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The Australian capital gains tax main residence exemption: firm foundations or flaky footings?

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Abstract

Professor John Taylor noted that much of the complexity in the Australian regime for the taxation of capital gains derived from the design of the main residence exemption. Building on this work, this article explores both the policy underlying this most generous concession and the legislative provisions introduced to give effect to that policy. It argues that the underlying policy has failed to provide an appropriate set of foundations for such a major concession, owing more to political pragmatism than to any notions of equity, efficiency or simplicity. These poor foundations have, in turn, meant that the legislative provisions suffer from uncertainty and ambivalence and often do not operate in an effective fashion or as intended. The article considers both policy issues and technical improvements which may lead to improved outcomes in the interpretation and operation of the exemption from capital gains arising on the disposal of the family home.

Keywords: capital gains tax; main residence exemption; family home; complexity

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1. INTRODUCTION

Professor John Taylor researched and published extensively on Australian capital gains tax (CGT) issues.[1] His work in the area embraced both the policy and the technical aspects of CGT. Of particular concern was his perception that the Australian CGT regime was 'one of the more complex elements in a very complex tax system'.[2] Much of that complexity, in Taylor's view, was explicable by certain design features in the Australian CGT regime, and the main residence exemption (MRE) was cited by him as one such feature.[3] If complexity is measured by reference to the length of legislative provisions, the MRE must rank highly. More pages of the *Income Tax Assessment Act 1997* (ITAA 1997) are contained in Subdivision 118-B (the subdivision devoted to this exemption) than to any other subdivision of Part 3-1 of the ITAA 1997, where the core provisions of the CGT regime are contained.[4]

This article seeks to build on John Taylor's work by undertaking an exploration of the MRE. It does so by considering both the policy rationale and the legislative provisions of the exemption, using a comparative international lens where appropriate. A key motivation is to affirm his concerns that the underlying policy is unclear and uncertain, that the existing provisions relating to this exemption are more complex than they need to be, and that the lack of solid foundations causes problems in the interpretation and operation of the exemption in all but the simplest of cases.

An exemption for the home is highly significant for the operation of the CGT regime, and directly impacts a considerable number of individual taxpayers and tax revenue. Treasury estimates in January 2024 indicate that the revenue forgone in 2023-24 from the existence of the MRE is a total of AUD 47.5 billion, comprising AUD 22.5 billion for the exemption itself and a further AUD 25 billion accounted for by the discount component (the 50 per cent exemption available for certain capital gains) on the main residence exemption.[5] These are significant sums that separately rank only behind the concessional taxation of employer superannuation contributions (revenue forgone of AUD 28.55 billion) and rental deductions (revenue forgone of AUD 27.1 billion) in order of magnitude of tax concessions.

The high cost of the concession in Australia is mirrored in other countries with a similar exemption. The concession in the United Kingdom (UK) – Private Residence Relief (PRR) – is estimated to have cost the UK Exchequer GBP 31.5 billion in the tax year 2023-24.[6] In Canada the tax shelter for the Principal Residence Exemption (PRE) is

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[1] See, for example, C John Taylor, *Capital Gains Tax: Business Assets and Entities* (Law Book Company, 1994); C John Taylor, 'CGT Reform and the Reduction of Tax Law Complexity' (2008) 23(4) *Australian Tax Forum* 427 ('CGT Reform'); Ann Kayis-Kumar and C John Taylor, 'The Application of Capital Gains Tax to Trusts: Conceptual, Technical and Practical Issues, and a Proposal for Reform' (Conference Paper, Australasian Tax Teachers Association Conference, 17 January 2019).

[2] Taylor, 'CGT Reform', above n 1, 427.

[3] Ibid 428. The other features he cited were the exemption for gains from the disposal of pre-CGT assets and the discounts applicable to capital gains accruing to certain taxpayers.

[4] Neil Brydges and Edward Hennebry, 'The CGT Main Residence Exemption: Tips and Traps' (2023) 58(5) *Taxation in Australia* 254.

[5] Australian Treasury, *Tax Expenditures and Insights Statement* (January 2024) 5, Table 1.1, 'Large Tax Expenditures and Deductions by Revenue Forgone 2023-24'.

[6] HM Revenue and Customs, *Non-Structural Tax Relief Statistics (December 2023)* (Updated 17 January 2024) <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs/non-structural-tax-relief-statistics-december-2023> (accessed 12 February 2024).

estimated to cost roughly CAD 10 billion at the Federal level in 2022, and a further amount up to that same amount at the provincial level.[7]

Although currently lower than at any time since the Australian Bureau of Statistics started the data series in 1994, home ownership in Australia remains at relatively high levels. As shown in Table 1, roughly two thirds (66.3 per cent) of Australian households owned their own home in 2019-20 (the latest year for which comparable figures are available), compared to nearly 71 per cent in 1999-2000. Over that period of time, again evident in Table 1, there has been a sizable shift from ownership without a mortgage to ownership with a mortgage.

Table 1: Australian Housing Tenure 1999-2000 to 2019-20

Year	Owner without a mortgage (%)	Owner with a mortgage (%)	Total home ownership (%)
1999-2000	38.6	32.1	70.7
2005-2006	35.3	35.0	70.3
2011-2012	30.9	36.6	67.5
2015-2016	30.4	37.1	67.5
2019-2020	29.5	36.8	66.3

Source: Australian Bureau of Statistics *Survey of Income and Housing* for relevant year, accessed at abs.gov.au, 12 February 2024.

By way of international comparison, the latest available estimate for home ownership in the UK is 63 per cent,[8] while in Canada it is 66.5 per cent,[9] in New Zealand it is 64.5 per cent[10] and the United States (US) it is 65.7 per cent.[11] Home ownership in Australia is thus at very similar levels to home ownership in other comparable countries. And all of these comparable countries – like Australia and others – are also experiencing, over recent decades, similarly problematic and potentially harmful outcomes related to home

[7] Department of Finance Canada, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations* (2022) 36.

[8] Ministry of Housing, Communities and Local Government (UK), 'Home Ownership' (February 2020; Last Updated 8 August 2023) <https://www.ethnicity-facts-figures.service.gov.uk/housing/owning-and-renting/home-ownership/latest/> (accessed 12 February 2024).

[9] Statistics Canada, 'To Buy or to Rent: The Housing Market Continues to be Reshaped by Several Factors as Canadians Search for an Affordable Place to Call Home', *The Daily* (21 September 2022) <https://www150.statcan.gc.ca/n1/daily-quotidien/220921/dq220921b-eng.htm> (accessed 12 February 2024).

[10] Statistics NZ, *Housing in Aotearoa: 2020* (8 December 2020, Updated 2021) 10 <https://www.stats.govt.nz/reports/housing-in-aotearoa-2020> (accessed 12 February 2024).

[11] US Census Bureau, *Quarterly Residential Vacancies and Homeownership, Fourth Quarter 2023* (Release CB24-10, 30 January 2024) <https://www.census.gov/housing/hvs/files/currenthvspress.pdf> (accessed 12 February 2024).

ownership, including rising housing unaffordability and housing wealth inequality,[12] as well as intergenerational inequity.

The fundamental policy underlying the CGT MRE is straightforward. Subdivision 118-B of the ITAA 1997 sets out the rules for the exemption of the whole or part of the capital gain (or capital loss) that otherwise would have been made by an individual taxpayer where a CGT event happens to their ownership interest in the dwelling that has been the taxpayer's main residence. For persons who dispose of a dwelling they did not acquire as a surviving joint tenant or as a legal personal representative (LPR), or beneficiary of a deceased estate, the disregard of capital gains and capital losses under the MRE depends mainly on the extent to which the dwelling was a person's main residence during their period of ownership. In some cases, the disregard is only partial (usually referred to as a partial MRE). The policy implications of the MRE are explored in section 2 below.

