THE TAXING ISSUE OF CHARACTERISATION IN PROPERTY DEVELOPMENTS

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The Taxing Issue of Characterisation in Property Developments – Understanding the Shades of Grey

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by

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1) Capital Revenue distinction – Why is it important?

a) With the introduction of capital gains tax in 1985, the distinction between gains made on capital account and those made on revenue account became less important. Gains on capital account were no longer necessarily tax free and therefore the incentive to ensure that a gain was taxed on capital account was diminished.

b) However, although less important, the distinction still has significant tax consequences, and so the distinction is not obsolete. Cases on the capital revenue distinction continue to occupy the courts today. There are a number of instances where the capital revenue distinction is of great importance to the taxpayer:

   i) some capital gains are exempt – eg pre-CGT property still exists and in such cases the great carrot of a tax free capital gain still looms large;[1]

   ii) where a CGT asset is held by an individual, trust or complying superannuation fund,[2] the CGT discount applies if the asset is held for over 12 months[3] (50% discount for resident individuals and trusts, $33^1/_3$% for superannuation funds).[4] Thus a tax bill can be effectively halved if the gain is on capital account, the asset is held by the correct vehicle and has been held for more than 12 months;

   iii) it may be possible to access the CGT small business concessions in Division 152 of the ITAA 1997;

   iv) the timing of the gain for tax purposes may be different depending on whether the property is held as a capital asset, a revenue asset or as trading stock.

2) Historical overview

a) The approach of the courts to matters where the capital revenue distinction is important is influenced by decisions on the old section 26(a).

b) Section 26(a) was enacted in 1930 to overcome a decision of the House of Lords in *Jones v Leming*[5] to the effect that property acquired for the purpose of sale at a profit is not necessarily on revenue account. When enacted, section 26(a) had retrospective application to all assessments back to 1922-3.[6] Section 26(a) provided:

> "The assessable income of the taxpayer shall include (a) profits arising from the sale by the taxpayer of any property acquired by him for the purpose of profit making by sale, or from the carrying on or carrying out of any profit making undertaking or scheme."

c) The 'first limb' of section 26(a) is the inclusion in assessable income of profits arising from the sale of property acquired for the purpose of profit making by sale.

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[1] However, see paragraph 2)i) below
[2] Section 115-10 ITAA 1997
[3] Section 115-25 ITAA 1997
[4] Section 115-100 ITAA 1997
[5] [1930] AC 415
[6] As set out by Mason J in *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR at 373

d) The 'second limb' of section 26(a) is the inclusion in assessable income of profits arising from the carrying on or carrying out of any profit making undertaking or scheme.

e) Section 26(a) was re-enacted as section 25A of ITAA 1936, and this section remains current although limited to pre-CGT property. The second limb of section 26(a) has also been incorporated as part of the re-write as s 15-15 of ITAA 1997.

f) Thus, the first limb of section 26(a) has effectively been abolished, other than for pre-CGT property. However, profit arising from the sale of property acquired for the purpose of re-sale at a profit would be ordinary income in any event.[7]

g) The second limb of section 26(a) has been retained for property acquired before or after 20 September 1985, provided that the profit making scheme does not involve the sale of post-CGT property. For profit making schemes giving rise to a profit in the 1997 or earlier years of income, section 25A applies and for profit making schemes giving rise to a profit in the 1998 or later years of income section 15-15 applies.

h) However, as will be discussed further below, profit arising from the sale of property purchased for the purpose of profit-making by sale and profit arising from the carrying on of a profit-making undertaking is ordinary income, and therefore there is only room left for the operation of s 25A or s 15-15 where the profit made is on capital account. This appears a little pursued point. Barwick CJ in *Steinberg v FCT*[8] and Mason J in *Whitfords Beach Pty Ltd v FCT*[9] cite conflicting authority as to whether the second limb captures capital amounts. However, a majority of the Privy Council in (the earlier case of) *McClelland v FCT*[10] said that the second limb did not apply to capital amounts.

i) If the second limb were to apply to capital amounts it would reduce the potential for a tax-free profit from the sale of pre-CGT property. However, this does not seem to be the approach taken by the Commissioner.

j) In summary, for profit made on the sale of property acquired pre-20 September 1985 the current position is:

    i) The first limb of s 25A(1) ITAA 1936 will apply to tax a gain made on the sale of pre-CGT property if it was acquired for the purpose of profit-making by sale;

    ii) Section 15-15 ITAA 1997 may apply to tax profit arising from the carrying on or carrying out of a profit-making undertaking or plan;

    however in both cases the profit would be ordinary income in any event, as is discussed in further detail below.

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[7] *Jones v Leming* was effectively overruled by *Edwards v Bairstow* [1956] AC 14 and Australian authority is that property acquired for the purpose of resale at a profit is on revenue account – see paragraph 6)a) below

[8] [1975] HCA 63; (1975) 134 CLR 640, 687-688

[9] [1982] HCA 8; 150 CLR 355, at 380

[10] (1970) 120 CLR 487, 495

3) *Myer Emporium* and *Whitfords Beach*

a) The tax landscape changed significantly with the landmark decisions of the High Court in *FCT v The Myer Emporium Ltd*[11] and *FCT v Whitfords Beach Pty Ltd*.[12]

b) *Myer Emporium* held that profit from an isolated transaction can be on revenue account and *Whitfords Beach* held that property not purchased with a profit-making purpose could be ventured into a profit-making scheme such that it began to be held on revenue account.

c) These decisions made the old section 26(a) further obsolete and changed the focus of the enquiry to the question of whether the taxpayer has the requisite profit-making purpose and the transaction is of a commercial nature or is an adventure in the nature of trade. Further, *Whitfords Beach* demonstrated that it is possible for property to be on revenue account even though not purchased with a profit-making purpose.

d) Nonetheless the question of whether property has been purchased for the purpose of profit-making by resale, or for the purpose of profit-making by the carrying on of a profit-making scheme often arises in cases considering the capital revenue distinction. These questions have their origin in section 26(a).

4) Profit or gain made in the ordinary course of carrying on a business

a) A profit or gain made in the ordinary course of carrying on a business constitutes income. Accordingly, if an entity is in the business of property development then it will be difficult to avoid the conclusion that every purchase and sale of property is on revenue account. Indeed, the land is then most probably trading stock of the entity. When Stockland purchases vacant land, it is practically a foregone conclusion that that is on revenue account, given the nature of Stockland's business and the fact that the purchase of such land is squarely within the ordinary course of its business.

b) Indeed, where a taxpayer has a history of property development, it is undoubtedly difficult for them to convince the ATO and the courts that certain property has been acquired on capital account.

c) For example, in *Crow v FCT*[13] the taxpayer had acquired land on eight different occasions starting in 1962 and had used some of the land for farming, grazing and growing crops. He then proceeded to subdivide and sell land from 1968 to 1981. The evidence was that he had incurred debt to purchase the land which he could only repay by subdividing and selling the land. Lockhart J found that he was carrying on a business of land development. Lockhart J observed that if he hadn't found that a business of land development was being carried on then he would have found a profit-making scheme.[14]

d) It is often the case that the courts consider whether a business of property development is being conducted but ultimately hold that it is not necessary to decide that issue because in the absence of such a finding they would find that

[11] (1987) 163 CLR 199; [1987] ATC 4363 (***Myer Emporium***)
[12] (1982) 150 CLR 355; [1982] ATC 4031 (***Whitfords Beach***)
[13] 88 ATC 4620; 19 ATR 1565
[14] (1988) 19 ATR 1565, at 1574

the taxpayer is carrying on a profit-making scheme. Thus in *Whitfords Beach* Mason J (at 385-6) and Wilson J (at 401) found that a business was being carried on and that the gross proceeds were assessable, but they also held that in the absence of this finding there would have been a profit-making scheme.

e) Despite these examples there are cases where persons with a history of property development have been able to convince the ATO that certain property is held on capital account. A review of some of the leading cases in this area will be conducted before some conclusions are drawn about what documentation or evidence may be required in order to convince the ATO that property is in fact held on capital account.

5) Acquisition for purpose of re-sale at a profit

a) Australian courts have said that buying an asset with the intention of resale at a profit is inevitably commercial.[15] Accordingly, where a taxpayer buys real estate with the dominant purpose of re-sale at a profit this will inevitably be on revenue account.[16]

b) For example, in *Antlers Pty Ltd (in liquidation) v FCT* [1997] FCA 114; 97 ATC 4201; 35 ATR 64 the taxpayer was a shelf company incorporated in 1971 on behalf of the Portelli family. The shares were held by Mrs Kavich and her brother, Mr Portelli. Mrs Kavich was a property developer but she claimed that, although she, or associated entities, had purchased other land for development and resale at a profit, the land purchased by the taxpayer in this case was purchased as a long term investment for the benefit of her children and the children of Mr Portelli.

c) Lockhart J found that the taxpayer purchased the land for profit-making by resale due to the prior history of Mrs Kavich, the fact that the land was "ripe for subdivision" and Mrs Kavich knew of this due to professional advice prior to purchasing the property, the low return from rental of the property which meant that the taxpayer was soon unable to service the outgoings on the property, and the fact that there was a business card prepared for the taxpayer describing it as a property developer. Lockhart J made this finding despite the fact that the property had been held for 20 years and many witnesses gave evidence that Mrs Kavich had said that she purchased the property as an investment for her family. Lockhart J interpreted that to mean that it would eventually be subdivided and sold with the profits to be distributed to the family.

