Topic 3: Capital Gains Tax (CGT)

Step 1: Is there a gain or loss?
- CGT Event
- CGT Asset
- Timing of the Event

Step 2: Determine the amount of the gain or loss.
- What are Capital Proceeds (Div 116)/Modifications
- What is the Cost Base?
- Reduced Cost Base?
- Cost Base Modifications.

Step 3: Calculating the gain or loss (net)
- GCT Losses
- 50% General Discount
- Exemptions and Concessions
- Roll-Over Concessions
- Net Capital Gains as Assessable Income

Recommended Structure:

1. *Is the amount/asset pre CGT?*
2. Asset (s 108-5) (two parts: property, legal and equitable rights)
    a. *Identify what the capital asset is*
    b. Collectables
    c. Personal Use Assets (PUAs)
3. CGT Event (s 104-10)
    a. *What happened to the asset – did you dispose of it, was it lost or destroyed?*
    b. *A1 – most commonly occurring event, C1, C2, D1, F1, H2.*
4. Timing
    a. When you acquired the asset
    b. When you disposed of the asset
5. Calculate a gain or a loss
    a. *This is a gross amount (gross gain or loss)*
    b. The two equations
        i. CG = CP – CB
        ii. CL = RCB – CP
6. Consider concessions or discounts
    a. Division 115
    b. Main Residence or Discount
    c. Death (disposal on death, or acquiring property on estate)
7. Net gain or loss.
    a. *This net amount is then included in your assessable income*

Introduction

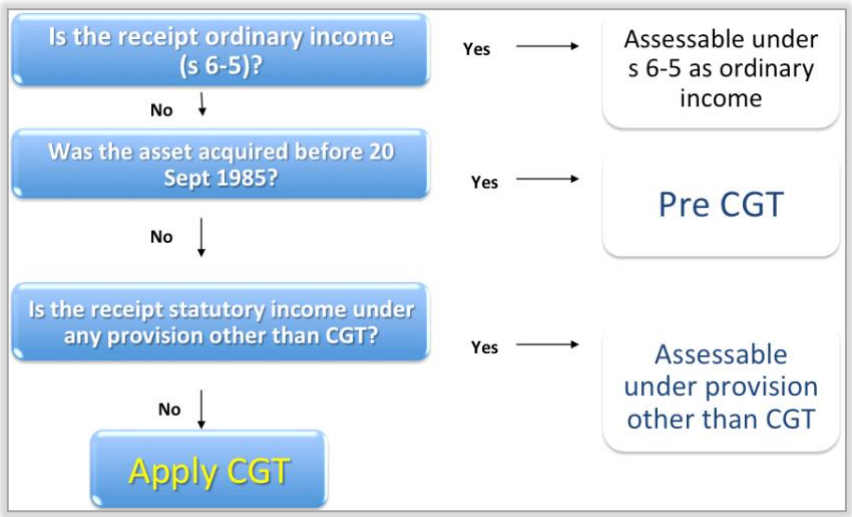
What is CGT?

- General:
  - Tax on capital gains.
  - Capital gain is the increase in the value of a capital asset (real estate or investment) that gives a higher worth than the purchase price.
  - The gain is not realised until the asset is sold.
- CGT is "essentially a tax upon gains from the realisation of property where the realisation is not an aspect of the carrying on of a business".
- In other words, CGT aims to tax gains made on the disposal of assets and sometimes also to tax the receipt of certain other capital amounts that do not derive from the disposal of assets.
- **Relates to assets acquired after 20 September 1985 (when CGT came into effect).**
  - If you acquired an asset Pre-CGT = No tax consequences.
- **CGT is a tax of last resort** – if an amount can be assessable elsewhere, then that is where it will sit.
  - You will get a clue that you need to deal with CGT.

CGT Provisions:

- The CGT provisions do not follow the basic structure of s 6-5 and s 8-1.
- The CGT provisions include as assessable income a net capital gain.
  - **As such CGT is statutory income.**

Step 1: Is there a Gain or Loss?



When does CGT arise?

- For Capital tax provisions to apply, **s 102-20** requires that there is a '**CGT event**' (a summary of these events is contained in **s 104-5**).
  - In other words, **unless there is a 'CGT event', there will be no capital loss or gain**.

- Basic rules relating to each event, the timing of acquisition and disposal and the method of calculating the net gain or net loss, are then outlined in more detail in **ss. 104-10 – 104-230**.

1. CGT 'ASSET'

- **S 108-5(1) ITAA 97** defines a CGT asset in general terms: any kind of property or a legal or equitable right that is not property.
- **Note: Collectables / Person Use Assets** – two separate and specific categories of assets, if the asset you are looking at fits into one of these categories, then we will no longer look at 108-5, we will look at their sections.

INCOME TAX ASSESSMENT ACT 1997 - SECT 108.5

CGT assets

(1) A ***CGT asset*** is:

(a) any kind of property; or

(b) a legal or equitable right that is not property.