The 'foundations' of the MRE may be 'solid' for the most basic of all cases as envisaged in 1985 – a person buys an established home (not land to build); owns (on a family basis) no other houses they have lived or do live in; does not derive any income from the home; and over the period of ownership, does not go and live somewhere else. Even that was probably not typical in 1985; today, it certainly is not with many more cases of multiple dwelling ownership, relocating for work reasons, more home-based work (affected by the Covid pandemic), and financial pressures encouraging Airbnb or similar arrangements. A common modern scenario is some distance from the basic case.

The exemption is subject to the satisfaction of a range of complex conditions. In addition to the rules that apply in the simple 'vanilla' or basic case situation, there are various rules which may limit the exemption and a further array of rules which may extend it. Sometimes these rules interact, and the interaction is unclear. These rules increase the complexity of the law whilst at the same time seeking to protect revenue and increase flexibility and fairness (equity) for taxpayers.

Ironically, many of the limitations designed to restrict the exemption while taxpayers are alive (such as part occupancy, and income producing use at some stage during ownership) drop away on death (with a market value acquisition cost for the LPR or beneficiary) provided the dwelling was the deceased's main residence and was not being used to produce income *just before* that time. This concession, done for compliance cost reasons, can result in undue tax savings contrary to the overall policy of the MRE.[13]

A number of technical issues derive from the applicable conditions of the basic case and the limitations and extensions that may be available, and these are considered in some detail in section 3.

The overwhelming conclusion of the analysis in sections 2 and 3 is that the underlying policy rationale and the legislative provisions enacted to give effect to that policy are not entirely 'fit for purpose', and that the edifice of the MRE may be less stable than should be the case. There are several reasons for this unsatisfactory situation:

[12] Paul Kershaw, 'Policy Forum: Revisiting the Principal Residence Exemption and Public Support for Reducing the Home Ownership Tax Shelter' (2022) 70(4) *Canadian Tax Journal* 827, 841.

[13] This article does not consider further, except occasionally in passing, the operation of the MRE so far as dwellings acquired from deceased estates are concerned. This may be the subject of a future article.

- confused or uncertain policy parameters and choices leading to the adoption of an inappropriate overall complex policy framework to underpin the legislative provisions of the exemption;
- an overemphasis on 'black-letter' and prescriptive drafting, and the desire for revenue protection, dating from the time of the introduction of the CGT provisions in 1986 (with effect from 20 September 1985) in the *Income Tax Assessment Act 1936* (ITAA 1936) and not relieved significantly in the ITAA 1997 provisions;
- the lack of a full appreciation of the relevant exemption scenarios that needed to be covered, and how they should be covered, when CGT was first introduced; and the subsequent 'tacking on' of amendments to existing provisions without consideration of any need to reshape or consolidate the whole; and
- the impact of compliance cost savings measures made to the regime in 1996-97 may not have been fully thought through and interactions with other provisions not made clear. This includes the use of 'precipice' tests (eg, looking at circumstances just before a CGT event) which may not interact well with other provisions and are capable of manipulation.

Because the MRE legislation can 'cope' with simple cases, but not much more, the law leads to high compliance costs for practitioners,[14] with certainty in relation to primary tax only obtainable through private rulings. There is a sparsity of binding Australian Taxation Office (ATO) views, though some matters are dealt with in guides providing at least protection from penalties and interest. In respect of individual private rulings, edited versions from the ATO pitched at a high level of abstraction suggest that it too may be experiencing difficulties arriving at sensible outcomes through a strict application of the provisions themselves.

In some cases there may be opportunities to consider the Commissioner's remedial power, and/or minor technical amendments, to address these issues at some time in the future.

This article focuses on identifying and managing some of the complexity, uncertainty, quirks and flaws in the CGT MRE, and where feasible makes suggestions about how some of the deficiencies might be addressed. It does not seek to deal with all aspects of the exemption. For example, it does not deal with the provisions (and parts of provisions) that now largely deny the main residence exemption for non-residents (excluded non-residents). These are well considered in the literature elsewhere.[15]

2. POLICY CONSIDERATIONS

The tax systems in almost all developed, and most developing, countries include CGT regimes. In 2017, 171 out of 220 countries had a broad, comprehensive CGT regime

[14] Chris Evans, 'The Operating Costs of Taxing Capital Gains: A Conspectus' (2000) 54(7) *Bulletin for International Taxation* 357.

[15] Brydges and Hennebry, above n 4.

applying to individuals and businesses, while a further 16 countries had a CGT regime that applied only to businesses.[16]

Most, though not all, also provide some form of concessional treatment for the family home, although not necessarily in a uniform or consistent manner. A 2017 analysis of eight countries evidenced the range of approaches to the treatment of the family home used by different CGT regimes.[17] Two of the countries (Australia and the UK) completely exempted gains made on the disposal of the family home. In South Africa, the gain was also exempt, but capped at a maximum gain of (roughly) USD 220,000 (following a similar capped approach in the US). In Turkey, by way of contrast, unlimited gains made on the disposal of the family home were exempt, but only if the family home had been held for at least five years prior to disposal. Yet another approach was taken in India, partially modelled on the Scandinavian approach to the CGT treatment of the family home: a rollover (deferral) was available where any capital gain (not just one derived from the disposal of the family home) was reinvested in the family home. Another variation occurred in Indonesia where a potential exemption could apply where the transferor of the property was on a low annual income (roughly USD 3,000) and the value of the property transferred was less than (roughly) USD 5,000. The final two countries (Bangladesh and Pakistan) of the eight that were studied did not have an overt exemption for disposals of the family home, although in Pakistan a zero rate was applied if the property has been held for more than two years, making it conceptually similar to the treatment in Turkey, albeit with different methods and time periods involved.[18]

Notwithstanding the differences in approach, the reasons for providing concessional treatment on the disposal of the family home are relatively clear, and can be summed up in the following quote from the UK's then Financial Secretary to the Treasury Niall MacDermot when CGT was introduced in that jurisdiction in 1965:

> The reasons for our exemption are to encourage home ownership, to avoid any feeling of resentment there might be – and I think that it would be widespread if this was subject to tax – and, also, from a social point of view, to assist greater mobility, which is an important matter from a labour point of view. The effect of it, as I say, is to make home ownership very attractive from the investment point of view.[19]

Despite this clear political statement in support of the exemption for capital gains on the disposal of the family home, there is considerable debate about whether it is appropriate on economic or tax policy grounds to provide such a generous concession.[20] While the

[16] Chris Evans, John Hasseldine, Andy Lymer, Robert Ricketts and Cedric Sandford, *Comparative Taxation: Why Tax Systems Differ* (Fiscal Publications, 2017) 121.

[17] Chris Evans and Richard Krever, 'Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand' (2017) 23(4) *New Zealand Journal of Taxation Law and Policy* 486, 498.

[18] Ibid 498. An historical curiosity is that in former section 26AAA of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936'), which taxed gains on property sold within 12 months of purchase, main residence gains were exempted only in circumstances of change of place of business or employment. Section 26AAA preceded CGT and operated alongside it until 1988.

[19] United Kingdom, *Parliamentary Debates*, House of Commons, 27 May 1965, vol 713, col 997.

