30 April 2021

Law Council
OF AUSTRALIA

Mr Bede Fraser
Assistant Secretary
Personal and Small Business Tax Branch
Individuals and Indirect Taxation Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: grannyflats@treasury.gov.au

Dear Mr Fraser

Supporting older Australians - exempting granny flat arrangements from Capital Gains Tax (CGT)

The Law Council of Australia (**Law Council**) is grateful for the opportunity to provide a submission to the Department of Treasury (**Treasury**)'s consultation on the exposure draft of the Treasury Laws Amendment (Measures for Consultation) Bill 2021: Exempting granny flat arrangements from CGT (**the Bill**), and its explanatory materials.

The Bill amends the CGT provisions in the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**) to provide a targeted CGT exemption in relation to granny flat arrangements (**GFAs**).

Against the backdrop of Australia's ageing population, and the focus on the inadequacies of aged care as highlighted by the Royal Commission into Aged Care Quality and Safety and the COVID-19 pandemic, GFAs are becoming increasingly common.

The Law Council therefore welcomes the measure proposed by the Bill 'to encourage the formalisation of granny flat arrangements to support the stable and long-term housing arrangements of older people and people with disabilities, and to reduce the risk of financial abuse or exploitation.'[1]

1. Overview of the Bill

The Bill proposes that a CGT event does not happen when certain GFAs are entered into, varied or terminated. There are three core operative provisions.

(a) **Clause 137-15:** A CGT event does not happen if an arrangement is entered into that creates a granny flat interest, if certain requirements are met. These requirements include that the individual having the granny flat interest has reached pension age or has a disability, and that the arrangement is in writing; indicates an intention for the parties to the arrangement to be legally bound by it; and the arrangement is not of a commercial nature.

[1] Explanatory materials, 1.15.

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(b) **Clause 137 – 20:** Similarly, a CGT event does not happen if an arrangement is varied to create or vary a granny flat interest if similar requirements are satisfied.

(c) **Clause 137-25:** A CGT event does not happen on the termination of an arrangement if a CGT event did not happen on the entering into or varying of the arrangement because clauses 137-15 or 137-20 applied.

Other transactions that may be associated with the granny flat interest, but do not relate to its creation, variation or termination, will continue to be subject to the CGT.

Members of the Law Council's specialist National Elder Law and Succession Law Committee, as well as the Taxation Committee of the Law Council's Business Law Section, provide the following additional comments on the Bill for consideration.

2. Meaning of Key Terms

Right to Occupy

Subclause 137-10(1) of the Bill provides that an individual holds a granny flat interest in a dwelling under an arrangement if the individual has a right to occupy the dwelling for life that has been conferred by the arrangement.

The Law Council is concerned that the term 'right to occupy' may not be the best concept to use. While a personal right is the most common type of GFA, it is not the only type. Some GFAs provide the older person with a proprietary interest in the real estate. There was a GFA of this type in *Manning v Matsen*[2], ie, a life tenancy. That type of GFA will not attract the exemption. This means that a personal right of residence may be too restrictive.

On this basis, because the exemption should apply whether the GFA establishes a proprietary or personal right to accommodation, it may be appropriate to use the terminology, a 'legal or equitable interest in the dwelling, flat or home unit or a licence or right to occupy the dwelling, flat or home unit'. This broader definition is aimed at picking up the definition of an 'ownership interest' in section 118-130 of the ITAA97 in the context of the main residence exemption for capital gains tax purposes in Subdivision 118-B of the ITAA97.

Arrangement

Example 1.1 of the explanatory materials for the exposure draft provides:

> Example 1.1
>
> Edith is an 80 year old widow. Living by herself in the family home is too much for her to manage. She intends to sell the home and move in with her daughter Christine and her family. Christine's house is not big enough for Edith to live in comfortably and it is decided that Edith will contribute to the costs of building a self-contained flat on the property. Edith and Christine enter into a written agreement under which Edith contributes $200,000 towards building the flat on Christine's property and acquires a right to live in the flat for life. The agreement also provides that it will terminate should Edith permanently vacate the unit in order to move into a residential care facility.

[2] [2015] NSWSC 1801.

> *Under the exemption, the CGT event D1 that would otherwise have arisen from the creation of Edith's contractual right to live on Christine's property, will not happen. In addition, should Christine sell the property, the existence of the agreement, and Edith's separate use of the flat,* ***would not affect Christine's or Edith's ability to claim the main residence exemption****.* [Emphasis added.]

