could affect taxpayers whose main residence is accidentally destroyed in any circumstance — not only if it is destroyed by a natural disaster.

Example 4(a): Loss of main residence exemption when dwelling accidentally destroyed

Alex's main residence accidentally burns down in January 2008 and he moves into rental accommodation. Over the next 6 months, Alex rebuilds his house. However, he decides to sell the house rather than moving back into it.

Alex is not able to access the CGT main residence exemption in Subdivision 118-B when he sells the land and new dwelling because the rebuilt dwelling has never been his main residence.

Proposed treatment

Taxpayers will access the CGT main residence exemption to the extent that they would have been able to if the original dwelling had never been destroyed — that is, without having to establish the new dwelling (and its adjacent land) as their main residence.

This will apply to all accidental destructions regardless of whether the destruction results from a natural disaster.

This will apply to subsequent CGT events happening to the land or dwelling or both on or after 1 July 2011.

Example 4(b): Main residence exemption maintained when dwelling accidentally destroyed

Jordan's main residence is accidentally destroyed on 1 January 2011 and he moves into rental accommodation for three months while he starts rebuilding his house. In Jordan's ownership period before the destruction he had lived in the dwelling for the entire time and had not used the dwelling for income producing purposes.

The rebuild takes eight months. Rather than extending his three month lease beyond 31 March 2011, Jordan decides to buy a new house and moves into the new house at the end of his lease. After the rebuild is completed at the end of August, Jordan sells the property with settlement occurring on 30 September 2011.

Jordan accesses the main residence exemption to the extent he could have had the original dwelling not been destroyed. Therefore, he accesses a full CGT main residence exemption on the original property. This takes into account the existing rule in section 118-140 about changing main residences that allows Jordan to treat both properties as his main residence for a maximum of six months.