[20] See, for example, Natalie Lee, 'Capital Gains Tax Principal Private Residence Relief Reform: An Alternative to the "Mansion Tax"?' [2015] (1) *British Tax Review* 130; Matt Grudnoff, *CGT Main Residence Exemption: Why Removing the Tax Concession for Homes Over $2 million Is Good for the*

exemption for capital gains realised on the disposal of a main residence may be appreciated by existing homeowners, who otherwise would be subject to CGT, the concession is predicated on uncertain, even shaky, foundations so far as both equity and efficiency considerations are concerned.[21] It is also the case that there is no clear policy rationale to be found in the third of the major criteria deemed critical in tax policy analysis – the concept of simplicity. Each of these three criteria – equity, efficiency and simplicity – and their relationship with the exemption, is now considered in more detail.

Removing the charge to CGT arising on the disposal of the family home runs counter to the equity principle on several levels. It very obviously offends the principle of horizontal equity – the notion that individuals with similar income and assets should pay the same amount in taxes. Homeowners obtain an advantage that is not available to those in rented accommodation. Critics also point out that the exemption is of far more value to high income taxpayers than to lower income taxpayers, thus offending the principle of vertical equity. Modelling commissioned by the Australia Institute shows that low-income households (those in the bottom 30 per cent) obtain almost no benefit from this tax break, and that almost 90 per cent of the benefit goes to the top half of income earners, with 55 per cent of the benefit going to the highest income households (those in the top 20 per cent).[22] The greatest benefit afforded by the exemption of gains on the family home is enjoyed by the most wealthy, who typically make the largest gains.[23]

The MRE (and its overseas equivalents) also fall short in relation to notions of intergenerational equity. The rapid growth in house prices in Australia and around the world in the last few decades, attributable, to some extent at least, to the existence of the very generous tax shelter treatment afforded to the family home, not only makes it increasingly difficult for low-income households to gain a step on the housing ladder, it also disproportionately disadvantages younger generations *vis-à-vis* their older peers. Research shows that housing wealth inequality is higher than income inequality and that it tends to grow across generations and over time.[24] For example, evidence from British birth cohorts' data supplemented by the Wealth and Assets Survey in the UK show that home ownership rates have fallen rapidly over time, most markedly amongst younger people in more recent birth cohorts.[25] Perhaps most critically in the Australian context, the growth of house prices well beyond the rate of household income growth is fuelling intergenerational inequality and destroying social mobility.[26]

Solid policy foundations for the exemption of the family home from the charge to CGT cannot therefore be found in arguments about equity. Nor can they be found in

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Budget, the Economy and Fairness (The Australia Institute Policy Brief, January 2016); Kershaw, above n 12.

[21] Chris Evans and Tim Russell, *Australian CGT Handbook 2023-24* (Thomson Reuters, 2023) 269-270.

[22] Grudnoff, above n 20, 5. The modelling was commissioned by the Australia Institute from the National Centre for Social and Economic Modelling (NATSEM) at the University of Canberra.

[23] David Collison, 'Reflections on Capital Gains Tax and Some Comments on the Office of Tax Simplification Capital Gains Tax – Second Report' [2021] (3) *British Tax Review* 253.

[24] Martin Lux and Petr Sunega, 'Housing Wealth Inequality, Intergenerational Transfers and Young Households in the Super-Homeownership System', *International Journal of Housing Policy* (advance online, 15 November 2023).

[25] Jo Blanden, Andrew Eyles and Stephen Machin, 'Intergenerational Home Ownership' (2023) 21(2) *The Journal of Economic Inequality* 251.

[26] Per Capita, *Housing Affordability in Australia: Tackling a Wicked Problem* (Report by Per Capita for V&F Housing Enterprise Foundation, May 2022).

efficiency arguments. It is argued that it has biased investment away from productive commercial and industrial activities and into owner-occupied housing, leading in many cases to over-investment in houses relative to the occupants' real needs.[27] The exemption encourages over-capitalisation in main residences since any increase in their value is tax free.[28] As a result, commercial enterprises have had less investment capital available to them[29] and have had to rely on more expensive debt financing and overseas financing, which has greatly exacerbated foreign debt problems. Moreover, over-investment in housing, with consequent increases in house prices, has meant that homes have become unaffordable for all but the very wealthy or very fortunate younger members of society.

As has already been noted, the MRE also adds significantly to the complexity of the Australian CGT regime, a feature which is also common to those other jurisdictions that exempt the family home. This was a fundamental point made by Taylor who considered, in the context of the Australian CGT, that the removal of this exemption, along with the removal of the 50 per cent CGT discount and the exemption for assets acquired before the introduction of CGT in 1985, would go a long way to reducing the inherent complexity of the regime.[30] Collison reinforces the point when he notes that 'every relief granted in taxation is an abandonment of the taxing principle. True simplification would follow the taxation of all capital gains equally. Every relief has a border and every border creates problems, as well as interesting work for the tax practitioner'.[31]

However, notwithstanding these equity, efficiency and simplicity arguments against the family home exemption, it is highly unlikely that any mainstream politician or political party would suggest that the exemption should be removed, whether in Australia or any other country with the exemption. The dream of owner-occupied housing represents a national aspiration in Australia, as elsewhere, and support for owner-occupied housing holds a high priority for leaders of all political parties. Therefore, it is unlikely to be removed. As noted by Lee in the UK context, 'the total abolition of principal residence relief would be … unacceptable to the public'.[32] And the point is well made by Kershaw that fixing the problem many years after such an exemption has been introduced and operating by eliminating the exemption is fraught with challenges, not the least of which would be the need to act retroactively in order to obviate the horizontal inequities that would ensue if the removal of the concession were to take place only on a prospective basis.[33]

There may, however, be stronger arguments in favour of adapting or curtailing the concession. This could be done in any one of a number of ways. One possibility lies in 'capping' the amount of the gain that is exempt (as in the US and South African provisions). The difficulty with this suggestion is that there are very significant differences in the value of homes in a country such as Australia, where Sydney and

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[27] Evans and Russell, above n 21, 269-270.
[28] Grudnoff, above n 20, iii.
[29] Kershaw, above n 12, 830.
[30] Taylor, 'CGT Reform', above n 1, 451.
[31] Collison, above n 23, 268.
[32] Lee, above n 20, 140. Note, however, that Kershaw argues that, in Canada at least, there is more public support for the removal or reduction of the home ownership shelter than is usually implied in Canadian political discourse: Kershaw, above n 12, 827.
[33] Kershaw, above n 12, 831-832.

Melbourne significantly outstrip other parts of the country in terms of house prices.[34] To counter these massive variations, it might well be necessary to introduce different caps for different parts of the country, which would potentially add yet more complexity to an already complex set of provisions.[35] Grudnoff, in contrast, has suggested a single cap of AUD 2 million across Australia, claiming that this would both be less politically contentious and have the advantage of raising revenue only from those who can most afford it while maintaining the exemption for the vast majority of householders.[36]

An alternative to 'capping' is to introduce a form of rollover relief (as in some of the Scandinavian and other countries such as India) where the exemption applies only if capital proceeds from the sale of the family home are used to purchase a new family home.[37] Such a policy is advocated by Lee for the UK, who suggests that rollover relief should be available in the same circumstances that currently allow for full exemption for the PPR.[38] One difficulty with such a proposal is that this policy adaptation may well be unfair on older taxpayers deciding to downsize but perhaps 'locked in' to their existing home by the potential tax charge that would arise. But this difficulty can, of course, be avoided by permitting downsizing retirees (those above a certain age) to extract a certain amount of equity from the family home on disposal without generating a chargeable capital gain (as is the case in Sweden).

A further alternative may be to provide an exemption only in certain circumstances, such as relocating for employment or business or selling and relocating because of ill-health. The difficulty with this would be determining a fair list of acceptable reasons and discouraging the sorts of contrivances that so often accompany the creation of artificial borders or boundaries alluded to above.