The conclusion in the italicised paragraph of the explanatory materials is not entirely clear at law. In Taxation Determination TD 1999/69 the ATO indicates that in a granny flat situation, where both the main house and the granny flat are used in an integrated fashion, the CGT main residence exemption applies on the sale of the whole property. However, where the granny flat and the main house are used separately, then they are each 'dwellings' for the main residence exemption and it is not a given that the CGT main residence exemption will apply to a sale of the whole property which may remain owned by the adult child. This issue is illustrated further in **Appendix A**.

Given the primacy of the family home in Australian cultural life, it would be helpful to have express wording in the legislation to ensure that the main residence exemption is not affected. This would encourage the take-up of legally binding GFAs.

3. Eligibility criteria

Subclause 137-10(2) of the Bill provides that an individual is eligible for a relevant granny flat interest if the individual has reached pension age (which is generally 67 years), or has a significant disability requiring assistance for most day-to-day activities for at least 12 months.

The Law Council is concerned that this criterion is overly restrictive. It is not apparent why these limits are imposed other than the stated aim of preventing someone with short-term injuries accessing the exemption.[3] The Law Council queries why the exemption does not apply, for example, to an able 65 year-old who moves in with their family. The Law Council suggests that retirement be allowed as another eligibility criteria.

4. Targeted exemption

The Bill provides that a GFA cannot be a commercial arrangement to qualify for the CGT exemption.[4] The Law Council seeks clarity on what is meant by 'commercial'. The explanatory materials suggest that this means the 'granny' cannot pay rent but can reimburse expenses.[5] However, it is not apparent why a rent at less than market rate is not acceptable. The Law Council suggests that further consideration could be given to situations in which the 'granny' pays a nominal rent and would not constitute a commercial arrangement.

For clarity, the Law Council further suggests that more examples and guidance be included in the legislation and explanatory materials on the commercial requirement. In this regard, it notes that section 100A of the *Income Tax Assessment Act 1936* (Cth) has an 'ordinary family or commercial dealing' exception which has been problematic.

[3] Explanatory materials, 1.31.
[4] Subclause 137-15(e).
[5] Explanatory materials, 1.41 – 1.42.

In the above context, the Law Council notes that in structuring a GFA many lawyers try to include safeguards in the arrangement in case the GFA terminates unexpectedly. This is because many GFAs involve a situation where an elderly person contributes their life savings into the arrangement in return for this promise of a right to occupy and care for life. Some safeguards may include commercial elements such as the child being required to refund an amount to the elderly parent if the arrangement ends prematurely, or a reduction in the child's inheritance as compared to their other siblings because the GFA results in an improvement of the child's home. The payment of an amount for care services and rent, which could be based on commercial rates, but is generally wrapped up in a broader arrangement, whereby overall it can be seen as a family arrangement rather than a commercial care home. The intention of these safeguards is to ensure that there is some continuing incentive for an adult child to look after their parent, after the parent has contributed their savings into the GFA.

5. Termination

The right to occupy must be created 'for life'.[6] Traditionally, a life interest may be determined before death and upon the occurrence of some other event.[7] An example is a right given to a person during widowhood, which terminates on remarriage.[8] A life interest may be conferred for a term of years.[9]

The explanatory materials suggest that the CGT exemption applies if the GFA provides that it will terminate when the 'granny' moves to a residential care facility.[10] However, it appears not to allow a GFA to end in other circumstances, such as those recognised as leading to a breakdown of the arrangement,[11] being:

- a relationship breakdown,
- the death of the adult child, and
- the bankruptcy of the child.

Other circumstances where the GFA may end, and where the exemption should not be lost, include the child losing mental or functional capacity, the older person deciding to move elsewhere (to live independently or with another family member), or there being a breach of the GFA by either the child or the older person'.[12]

The Law Council suggests that the Bill should clearly state that the exemption is not lost in any of these circumstances, and that the GFA can specifically provide for termination in these events and still constitute a right conferred 'for life'.

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[6] Subclause 137-10(1).
[7] *Pead v Pead* [1912] HCA 77; (1912) 15 CLR 510, 515.
[8] *Wiegele v Thomson as Executrix for Walter George Thomson* [2019] WASC 12.
[9] *Hatzantonis v Lawrence, Cox* [2003] NSWSC 914.
[10] Explanatory materials, 1.43, example 1.
[11] Explanatory materials, 1.7.
[12] In *Stoklasa v Stoklasa* [2004] NSWSC 518 it was decided that a one-off request for sexual favours was reprehensible but didn't justify the owner terminating the GFA. With the benefit of that decision, it is not uncommon for a GFA to include clauses which allow for early termination for specified breaches, such as the reprehensible conduct of a party.

The Law Council hopes that the above comments are useful. Please contact Ms Sarah Swan, Policy Lawyer on (02) 6246 3703, or at sarah.swan@lawcouncil.asn.au in the first instance if you would like to discuss this submission further.

