GST for new residential properties

***Michael Quinn* explains the latest ruling on GST regarding renting out new residential premises that were originally intended to be sold**

It is commonly known that if you are registered for GST, or required to be, you are expected to pay this on any taxable supplies that you make.

Perhaps what is not so widely known – or understood – is that if you build a new residential property through a GST-registered entity, with the intention of selling it on completion, it is considered to be built for a creditable purpose. Thus, as the asset(s) were acquired for a creditable purpose, you are generally entitled to claim GST credits for their acquisition

In simple terms, this means that if you have paid GST for 'things' such as supplies or labour in order to build the new residential premises that you intend to sell on completion, you are entitled to claim GST credits for the amount of GST that had been paid previously.

With the current uncertainty in the financial climate, this has become a lot more common in recent times, and people who built a property with the intention of selling it have changed their minds and decided not to – opting to rent it out instead.

When you decide to rent rather than sell

A change in the original intention for the property also results in a change of the creditable purpose. As mentioned earlier, selling a property is considered a creditable purpose, whereas renting it is input-taxed.

So, if you have built a property and claimed GST credits, but then decide to rent it out, you will more than likely be required to make an adjustment to the amount of GST credits claimed – which is known as an increasing adjustment. However, if you then again decide to sell the property after renting it for a period, you are entitled to make a decreasing adjustment.

Under the GST Act *(A New Tax System (Goods and Services Tax) Act 1999)* there are two particular Divisions that relate to the construction of a residential property, namely determining the tax credits you are entitled to when you acquire a 'thing' (Division 11 of the 'GST Act') and determining the required adjustment in relation to the change in the use of that 'thing' (Division 129 of the 'GST Act').

As with all tax-related issues, there is a range of 'ifs and buts' that exist within the application of the legislation, which is why it's so important that you consult a tax professional to ensure you are both legally compliant and that you also get the maximum return due to you.

These details include whether the construction of a house or other residential premises is paid for in progressive payments, in which case each payment can constitute the acquisition of a separate 'thing' for the purposes of Division 129, but not for Division 11. But if you account for GST on a cash basis, the acquisition in relation to progressive payments does not apply.

Additionally, if a builder constructs a property on land that is owned by them, each individual acquisition is considered a 'thing'. For example, the bricks, or the services of the painter or the electrician are all separate acquisitions. Another point to note for builders constructing on their own land is that if the premises are built with the intention of renting and then selling, they must consider both the creditable and non-creditable purposes in relation to the acquisitions made to construct the premises and, as a result, apportion the tax credits under Division 11.

The two primary Divisions (11 and 129) that we are looking at here deal with the consideration of the *actual* use and *intended* use of an acquisition. For Division 11 – that is, determining tax-credit entitlements – the taxpayer must estimate the intended use of the acquisition. And, for Division 129 – in assessing whether there is a necessary adjustment in relation to the change of use – the taxpayer needs to look back and report how the property was *actually* used, as opposed to its *intended* use.

Any necessary adjustments are usually reported on the June activity statement for each tax period. But it is important to note that the first adjustment period must be a tax period that ends on 30 June and starts at least 12 months after the end of the tax period in which the 'thing' was acquired. For example, if the first progressive payment for construction of a residential premises is received in September 2005, the tax period pertaining to that acquisition ends on 30 June 2006 – so the first adjustment period for which any adjustment can be made, or for which tax credits can be claimed, will be the tax period that ends 30 June 2007.

> If you built a property and claimed GST credits, but decided to rent it out, you are likely to be required to make an adjustment to the amount claimed…

Calculating adjustments when progressive payments are made

There are five aspects to be considered when calculating the necessary adjustment for a single tax period.

Step 1: Calculate the extent to which the acquisition was *applied* for a creditable purpose from the time of acquisition until the conclusion of the adjustment period.

This is considered the *actual* application of the 'thing'.

Step 2: If you have not previously made an adjustment for the acquisition, calculate the extent to which the 'thing' was *acquired* for a creditable purpose. If there was a previous adjustment for this acquisition, calculate the extent of the *actual* application of the acquisition in relation to the previous adjustment.