What is clear from this analysis of the policy foundations for the exemption of the family home is that – once such an exemption is entrenched in the tax system – it becomes very hard to seek to remove it. In such circumstances, and despite its inequity, inefficiency and complexity, it may prove most sensible to accept that the main residence exemption cannot easily be removed and that the optimal course of action may be to accept its continuation, perhaps along with other measures to counteract its worst implications. For example, Kershaw, in Canada, considers that leaving the PRE in place but adding a progressive annual surtax to existing annual property taxation (domestic rates in the case of Australia) would help to raise revenue as well as reduce inequity, improve efficiency and enhance the simplicity of the tax system.[39] And – if the continuation of the exemption is accepted – it is also critical to ensure that the rationale for its continuation is clearly enunciated, which in turn can help to ensure its technical

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[34] The same is, of course, true of countries such as the UK, where house prices in London and the South-East are vastly different to the prices encountered elsewhere in the UK; and of Canada, with significant regional and provincial variations.
[35] Differential capping may also raise Commonwealth constitutional issues as taxes should not discriminate between States or parts of States. Section 51(ii) of the *Commonwealth of Australia Constitution Act* gives Parliament the right to make laws relating to, inter alia, taxation but 'so as not to discriminate between States or parts of States'. In addition, Section 99 of the *Constitution* also provides that the Commonwealth may not 'by any law or regulation of trade, commerce, or revenue (including a taxation law) give preference to one State or any part thereof over another State or any part thereof'.
[36] Grudnoff, above n 20, 7.
[37] Evans and Russell, above n 21, 269-270.
[38] Lee, above n 20, 140-141.
[39] Kershaw, above n 12, 832.

legislative provisions – to which the analysis now turns – can operate in as efficient and effective a fashion as is possible or practicable.

3. TECHNICAL ISSUES

3.1 Observations relating to the 'basic case'

As will be shown, the MRE provisions are among the most difficult and complicated of all the CGT provisions to navigate unless a practical scenario under consideration 'fits neatly'. This is often not the case. Unfortunately, even though it is usually quite clear what the answer 'should be' in such cases, it may not easily be obtained from a reading of the law. The inappropriateness of this is clearly evident as the provisions are directed mainly at ordinary individuals in relation to the family home.

The 'basic case' for disregarding (in full or in part) a capital gain or capital loss arises where a CGT event happens in relation to a CGT asset that is a dwelling or an ownership interest in it.[40] 'It' refers presumably to the CGT asset that is a dwelling. The dwelling needs to have been the individual's main residence throughout the period of ownership.

Although nothing practically turns on this, the change in terminology from 'sole or principal residence' in the ITAA 1936 to 'main residence' in the ITAA 1997 is arguably inexact – if a person owns only one dwelling, how can it be a 'main' residence?

There are a number of further issues that arise from the basic case terminology set out in section 118-110.

3.1.1 CGT asset and dwelling may not be the same

The legislation assumes that the dwelling will be a CGT asset. But it often happens that the CGT event happens in relation to a CGT asset that is not the same as the dwelling. For example, if a property comprising four hectares of post-CGT acquired land and a house is sold, the CGT asset is most likely to comprise the entire land parcel with the improvement, whereas the 'dwelling' is statutorily limited to the building and up to two only hectares of land (including the land beneath the building).[41]

There are no provisions that address this issue, and the ATO does not appear to have publicly ruled or advised on it. While a CGT asset includes part of an asset (if a CGT event happens to only part), the dwelling is not sold 'as part of' the land.[42] Further, the capital proceeds apportionment rule in section 116-40 of the ITAA 1997 does not work either because all the proceeds relate to the CGT event; it is just that not all relate to the 'dwelling'. And how is the cost base of the 'dwelling' to be determined? Neither section 112-25 of the ITAA 1997 dealing with split, changed or merged assets, nor section 112-30 of the same Act has any application.

Obviously, some sort of reasonable apportionment of capital proceeds and cost base is necessary. The fix would be to treat a 'dwelling' as a 'separate CGT asset' just for the exemption calculations. The current 'gap' in the law is not a major issue, certainly, but it is not a good start.

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[40] *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') s 118-110.
[41] See ibid ss 118-115 and 118-120.
[42] Ibid s 108-5(2)(a).

3.1.2 What is a taxpayer's CGT asset – the physical dwelling or the ownership interest?

The basic case applies to a CGT event that happens in relation to a CGT asset that is a dwelling or a person's ownership interest in it. Although the definition of 'dwelling' in section 118-115 of the ITAA 1997 is inclusive, it is defined very much in 'physical' or tangible terms. However, ownership interest in section 118-130 is, as might be expected, defined in terms of a person's intangible legal or equitable interests (or a right to occupy). Hence, while in common parlance a person sells 'the dwelling', they actually sell their ownership interest in it.

Thus, it is the dwelling (the physical element) in relation to which 'main residence' is tested, whereas it seems the CGT event would ordinarily happen in relation to an individual's ownership interest, for example, when an individual sells their freehold title to property.

If that is correct, the question arises as to why it is necessary to refer at all to a CGT event that happens 'in relation to a CGT asset that is a dwelling'. This is not clear, but a possible explanation may lie in the specific exemption for a forfeited deposit amount in section 118-110(2)(b) of the ITAA 1997 where it is part of an uninterrupted sequence of events leading to a CGT event referred to in section 118-110(2)(a). At the time the deposit is forfeited, CGT event H1 happens 'in relation to … a dwelling' but the ownership interest is not (at that point) sold.

3.1.3 Dwelling includes the land underneath it, but no other land (unless the adjacent land provision in section 118-120, discussed below, applies)

When the CGT provisions were rewritten in 1998, it was decided to clarify the law to provide expressly that the land beneath the dwelling was part of the dwelling as defined, without needing to have regard to the adjacent land rule in section 118-120 (although it takes account of the land under the dwelling in the two-hectare maximum). No explanation was provided in explanatory materials for the change.[43] One effect of it, perhaps, is to make it more difficult to assert that 'curtilage' is automatically part of a dwelling. Interestingly, land above the dwelling (eg, in the case of underground accommodation) is not covered, and falls to be considered only under section 118-120. (One might say that such land could more readily be used by the taxpayer differently from land under the dwelling which probably cannot be 'actively' used at all, except in the case of 'Queenslanders' (houses on stumps).)

With one exception, discussed below, including land under the dwelling in its defined meaning merely raises the theoretical possibility that if land under the dwelling exceeded two hectares, it may qualify for exemption whereas it would not under the previous law. This is of course an extremely unlikely scenario.

Mostly the change has no practical effect at all (as that land will generally be much less than two hectares integral to the dwelling and its use), but a potential problem arises if the dwelling is removed and the land under the building is sold. Is the sale of the land (now vacant) that was under the building the sale of a dwelling? The ATO considers not,[44] with a finessed argument that the land is covered only while the building or other

[43] Senate Explanatory Memorandum to the Tax Law Improvement Bill (No 1) 1998, 90.

[44] ATO, 'Income Tax: Capital Gains: Is Land Under a Unit of Accommodation Subject to the Main Residence Exemption Under Subdivision 118-B in Part 3-1 of the Income Tax Assessment Act 1997 if the

'dwelling' remains present. In other words, the land is treated if sold in the same way that the sale of adjacent land is treated (generally no exemption, subject to some narrow exceptions for involuntary destruction or acquisition). The ATO interpretation may be correct, but the outcome is certainly unclear, and the clarification to the law has probably raised more issues than it has solved.

3.1.4 'Main residence' not defined

Whether something is someone's main residence has for years been a question of fact. The ATO has published some guidance,[45] but the legislation could usefully include some (non-exhaustive) factors that would usually be relevant.