Yours sincerely

Michael Tidball
Chief Executive Officer

Appendix A

Contrast example 1 and example 2 extracted from Taxation Determination TD 1999/69 below:

> *Example 1*
>
> *[6] Mr and Mrs Brown reside with their three children in a suburban house. Mrs Brown's mother (Dora) resides in a detached granny flat built for her in the backyard. Although the flat is fully self-contained, and Dora eats and sleeps there, Dora's daily life and activities are closely integrated with those of the Browns. She spends considerable time in the main house and family members regularly spend time in Dora's flat. In the circumstances, having regard to the proximity of the flat and the integration of activities, the house and the flat are the Browns' dwelling for the purposes of section 118–115.*
>
> *Example 2*
>
> *[7] Mary decides to build a duplex. Mary lives in one unit and her 30 year old daughter, Elizabeth, lives in the other. There is a connecting door from one unit to the other via the garages with Mary and Elizabeth having unrestricted access to each other's unit. They generally use the main entrance to each other's unit. Mary and Elizabeth have dinner together usually once a week. Mary maintains the whole of the surrounding garden. All other costs of maintenance and other costs of the duplex are paid separately.*
>
> *[8] Each unit is a separate 'dwelling' in terms of section 118–115 because Mary and Elizabeth use each unit as a separate place of residence.*'

In the first example, if Mr and Mrs Brown sold their house (including the granny flat) they should be able to claim the benefit of the main residence exemption on the whole property. By contrast, in the second example, if Mary sold the whole of the land on which the duplex stands (and which she owns assuming Elizabeth only has a right to occupy), Mary should be able to claim the main residence exemption on her unit. The unit used by Elizabeth may not necessarily be covered by the main residence exemption because Mary did not use it as her main residence.

For the purposes of discussion, assume Elizabeth has a disability and her right to occupy the unit is the granny flat interest covered by the proposed CGT concession.

In the Mary and Elizabeth example, if the property were sold there are two possible ways to structure its sale:

(a) the sales contract is between both Mary and Elizabeth and the third party buyer (the first, unlikely, scenario); or

(b) the sales contract is between Mary and the buyer, with Mary having a side agreement with Elizabeth that she will pay Elizabeth an amount to cancel her right to occupy her unit at completion of the sale of the property to the third party buyer (the second, likely, scenario).

In the first scenario, where the third party buyer contracts with both Mary and Elizabeth the CGT main residence exemption should apply to any capital gain made on the sale of the wider duplex property and the sale of the right to occupy. The proposed new exemption for termination of a GFA under proposed section 137-25 may also apply to exempt any capital gain made on the right to occupy.

The CGT consequences of the second and more likely scenario are not so clear, and clarification in law would be appreciated. Arguably in substance there should be a tax free result same as the first scenario but the tax reasoning to reach this position is not clear. In the second scenario Elizabeth will be exempt from CGT on the ending of her right to occupy under proposed section 137-25 or even perhaps the CGT main residence exemption.

The amount paid by Mary to end the right to occupy, should be able to be included in the adult child's cost base in their wider interest in the property under the fourth element of cost base in section 110-25(5) of the *Income Tax Assessment Act 1997* (Cth) as a capital expenditure to increase or preserve the value of the relevant CGT asset. In private rulings the Commissioner accepted that a payment to end a right to occupy formed part of this fourth element.[1]

The increase in cost base effectively reduces Mary's capital gain made on the sale of the wider duplex property. The issue then is whether the whole of the capital gain made by Mary is covered by the main residence exemption. Numerically, if Mary's original cost base in the property is $500,000 and the price paid by Mary to end the right to occupy is $200,000, Mary's cost base in their interests in the property should be $700,000 (ie, $200,000 + $500,000).

Say the property is then sold for $1,000,000. The issue is whether the whole of the $300,000 capital gain is covered by the main residence exemption, or whether there is still a portion relating to the right to occupy that is taxable because Mary did not use Elizabeth's unit (ie, the granny flat) as her main residence. Rather, Elizabeth used that unit solely as her main residence. Arguably, the better view is the entire $300,000 should be exempt since it is related to Mary's original wider interest in the property, which Mary used as her main residence. However, the issue is not very clear under the tax law and conservatively under the current tax law. Mary may want to seek a private ruling from the Commissioner on the application of the main residence exemption.

Clarification of the application of the main residence in scenario two would be beneficial as part of the proposed granny flat reforms under the Bill. Arguably, since scenario one and two are in substance the same transaction, the same tax free result should apply.

[1] See PBRs 1051433138903 and 1051430110536.