The Unanticipated Consequences of Rebuilding your Rental to Sell

Whether it be fire, flood, or other catastrophe you need to consider the CGT, income tax and GST consequences if you receive an insurance cash payout then rebuild your rental with the intention of selling it. GST in particular could be brutal yet the damage can at least be minimised with the right advice.

Due to the difficulties of getting materials and builders, insurance companies may be quick to offer you a cash settlement. The first catch is that by the time you get around to the rebuild it may cost a lot more and you might not qualify for loss of rent in the interim. Nevertheless, the cash maybe tempting if you are able to save yourself some money by taking part in the project yourself or you want to rebuild something different.

If you rebuild to continue renting out the property there is a rollover relief under section 124-75 ITAA 1997, that means you do not have to pay any tax on the insurance proceeds, even if they are not all fully expended. It is a condition of this relief that you must continue to use the property as a rental for “reasonable time” after the rebuild.

This brings us to the tax consequences of deciding to sell straight after the rebuild has finished. The first problem is you have built that house with the intention of reselling at a profit, you are now in the business of building a property for resale. This means you are required to register for GST as your business turnover will be more than $75,000. Make sure you do this promptly so you can claim GST input credits on the building costs. Also make sure you put a margin scheme clause in the contract. Even with all this you are bound to lose some money to the ATO in GST all because you decided not to continue to hold it as a rental.

The next problem is the lack of rollover relief when you receive the insurance payout. Effectively you are considered to have sold the house to the insurance company with the insurance proceeds being the consideration. The cost base will need to be split between the land and the house in order to determine the capital gain. Proper insurance should mean there is a capital gain. You will be entitled to the 50% CGT discount if there has been more than 12 months since you signed the contract to buy the property and the date you received the insurance proceeds. Providing of course you have not been a non resident for tax purposes during that time. Here is the formula to apportion the cost base.

$$\text{Cost Base of House} = \frac{\text{Cost Base x Insurance Proceeds}}{\text{Insurance Proceeds + Market Value of the Land}}$$

The CGT will eat into that spare cash you thought you might have by doing the build yourself, but there is more!

Once you start to rebuild with the intention of selling you are in business so any further gain from this point will be subject to normal income tax not just CGT, so no 50% CGT discount. Start by looking at the value of the land at the time you commit it to the project of rebuilding to sell. You are entitled to the 50% CGT discount on the capital gain up to this point but you have to pay that CGT in the financial year that the project starts even though you have not yet received the sale proceeds. Though you do have a choice, at this time to transfer at cost or market value. Transferring at cost would not trigger a CGT event at this time but will probably mean that eventually more of the profit will be taxed without the benefit of the 50% CGT discount. There is a lot to consider when making this choice and you need to talk to your accountant about your particular circumstances. Generally, if the land is currently worth more than its cost base, calculated in accordance with the formula above, it is better to transfer at market value so at least that portion of the profit receives the 50% CGT discount.

When you come to selling the property, assuming you elect to transfer the land at market value, you will be up for normal income tax on the sale proceeds after deducting the selling costs, rebuild cost and market value of the land at the time you committed it to the project.

This may lead you to think I will just keep it for a year then sell it. Whether you rebuild with the intention of selling at a profit is a question of fact, that you have to prove. Waiting a year or two won't change that, the facts are you rebuilt and sold so that must have been you intention all along. You would need to have a change of circumstances to point to as a reason you changed you mind a year or two later and decided to sell. Alternatively, holding the new property as a rental for a continuous period of 5 years and not claiming input credits on the build will get around the GST but might not avoid being taxed on the profit as a business unless you have a change of circumstances.

Note the CGT consequences mentioned here would not apply if the property was purchased before 20th September 1985 but the GST and tax on the business profits still needs to be considered.

Please crunch the numbers before you commit to selling, especially if you are only going to buy another investment property elsewhere, then you need to consider the buying and selling costs too.

This blog has come about due to the unique circumstances we are currently experiencing. For our general blog on the tax consequences of insurance payouts, repairs or rebuilds please read https://bantacs.com.au/Jblog/property-damage-from-fire/#more-419