There are some curiosities in this area. The ATO would almost certainly insist on the need for (at least some initial) physical occupation of the dwelling, but the legislation does not actually specify this. If a house is set up to be a person's main residence and it is available to be occupied as such by the person (whether they live there or not), can it not be the person's main residence? For example, assume the person keep many of their belongings there, but is otherwise itinerant.

The use of 'main' is also interesting. Some people are able to 'duplicate' lifestyles in different countries such that it may be very difficult to determine (or for the taxpayer with the onus to prove) which of the dwellings is their 'main' residence. In such a case, it would seem that no exemption may exist at all. A fairer result in such a case would be to allow the taxpayer to nominate one dwelling, as is the case where spouses, or dependent children, have more than one dwelling.

This is in fact the position in the UK's PRR where a taxpayer with more than one house may nominate which house is to receive the relief. If they fail to do so, a similar factual enquiry as must occur in Australia is needed, but at least the taxpayer has the choice to nominate. While some concerns have been expressed about the nomination approach, such as the fact that less well-advised taxpayers may not be aware of it, and in some cases the nomination might be 'flipped' by taxpayers as circumstances change,[46] this does not go to the fundamental merits of the idea in the first place.

3.1.5 Ownership period defined by reference to 'legal ownership'[47]

In order to obtain a full exemption, the dwelling must have been a person's main residence for their full ownership period. (A partial exemption may be available in other cases under section 118-185.) What some say is a 'quirk' of the exemption is that the 'ownership period' (for which period a dwelling can be – or be taken to be – a taxpayer's main residence) is defined in terms of the period of 'legal' ownership of the dwelling (or of the land on which it sits).

Taxpayer Sells the Unit of Accommodation Separately from the Land?', Taxation Determination TD 1999/73.

[45] See, for example, the list of factors in former Taxation Determination TD 51, 'Capital Gains: What Factors Are Taken into Account in Determining Whether or Not a Dwelling Is a Taxpayer's Sole or Principal Residence?' (26 March 1992), now withdrawn but cited with approval in AAT *Case 8769* (1993) 26 ATR 1051.

[46] Office of Tax Simplification (UK), *Capital Gains Tax – Second Report: Simplifying Practical, Technical and Administrative Issues* (May 2021) 41-44 ('*Capital Gains Tax – Second Report*').

[47] ITAA 1997, above n 40, ss 118-125 and 118-130.

The rationale for this was that although CGT usually works on the basis of contract dates for the timing of disposal and acquisition, that would not usually be the period where a person was actually able to occupy a dwelling. Rather, a person would usually be able to occupy only from settlement on purchase through to settlement on sale. However, the contract rules require first an ordinary disposal (or change in ownership as per CGT event A1), and so 'ownership' (its ordinary meaning) rather than 'legal ownership' would seem to have been a better term.

Arguably, however, in relation to land, 'legal ownership' is not obtained, at least under the Torrens land title system, until registration of title.[48] This is not settlement, but sometime later. It is a system of title by registration not registration of title. This is an example of a mismatch between the law and practice: the ATO treats contract completion (or 'settlement') as the time legal ownership is acquired or disposed of, but the law arguably provides differently.

3.1.6 *Can a person obtain an exemption for more than one dwelling (more than one unit of accommodation) on a single parcel of land?*

If, notwithstanding the inclusive-only definition, 'dwelling' is technically limited to a single unit of self-contained accommodation, there would be a problem if, for example, a family resided in two adjoining self-contained flats, or in two houses on a parcel of land. A full exemption would require the identification of one dwelling that was the 'main' residence (if it was possible to so describe one), but no exemption would be available for the other. However, an exemption might arguably be available for the other building as part of adjacent land even if it were a complete separate accommodation unit, although this is not clear. There would appear to be no difficulty for a building not fully contained, for example a rumpus room used by children with a toilet and sleeping area.

It is not desirable that the legislation fails to make clear whether an exemption can apply to more than one fully self-contained accommodation unit.

Fortunately, the ATO does not in practice take a narrow view of 'dwelling' and will allow an exemption for multiple units of self-contained accommodation where they are used together (as a matter of fact) as the taxpayer's main residence.[49] Hence, an exemption would be available in the case where adjoining units were used by a family, whether or not there was a common door. Provided, that is, one could say that both units comprised the main residence. It is less clear what happens if the units are physically separate but in the same apartment block, or if they are in different blocks. The greater the physical separation the more difficult it may be to argue that they constitute one main residence.

The UK provisions and case law are more easily and flexibly applied in this regard. It is clear in the UK that a main residence can be more than one building.[50] The UK has the concept of 'curtilage' which identifies the dwelling-house that attracts the relief. (This is different from the additional permitted area in the UK (like 'adjacent land' in

[48] The alternative view is that entitlement to be registered is enough.

[49] ATO, 'Income Tax: Capital Gains: Can the Term "Dwelling" as Defined in Section 118-115 of the Income Tax Assessment Act 1997 Include More Than One Unit of Accommodation?', Taxation Determination TD 1999/69.

[50] *Batey v Wakefield* [1981] STC 521.

Australia as discussed below) of garden and grounds, which is usually one-half a hectare (about an acre), but can be increased if the area required 'for reasonable enjoyment of the dwelling house' is larger.) In Australia, the dwelling by definition includes only land beneath it, whereas the UK curtilage concept can extend further, though not too far.[51] It can, for example, embrace different buildings that comprise an integral whole. So, buildings around a courtyard will generally be considered part of the one dwelling-house, but not perhaps a cottage 175 metres from the main house,[52] although it may still fall within the 'permitted area'. In this sense, the curtilage of an estate must be distinguished from curtilage of the dwelling-house.

It is clear that in the UK case law has gone a long way to clarify some of the issues that remain uncertain in Australia.

It can be said, however, that Australia provides greater certainty by placing a fixed two-hectare limit on the adjacent land, whereas in the UK the area required for 'reasonable enjoyment' depends on the facts – there is no fixed limit – and this is apparently a frequent source of disputes with HM Revenue and Customs.[53]

In summary, it can be seen that technical difficulties and anomalies can arise even in dealing with relatively straightforward scenarios, and these peculiarities are even more evident when considering both limitations to the basic case and extensions of the exemption, which are now briefly discussed.

3.2 Limitations to the exemption

The main aims of the limitations are to limit the exemption to one post-CGT property per family unit, and the special rules regarding land (including the two-hectare maximum) reflect the fact that 'extra' (often potentially subdivisible) land can fairly easily be acquired in Australia. Specifically, rules that can limit the exemption include denying the exemption to land sold separately from the dwelling (except in certain cases, such as involuntary sales including resumptions), limiting spouses (and minor dependants) essentially to one MRE, and reducing the exemption where the dwelling is concurrently used to produce assessable income (eg, a business run from home).

It may legitimately be queried as to the extent to which taxpayers actually take these limitations on the exemption into account when filing their tax returns.

3.2.1 Adjacent land

The 'adjacent land' provisions are sometimes referred to as extending the exemption that can apply to a dwelling (eg, the accommodation unit with land beneath). While that is often true, there is 'devil in the detail'.

There are two aspects of section 118-120 that deserve comment here.