This is the *intended* or *former* application of the 'thing'.

Step 3: Consider the value of the extent of actual application in relation to the extent of intended or former application. If the extent of the actual application is *less than* the intended application, you will have an increasing adjustment.

Step 4: If the extent of the actual application is found to be *more than* the intended application, you have a decreasing adjustment.

Step 5: If the extent of the actual application is found to be *equal to* the intended application, no adjustment is necessary in relation to the acquisition for the adjustment period.

The extent of both the actual and intended application of a 'thing' for a creditable purpose is represented as a percentage.

Example in context

Sarah and Jack build a residential premise through their GST-registered business with the intention to sell it. The relevant milestones relating to the acquisition of the assets are as follows:

September 2005	Sarah and Jack purchase a block of land for $330,000 (incl. GST)
November 2005	Sarah and Jack enter a contract with a builder for the construction of a home on the newly acquired land
January 2006	A progress payment of $66,000 is made to the builder
July 2007	A further progress payment of $88,000 is made to the builder
November 2007	A final payment of $88,000 is made to the builder and construction is complete
December 2007	A change in circumstances sees Sarah and Jack decide to rent the property as opposed to selling them
December 2007	The property is rented to a tenant
January 2009	The property is sold for $660,000

From December 2007 until January 2009 Sarah and Jack received $33,000 in rental income.

In order to demonstrate how to calculate tax credit adjustments, let's use the first progress payment as an example.

The formula used to calculate the increasing adjustment is:

Increasing adjustment = full input tax credit x (intended application – actual application)

As the progress payment of $66,000 contained GST, Sarah and Jack had claimed $6,000 as an input tax credit.

Using the five steps above to determine the extent of *intended* and *actual* application, we can conclude that the *actual* application of the acquisition for a creditable purpose for the adjustment period ending 30 June 2007 was nil, as the sale did not take place. The *intended* application for the adjustment period is 100% as, at the time of this acquisition, Jack and Sarah still fully intended to sell the property.

As a result, Jack and Sarah are liable for an increasing adjustment of $6,000 ($6,000 x (100% - 0%)) for this transaction, meaning they must essentially 'pay back' those GST credits previously claimed. In looking at the bigger picture, this won't be their total adjustment for this period as the land purchase and second progress payment also fall in this adjustment period.

When there is a change in the application of the acquisition for a creditable purpose, the same process is used to determine the necessary adjustment for all payments where GST credits were previously claimed.

Once Sarah and Jack decide to sell the property, they are then able to make a decreasing adjustment for GST credits.

Using the same five steps, we determine the extent of the *actual* and *former (or intended)* application of the acquisition over the period since construction was completed.

For step one, the extent to which the acquisition has been applied for a creditable purpose during the period is calculated using the formula:

Consideration for taxable supply of the premises divided by consideration for taxable supply of the premises plus consideration for the letting

This formula is used as it is impractical to try and base the extent percentage on a time ratio, as a sale (the taxable supply) happens instantaneously instead.

So, Sarah and Jack's application of the acquisition for a creditable purpose from December 2007 until January 2009 is 95.24% ($660,000 / ($660,000 + $33,000))

For step two, as there were previous adjustments applied to the acquisition, the application of the 'thing' for a creditable purpose (or the former application) in respect of the last adjustment is nil as, like in the last adjustment, the premises were rented – no application for a creditable purpose.

As the *actual* application is more than the *former* application, Sarah and Jack are eligible for a decreasing adjustment.

Decreasing adjustment = full input tax credit x (actual application - former application)

Using the first progress payment, we can determine that Sarah and Jack are able to claim an adjustment of $5,714.40 for this acquisition.

For the adjustment period ending 30 June, 2010, Sarah and Jack must calculate the decreasing adjustment amount for each acquisition and make the according adjustments on the June activity statement.