6) Profit-making scheme

a) In *McCurry v FCT* (1998) 39 ATR 121 the taxpayers acquired property in a country town in early 1986 and subsequently built three townhouses which were offered for sale in May 1987. They lived in two of the townhouses and made no attempt to lease the third. Davies J said at 125:

> *"Schemes may be precise or vague; every detail may be arranged in advance, or the working out of the plan may be left for decision in the light of*

[15] See Barwick CJ in *FCT v Steinberg* (1975) 134 CLR 640, 687 and Mason J in *Whitfords Beach Pty Ltd v FCT* 150 CLR 355, at 380

[16] See also paragraph 270 of MT 2006/1 which states that the sale of land that was purchased with the intention of resale at a profit amounts to an enterprise because it is a profit making undertaking or scheme and therefore an adventure or concern in the nature of trade

> *circumstances as they may arise. It is no objection to a plan that it allows room for manoeuvre. Where property is bought with the purpose of making a profit in the easiest and most advantageous way that may present itself, and the taxpayer adopts 'one of the many alternatives' that his plan leaves open, thereby returning himself a profit, he will rightly be said to be carrying out a profit-making scheme: cf Premier Automatic Ticket Issuers Ltd v FCT;*[17] *Buckland v FCT.*[18]*"*

b) Davies J found that the taxpayers had the purposes of either resale at a profit or rental, but that resale at a profit was the dominant one, given that the level of borrowings could only be repaid by a sale, there were no efforts to lease the third townhouse and the units were on the market shortly before completion. Thus, this is an illustration of a case where the profit-making scheme was in fact the purchase, development and sale of land.

c) *Allied Pastoral Holdings Pty Ltd v FCT*[19] is one of the few cases where a property developer was able to rebut the inference that land sold for a profit had been acquired as part of a profit-making scheme. There, the taxpayer company was formed in 1966 for the purpose of acquiring a property known as "Yarrick". The shareholders and directors were persons who had been involved in real estate development for many years. Part of the property was subdivided and sold in 1968. In 1970 the taxpayer acquired a further property contiguous with the first. In 1972 the taxpayer subdivided these properties into 25 acre lots and sold them in 1973 and 1974 realising a large profit. The Commissioner assessed the taxpayer to tax under s 26(a). But the *Whitfords Beach* decision was handed down while the matter was still in dispute and that became an alternative basis for the assessments – i.e. that they had been ventured into a profit-making scheme.

d) Hunt J of the NSW Supreme Court found that the initial property had been purchased for the purpose of farming, for improvement for cattle grazing and similar pastoral purposes. It was in fact worked as a grazing property for 6 years and money was spent by the taxpayer on improvements for that purpose. The second property was said by the taxpayer to have been acquired to be run as an enlarged grazing property with the original property. The Commissioner challenged the credibility of this explanation, contending that the taxpayer had acquired it with the purpose of subdivision and re-sale at a profit.

e) However, Hunt J found that, although the taxpayer's evidence was required to be carefully scrutinised, being self-serving, there was no reason not to believe the taxpayer. He found it credible that the decision was taken to sell because the farming was not proving profitable as quickly as had been budgeted and that there was a pending zoning change from a minimum 25-acre subdivision to a minimum 100-acre subdivision which would reduce the value of the land. Accordingly, Hunt J held that the taxpayer's dominant purpose was not a re-sale at a profit and thus the first limb of s 26(a) did not apply. He then considered whether it might be ordinary income or income under the second limb of s 26(a). He commented that if it were ordinary income then it would be the net profit brought to account rather than gross receipts. However, he held that this

[17] (1933) 50 CLR 268, 300
[18] (1960) 48 ALJR 60,62
[19] [1983] 1 NSWLR 1; (1983) 70 FLR 447; (1983) 13 ATR 825

was simply the mere realization of a capital asset and thus did not generate ordinary income nor income within the second limb of s 26(a).

f) In *August v Commissioner of Taxation*[20] the Federal Court comprised of Siopis, Besanko and McKerracher JJ considered a case where a taxpayer had, over the course of around 2 years, acquired a number of adjoining shops and had undertaken construction works to renovate existing buildings and to build new ones as well as broadening the permitted uses, and securing tenants before selling the properties at a significant profit some 6-8 years later. A second taxpayer associated with the same key individual had in November 2001 purchased the lease for a vacant property in the ACT for $800,000 and sold it some 4 years later for $5,472,500 inc. GST. In both cases the taxpayer argued that the gain was on capital account and the 50% CGT discount applied whereas the Commissioner argued that the gain was on revenue account. The Full Court held that the correct test is that stated by Hill J in *Westfield Limited v Commissioner of Taxation*[21] being that the profit or gain must be associated with a scheme, business operation or commercial transaction as well as being accompanied by the relevant purpose.[22] The Full Court upheld the trial judge's finding that both gains were on revenue account. In each case the Full Court was satisfied that there was a profit-making scheme and that the profit was made by a means contemplated by the taxpayer from the outset.[23]

g) Essentially in this case the Court did not believe the taxpayer that the properties had been acquired for the purposes of long term investment to generate rental income, but rather considered the taxpayer had modelled himself on his real estate agent who had a long history of the purchase, development and sale of commercial property for profit.

7) Mere realisation of a capital asset

a) It is accepted that the "mere realisation of a capital asset" will be on capital account. Thus for most people, the sale of the family home is on capital account as it is an asset held long term for the purpose of dwelling in it and not for the purpose of profit-making by sale, and the sale of a family home is generally driven by factors such as the size of the home required for the current family situation, proximity to work etc. Thus, when sold it is generally the mere realisation of a capital asset rather than a profit-making venture.[24] The fact that the family home is on capital account is of course critical in order for the main residence exemption from capital gains tax to apply.[25]

b) Similarly, as was said by Hill J in *Westfield*:

> *A taxpayer carrying on a business might sell its headquarters in order to move to larger premises and make a profit over historical cost. The transaction of sale may be one which arises in the ordinary course of the taxpayer's business, but that profit will not ordinarily be income, particularly where, at the time of acquisition of the site, there was no*

[20] [2013] FCAFC 85
[21] (1991) 28 FCR 333 (***Westfield***)
[22] [2013] FCAFC 85, at [144]
[23] [2013] FCAFC 85, at [149]-[152]
[24] See obiter to this effect in *McCormack v The Commissioner of Taxation of the Commonwealth of Australia* (1979) 143 CLR 284 at 302
[25] Section 118-110 ITAA 1997

intention or purpose of profit-making by sale when the premises became too small.

c) In *Myer,*[26] the Full High Court distinguished a mere realisation from a revenue transaction on the basis of the intention at the time of acquisition:

> *'It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realisation. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.'*

d) The Commissioner provides some examples of the 'mere realisation of a capital asset' in TR 92/3:

i) Example 2 at paragraphs 74-75: Mr Leary carried on a pharmacy business as a sole trader. He acquired a residential property and leased the property to an arm's length party for 3 years, bring small net returns. Leary then sold the property at a large profit during a property boom. He had no previous dealings in property, other than as lessee of his shop premises. Mr Leary's profit is not income because the acquisition and sale of the residential property was not a business operation or commercial transaction. It was the acquisition and sale of an investment, even if a significant purpose of Leary in acquiring the property was profit-making.

ii) Example 9 at paragraphs 93-94: Mr Bates purchased a motel in a country town intending to carry on a business as the owner and operator of that motel. He ran the motel for 7 years earning moderate returns and then sold it at a large profit. Mr Bates had not previously purchased property other than a house in which he had lived. The profit on the sale of the motel is not income. It cannot be inferred from the objective facts that Mr Bates acquired the motel with a purpose of making a profit (as distinct from income from the carrying on a business). Furthermore, the sale of the motel was not made in the ordinary course of carrying on a business. The motel was a structural asset of the business.

e) In contrast, the following examples of a property sale giving rise to ordinary income are provided in TR 92/3:

i) Example 7 at paragraphs 85-89:

85. A family company acquired 500 hectares of land, which had been used as a grazing property, for $1 million. The company was formed for the purpose of acquiring the land and Mr and Mrs Soil owned all the shares in the company and were the directors. Four years after acquisition, the Soils sold all their shares in the company to an arm's length party for $2 million.

86. The Soils maintain that the property was purchased for use as a grazing property but the land was never so used after the company acquired it. The Soils had no knowledge of, or experience in, grazing but on

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[26] At 163 CLR 213; 87 ATC 4369; 18 ATR 699-700

several occasions they had been involved in the purchase and resale of land. Furthermore, under local government legislation, the land had been zoned for residential development before the company acquired it.

87. The profit made by the Soils is income. The objective evidence establishes that the Soils incorporated the company and arranged for the company to acquire the land with the purpose of making a profit from the anticipated appreciation in the value of the land.

88. The profit from the appreciation in the value of the land could have been realised in a number of ways. For example, the company could have sold the land, the shares in the company could have been sold or the company could have been placed in voluntary liquidation and the land distributed in specie by the liquidator. It is not necessary that the Soils planned each step which led to the making of the profit. It is sufficient that the Soils intended to make a profit from the appreciation of the land when they entered the transaction and that the intended profit was made.

89. Furthermore, the acquisition of the land through the company and the subsequent sale of the shares in that company was a business operation or commercial transaction because of the following factors: the use of a corporate structure, the large amounts of money involved and the Soils' other dealings in land.

ii) Example 8 at paragraphs 90-92:

90. Mr Develop has been involved in property development, mainly through a company group he controls, for many years. In recent years, each acquisition of property by the group has been effected by a different company. Thus, each company in the group of more than 50 companies has been involved in only one acquisition, development and sale of property. Over the last 5 years the companies have made profits totalling more than $50 million from the development and sale of properties.

91. The profits derived by each of the companies from the development and sale of property are income. In determining whether a company has the purpose of profit-making, the acts and intentions of the natural persons who control the company should be examined. The actions of Mr Develop in repeatedly using companies he controls to make profits from the development and sale of property indicate that the purpose of each company in acquiring property was profit-making.

92. Furthermore, the acquisition, sale and development of the properties undertaken by the companies amount to a business operation or commercial transaction. The scale of the activities, the nature of the entities (members of a large group of companies), and the business-like way in which the companies have carried out their development activities indicate that the transactions were business or commercial in nature.

8) Mining and farming land

a) Land acquired for the purposes of mining and farming is generally land held on capital account – it is in the same boat as the family home, or company headquarters. However, if it is not acquired for the purposes of farming or mining, but rather for the purpose of re-sale at a profit, then it is held on revenue account.

b) This is demonstrated by *Californian Copper Syndicate v Harris,*[27] which is often referred to as the starting point of the enquiry as to whether a gain in the context of a sale of real property is on capital or revenue account. In that case the company was incorporated on 5 February 1901 with a share capital of 30,000 pounds. 28,332 shares were issued at 1 pound each and the company used the capital to acquire 480 acres of land bearing copper in Fresno for 24,000 pounds and spent the remainder of its capital in preliminary development of the land and head office expenses. In April 1902 it sold 80 acres of the property to Fresno Copper Company Limited for 105,000 pounds payable in fully paid shares of that company. In August 1903 it sold the remaining 400 acres to the same company for 195,000 pounds, again payable in fully paid shares of the company.

c) The company argued that the gain made by the company on disposal of the land was a capital gain whereas the tax office argued that it was on revenue account.

d) The Lord Justice Clerk (the Right Honourable J H A MacDonald) said at 165-166:

> *"It is quite a well-settled principle in dealing with questions of assessment of income tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit...assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business."*

e) Thus he drew a distinction between profit made in carrying on a business, which is on revenue account, and profit made on the realisation of an investment, which is on capital account. In discussing the line that separates the two classes of case he said that "each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?"[28]

f) In holding that the gain in that case was a revenue gain, he was persuaded by the objects set out in constitution of the company, which "point to a highly speculative business"[29] and the fact that "It is manifest that it never did intend to work this mineral field with the capital at its disposal. Such a thing was quite impossible. Its purpose was to exploit the field, and obtain gain by inducing others to take it up on such terms as would bring substantial gain to themselves."[30]

g) In *Scottish Australian Mining Co Ltd v FC of T*[31] land acquired in 1863 for the purpose of carrying on coal-mining operations was sold after the coal seam was exhausted and the mining operations therefore ceased in 1924. The company went about the subdivision and sale on a grand scale, as it built roads and built a railway station to make the land more attractive. It granted land to public institutions such as schools and churches and set aside land for parks. Williams J held that there was no evidence on which a finding could be made that the