First, it would appear that a dwelling only includes adjacent land if a CGT event happens to the owner of the interest in the dwelling. At other times, 'dwelling' seems *prima facie* limited to the unit of accommodation and underlying land. This causes problematic interactions with provisions like section 118-192 which treat a 'dwelling' as acquired at

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[51] *Methuen-Campbell v Walters* (1978) 1 QB 525.
[52] *Lewis v Rook* [1992] STC 171, per Balcombe LJ.
[53] Office of Tax Simplification, *Capital Gains Tax – Second Report*, above n 46, 40.

market value at the time of its first income-producing use. There is no CGT event happening at that time in this case. (Even if that technicality is overlooked, it is evident that it may not be knowable until a CGT event whether adjacent land is included in the dwelling at all, and whether the section 118-192 market value could apply to the adjacent land. It may have been used to produce income at some point, but overall may have been used mainly for private purposes in association with the dwelling.) Clearly, the adjacent land is meant to be included in the section 118-192 market value in at least some cases, and taxpayers would usually be very keen to obtain a market value uplift, but the law itself is unclear.

Secondly, the extension for adjacent land is expressed to be for the purposes of Subdivision 118-B, which raises the question whether it applies for other parts of the CGT provisions not in Subdivision 118-B, such as the market value cost base rules for a dwelling that is inherited in Division 128.

At a less intricate level, it is commonly (and incorrectly) thought that the main residence exemption applies automatically to up to two hectares of adjacent land (including land under the dwelling) without appreciating that any 'extra' land (over and above what sits beneath the physical structure) must satisfy some very specific requirements set out in section 118-120 of the ITAA 1997.

First, it must be 'adjacent' to the dwelling, where 'adjacent' is not defined. Arguably, it need not be contiguous, and does not have to be on the same title.[54] It could possibly extend to a nearby field, or some land across the road from a dwelling. But it probably would not extend to vacant land some distance from the dwelling itself (eg, the other side of town) even if used for private family purposes.

Secondly, the land must have been 'used primarily for private or domestic purposes in association with the dwelling'.[55] 'Use' arguably does not require 'active use'. The land can provide amenity or give ambience to the dwelling, by distancing the home from neighbours or by facilitating good 'views'. But 'extra' land purchased with an eye to capital growth or later subdivisional potential which has no reasonable connection at all with residential use would not qualify. Note that the test of use is throughout the period of ownership, and not simply at the time the dwelling is sold. Thus, 'use' has both an area and a time dimension, and, especially where there is income producing use or other 'non-private' use, details of what parts of the land are involved and for what periods need to be retained. It should also be observed that even where land satisfies the 'primary use' test and is included in the dwelling, income-producing use may still lead to a partial loss of exemption.[56]

Thirdly, difficulties arise when there is more than two hectares of adjacent land and all is used integrally with the dwelling. Obviously, a reasonable apportionment is acquired, but identifying what two hectares to include can be problematic. The taxpayer may wish to identify the more valuable land, the ATO the less valuable.

Finally, the question arises whether some dwellings may not qualify for adjacent land at all. For example, if a houseboat is moored up against vacant land owned by the

[54] The Privy Council held in *Mayor of Wellington v Mayor of Lower Hutt* [1904] AC 773, 775 that the word adjacent 'is not confined to places adjoining, and it includes places close to or near'.
[55] ITAA 1997, above n 40, s 118-120(1).
[56] Ibid s 118-190.

taxpayer, can that land be adjacent land? If the land is used with the boat as part of the residence, one might ask why not, but then would the boatowner have to sell the boat with the land at the one time (and perhaps to the one buyer who may not want the boat)? A similar issue arises with mobile homes like caravans that are not fixed to any land. There is no apparent requirement in the law that the dwelling must be 'part' of (an improvement fixed to) the land in a real property law sense.

It has on some occasions been questioned whether a main residence exemption can be obtained for vacant land that has been owned for less than four years by erecting a tent on it (concreting in the tent posts if required) and living in the tent as a main residence for three months and making a 'construction period' choice under section 118-150. (It is of course a definite challenge to establish that the tent was, on all the facts, a person's 'main residence' but if that is established, the question about the degree of integration with the land required and the taxpayer's 'use' will be relevant. The law does not, however, help to make this clear.) The MRE policy is not to provide an exemption for vacant land where there is a very tenuous, and perhaps, contrived connection with a dwelling.

It is arguable, too, that the law now more clearly accommodates a less than permanent and substantial structure[57] such as a tent as a 'dwelling' because of the now separate test of a 'unit of accommodation' comprising a caravan, houseboat, or other mobile home.[58]

3.2.2 *Use of a dwelling for producing assessable income*[59]

Much has been written about the potential reduction in exemption that can apply if a dwelling being a main residence of a relevant person is used to produce assessable income.[60] This, ordinarily, means actual concurrent use as a residence and partly to produce assessable income.

Essentially, concurrent income producing use will occur if a person lets part of the property at commercial rates, or runs a 'business' from part of it, in circumstances where a tax deduction for interest expense would be available (whether or not any interest has actually been incurred). In other words, use of the home as a study where there is no separate place of business would not result in a loss of main residence exemption.

Calculating the loss of exemption from income-producing use can raise some particular challenges, notably where there are joint owners of a property, or where the joint owners have different ownership and usage profiles. There is tension, for example, where a proportion of a physical dwelling is used for income production, and a person's ownership interest in the dwelling may differ from that. For example, if a dwelling is used overall 60 per cent for the production of income (based on the notional interest deductibility test), but a taxpayer has only a 50 per cent ownership interest, arguably the withdrawal of exemption for that taxpayer would be better determined on the basis of 60 per cent of the 50 per cent interest rather than on 60 per cent of the overall dwelling.

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[57] See ATO, 'Income Tax: Capital Gains: Can the Following Comprise a 'dwelling' and Therefore Be Eligible for Exemption as a Main Residence (i) a Structure Built Underground? (ii) a Yacht? (iii) a Tent?', Taxation Determination TD 92/158.

[58] Evans and Russell, above n 21, 272-275.

[59] ITAA 1997, above n 40, s 118-190.

[60] See, for example, Kathrin Bain and Dale Boccabella, 'The Age of the Home Worker – Part 2: Calculation of Home Occupancy Expense Deductions, Deduction Apportionment and Partial Loss of CGT Main Residence Exemption' (2019) 34(1) *Australian Tax Forum* 65, 83ff.

These issues are dealt with comprehensively by Bain and Boccabella and so are not considered further here.[61]

It is important to note that where an absence choice is made (see below), it does not cover income-producing use that existed just before the absence. For example, if a doctor leased out her house which include a surgery for six years, and she made an absence choice, it would not apply to the part that was the surgery. But the rest of the income-producing use would be ignored.

3.2.3 First income-producing use rule[62]

This provision has an interesting history and its application, from 20 August 1996, is not widely understood. Its effect is to substitute market value at the time of first income-producing use for the dwelling's actual cost base. Before the equivalent of this provision was inserted into the ITAA 1936, a person's loss of exemption was based on the capital gain or capital loss that arose over the entire period of ownership.

The problem was that if a taxpayer started out on the assumption that the property would never be used to produce assessable income and any capital gain or capital loss would always be exempt, records may not have been kept of relevant costs, such as those of capital improvements, or non-deductible holding costs such as interest and rates. A person who did not keep those records was therefore likely to have been disadvantaged.

For example, if a person bought a house for $100,000, lived in it for two years, then rented it out for three years after which time it was sold, under the previous rule (assuming no absence choice was made) the non-exempt capital gain or capital loss would be 3/5 (60 per cent) of the amount calculated normally. Assume, for example, that there was a sale price of $600,000 and a capital gain of $500,000. $300,000 of this would not be disregarded. But the person may have had no records for any costs, which might for example have been $200,000, incurred during the first two years of ownership.

The law was therefore changed to provide a substituted market value acquisition cost at the time of first income-producing use. In the case above, if that was, say, $400,000 after the end of the first two years, the non-disregarded capital gain would be calculated as $200,000. In other words, the taxpayer would only be taxed on the capital gain that arose during the actual period they were not using the house as a main residence.