The above example is applied very generally to provide you with an overview of how increasing and decreasing adjustments need to be applied. There are numerous variables that make each situation different. It is for this reason that it is important that you seek the advice of a qualified taxation and/or accounting expert, not only to ensure that you are getting the maximum tax benefits due to you, but also that you are conducting your business operations in a legally compliant manner. ■

Michael Quinn, director of The Quinn Group (www.quinns.com.au), is an experienced lawyer, accountant and educator. As an integrated professional services firm, The Quinn Group provides the total solution. Clients have access to a range of services that include: accounting and taxation advice, legal counsel, as well as financial and investment planning.

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Glossary

The definitions in the following glossary do not cover all terms used in this publication. You will, however, come across most of them at some stage while reading through a contract of sale for a property, a letter of offer for a loan, or the mortgage documents from the lender's solicitor. If you are unclear on any term, seek a satisfactory explanation from the relevant experts or authorities

Acquisition cost – Cost of acquiring an asset, including stamp duty payable and any other expenses incurred by the purchaser.
All-in-one loan – Allows you to deposit all of your income into the loan account and then withdraw money from that account for day-to-day transactions. The longer that spare funds stay in the account, the greater the interest savings.
Amortisation period – The period of time over which a loan is calculated (and repaid).
Appreciation – An increase in the value of a property due to changes in market conditions or other causes.
Assessed value – The valuation placed on a property for the purposes of taxation by an authority.
Asset – Anything of monetary value that is owned by a person, eg: personal property, real property, bank accounts.
Average Annualised Percentage Rate (AAPR) – Sometimes referred to as the Compulsory Comparison Rate, this figure takes into account the other costs associated with the loan, and expresses them as an average interest rate to create a level field with which to compare similar loan product interest rates.
Basic variable – A variable home loan at a reduced rate with fewer features than a standard variable.
Body corporate – An administrative body made up of all the owners within a group of units or apartments of a strata building. The owners elect a committee which handles administration and upkeep of the site.
Break costs – Incurred when a loan is paid off before the end of its term.
Bridging finance – Enables you to cover the purchase of a new property when you are yet to sell your existing property.
Buyer's agent – Person who acts on behalf of a buyer in finding and negotiating on properties the buyer wishes to purchase.
Buyer's market – When the demand for property is less than supply; the advantages shift to the buyer.
Capital expenditure – The cost of an improvement made to extend the useful life of a property or to add to its value.
Capital gain – The gain on the sale of a capital asset.
Capital improvement – Any structure or addition to a property erected as a permanent improvement that adds to its value and useful life.
Capped loan – A loan where the interest rate is not allowed to exceed a set level for a period of time, but is allowed to drop.
Cash flow – A measure of cash inflow and outflow from a business. Positive cash flow means more money is coming into the business than is leaving it. Negative cash flow is the converse.
Collateral – An asset (such as a car or a home) that guarantees the repayment of a loan. The borrower risks losing the asset if the loan is not repaid according to the terms of the loan contract.
Commercial property – Property intended for use by all types of retail and wholesale stores, office buildings, hotels and service establishments.
Common property – Land, amenities or areas of a building within a strata title property that are shared by all owners, eg: a driveway.
Contract of sale – An agreement in writing setting out the terms and conditions relating to the sale or purchase of a property. It is the purchase document signed at auction.
Conveyancing – The legal process for transferring ownership of real estate.
Default – Failure to meet debt payment on a due date.
Deferred establishment fee – Is charged when you pay out your loan within a short period of taking it out, such as three years.
Deposit bond – Guarantees that the purchaser of a property will pay the full deposit by the due date.
Depreciation – A decline in the value of a property due to changes in market conditions or other causes.
Disbursements – Solicitor's incidental costs involved when dealing with a client on behalf of the lender, eg searches, certificates, pest reports, etc.
Dual occupancy – A block of land which is zoned so that two distinct dwellings are permitted to be constructed.
Easement – A right, such as a right of way, afforded a person to make limited use of another's real property.
Equity – The amount of an asset actually owned. Equity is the difference between the market value of the property and the amount still owed on its mortgage.