[27] (1904) 5 TC 159
[28] Ibid., at 166
[29] Ibid., at 166
[30] Ibid., at 167
[31] (1950) 81 CLR 188

property had been acquired for the purpose of sale at a profit. The evidence was that it had been purchased for the purpose of coal mining. Therefore, the profit on the sale could only be assessable income if the company was carrying on a business of selling land or was carrying on a profit-making scheme. Williams J held[32] that:

> *"The crucial question is therefore whether the facts justify the conclusion that the appellant embarked on …[a profit-making] …business or undertaking or scheme. The facts would, in my opinion, have to be very strong indeed before a court could be induced to hold that a company which had not purchased or otherwise acquired land for the purpose of profit-making by sale was engaged in a business of selling land and not merely realising it when all that company had done was to take necessary steps to realise the land to best advantage, especially land which had been acquired and used for a different purpose which it was no longer businesslike to carry out"*

h) Williams J drew a distinction between an owner selling an asset and an individual who enters into a business of buying and developing and selling land and was not persuaded that the company in this case had crossed the line such that it could be said that the company had embarked on a business or undertaking or scheme in 1924 of selling land for profit.

i) *Statham v FCT*[33] involved the trustees of the estate of the deceased, who had acquired 270 acres in 1970 from his late father for the purpose of raising his family in a rural setting and for some "desultory" farming. The property was not acquired for the purpose of subdivision and sale. In 1976 the deceased sold two urban blocks and a 36 hectare portion of the property. In the same year his sister and brother-in-law purchased a half share in most of the balance of the farm through their company. Again there was no dominant purpose of subdivision and sale. Rather, they entered a partnership with the deceased to raise beef cattle on the property. The deceased retained approximately 6 hectares for the purpose of subdivision.

j) The deceased had a number of changes of job and suffered a deterioration in health in 1977. The sister and brother-in-law were busy with the brother-in-law's medical practice. In addition, the cattle market was depressed. Accordingly, in 1979 they determined to sell all or part of the land. They applied for approval for a staged plan of subdivision. The deceased then died in October 1980 and the first plan of subdivision was not registered until after his death. There were a total of four stages of subdivision and 105 lots were sold.

k) The Full Federal Court (Woodward, Lockhart and Hartigan JJ) held that the Tribunal had erred in law by concluding that, because the owners decided not to persist with farming the land in partnership, but instead to sell it by means of subdivision, the proceeds of realisation necessarily became taxable stating:

> *"It is well established by the reported cases, including those mentioned above, that the mere realisation of an asset at a profit does not necessarily render the profit taxable. The profit must arise from the carrying on of a business or a profit-making undertaking or scheme. The mere magnitude of*

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[32] Ibid., at 195
[33] [1989] ATC 4070

> *the realisation does not convert it into such a business, undertaking or scheme; but the scale of the realisation activities is a relevant matter to be taken into account in determining the nature of the realisation, i.e. in determining whether the facts establish a mere realisation of a capital asset or a business or profit-making undertaking or scheme."*[34]

l) The Full Federal Court found that "*the way in which the subdivision and sale of the land progressed was simple and had few of the hallmarks of a business enterprise*."[35] The Court identified the following matters as significant:

   i) the owners were at first content to sell the land as one parcel, but were unable to do so;

   ii) no moneys were borrowed by them, although a guarantee was provided to the Kingaroy Shire Council by way of bank guarantee;

   iii) only very limited clearing and earthworks were involved;

   iv) the owners relied upon the Kingaroy Shire Council to itself carry out roadworks, kerbing, electricity and sewerage works which were required to be done;

   v) the owners did not erect buildings on the land; not even, for example, a site office;

   vi) they had no business organisation, no manager, no office, no secretary, and no letterhead;

   vii) Dr Bickerton maintained his medical practice;

   viii) the owners did not advertise the land for sale;

   ix) apart from the Kingaroy Shire Council's activities, the owners did not engage any contractors, although they did obtain some professional advice;

   x) the books kept in relation to the sales of land were kept by Mrs Bickerton; and

   xi) the land was sold simply by listing it with local real estate agents.

   The Court held that these matters strongly suggest that the owners were not conducting a business or engaging in a profit-making undertaking or scheme.

m) In *Casimaty v FCT*[36] the taxpayer obtained farming land by way of gift from his father in 1955. The following year he purchased a further 40 acres adjoining the property and constructed a homestead. For the next 20 years he conducted a primary production business on the property. Due to financial hardship and deteriorating health, the taxpayer had to sell the land. Again he initially attempted to sell it as a whole, without success. A few years later he commenced selling portions of the land in eight separate subdivisions over twenty years from 1975 to 1993 as and when he required funds. He carried out activities necessary to obtain subdivision approval, such as road construction, fencing and the establishment of water and sewerage facilities, but no additional activities. Ryan J held that this was simply the realisation of a capital asset in an enterprising way. Ryan J stated[37] that he was influenced primarily by the indisputable fact that the

[34] Ibid., at 4075
[35] Ibid., at 4076
[36] [1997] ATC 5135
[37] At 5151

taxpayer acquired and continued to hold the property for use as a residence and the conduct of the business of a primary producer.

n) Other cases where it has been held that the taxpayer had merely realised a capital asset are *AGC (Investments) Ltd v FCT* (1992) 23 ATR 287, *Price Street Professional Centre Pty Ltd v FCT* (2007) 67 ATR 544, *Burnside v FC of T* 77 ATC 4588 and *Mount Louisa Grazing Co v FC of T* 86 ATC 4933.

9) Land acquired through inheritance or gift

a) Where land is acquired through inheritance or gift it generally cannot be asserted that it has been acquired for the purpose of resale at a profit. Thus it is only if it is part of a business, a profit-making scheme or adventure in the nature of trade that it will be found to be held on revenue account.

b) In *Re McCorkell and FCT*[38] a taxpayer inherited land in 1960 which had originally been acquired by the taxpayer's father in 1917 for the purpose of conducting an orchard outside Shepparton in Victoria. The taxpayer had lived on the property since birth and worked full time with his father on the property from 1931 until he inherited the land on his father's death in 1960. With the expansion of Shepparton the property acquired urban neighbours who complained about the use of pesticide on the property. The taxpayer decided to subdivide and sell the property. The Tribunal held that the property was held on capital account, referring to the following key factors:

i) the taxpayer had initially sought to sell the property as one parcel but had not been able to attract a satisfactory offer,

ii) he borrowed only a limited amount for a short time in order to carry out the subdivision, but he was not prepared to risk funds for the complete subdivision at the outset;

iii) that the works carried out in developing the subdivisions were no more than what was necessary to obtain approval for it,

iv) that the taxpayer did not have a site office or building on the land;

v) he had no direct contact with contractors or potential purchasers,

vi) he had no business organisation, office or letterhead,

vii) he continued as an orchardist until 1991 when he retired and leased the balance of the property as an orchard.

c) In *FC of T v McClelland*[39] the High Court considered a case where Mrs McClelland and her brother inherited 3600 acres of land at Rockingham, South of Fremantle on the death of their uncle in 1958. Before his death it had been used by him or let by him for agistment of stock and in part for farming. On the date of his death it was under crop. Mrs McClelland wanted to keep the land with a view to the future whereas her brother wanted it sold at once. The taxpayer was able to convince her brother to grant her an option to purchase his share for 40,000 pounds, and on the strength of this she negotiated a sale of a large portion of the property before exercising the option. In this way she sold 3,073 acres for 153,632 pounds and retained 525 acres. The Commissioner assessed Mrs McClelland under s

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[38] [1998] AATA 562; (1998) 39 ATR 1112
[39] [1969] HCA 72; 118 CLR 353

26(a) on a profit of 56,951 pounds. This was estimated to be the profit she had realised on the purchase and sale of her brother's half interest in the land sold. The figures were achieved by means of a valuation of the whole property as at the date of exercise of the option as well as a valuation of that part of the property that was sold. The price of 40,000 pounds was then apportioned to that part of the property that was sold in accordance with the relative value of the land sold in accordance with the valuations obtained. In this was she was deemed to have received 76,816 pounds for the sale of her brother's share and to have paid 19,865 pounds for it, yielding a profit of 56,951 pounds. This methodology was queried by the High Court but ultimately no decision was required on this point.

d) At first instance, Windeyer J held that the profit was not income under s26(a) nor under ordinary principles.

e) On appeal, the High Court unanimously held that Mrs McClelland did not purchase her brother's share with a view to resale. Barwick CJ commented that the price paid for the brother's share, although significantly less than half of what Mrs McClelland received on selling the property, may nonetheless have been the market value of a 50% share in the property because that is undoubtedly worth less than half the value of a 100% share. Thus, Mrs McClelland's interest in the land became much more valuable once she held the entirety of it rather than a 50% share. Barwick CJ said at [3] "She undoubtedly made a profit by getting in her brother's interest but that was not a taxable profit. The profit consisted of the increase in value of her inheritance, the entire interest in the land being much more valuable than the sum of values of the separate interests in common, though, of course, no longer capable of being regarded as consisting of two parts."

f) However, the majority (Kitto, Menzies and Owen JJ, Barwick CJ dissenting) held that Mrs McClelland had made a profit from carrying on a profit-making undertaking or scheme. In doing so the majority referred to her purpose of acquiring her brother's interest in the property, which was to enable her to sell the fee simple, part of it immediately and the rest at a future time. "She had no purpose than that of selling the entirety, and of doing so in such a way as would bring in the best price. Kitto J said at [7] "What it had cost her consisted of the half interest she had become entitled to under the will plus 40,000 pounds. The excess arising from the carrying out of the scheme would plainly be profit which would answer the description in the second limb of s 26(a) and would also, I think, be income according to ordinary concepts since it would be the net proceeds of an adventure in the nature of trade."

g) Kitto J considered whether any amount should have been included in assessable income because the 153,632 pounds may not have exceeded the total cost to the taxpayer of 40,000 pounds plus half of the interest in the entire property. However, he considered it acceptable for an estimate of the profit in respect of the portion of the property sold to be made by the Commissioner and tax paid on that basis.

h) However, that was not the end of the matter as the taxpayer appealed to the Privy Council[40] and the majority of the Privy Council agreed with Windeyer and Barwick CJ that this did not amount to an adventure in the nature of trade, and was therefore not a profit-making undertaking or scheme. It is an interesting