When the change was made there was no option to continue calculating the non-disregarded capital gain or capital loss on the previous basis, even where the person had kept records of expenditure during the period of actual residence. For example, if the person had records of the $200,000 costs, the non-disregarded gain would have been only 3/5 x $300,000 = $180,000. The change in the law was therefore to an extent 'retrospective' in its operation. The argument for not allowing a choice is that the law change was meant to be compliance-cost saving, and that if the choice were present, costs would be incurred to determine which outcome was better. But fairness would suggest that if a taxpayer has records that enable them to calculate an exemption more accurately and precisely and pay less tax, that taxpayer should not be denied the opportunity.

[61] Ibid.

[62] ITAA 1997, above n 40, s 118-192.

The wording of one of the preconditions for the operation of current section 118-192 is also highly nuanced and not well understood. Paragraph (a) says:

> you would get only a partial exemption under this Subdivision [ie, Subdivision 118-B] for a *CGT event happening in relation to a *dwelling or your *ownership interest in it *because* [emphasis added] the dwelling was used for the *purpose of producing assessable income during your *ownership period.

This is clearly meant to apply both to a case where there is concurrent income producing use of the dwelling (eg, a home office) as well as where the dwelling is rented out in its entirety. 'Because', however, suggests 'cause and effect'. Where the property is fully rented out the partial exemption results not because the dwelling is income producing[63] but because (without an absence choice) the dwelling is not a person's main residence for part of the ownership period.[64]

3.3 Extensions to the exemption

The rules that may extend the exemption include relief from having to occupy a dwelling immediately as a main residence when it is not practicable so to do (eg, if a person has been hospitalised, or the dwelling has been flooded), allowing two dwellings to qualify for up to six months when a person is changing main residence, allowing absences (including where the dwelling is rented out), and various rules relating to building and construction of a dwelling on land. Although the extending rules can be stated relatively simply, once again they mask a measure of complexity that causes practical difficulties in the operation of the exemption. Some of these shortcomings are now explored.

3.3.1 Moving in as soon as reasonably practicable

Section 118-135 which allows a dwelling a person owns to be treated as their main residence before they move in was introduced in the rewritten CGT provisions. Prior to this, it was most likely the subject of an administrative concession on a case-by-case basis by the ATO. Unfortunately, the scope of the relief remains uncertain, and it does not involve a loss (or denial) of exemption on another property during the period concerned. The scope is uncertain because it is not time restricted and takes (at least some) personal circumstances into account. It is not clear whether the reason for not moving in has to be something involuntary that has happened to either the dwelling or the taxpayer. This would cover, for example, a collapsed roof on the day of settlement that prevented occupancy, or the taxpayer recovering in hospital. It is not clear whether voluntary actions (such as accepting a job for two years in another part of the world) count, or leaving a tenant *in situ* for the balance of the lease term, count. The AAT in several cases[65] has indicated that the test is 'practicable' not 'convenient' and so having to shift from another part of the world, or quit a job and take up a new one, are more likely to be issues of convenience rather than practicability. This may mean that in terms of personal circumstances, only things that go to actual capacity or ability to occupy (eg, illness or injury) as opposed to personal preference may be relevant. Being incarcerated may be another example!

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[63] Ibid s 118-190.
[64] Ibid s 118-185.
[65] AAT Case [2009] AATA 890 (*Caller v Federal Commissioner of Taxation*) and AAT Case [2009] AATA 41 (*Couch v Federal Commissioner of Taxation*).

This concept of 'moving in' also reinforces the long-held contention that physical occupancy of a dwelling (living there) is necessary for establishing a main residence. It is noteworthy that the legislation overall is strict on when a dwelling becomes, or is, actually a main residence, but is rather generous once established for it to continue to be treated as one (eg, via the absence choice).

Interestingly, the UK law allows taxpayers to nominate a dwelling-house as a main residence before moving in for up to two years from the commencement of ownership of a property which is not occupied by them or someone else, either where a taxpayer sells another home in that period, or is building/getting the property ready for occupancy. This is more generous generally than the Australian rules, although they allow up to four years for construction, renovation etc. The UK also 'backends' their exemption to allow non-occupancy for the last nine months of ownership (which may extend to 36 months for people with disabilities). The generosity of the UK provisions may, in part, be accounted for by the fact that land transactions in the UK can often take much longer to finalise than in Australia.

3.3.2 The absence choice[66]

A person can choose to treat a dwelling they are absent from as their main residence indefinitely if the property is not used to produce assessable income, or for up to six years where it is. Multiple six-year periods are possible as well, but the dwelling must 'again become and cease to be' the person's main residence. Whether this has occurred is a question of fact, which is of the same type as whether the dwelling has become a person's main residence in the first place. Suffice it to say that whilst it might be thought that a short period (eg, one month or even one week) of occupying the property between tenants would suffice, occupying does not necessarily mean the dwelling has become a person's 'main residence' again.

The six-year period and the possibility of 'restarts' after resuming actual residence, is very generous. Admittedly, if the absence choice is made, normally no other main residence exemption for the same period can be claimed, but even so with a little tax planning an almost indefinite exemption for what is fundamentally a rental property with negligible total actual main residence use can be obtained.

It is interesting to note that, in the UK, the time periods are not so generous, and are to some degree based on the reason for the absence, with a maximum of three years where there is no specified reason.[67] The longer permitted period of absence in Australia may be accounted for, in part, by the fact that in the 1980s and before that time many Australian public servants were often required, under the terms and conditions of their employment, to serve in remote or rural communities, necessitating a move away from 'home'. It is also not clear that an absence choice can be made after a person has died. Literally, there is no provision which says that a person's LPR or surviving joint tenant or a beneficiary of their estate can make a choice to cover a period where the deceased was absent. This is in contrast, for example, to specific provisions such as section 118-155 that refer to a choice being made by a legal personal representative or surviving joint tenant.

[66] ITAA 1997, above n 40, s 118-145.
[67] See HM Revenue and Customs, 'HS283 Private Residence Relief' (Guidance, 2023).

It is far from clear on the words of the ITAA 1997 that such a choice is available under section 118-145, though it was clear in the ITAA 1936 that it was.[68] Section 118-145 refers to 'you' choosing to treat a dwelling that was 'your' main residence as if that continued. There is no reference to someone else doing it on the person's behalf if the person dies. The ATO does, however, seem to allow absence choices to be made by persons after a death has happened, at least the LPR.[69] There remains a question whether a beneficiary who inherits the property can make a choice on behalf of the deceased.

3.3.3 *Where a dwelling is built on land, the ownership period for a dwelling constructed on post-CGT land starts when ownership of the land was acquired*[70]

It is frequently misunderstood that the MRE requirements start 'ticking' once post-CGT land is acquired on which a dwelling is later constructed. Obviously, a person cannot reside on vacant land, so it cannot actually be someone's main residence at that time, but section 118-150 enables a person to make a choice to treat the dwelling (retrospectively – at a point in time when it was not actually there) as their main residence for the period from the time of land acquisition through to their moving into the constructed dwelling ('construction period'). This choice comes at a cost, however; because if the choice is made, it will prohibit the person from treating another post-CGT dwelling as a main residence for the same period to which the choice relates, except for the six-month overlap period where a person is allowed to have two dwellings treated as their main residence.[71]

The rationale for this complex rule is that it prevents someone 'speculating' to make a profit on land through the main residence exemption. For example, a person buys two blocks of land in Adelaide. She builds a home on one, and after one year it is ready, so she moves in. She lives there for a year then sells. She then builds on the other block and does the same thing. If she makes the 'construction period' choice for the first home, that will not be a period for exemption purposes on the second home. In effect, she is prevented from obtaining a full exemption from gains on 'two' blocks of land.