Gearing – Total borrowings divided by total tangible assets.
Fixed rate mortgage – A mortgage in which the interest rate does not change during the term of the loan.
Freehold – An estate in real property which continues for an indefinite period of time. Freehold estates may be inheritable or non-inheritable.
Interest-only loans – A loan where the principal is paid back at the end of the term and only interest is paid during the term. These loans are usually for a short period of time, typically one to five years.
Internal rate of return (IRR) – The total rate of return generated by an investment over its life or a given time scale, taking into account sale and purchase prices and all cash flows associated with the holding.
Introductory loan – A loan offered at a reduced rate for an introductory period (usually no longer than 15 months and often called the 'honeymoon period') to new borrowers.
Investment property – A property that is not occupied by the owner but leased to produce income.
Joint tenancy – A form of co-ownership that gives each tenant equal shares and rights in the property, including the right of survivorship.
Lenders mortgage insurance (LMI) – This is insurance taken out by the lender – but paid for by the borrower – to cover themselves if the borrower defaults on the loan and property sale proceeds do not cover the outstanding amount.
Liquid asset – An asset, cash or otherwise, that can be converted into cash.
Loan application fee – Also called the establishment fee. This is a fee paid to a lender for processing a loan.
Loan to value ratio (LVR) – The ratio of the amount lent to the value of the property.
Low-doc loan – A loan where limited documents are needed to prove an applicant's income.
Market rent – The rental that would apply to a property if space were offered on the open market.
Market value – The price at which a seller is happy to sell and a buyer is willing to buy. This assumes that there is sufficient activity in the marketplace to generate enough buyers and sellers so that neither party controls the price. Establishing the market value is the objective of an appraisal.
Mortgage protection insurance – Different from lenders mortgage insurance, this covers borrowers' loan repayments in the event that they are not able to meet them, eg through illness or redundancy.
Negative gearing – Where the return on an investment is not sufficient to cover the costs on the investment, eg property maintenance and interest on the loan.
Net income – Income after taxes are deducted.
Net worth – The value of a person's assets minus liabilities.
Offset account – A savings account linked to your mortgage in such a way that the interest earned on your savings is applied to reduce the interest payable on your mortgage.
Off the plan – To purchase a property before it is completed, having only seen the plans.
Portability – Where a new property can be used as security for an existing loan, ie: when the loan is transferred to a new security property without needing to repay the loan, reapply or restructure.
Principal – The capital sum borrowed on which interest is paid during the term of the loan.
Principal & interest loan (P&I) – A loan in which both the principal and the interest are paid during the term of the loan.
Private treaty sale – A property sale where the buyer negotiates directly with the seller, as opposed to an auction sale.
Redraw – Borrower is able to draw on pre-paid funds, over and above minimum repayments.
Refinance – The process of paying off one loan with the proceeds from a new loan using the same property as security.
REIA – Real Estate Institute of Australia. National representative body of real estate agents.
Restrictive covenant – A legal obligation in a deed by the seller upon the buyer of real estate to do or not do something.
Seller's market – When demand for property is greater than supply. The result is greater opportunities for owners who may find purchasers willing to offer the asking price or even a figure greater than the asking price.
Semi-detached – Also called a duplex. A type of construction where two buildings are attached together by a common wall.
Stamp duty – A state tax on conveyance or transfer of real property calculated on the total value of the property (including chattels). This calculation varies from state to state.
Standard variable – A variable rate home loan with comprehensive features. This is often the variable rate that fixed rate loans roll to at the end of the fixed term.
Strata title – A title to a unit or lot on a plan of subdivision associated with townhouses, units and blocks of flats and based on the horizontal and vertical subdivision of air space. Owners have a certificate of title, are absolute owners of a freehold unit or townhouse, and have an undivided share of the common property.
Subdivision – A tract of land divided into individual lots for a housing development.
Title deed – Registration showing the ownership of property.
Valuation – A written analysis of the estimated value of a property prepared by a qualified valuer.
Vendor – The seller.
Yield – The interest earned by or returned to an investor from an investment, stated as a percentage of the amount invested.
Zoning – Local authority guidelines for the permitted use of land.