[40] *McClelland v FCT* [1970] HCA 39; 120 CLR 487

aside to note that this was the last appeal to the Privy Council involving the application of a law of the Commonwealth, following the introduction of *The Privy Council (Limitation of Appeals) Act* 1968 (Cth) which blocked appeals in which a Commonwealth law was, or might have been, involved.

i) The majority of the Privy Council held that there was no profit-making undertaking or scheme within the meaning of s 26(a):

> *"It is clear in the first place that not all such undertakings or schemes are caught by the section. Otherwise every successful wager would be within it. So also would the purchase of investments bought by a private investor as a hedge against inflation and sold – perhaps long afterwards – at more than the purchase price. The participator in a lottery would also be liable if he drew the winning ticket. The undertaking or scheme, if it is to fall within s26(a) must be a scheme producing assessable income, not a capital gain. What criterion is to be applied to determine whether a single transaction produced assessable income rather than a capital accretion? It seems to their Lordships that an "undertaking or scheme" to produce this result must – at any rate where the transaction is one of acquisition and resale – exhibit features which give it the character of a business deal. It is true that the word "business" does not appear in the section; but given the premise that the profit produced has to be income in its character their Lordships think the notion of business is implicit in the words "undertaking or scheme"."*

j) This was followed by Gibbs J in *Steinberg v Commissioner of Taxation (Cth)*[41] with respect to the shares that Malcolm Steinberg had obtained by way of gift from his father, which ultimately led to him enjoying a profit when he received a distribution in specie of an interest in the land held by the relevant company and that land was sold at a profit. Gibbs J considered that it could not be held that he was a participant in a profit-making scheme when he was simply the owner of the shares due to a gift.[42] As Barwick CJ held that there was no profit-making scheme at all in relation to this land,[43] Malcolm Steinberg's appeal on this issue was successful.

10) Isolated business or commercial transactions

a) Typically the notion of a business requires repetitive transactions carried on with a profit-making intention. However, the High Court in the case of *Myer Emporium* held that even an isolated transaction outside of the taxpayer's ordinary course of business, but carried out with a profit-making intention, would generate profit on revenue account. The question that remains in dispute is the level and specificity of profit-making intention required in such circumstances.

b) In that case the High Court (Mason A.C.J., Wilson, Brennan, Deane and Dawson JJ) said:[44]

> *"Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or*

[41] [1975] HCA 63; 134 CLR 640
[42] 134 CLR 640 at 702
[43] 134 CLR 640 at 692-693
[44] At 163 CLR 209-210, 87 ATC 4366-7, 18 ATR 697

gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income (Whitfords Beach 150 CLR at 366-367, 376; 82 ATC at 4036-4037, 4042; 12 ATR at 695-696, 705). The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit."

c) TR 92/3 provides the Commissioner's view on the application of this decision. In that ruling the Commissioner states at paragraph 15 that profit made from a transaction or operation is income if the intention or purpose of the taxpayer in entering into the transaction or operation was to make a profit or gain and the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction. This is said to be the case regardless of whether the taxpayer is otherwise in business but the transaction is not within the course of that business, or the taxpayer is not otherwise in business.

d) The Commissioner states at paragraph 13 that the matters which may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are the following:

i) the nature of the entity undertaking the operation or transaction;

ii) the nature and scale of other activities undertaken by the taxpayer;

iii) the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;

iv) the nature, scale and complexity of the operation or transaction;

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

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

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

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

e) There is a link between the enquiry as to whether an isolated transaction amounts to a business operation or commercial transaction and the question of whether an enterprise is being carried on for the purposes of GST. The common question is whether there is an adventure or concern in the nature of trade as opposed to the mere realisation of a capital asset. This can be found in paragraph 263 of MT 2006/1, where it is stated with respect to the question of whether one-off or isolated transactions amount to the carrying on of an enterprise:

"The issue to be decided is whether the activities are an enterprise in that they are of a revenue nature as they are considered to be activities of carrying on a business or an adventure or concern in the nature of trade (profit making undertaking or scheme) as opposed to the mere realisation of

a capital asset. (In an income tax context a number of public rulings have issued outlining relevant factors and principles from judicial decisions. See, for example, TR 92/3, TD 92/124, TD 92/125, TD 92/126, TD 92/127 and TD 92/128.)"

f) This basically brings us full circle because where profit is made from the sale of property purchased with the intention of re-sale at a profit or through the carrying on of a profit-making scheme, this will satisfy the *Myer Emporium* test such that the profit constitutes ordinary income. That is to say, *Myer Emporium* can be seen to stand for the principle that profit that falls within the old section 26(a) is ordinary income.

11) Venturing a capital asset into a business or profit making scheme

a) If land is not bought with a purpose of profit-making, it might nonetheless start to be held on revenue account if it is "ventured into" a business or a profit-making scheme.

b) Older cases appear to proceed on the assumption that a profit-making scheme cannot be constituted by selling alone and therefore a profit-making intention must exist at the time of purchase: *C H Rand v Alberni Land Co Ltd* (1920) 7 TC 629 and *Alabama Coal, Iron and Colonisation Co Ltd v MyLam* (1936) 11 TC 232: 'there must be something in the nature of buying at any rate, and not merely selling, which is mere turning your property into money'. This case was applied in *Scottish Australian Mining Co Ltd v FCT* (1950) 81 CLR 188.

c) However, this was turned on its head with the landmark High Court decision in *Whitfords Beach*. In that case the High Court found that land originally held by a company to facilitate access to fishing shacks, which, following a takeover of the company by new shareholders, was later subdivided, developed and sold as part of a large scale property development of 2,200 residential lots had been "ventured into" a profit making scheme such that it was no longer held on capital account.

d) Similarly, in *Stevenson v FCT*,[45] where land originally held for farming was subsequently subdivided and sold at a profit as part of a project involving 220 subdivided blocks over a period of time from 1980 to 1986, the Tribunal found that the taxpayer was carrying on a business of property development and therefore the property had been held on revenue account since commencement of that business. The Tribunal said:

> *"In particular I regard as significant the degree of his personal involvement in the planning, in the negotiations with the Shire Council and the State Rivers and Water supply Commission, in obtaining finance, in the employment of contractors, in the marketing of the blocks and in their actual sale. The subdivision and development was substantial. The land has been subdivided into over 180 small blocks. The development has turned farmland which had been unserviced by water supply or sewerage and without a made road into fully serviced residential blocks with a sealed road and drainage. The taxpayer not only obtained finance but he risked it."*

[45] 91 ATC 4476; (1991) 29 FCR 282

e) On appeal, Jenkinson J found no error of law in the Tribunal's decision.

f) However, these are rare examples where a profit made from the sale of a property has been held to be on revenue account where that property was not purchased with a profit-making intention.

g) In *FCT v Williams*[46] the taxpayer's husband was a senior partner in a firm of real estate agents. He purchased an interest in some land which was zoned urban, and subsequently gave it to his wife without informing her at the time of the gift. She could not be assessed under the first limb of s 26(a) since she could have no profit making purpose at the time of acquisition. In upholding the approach that a scheme could not be constituted by selling alone, Barwick CJ said of the second limb:

> *I remain of the opinion that the realisation of a gift, however elaborately made, can neither yield a profit nor in itself be a profit making scheme. Her contribution to the cost of subdividing land was part of her expense of realisation and nothing more. In the second place, neither the resolution to realise the land by subdivision on sale, nor the subdivision and sale could, constitute a profit making scheme so far as the respondent was concerned.*

h) Similarly, Gibbs J said:

> *An owner of land who holds it until the price of land has risen and then subdivides it and sells it is not thereby engaging be in an adventure in the nature of trade, or carrying out a profit making scheme. The situation is not altered by the fact that the land owner seeks and acts on the advice of an expert as to the best method of subdivision and sale or by the fact that he carries out work such as grading, levelling, road building and the provision of reticulation for water and power to enable a land be sold to its best advantage. The proceeds resulting from mere realisation of a capital asset are not income either in accordance with ordinary concepts or within the second limb of section 26 (a), even though the realisation is carried on in an enterprising way so as to secure the best price: McClelland v FCT.*[47]

i) *Whitfords Beach* has shown that these statements require some qualification. However, they do illustrate that it will be a rare case where land initially held on capital account will be found to have been ventured into a business or a profit making scheme.

12) Documentation – what will the ATO look for?

a) Having considered the above cases, some conclusions can be drawn about the type of evidence required to convince the ATO and the courts that property is held on capital account:

   i) Evidence from the taxpayer themselves about their intentions at the time of purchasing property will be treated sceptically as it is self-serving evidence. Similarly, evidence from family members and even from third parties reciting what the taxpayer has told them about their intentions will carry little weight. It must be supported by objective documentary evidence in order to hold water.

[46] (1972) 3 ATR 283
[47] (1970) 120 CLR 487, 494 and 496 (Privy Council)

ii) It is definitely advantageous if the property has not been bought, but has been acquired through gift or inheritance. This removes the inference that it was bought with the intention of profit-making by sale.

iii) It is helpful if the property has in fact been farmed or mined or otherwise used by family for a lengthy period of time. Again, this displaces any inference that it was purchased with the intention of profit-making by sale.

iv) It is important that any finance acquired backs up the assertion that the property was intended to be held long term for purposes other than sale at a profit. For example, it should be within the taxpayer's means to service the necessary finance long term, the loan application should refer to the intended long-term use and not to a proposed subdivision and sale, the valuation acquired by the financier should also ideally not refer to an impending rezoning or other change that might greatly enhance the value of the land.

v) It is better if the taxpayer can demonstrate they have not risked their asset, or speculated. For example in *Casimaty* it was held to be significant that the taxpayer had first undertaken a very small subdivision and sale so as to be able to repay the finance obtained for that purpose before proceeding with further subdivision and sale.

vi) It is ideal if the taxpayer does not sell the entire property but retains a parcel to live on and, even better, to continue historical farming or family activities on the portion retained.

b) The "*Statham*" factors will be critical in determining whether land originally purchased for farming, mining, or family purposes is simply being realised in an enterprising way, or whether a profit-making scheme is in train:

i) the owners initially seek to sell the land as one parcel, but are unable to do so;

ii) there is no or little finance required;

iii) only very limited clearing and earthworks are involved. The ATO test is whether only the minimum works required for planning approval have been carried out: see paragraph 265 of MT 2006/1;

iv) the owners have not acted as developers by engaging numerous contractors but have rather left that work to the council, or have only engaged one entity to manage all development work required for development approval;

v) the owners have not erected buildings on the land; not even, for example, a site office;

vi) there is no business organisation, no manager, no office, no secretary, and no letterhead;

vii) the owners maintain employment elsewhere;

viii) the owners do not advertise the land for sale but rely on local real estate agents to secure buyers.