(2) To avoid doubt, these are ***CGT assets*** :

(a) part of, or an interest in, an asset referred to in subsection (1);

(b) goodwill or an interest in it;

(c) an interest in an asset of a partnership;

(d) an interest in a partnership that is not covered by paragraph (c).

Note 1: Examples of CGT assets are:

- land and buildings;
- shares in a company and units in a unit trust;
- options;
- debts owed to you;
- a right to enforce a contractual obligation;
- foreign currency.

What is 'Property'?

- *Property* is a very broad term and can be used to describe everything that a person may have control over. Langdale M. R. (***Jones v Skinner***) said:
  - *Property is the most comprehensive of all terms that can be used, inasmuch as it is indicative and descriptive of every possible interest that a party may have.*
- Tangible:
  - Items of tangible property (have physical existence) such as land, buildings, and chattels do not provide any difficulty when considering the meaning of the term *property*. They are capable of possession, ownership may be transferred and the right of ownership may be defended in a court.
- Intangible:
  - An idea may be a CGT asset if it is manifest either in a Trademark, a copyright or an application for patent.
  - Something still in your head is not property (knowledge or know-how). It has to be in the form of copyright, IP or patent.

- If you create a patent or other industrial property over your idea or knowledge, property exists in the patent as it is **transferable and may be the subject of legal action**. If you sell the patent to another person, you have given up the right to use that idea and therefore you have transferred property to a new owner.

Legal and Equitable Rights that are Not Property

- Enforceable contractual obligations
  1. *Specific to individual*
  2. *Not a general right or something that is available to everyone – has to be crystallised, specific to someone.*
  3. *Enforceable*
     - *So we have a right to a safe learning environment, but until someone falls over and hurts themselves, the right is not enforceable*
  - *e.g. judgement and right to receive compensation – specific to you, not transferable, you can sue and recover damage/loss*
- The second limb **(S108-5 (1)(b))** of the definition of a CGT asset includes legal and equitable rights that are not property. This would include non-proprietary rights.
- For example, right to compensation for a cancelled contract for work, or the terms of an employment contract.

***Hepples v FCT* (1991)**

- In *Hepples v FCT* (1991) the taxpayer was paid $40,000 on his retirement for agreeing not to disclose the secrets of his employer → receipt was not a substitute for income and was a capital payment for entering the restrictive covenant on termination of employment.
- *He has a receipt for $40,000, a capital gain, created a contractual right in another person being his employer, and then that will be a capital loss for them paying the $40,000.*

  - An asset is real or intangible property
  - Proprietary right – right relating to property
  - **Not** personal rights eg. right to work or trade
  - **Not** civil rights - available to all

<u>Extract from provision:</u>

- **S 108-5(1),** defines a CGT asset in general terms and then s 108-5(2) specifically includes in the definition of a CGT asset:
  a) Part of, or an interest in, an asset referred to in s 108-5(1)
  b) Goodwill or an interest in it
  c) An interest in a partnership asset
  d) An interest in a partnership not covered in (c).
- Inclusion of item (a) resolves a difficulty with the ITAA 36 legislation by making it clear that CGT applies to parts of assets and interests in assets.

Collectables and other personal use assets (if it is <u>NOT</u> property or legal and equitable rights)

- If it is one of these, skip 108-5 and go to their provisions.

<u>108-10: Collectables</u>

1. **An exhaustive list / has to be on the list** – is it on the list in 108-10(2)?
2. Only consider CGT if **acquisition is more than > $500?**

3. **118-10:** if you have a collectable, and it is purchased for less than 500, then this is the operative provision to disregard any CGT consequences.
    a. Conversely, If it is purchased for more than $500, you should still note that it is a collectable under 108-10, and you do consider CGT.
4. ***You can only offset or use a capital loss on a collectable for a gain on another collectable.***
    a. E.g. purchase a collectable for $600, make a capital loss of $400, you can only use that $400 loss to offset a gain on another collectable.

- **S 108.10(2) a *collectable* is:**
    a) Artwork, jewellery, an antique, or a coin or medallion
    b) A rare folio, manuscript or book
    c) A postage stamp or first day cover
    that is used or kept mainly for your personal use or enjoyment.