While the intention of the rule is clear, it is debatable whether the complexity it produces is justified. It seems very unlikely that taxpayers who do not receive professional advice would even think that a full exemption was not available on both properties.

The approach also produces a strange anomaly in the following circumstances. A taxpayer lives in a dwelling which includes land on a separate title (bought at the same time as the dwelling) that would qualify as adjacent land if sold with the dwelling. The taxpayer chooses to build a new home on the adjacent land, move into it as a new residence, and sell the original dwelling. If the taxpayer does not make a section 118-150 choice for the new build, only a partial CGT exemption will be available because the clock starts ticking on that from the time the land was acquired and not when the dwelling was built. If the section 118-150 choice is made, a full exemption may be obtained on the new build but there will be a loss of exemption on the initial dwelling that is sold. This makes no policy sense when the new build is on land that was bought at the same time as the original dwelling and would qualify as adjacent land for the initial residence had it been sold with that dwelling. There is a need for the law to reset

[68] ITAA 1936, above n 18, s 160ZZQ(11A).
[69] See, for example, ATO, 'Deceased Estate', edited private ruling 1051979216697 (5 May 2022).
[70] ITAA 1997, above n 40, s 118-125(b).
[71] Ibid s 118-140.

the clock for the adjoining block of land in that instance, reflecting its history in use with the previous dwelling. This anomaly can discourage the division of land, and the building of new dwellings, in times of housing shortages, urban infill, and in the provision of new accommodation for relatives (such as certain 'granny flat' arrangements where a fee simple interest is desired).

If the taxpayer had sold the first dwelling and all the land to a developer, and then bought the adjoining block back at some point, then (subject to the general anti-avoidance provisions in Part IVA of the ITAA 1936), a full exemption would ultimately be obtainable on both properties because the land on which the new dwelling was built has a 'freshened up' acquisition date.

The UK tax authorities have also struggled with the anomalous tax outcomes that can arise if a taxpayer sells part of the dwelling's garden to a developer, as opposed to building a new home on the garden, moving in, and selling the original residence. Unlike the Australian position, where a person generally cannot sell adjacent land separately from the dwelling and obtain an exemption (there is an exception for accidental destruction of the dwelling or involuntary sales), a person can do so in the UK although HMRC may seek to argue that if the person sells it (except for reasons of financial necessity and other involuntary circumstances) it was never part of the permitted area to start with.[72]

The UK grappled for some time with the issue of when 'ownership' of a residence commences when it is built on land – is it when the land was acquired or when the dwelling was built? The UK does not have the express rule existing in Australia that the clock starts ticking when the land is acquired. The question is just when ownership of a dwelling-house commences when it is constructed on land the taxpayer owns. There have been a number of cases which have considered the point.[73] On appeal, the Upper Tribunal in *HMRC v Lee*[74] have confirmed that the period of ownership commences when the construction of a dwelling-house is completed, not when the land was acquired. This gives the opposite result to that in Australia.

Again, this is a situation where UK case law has been able to provide a practical and sensible outcome despite the conceptual purity of the alternative view, although it remains to be seen whether the UK government will change the law.

The technical analysis set out in this section above has demonstrated that the lengthy black-letter style drafting of the MRE has nevertheless left many key concepts undefined (with policy unclear). The exemption is meant to apply to an individual's major asset, but the various interacting provisions, including all the conditions and restrictions, are unlikely to be comprehended or properly managed by the average person without obtaining tax advice. That is an unsatisfactory situation. The provisions are meant to offer relief from tax, but they make the quantum of that relief very difficult to ascertain because the provisions are actually drafted not with the flavour of providing relief, but with the flavour more characteristic of anti-avoidance provisions.

[72] See HM Revenue and Customs, 'Private Residence Relief: Permitted Area: More Than One Disposal' (Internal Manual, Capital Gains Manual CG64829, 12 March 2016; Updated 28 February 2024).
[73] See *Henke v HMRC* (2006) SpC 550 and *Lee v HMRC* [2022] UKFTT 175.
[74] *HMRC v Lee* [2023] UKUT 00242 (TCC).

4. CONCLUSIONS

John Taylor has correctly identified that the Australian MRE is one of the key drivers of complexity – however measured – in the Australian tax system. Nearly 20 years ago it was noted that many of the difficulties encountered in the CGT regime 'lie in inappropriate policy selection, poor or incomplete legislative drafting, poor implementation and administration of the provisions and "legislative layering" – whereby new policy and legislation is superimposed upon an existing framework that is insufficiently robust or compatible'.[75] That position has not changed in the intervening years, and the MRE is a clear example of these forces at work.

This article has shown that much of the complexity and confusion in the MRE derives from a lack of clarity about what the exemption is supposed to do, itself a product of the somewhat equivocal policy decisions relating to how and why capital gains are taxed – or not taxed – in the Australian tax system. Poor policy begets poor legislation, and the consequences are now all too evident. It may now be time for a reconsideration of the policy rationale that underpins the existence of the MRE. As it currently exists it is neither simple, nor equitable, nor efficient.

Australia, like many other countries, is plagued by rising housing unaffordability and significant intergenerational wealth inequality, and the tax shelter provided by the MRE not only does nothing to alleviate these problems, it exacerbates them considerably. It may not prove politically acceptable to remove the MRE, and indeed its elimination might well produce its own horizontal inequities and would certainly prove complicated and potentially add further complexity to the CGT regime whether applied retrospectively or prospectively.[76] But it may, nonetheless, be possible to mitigate some of the more egregious aspects of the policy shortcomings by imposing a monetary cap on the extent of the concession, or by imposing a deferrable progressive annual surtax on the value of all property, including family homes.

This article has also explored some of the complexity, uncertainty, quirks and flaws in the technical legislative provisions that comprise the CGT main residence exemption, and suggested ways that these can be managed. There is scope for legislative amendments to clarify a number of areas, or at least to identify and provide binding ATO positions so that taxpayers can achieve a greater level of certainty.

In a legislative sense, it should be possible to:

(a) rationalise, and correct errors in, such concepts as 'dwelling', 'adjacent land' and 'ownership period'; and

(b) provide more legislative guidance (by way of relevant, but non-exhaustive factors) that may be relevant to determine whether a dwelling is a person's main residence.

In a broader sense, there is a question whether the complexity of the MRE is justified given the amount of revenue likely to be collected (for example, as a result of ATO audit activity) as a result of technical non-compliance by taxpayers. In other words, if

[75] Chris Evans, 'CGT – Mature Adult or Unruly Adolescent?' (2005) 20(2) *Australian Tax Forum* 291, 291.

[76] Kershaw, above n 12, 841.

the exemption does not have or need an audit focus, it is likely that the revenue potentially available from the current legislation is not being collected, and as long as big loopholes do not result from a simplification, the revenue effect is likely to be minimal, but the reduction in compliance and administration costs significant.

On that basis, and assuming the existing generosity of the current MRE might be tempered by the imposition of either a cap on the extent of the shelter or by the levying of a progressive annual surtax to existing domestic property taxes, it may be possible to reformulate the current MRE provisions in such a manner as to provide firmer foundations through greater certainty in their operation and interpretation. Revisiting the technical provisions of the exemption with less focus on the prevention of abuse and more attention to the intention of the provisions to provide a sensible measure of relief in an equitable, efficient and less complex manner might indeed give credence to the apparent Confucian quote that 'the strength of a nation derives from the strength of the home'.