13) Tax consequences of characterisation of land as capital, revenue

a) Consider the following example:

i) In June 1993, a taxpayer inherits three blocks of pastoral land that has been used by the family for many decades for grazing and agistment.

ii) There is a total of 100 acres. The taxpayer determines to sell the land.

iii) The taxpayer seeks approval from the local council to subdivide the land into 200 lots. Approval to subdivide the land is given in January 1994 and the taxpayer is required, as a condition of the approval, to dedicate approximately two acres of the land for roadways, footpaths and a public park, and to carry out the necessary infrastructure work. The taxpayer incurs $125,000 development costs during the remainder of that year of income.

iv) In the 1994-95 year of income, the taxpayer incurs further development costs of $75,000. Development work is completed in May 1995.

v) The plan of subdivision is approved by the local council and is sealed in June 1995. The plan is registered immediately with the Registrar of Titles, who creates separate titles for the 200 residential lots.

vi) In June 1996, the taxpayer enters contracts of sale to sell 150 of the lots for $200,000 each. The proceeds of sale total $30,000,000.

vii) The sales settle in September 1996.

b) If the taxpayer is able to maintain that the property is on capital account and the taxpayer is merely realising a capital asset to best advantage then the capital gains tax provisions will apply.

c) Had the taxpayer inherited the property in June 1985, the sales of the lots in the 1996 tax year would have been tax free. However, as s/he inherited the property in June 1993, capital gains tax will apply. If the property was pre-CGT property in the hands of the deceased then the first element of the cost base in the taxpayer's hands will be the market value of the property in June 1993.[48] If the property was post-CGT property in the hands of the deceased then the taxpayer will inherit the deceased's cost base in the property as at June 1993.[49]

d) The taxpayer will have a tax liability on the sale of the lots in the 1996 tax year because the contracts of sale were entered into in that year.[50] The capital gain is calculated by deducting the cost base from the capital proceeds from the sales. The cost base includes the acquisition cost, interest on any finance required for the subdivision, rates or land tax, the development costs and the costs of consultants. This is likely to give the taxpayer a large capital gain in the 1996 tax year for which the taxpayer can utilise the 50% CGT concession because the property will have been held by over 12 months.

e) If, on the other hand, the taxpayer goes too far with the subdivision of the property, conducting more work than required for development approval such

[48] See Item 4 of the table in section 128-15 ITAA 1997
[49] See Item 1 of the table in section 128-15 ITAA 1997
[50] See section 104-10(3) ITAA 1997

that the taxpayer is found to be carrying on a profit-making scheme, then the net profit will be taxed on revenue account. In this case the taxpayer will not have to include the proceeds of sale in assessable income until the 1997 tax year when the sales settle and the proceeds are in fact received. At that point *Whitfords Beach* indicates that the net profit needs to be calculated and included in assessable income. Where land is inherited it appears that the correct approach is to treat the market value of the property on the date it is ventured into a profit-making scheme as the deductible cost to the taxpayer.

f) In *Whitfords Beach*, following the holding in the High Court that the taxpayer was assessable on a profit making scheme, the matter was remitted to the Full Federal Court to calculate the profit. The Commissioner and the taxpayer agreed that the land was not trading stock because the High Court had found the taxpayer was carrying out a profit-making scheme, rather than carrying on a business. The Full Federal Court thus had to calculate the net profit. They did so by determining the value of the land at the date that the company had been taken over – the date that the land had been ventured into the profit-making scheme. The land was found to have a value of $3.1 million at that date. This was a somewhat advantageous finding for the taxpayer because in fact it was the purchase of the shares in the landholder in that case for $1.6 million that enabled the land to be developed.

14) Further issues with the capital revenue distinction – Degree and specificity of purpose

a) There is authority to the effect that it is necessary for the taxpayer's dominant purpose to have been the acquisition of property for the purpose of profit on re-sale before the property will be considered to be held on revenue account.[51] For example, in *McCurry v FCT* (1998) 39 ATR 121 Davies J found that the taxpayers had the purpose of either resale at a profit or rental, but held that the dominant purpose was resale at a profit.

b) In relation to the first limb of s26(a) the authorities are clear that a dominant purpose is required: see eg *Evans v. Deputy Federal Commissioner of Taxation (S.A.)* (1936) 55 CLR 80, at p 99 , per Rich, Dixon and Evatt JJ. ("The purpose of which it speaks is the dominant purpose actuating the acquisition of the assets - the use to which they are to be put"); *Buckland v. Federal Commissioner of Taxation* (1960) 12 ATD 166, at p 169; 34 ALJR 60, at p 62, per Windeyer J. ("When a person buys property, as a commercial money-making transaction and not for his personal use or enjoyment, the purpose he has in view is the use to which he intends to put the property to achieve this end. He may intend either to sell it at a profit, or to keep it as a revenue-producing asset. In relation to s. 26 (a) it is the main or dominant purpose of the acquisition that is significant. If a property, say a house or farm, were bought for the purpose of resale at a profit it would be immaterial that the purchaser also had in mind to take the rents and profits in the meantime or pending selling to use it for some purpose of his own.") and *Pascoe v. Federal Commissioner of Taxation*, per Fullagar J (1956) 11 ATD 108, at p 112; 30 ALJ 402, at p 404. (at p500).

[51] See *Pascoe v FC of T* (1956) 6 AITR 315, 320 (per Fullagar J)

c) However, there is conflicting authority as to whether a dominant purpose is required to render the profit from a profit-making scheme assessable. Gibbs J in *Federal Commissioner of Taxation v Bidencope*[52] in dissent, held that it is only necessary for one of the purposes of entering into a profit-making scheme to be the securing of a profit in order to attract s 26(a).

d) However, in *Burnside v FC of T*[53] Mason J (with whom Barwick CJ and Jacobs J agreed) suggested that a "dominant purpose" test applied. In that case the taxpayer acquired shares as an employee in a mining company and it was accepted that the shares were not acquired for the purpose of profit-making by sale but rather for the purpose of holding as a long term investment. However, the taxpayer needed funds to pay off a short term loan provided by the bank to enable him to buy a house and so he sold some of the shares in the company in order to pay off that loan. The issue before the court was whether the profit made on disposal of the shares was nonetheless income because of the existence of a profit-making scheme. The comments in that case may have been influenced by the fact that the alleged scheme was the purchase and disposal of the shares and as it had been found that the shares had not been purchased with a profit-making purpose, it was difficult to find that the scheme existed.

e) Also, Jacobs J in *London Australia Investment Co Limited*[54] held that where there is a business of acquiring property, then the existence of a "dual purpose" is sufficient to give an asset a revenue character. In that case the taxpayer was an investment company. It purchased shares with a view to the production of an income from dividends. It pursued a policy of attaining a consistent yield on its invested capital and this necessitated a sale of shares from time to time where they ceased to provide that yield. In 1967, 1968 and 1969 these sales produced significant profits which the Commissioner assessed to tax.

f) Gibbs J held that the position of an investment company is different from that of an individual managing his own portfolio of shares and that where, as here, the sale of shares is part of the ordinary business conducted by such investment company then the profit realised on such sale is assessable income. Barwick CJ dissented.

g) This was applied by the Full Federal Court (Sheppard, Wilcox and Lee JJ) in *Moana Sand Pty Ltd v FC of T.*[55] In that case the taxpayer company acquired land containing sandhills with the twofold purpose of selling the sand and later subdividing the land for sale. Before the sandhills had been fully sold by the taxpayer the land was compulsorily acquired as part of the coastal protection policy of the South Australian Government. The taxpayer argued therefore that the compulsory sale brought any profit-making scheme to an end. The Full Federal Court rejected this argument stating at [29] that "… the sale of the land was the fulfilment of the ultimate purpose of the company in relation to the land."

h) There are also statements in *McCurry* regarding the method of profit-making being "one of the many alternatives contemplated by the taxpayer" although ultimately Davies J found that profit by resale was the dominant purpose.

[52] [1978] HCA 23 at [19]; 140 CLR 533 at 554; 78 ATC 4222, 4234
[53] [1977] HCA 66; (1977) 138 CLR 23; 77 ATC 4588
[54] [1977] HCA 50; (1977) 138 CLR 106
[55] [1988] FCA 671; 88 ATC 4897; 19 ATR 1853

i) At paragraph 8 of TR 92/3 the Commissioner states that it is sufficient if profit-making is a significant purpose. It relies on the following cases for that proposition: *FC of T v. Cooling* 90 ATC 4472 at 4484; 21 ATR 13 at 26; *Moana Sand Pty Ltd v. FC of T* 88 ATC 4897; 19 ATR 1853; *AGC Investments Ltd v. FC of T* 91 ATC 4180; 21 ATR 1379; *Forwood Down and Co Ltd v. Commissioner of Taxation* (WA) (1935) 53 CLR 403 (especially Evatt J) and Jacobs J in *London Australia Investment Co Ltd v. FC of T* 77 ATC 4398 at 4409-4411; 7 ATR 757 at 770-772.

j) Indeed, where the facts do not support a finding that the taxpayer acquired the property with the intention of profit by resale, the courts have tended to focus more on the question as to whether the activities of the taxpayer are sufficiently business-like to render the profit income as opposed to a mere realisation of an asset. Thus the focus is not so much on the dominant purpose of the taxpayer but rather on whether the taxpayer's activities are sufficiently business-like to amount to an adventure in the nature of trade.

k) In *FCT v Cooling* a firm of solicitors received a leasing incentive to relocate to new premises. The Full Federal Court (Lockhart, Gummow and Hill JJ) held that this was ordinary income because it was a commercial transaction forming part of the business activity of the firm and a "not insignificant purpose" was the obtaining of a commercial profit by way of the incentive payment.[56] This case is difficult to fit within the usual concepts. It is not possible to say that the transaction was an ordinary part of the firm's business, and it is also not possible to say that it was a commercial transaction entered into for the dominant purpose of profit-making. Rather, the Court reached something of a compromise saying that the transaction was a part of the firm's business, and there was a "not insignificant purpose" of profit-making.

l) In *Forwood Down* the company traded in machinery. Sometimes it bought mining machinery in situ on mines which had closed down. In order to be able to leave the machinery in place until a sale could be effected it sometimes acquired the mining leases. Usually it abandoned the lease after sale and removal of the machinery. However, in one case it subsequently sold the lease together with the machinery at a profit. Evatt J held that the company acquired the mining lease both for the purpose of storing machinery on the lease and the purpose of reselling the lease when a place of storage was no longer required. He found that the transaction of buying and selling the lease was sufficiently related to the company's business to bring the profit to tax. Rich, Starke, Dixon and McTiernan JJ found that the sale resulted in a profit arising from the carrying on of the business of the company.

m) Therefore, it appears that where the taxpayer is conducting a business and profit is made from a transaction that can be described as being within that business, then a dual purpose will suffice. However, where no business is being conducted and it is an isolated commercial transaction, stronger evidence of a profit-making intention may be necessary.

n) In the context of property acquisition in Australia it is generally difficult if not impossible to demonstrate that the taxpayer has not given some thought to profit by an ultimate sale. Hence where property has been purchased rather

[56] See judgement of Hill J at 90 ATC 4484; 21 ATR 27

than inherited or received by way of gift, it can be an uphill battle to prove that it is held on capital account.

o) Further, as alluded to above, (see paragraph 12)a)i)), the taxpayer's evidence of their intention will be treated sceptically. The Commissioner states at paragraph 7 of TR 92/3 that it is not the subjective intention of the taxpayer but rather the intention or purpose discerned from an objective consideration of the facts and circumstances of the case. Lockhart J in *Antlers* said that "The taxpayer's purpose or intention is usually ascertained from an objective consideration of the circumstances of the case but his subjective purpose or intention is also of course relevant and may sometimes be the determining factor."

p) Where the taxpayer is a company, its purpose is that of the persons who control it: *Whitfords Beach* at 150 CLR 370; 82 ATC 4039; 12 ATR 701.