- **<u>Collectables are only included in calculations for CGT if their PURCHASE value was over $500</u>**
    - The acquisition cost/purchase price.
    - If it is less than $500, we *disregard* it, rather than it being exempt.
- **Subdivision 108-B** defines collectables and enacts the major difference from other CGT assets, in that capital losses realised on collectables can only be used to reduce capital gains from collectables (**s 108-10(1)**).
- Where losses on collectables cannot be utilised in the year of realisation they may be carried forward to reduce future capital gains on collectables only. However, you should note **s 118-10 which exempts from CGT collectables which cost $500 or less.**

<u>Summary for collectables</u>

- Collectables: **s 108-10(2)**
    - Listed and for personal use and enjoyment
    - Event A1 on sale
    - **S 118-10(1):** Cost $500 or less gain/loss disregarded
    - **S 108-10(1):** Losses only available against other gains realised on collectables
    - **S 108-15**: Sets of collectables are a single asset

<u>Personal Use Assets</u>

- This is not a set list! Think of household items – personal use or enjoyment.
- ***Personal use assets*** that are not included in the definition of collectables are covered by **Subdiv 108-C**.
    - These assets are **exempt** from **CGT if they cost $10 000 or less** (**s 118-10(3)**), but any **capital losses** realised are also **disregarded** (**s 108-20(1)**).
        - Include cars (but not really), television, fridge, furniture etc.
        - Note that collectables is exhaustive definition, so start there, then query whether PUA
    - You cannot use a capital loss under this category to offset – they are disregarded

2. CGT EVENT

Really all you're doing at this point is identifying which event it is.

- **S 102-20** states that a **capital gain/loss only occurs if a CGT event happens and s 104-5 sets out the events that need to be considered.**
  - Therefore, you need an event to occur to have CGT consequences.
  - You need to determine which event applies as this may affect how you work out capital gain or loss (and may determine the timing of it).
- **S 102-20**: Only applies if there is a CGT events
  - **Div 104:** Covers all CGT events - **each event describes:**
    - What causes the event
    - When the event occurs
    - Calculation of gain or loss
    - Some specific exemptions
- There are 53 separate events.
- Events are grouped by letter: summary **s 104-5.**
  - EG: C1 - C3 – deals with assets that no longer exist but not sold.

- **We look at only the main CGT events: A1, C1, C2, D1, F1, H2.**
  - A1 – disposal of a CGT asset
  - C1 – loss or destruction of a CGT asset
  - C2 – cancellation, surrender and similar endings
  - D1 – creating contractual or other rights
  - F1 – granting a lease
  - H2 – receipt for event relating to CGT asset
- Event A1 is the most general: **s 104-10** – we use this to teach the principles.

To resolve any conflicts that may arise in determining which CGT event is to be applied, **s. 102-25** describes the steps necessary to make this determination.

- **As a general rule the most specific event is to be used but there are some exceptions.** The steps for selecting the applicable CGT event can be summarised as follows.

1. Select which of the CGT events apply (ignore D1 and H2—these are left to last).
2. If more than one event applies select the most specific.
3. If no previously considered CGT event applies consider if D1 applies.
4. If D1 does not apply consider if H2 applies.
5. If none of the above apply there is no CGT.

- **So now you have picked your event (1), you need to then identify your CGT asset (2).**

- The most important and broadest CGT event is event A1.
  - Event A1 raises some terms that are important to the operation of CGT.
- Pursuant to **s 104.10 ITAA 1997** *CGT event A1 happens if you **dispose** of a **CGT asset**.*
- We therefore need to address the meaning of **disposal** and **CGT asset**.
- The definition of CGT asset is critical - the CGT events are based on circumstances affecting these assets.

3. TIMING OF THE EVENT

***Disposal:* 104-10**

- As we said, CGT event A1 occurs on the *disposal* of a *CGT asset.*
  - We have discussed *CGT asset* (property) and we now look to disposal of that asset.
- Using CGT Event A1 as an example, 'disposal' of a CGT asset would generally occur when **ownership of an asset passes from one owner to another**.
  - This can occur because of some act or because of the operation of law.

- For example, for CGT Event A1 (**see s 104.10(3)**), the timing of the event is when:
  a) You enter into the contract for the disposal; or
  b) If there is no contract – when the change of ownership occurs.

- The time of disposal occurs as prescribed by the Act.
  - For **property/land**, there will always be a contract – and REMEMBER it is the **earlier date** that disposal occurs, **note settlement.**
- Note that for event A1, a 'disposal' will not occur where you stop being the legal owner, but continue to be the beneficial owner of the asset.
  - Goes to the point that, if you own something, you generally have legal and beneficial ownership (e.g. of house – title (l) and can live in it (b)) – what if house moves into trust of which you are beneficiary, legal ownership is held by trust, but beneficial ownership is still yours.

***Acquisition:* 109-5**

- You can only dispose of a CGT Asset that you have *acquired.*
  - **S 109.5** provides that in general, you acquire a CGT asset when you become its owner.
- Date of acquisition is the flip of date of disposal – same terms
- **S 109-10** - For an asset that you create (build a building, paint a picture, write a book) the asset is acquired "when the work ... started"

SUMMARY OF STEP 1

1. Identify that there is a CGT asset;
2. Identify that there has been disposal of the asset to trigger a CGT event;
3. Identify the date you had acquired the asset;
4. Identify the date you disposed of the asset.

This information can now be used to work out CGT liability – calculating the capital gain.