15) Further issues with the capital revenue distinction – Profit realised by different means than that anticipated or planned for

a) There is some tension between the Tax Office and taxpayers as to whether every isolated transaction carried out with a profit-making intention gives rise to a gain on revenue account or whether the profit must be realised by the means anticipated.

b) In *Westfield* Hill J (with whom Lockhart and Gummow JJ agreed) found that the sale of land by the taxpayer was on capital account because when purchasing the land the taxpayer had had no intention of selling the land, but rather intended to develop it as a shopping centre, which was the taxpayer's business activity. It later transpired that the taxpayer sold the land to the owner of the adjacent land and entered into contracts with the purchaser for the design and construction of a shopping centre. The land was sold for less than could have been obtained because the taxpayer wanted to procure contracts for the design and construction of the shopping centre. Nonetheless the taxpayer made a profit on the sale. The court held that the profit was not on revenue account because, although the taxpayer had a profit making purpose on acquisition of the land it was necessary for such purpose to be to make a profit by means of the actual transaction.

c) Hill J said that "where a transaction falls outside the ordinary scope of the business, so as not to be a part of that business, there must exist, in my opinion, a purpose of profit-making by the very means by which the profit was in fact made."[57]

d) And later, at 344-5:

> **While a profit-making scheme may lack specificity of detail, the mode of achieving that profit must be one contemplated by the taxpayer as at least one of the alternatives by which the profit could be realised. Such was the case in *Steinberg*. But, even if that go too far, it is difficult to conceive of a case where a taxpayer would be said to have**

[57] 91 ATC 4234, 4243

made a profit from the carrying on, or carrying out, of a profit-making scheme, where, in the case of the scheme involving the acquisition and resale of land, there was, at the time of acquisition, no purpose of resale of land, but only the possibility (present, one may observe, in the case of every acquisition of land) that the land may be resold. The same may be said to be the case where s 25(1) of the Act is involved. As the court observed in *Myer*, in the passage already set out, the property which generates the gain must be acquired in an operation of business or commercial transaction *"for the purpose of profit-making by the means giving rise to the profit"*. [Emphasis added.]

e) In *Steinberg v Commissioner of Taxation (Cth)* [1975] HCA 63; 134 CLR 640 there were a number of land acquisitions under consideration. Mr Steinberg had been involved in some 13 syndicates that had bought and sold land at a profit during the period in question. In respect of the "Rockingham land" Mr Steinberg obtained an option to purchase the land in 1960. He then incorporated a company (Malgor Pty Ltd), the shareholders of which included his wife and himself, to purchase the land. In the first half of 1963 further shares were issued in the company including the issue by way of gift to Mr Steinberg's son, Malcolm. In July of 1964 Mr and Mrs Steinberg sold 50% of the shares in Malgor Pty Ltd to a Mr Markham when Mr Steinberg became short of funds. The company was later placed in liquidation and the land distributed in specie to the shareholders. The land was then sold at a profit. The issue was whether the profit realised by Mr Steinberg (and Malcolm Steinberg) on the sale of the land was assessable income under section 26(a).

f) The taxpayer maintained that the land was bought for pastoral pursuits and the conduct of the business of farming and grazing. However, this evidence was not believed. Mason J held at [90]; 668:

> *"When property is acquired in the expectation that it will increase in value with the intention that a profit is to be made out of that increased value and a company is incorporated to acquire the property, the profit may be realized in a variety of ways. First, the company may sell at a profit which is then distributed by way of dividend to the shareholders. Secondly, the increased value of the property will reflect an increased value of the shares which may be sold at a profit by the shareholders. Thirdly, the company may be placed in voluntary liquidation in the course of which the liquidator may distribute the property in specie. Other methods of realizing and distributing a profit arising from the increased value of the property, or a combination of methods, may be selected."*

g) The High Court by majority held that it was not necessary that every step which culminates in the making of a profit should be planned or foreseen. In the words of Mason J (at [96]; 670):

> *"In a business transaction of this kind where property is acquired with the intention that a profit should be made out of its anticipated appreciation in value by whichever means prove most suitable, it matters not that the particular means by which the profit is to be made are left for subsequent decision."*

h) Gibbs J held at [10]; 699 that a transaction must exhibit features which give it the character of a business deal to fall within section 26(a): "The mere realization of a capital asset, albeit in an enterprising way, would not amount to the carrying out of a profit-making scheme." And further at 700:

> *"In the present case, Morris Steinberg devised and carried into effect a profit-making scheme when in 1960 he arranged for Malgor to be incorporated and to purchase the Rockingham land. These things were done in accordance with a plan devised for the purpose of making a profit, and what was done had the character of a business deal. It cannot be said with certainty whether the purpose of the scheme was to make a profit from the sale of the shares or from the sale of the land, but that is immaterial: if the scheme had the requisite purpose it was a profit-making scheme notwithstanding that the exact manner in which the profit was to be made had not been finally decided."*

i) These issues are discussed in paragraphs 51 to 58 of Taxation Ruling TR 92/3 where the conclusion is at [56] that a profit is on revenue account if a taxpayer:

   i) acquires property with a purpose of making a profit by which ever means prove most suitable and a profit is later obtained by any means which implements the initial profit-making purpose; or

   ii) acquires property contemplating a number of different methods of making a profit and uses one of those methods in making a profit.

j) The Ruling goes even further at paragraph [57| and states:

> *"We also consider that an assessable profit arises if a taxpayer enters into a transaction or operation with a purpose of making a profit by one particular means but actually obtains the profit by a different means. Thus, a taxpayer may contemplate making a profit by sale but may ultimately obtain it by other means (such as compulsory acquisition, through a company liquidation or a distribution in specie) that were not originally contemplated."*

k) The Commissioner places reliance on *Moana Sand Pty Ltd v FC of T* where the Full Federal Court (Sheppard, Wilcox and Lee JJ) found that the profit on the disposal of land by means of compulsory acquisition was income according to ordinary concepts even though it was not one of the means by which the taxpayer had contemplated that a profit might be generated.

l) The Commissioner acknowledges at paragraph 58 of TR 92/3 that his statements regarding profit being on revenue account even if generated by means not originally contemplated by the taxpayer goes further than the courts have yet gone and needs further judicial elucidation.

16) Further issues with the capital revenue distinction – Land acquired for development and sale at a profit but development abandoned before sale

a) There are cases that indicate that where land is acquired for the purposes of development and sale at a profit, but the development is abandoned before completion, then a subsequent sale of the property may be on capital account.

b) For example, in *Kratzmann v. Commissioner of Taxation*[58] a taxpayer had purchased land to carry out a profit-making scheme involving the borrowing of money to erect a building and the realization of units in the building to enable the repayment of the loans and the cost of the project, leaving him with a substantial asset which would constitute a surplus. For financial reasons he gave up the idea and sold the land at a profit. Menzies J held that the profit on the sale was on capital account. Menzies J said (p 294) that the profit arose, not from the purchase of the land, but from its sale, and because the sale was not part of the profit-making scheme, the profit did not arise from the carrying out of that scheme. He added that the profit in question did not arise until the scheme had been abandoned.

c) Similarly, in the recent case of *Rosgoe Pty Ltd v Commissioner of Taxation* [2015] FCA 1231 a taxpayer acquired two lots of land, one on 28 March 2006 and the other on 23 August 2007, for the purpose of development and sale as part of a joint venture. However, negotiations with the joint venture partner fell through in the 2010 financial year. The taxpayer then engaged a development management company to obtain a DA, which was obtained on 20 September 2013, following which the property was sold at a profit. On appeal from the AAT, Justice Logan expressed the view that the facts described by the Commissioner involved the carrying out of a profit making scheme which later came to be abandoned, and the profit did not arise until the scheme had been abandoned. Accordingly, the correct conclusion was that the profit was not income because what occurred was the mere realisation of a capital asset. However, care must be taken with this case as it involved an appeal from a private ruling and the private ruling had not stated that the taxpayer was engaged in a business of property development. Therefore the case had to proceed on this basis.

d) Interestingly in *Steinberg*, Mason J said at [100]: "Difficult questions would have arisen had I concluded that the profit-making scheme as initially formulated was confined to a sale of land by the company and that it was altered or amended in 1964 or 1965 so as to provide for the steps which were thereafter taken…" Gibbs J also alluded to this at [12]; 700 where he examined whether the scheme had been abandoned in 1963. However, he ultimately found that the scheme had been amended but it had not been brought to an end and thus "… the eventual sale of the land was something done in carrying out the scheme made in 1960, notwithstanding the intervening events." Stephen J provided the following analysis at 714:

> *"Once it is determined that a scheme exists the effect of supervening events which cause a departure from the original scheme will vary depending upon the view taken of those events. If they be seen as involving an abandonment of the scheme as a whole, as in Kratzmann v Federal Commissioner of Taxation (1970) 45 ALJR 110; 2 ATR 3; (1971) ATC 4022, profits made subsequent to its abandonment will not be assessable under s. 26(a). If, instead, a scheme in an amended form is thereafter carried out which can be seen to be a different scheme from the original scheme the date of inception of the new scheme will be the starting point for the calculation of profit, so that if the acquisition and resale of land is in question the value of the land*

[58] (1970) 44 ALJR 293

> *at the date of inception of the new scheme will be the relevant starting figure. Again not every change in the planned details will involve the adoption of a new scheme, this will always be a question of fact and will be much affected by the degree to which the original scheme was precise in its details. An imprecise scheme, the details of which have not been worked out in advance, will more readily take in its stride unexpected events without becoming a different scheme."*

e) These cases are arguably at odds with Taxation Determination TD 92/126 which states that, if land is acquired for the purpose of development, subdivision and sale in an isolated commercial transaction but the development and subdivision do not proceed then the net profit made on the sale of the land is assessable income under subsection 25(1) of the ITAA 1936.

17) When is land trading stock?

a) A further distinction to be drawn is whether property is held as trading stock for the purposes of Division 70 of the 1997 Act. Although any profit on sale would still be on revenue account if the land is trading stock, rather than the 'net profit' being returned as assessable income, the provisions for the taxation of trading stock in Division 70 of the ITAA 1997 must be applied.

b) Trading stock is defined in section 70-10 of ITAA 1997 as: "(a) anything produced, manufactured or acquired that is held for the purposes of manufacture, sale or exchange in the ordinary course of business".

c) *FC of T v St Huberts Island Pty Ltd* [1978] ATC 4104 is the leading case in this area and indicates that land will be trading stock if the taxpayer is carrying on a business in the course of which land is acquired for development and sale. In that case the taxpayer bought an island and part of a second island for the purpose of developing and subdividing them and selling the allotments for residential purposes. Substantial developments works were carried out but then the company was placed into voluntary liquidation at a time when no subdivision had occurred. The whole land was transferred to the sole contributory of the company. The High Court held that it was trading stock and thus the taxpayer was assessable on revenue account on the gain.

d) *Huberts Island* also stands as authority for the proposition that land is trading stock even where it is intended that further development work is to be done before it will be converted into the condition in which it is intended to be sold (at CLR 228; ATC 4113; ATR 463 per Mason J):

> *"If trading stock according to its ordinary meaning denotes land as well as goods and commodities, it must follow that land may form part of the trading stock of a business before it has been converted into the condition in which it is intended to be sold. Just as raw materials and partly manufactured goods form part of the trading stock of a manufacturer, so also virgin land which has been acquired by a land developer for the purpose of improvement, subdivision and sale in the form of allotments will form part of his trading stock."*

e) In *John v Federal Commissioner of Taxation* (1989) 166 CLR 417 there was some indication (at 429) that a single item acquired for the purpose of sale is not trading stock unless the purchaser is or will be engaged in trading goods of that nature. However, that was in the context of share trading and Finn J in *R & D Holdings Pty Ltd v FCT* [2006] FCA 981 at [48] expressed the view that it did not address the "quite particular and distinctive issues raised in cases of single venture land development and subdivision for purposes of sale by lots." Rather, Finn J considered that St Huberts remained good law for such cases.

f) Note that the Commissioner relies on *John* in ATOID 2004/25 for the proposition that the purpose of holding land for sale need not be the dominant purpose of the taxpayer in order for the land to be trading stock.

g) In *R & D Holdings Pty Ltd v FCT* [2006] FCA 981 Finn J held that land acquired by a trust in 1993 for the purposes of development as a strata building was trading stock of the trust even though it was never strata titled and even though the trust had never previously sold any land. Finn J found that the trust was involved in one venture involving the purchase, development and sale of the property and thus the ordinary course of the business included a sale of the property. In particular Finn J rejected any contention that the trust must be buying and selling land with some regularity or system before the land could be trading stock of the trust. He further rejected any notion that the land could not be trading stock before being subdivided because there was a lack of a real market for it prior to subdivision.

h) This result is reiterated in Taxation Determination TD 92/124, which addresses the question of "In what circumstances is land trading stock?" That Taxation Determination expresses the view that it is not necessary for the taxpayer to be involved in regular land acquisitions in order for land to be trading stock. A single acquisition of land for the purpose of development, subdivision and sale by a business commenced for that purpose would lead to the land being treated as trading stock.

i) TD 92/124 states that:

   i) land is treated as trading stock for income tax purposes if it is held for the purpose of resale and a business activity which involves dealing in land has commenced;

   ii) both the required purpose and the business activity must be present before land is treated as trading stock. The business activity is taken to have commenced when a taxpayer embarks on a definite and continuous cycle of operations designed to lead to the sale of the land.

   iii) It is not necessary that the acquisition of land be repetitive. A single acquisition of land for the purpose of development, subdivision and sale by a business commenced for that purpose would lead to the land being treated as trading stock.

j) In *ARM Constructions ty Ltd & Ors v FCT*[59] Yeldham J of the NSW Supreme Court found that, where two companies had purchased land with a purpose of constructing residential units for retention as a long term investment, those units were not trading stock. Yeldham J held at 4806 that "The decisive factor in determining whether or not the units at Bankstown became trading stock at any time up to and including the date of partition was the primary or substantial intent or purpose of the parties, which intention or purpose was carried into execution. The fact that they may have had a secondary or subsidiary purpose in

[59] 87 ATC 4790; 19 ATR 337

selling the units if that became necessary in order to discharge their subsequent borrowing from General Credits Limited did not stamp upon the units the character of trading stock up to the time of the date of the deed of partition." He similarly held that properties at Newton were not trading stock although in the case of those properties he found that they had been purchased for the purpose of sale at a profit and as such the profit was assessable under section 26(a).

k) Thus it can be seen that a critical distinction with respect to the question of whether land is trading stock is whether a business is being carried on as opposed to a profit-making scheme or an acquisition of property with the intention of re-sale at a profit.

18) Taxation of land as trading stock

a) A taxpayer is entitled to a deduction under s 8-1 for the cost of trading stock, including taxes, insurance and other acquisition costs. Section 70-15 provides that such a deduction is available where the item becomes part of the trading stock on hand before or during the income year in which the outgoing is incurred. Otherwise, the deduction is available in the year in which the item becomes trading stock on hand or in the year in which the item is disposed of and an amount included in assessable income as a result.

b) Section 70-35 then requires any excess in the value of trading stock on hand at the end of the income year over the value of trading stock on hand at the start of the income year to be included in assessable income. Conversely, if the value of trading stock on hand at the end of the income year is less than the value on hand at the start of the income year, then the taxpayer is entitled to a deduction. A taxpayer can choose between cost, market value and replacement value for the purposes of determining the value of the trading stock.

c) Amounts realised on a sale of trading stock are assessable income.

When is land "on hand"

d) With respect to land, it is considered to be 'on hand' if the taxpayer has dispositive power over the properties. This is illustrated in ATOID 2004/26 which considers a taxpayer who purchased residential properties and sold them within a year later under terms contracts with settlement not occurring for 25 years. The Commissioner refers to the High Court decision in *Farnsworth v Federal Commissioner of Taxation*[60] where it was held that the critical determinant of whether trading stock is 'on hand' is whether the taxpayer has the power to direct or control the disposal of it. This was applied in the context of real property in *Gasparin v Federal Commissioner of Taxation*[61] where it was held that the vendor of land has dispositive power until settlement because if a purchaser under an unsettled contract of sale did not proceed, the vendor could elect to treat the contract at an end, and resell it.

e) ATOID 2004/27 then examines the consequences of this for the proceeds of sale and determines that the proceeds are not part of the vendor's income until settlement, despite the fact that instalments of the price are payable over the 25 year period until settlement. Again the Commissioner relies on *Gasparin* for this

[60] (1949) 78 CLR 504
[61] (1994) 50 FCR 73

result. Interest payable in respect of the vendor finance is assessable in each year of receipt.

f) ATOID 2004/28 indicates however that the forfeited deposit and any instalments retained when a purchaser defaults are included in the vendor's assessable income in the year of the default. The Commissioner relies on *L'Estrange v Federal Commissioner of Taxation*[62] and *Gasparin* for this result. Finally in ATOID 2004/29 the Commissioner concludes that an amount paid by a taxpayer to persuade a person to vacate a residential property following their default under an instalment sales contract is deductible under s 8-1.

Land previously held on capital account

g) Where land previously held on capital account starts to be held as trading stock, s 70-30 ITAA 1997 provides that the taxpayer is deemed to have sold the land for its market value or cost and immediately reacquired it for the same amount.

h) If cost is chosen, then no capital gain should result. This is also specified in section 118-25(2). The cost is what would have been its cost for the purposes of section 70-45 it if had been trading stock since acquisition. However, if it was acquired for no consideration then the table in s 70-30(4) sets out the deemed cost.

i) However, if market value is chosen then a capital gains tax liability may arise under CGT event K4. If market value is chosen, TD 97/1 indicates that the market value of the land calculated at the time it is ventured into the business is to be determined having regarding to the 'highest and best use' that can be made of the land.

j) Although electing to use market value when land becomes trading stock may give rise to a capital gains tax liability, this may still produce the best tax outcome overall as it will enable part of the overall gain to be taxed on capital account with potential access to CGT concessions.

Absorption method of determining cost

k) Although a taxpayer is entitled to a deduction for the cost of trading stock in the year the cost is incurred under s 70-15, because this will effectively increase the trading stock on hand at the end of the year, the deduction is effectively nullified and delayed until the trading stock is actually disposed of, at which time the capital proceeds will be brought to account as assessable income, and the deduction will effectively be enjoyed because the taxpayer's stock on hand at the end of the year will be reduced by the disposal.

l) Accordingly, where a taxpayer chooses to account for trading stock at "cost", it is important to distinguish between costs that must be "absorbed" into the cost of trading stock, and where the deduction is thus effectively delayed, and between those costs that are immediately deductible without adding to the cost of the trading stock.

Practical guidance on correct treatment of land as trading stock in the context of property development

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[62] (1978) 9 ATR 410

m) The case of *FC of T v Kurts Development Limited*[63] provides Full Federal Court guidance on this issue.[64] In that case the taxpayer was a property developer in the business of purchasing broadacres, developing and subdividing it and selling the subdivided lots. It was not in dispute that the land was trading stock in the taxpayer's hands and that the taxpayer had elected to use cost to value the trading stock on hand. The Court was required to consider the correct treatment of "Infrastructure Land", being land on which the taxpayer was required to develop services and facilities such as roads, parks, sewerage, drainage, electricity and telephone following which the land is dedicated to the Crown or a public authority on registration of the plan of subdivision. The Court was also required to consider "external costs" incurred by the taxpayer as a condition of its obtaining approval from a local authority to a proposed subdivision, being payments made to local authorities for "headworks" and other works which are physically external to the taxpayer's land.

n) The taxpayer contended that the infrastructure costs and external costs are allowable deductions but never become part of the cost price of the taxpayer's trading stock.

o) Emmett J (with whom Burchett and Lindgren JJ agreed) drew an analogy between broadacres in a partially developed state, before individual subdivided lots are created by registration of a plan of subdivision, and work in progress. He said, at 4883, that "the reality is that the individual subdivided lots have a value which includes the road access and other services constructed on the Infrastructure Land". Further, at 4883-4 he said: "It is not possible for the Taxpayer to sell individual subdivided lots unless they have access to public roads to enable the owners to gain access to the lots themselves. That access is gained by means of the Infrastructure Land….In a real sense, the expenditure of the Infrastructure Costs is part of the cost of producing the individual subdivided lots."

p) Emmet J held at 4884 that the Infrastructure Land is never at any stage a separate article of trading stock and that the costs in connection with the infrastructure are properly characterised as part of the cost price of the resultant individual subdivided lots. Similarly, he held that the external costs are properly characterised as part of the cost price of the individual subdivided lots: "They are all expenses which had to be incurred in order to create the individual subdivided lots. But for that expenditure, the individual subdivided lots would not have been created."

q) Accordingly, on registration of the plan of subdivision the taxpayer had a number of individual lots ready for sale and the cost of them included the costs incurred on the infrastructure land and the external costs.

r) Draft ruling TR 95/D15 explores these issues in more detail but was withdrawn before being finalised following the Full Federal Court decision in *FC of T v Kurts Development Limited*, because the Commissioner considered that the issues canvassed in the draft ruling were adequately addressed by the decision in that case. Nonetheless the draft ruling provides some helpful detail and explanations as to the correct tax treatment of trading stock valued at cost in a property

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[63] [1998] FCA 1037; 98 ATC 4877; 39 ATR 493
[64] Special leave was sought for an appeal to the High Court but this was refused: *[1999] HCATrans 90*

development context. The draft ruling states that the following costs would be treated as outlined:

i) Holding costs are deductible in the year in which they are incurred and do not form part of the cost price of the trading stock:

(1) Interest on funds borrowed to acquire the land

(2) Rates and land tax

(3) Marketing, advertising and selling expenses.

ii) Costs that are part of bringing the land into the state in which it is intended to be sold are deductible in the year in which they are incurred but they are also absorbed into the cost price of trading stock where the taxpayer elects to use cost as the method of valuing trading stock on hand:

(1) Land acquisition

(2) Professional fees for design work, including drafting, architectural, engineering and surveying

(3) Council application fees for the subdivision

(4) Contribution to the council for off-site upgrading of sewerage works

(5) Construction of roads.

iii) Where land is dedicated for special uses, such as roads and reserves, as part of a subdivision the cost of acquisition and developing that land is part of the cost price of the taxpayer's trading stock, but the lots that end up as roads and reserves are not trading stock. Rather, the cost of developing those lots must be allocated to the lots that are intended for eventual sale. Similarly, if a developer is required to construct a public golf course as part of a subdivision that will ultimately vest in the Crown. However, if a developer constructs a private golf course as part of a development and retains the golf course then the golf course is a fixed asset of the taxpayer's business and its cost is an outgoing of a capital nature. It is not a cost of acquiring trading stock.

iv) Administration costs form part of the cost price of the trading stock where they are clearly identified with the development of the specific project. Otherwise these costs are deductible in the year they are incurred, but are not reflected in the cost price of trading stock:

(1) Salary and wages to working directors

(2) Motor vehicle expenses

(3) Travelling expenses

(4) Telephone expenses

(5) Office expenses

(6) Accounting fees

(7) Printing and stationery expenses.

s) In terms of allocating costs to specific allotments, the draft ruling indicates that any reasonable method of allocation will be accepted, but generally an allocation on the basis of anticipated selling prices would be appropriate. For multi-stage developments, where development costs attributable to the whole project are incurred at an early stage, these costs must be allocated to all items of trading stock, including land to be used in later stages. The allocation must be made on a reasonable basis, such as on the basis of engineering estimates.

t) The following example is given of the tax treatment of a development project:

i) In June 1993, a taxpayer acquires three blocks of vacant land totalling 10 acres for $100,000 for the purpose of developing, subdividing and selling as residential allotments. It is proposed to develop 20 lots. The taxpayer receives a deduction under section 51 of the Act for the expenditure incurred in acquiring the land. The taxpayer opts to value the land, which is trading stock on hand at the end of the 1992-93 year of income, at its cost price of $100,000. That cost is allocated to each of the three articles of trading stock on hand in accordance with the contract price.

ii) The taxpayer seeks approval from the local council to subdivide the land. Approval to subdivide the land is given in January 1994 and the taxpayer is required, as a condition of the approval, to dedicate approximately two acres of the land for roadways, footpaths and a public park, and to carry out the necessary infrastructure work. The taxpayer incurs $25,000 development costs during the remainder of that year of income. The taxpayer is entitled to a deduction under section 51 of the Act for that expenditure. As in the prior year, the taxpayer opts to value trading stock on hand at the end of the year at cost price. Applying absorption cost principles, the cost price is the original cost of acquiring the land and the costs of development incurred so far in respect of that land, being a total of $125,000. Once again, the costs are allocated to each of the three articles of trading stock on an acreage basis.

iii) In the 1994-95 year of income, the taxpayer incurs further development costs of $75,000. Development work is completed in May 1995. Of the total development costs of $100,000, approximately $75,000 is incurred in respect of infrastructure development work on areas of land that ultimately will vest in the local council.

iv) The plan of subdivision is approved by the local council and the linen plan is sealed in June 1995. The plan is registered immediately with the Registrar of Titles, who creates separate titles for the 20 residential lots. Separate titles are also created for the land dedicated to special uses, all of which vests in the local council by operation of law.

v) At the beginning of the 1994-95 year of income, the taxpayer has three articles of trading stock on hand and their opening value for tax purposes is the same as their closing value at the end of the prior year of income. However, at the end of the 1994-95 year of income, the taxpayer has 20 articles of trading stock on hand, being the 20 residential lots.

vi) The taxpayer again opts to value trading stock on hand at cost and decides to allocate costs in proportion to the number of allotments in the subdivision, there being little difference between the characteristics of each of the lots.

vii) In applying the principles of absorption costing, the taxpayer must include all expenditure incurred in converting the residential lots into the condition in which they can be sold.

viii) The taxpayer, in converting the broadacres into subdivided lots, has surrendered a portion of the land originally acquired as trading stock (the land that vests in the local council), and has incurred infrastructure development costs in constructing, for example, roads and footpaths on that area of land. Nevertheless, all costs of acquiring the land and developing it to its subdivided state must be reallocated to the articles of trading stock on hand at the end of the 1994-95 year of income. The cost of the area of land dedicated to public use and the cost of any improvements to that land are part of the cost of converting the vacant land into the condition in which it will be sold by the taxpayer.

ix) In this example, for the purposes of subsection 31(1) of the Act, the cost price of each article of trading stock on hand at the end of the 1994-95 year of income is $10,000 ($200,000/20).

x) In the 1995-96 year of income, the taxpayer sells 15 of the lots for $20,000 each. The proceeds of sale ($300,000) are brought to account as assessable income in that year.

xi) At the beginning of the 1995-96 year of income, the value of trading stock on hand is $200,000 ($10,000x20). The value of trading stock on hand at the end of the year is $50,000 ($10,000x5). Subsection 28(3) of the Act allows a deduction for the excess of the value of trading stock on hand at the beginning of the year over the value of trading stock on hand at the end of that year. In this example, the taxpayer is entitled to a deduction of $150,000.

xii) The net result of the trading activities for the 1995-96 year of income is a taxable income of $150,000.

u) The treatment of holding costs is confirmed by Taxation Determination TD 92/132 which considers the question: if land is trading stock, do related interest costs, council rates and land taxes, form part of the cost price? The determination states that if land is acquired by a business as trading stock, interest, council rates and land tax incurred on and after the acquisition of the land do not form part of the cost price 'of trading stock'. These costs are incurred in holding the land whether or not it is subject to any future development and therefore the costs are not necessarily incurred in order to bring the land into the state in which it is intended to be sold.

v) ATOID 2003/150 adds to this by stating that the development of areas adjacent to land held by a property developer for the purpose of subdivision, development and sale is part of the cost of the trading stock where such development is necessary to gain development approval.

Other relevant Tax Determinations

w) Taxation Determination TD 92/127 addresses the issue of land that is acquired for development, subdivision and sale where the development is abandoned and the land sold in a partly developed state. It states that a closing value for the land must be returned when the development activities cease and that the net profit is assessable income under section 25(1) ITAA 1936 once the property is disposed of on the basis that the land is trading stock during the time the development activities are being conducted, but ceases to be trading stock once the development activities cease. The Commissioner relies on *FC of T v Murphy*[65] in support of the revenue treatment of the net profit on the eventual sale.

x) In that case the taxpayer was carrying on the business of a grazier on land which he owned at Tarago, NSW. The business ceased on 30 June 1954 and on 25 June 1954 he sold the land, plant and improvements to a company and entered into a written agreement whereby the livestock were leased to the company for a term of five years. The company was entitled to the natural increase, wool and other produce of the livestock but any proceeds of sale of the livestock belonged to the taxpayer. In February 1955 some stock were sold and the proceeds given to the taxpayer. The taxpayer did not account for this as assessable income on the basis that the stock had become capital assets. The Commissioner considered the stock were trading stock of a business that had been carried on and therefore assessable under s 36(1) ITAA 1936. The High Court (Kitto, Taylor and Windeyer JJ) agreed with the Commissioner and found no inconsistency in the phrase trading stock covering property that had been trading stock of a business that had ceased to be carried on.

y) The result in TD 92/127 of returning a closing value for the land on the cessation of development activities is now mandated by section 70-110 of the ITAA 1997 which provides that if land ceases to be trading stock, but is not disposed of, then the taxpayer is deemed to have sold it for its cost and immediately bought it back for the same amount. The issue is whether a later disposal of the land should be treated on revenue account, and net profit included in assessable income, or whether it should be treated on capital account and the gain included under the CGT provisions.

z) The example given in TD 92/127 is as follows: A taxpayer acquires broadacres for development, subdivision and sale. Subdivision plans are approved and work on kerbing and guttering commences. Due to financial difficulties the taxpayer is unable to continue the project and it is abandoned. Some years later the partly developed land is sold. The conclusion is that net profit on the sale of the land is assessable income under subsection 25(1). In my view this result does not automatically follow.

aa) Finally in TD 92/128 the Commissioner considers the position of land acquired for development, subdivision and sale where, after some initial development, the project ceases and is recommenced in a later year. The Commissioner concludes that the land is trading stock when it is acquired and during the initial development stages. It ceases to be trading stock when the business activities cease. However, when the business activities recommence, the land is not brought back into the business and treated as trading stock because no section in the Act allows a deduction for the notional cost of introducing trading stock into a business. However, section 70-30 now rectifies this.

bb) Thus the Tax Office continues to press the line that property acquired for the purposes of sale at a profit or for the purpose of a profit-making scheme is on

[65] (1961) 106 CLR 146

revenue account no matter what, whereas the cases indicate that there are circumstances where such property will start to be held on capital account.