Property and Development Series

Five steps to success for property developers

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ARTICLES

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How legal structures have a far-reaching impact on your property development

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INTRODUCTION

RSM has been providing accounting, taxation and advisory services to clients operating in the Australian property industry (property development and construction, property management and property investment), for many years.

Throughout that time, we have seen a wide variety of property transactions, each with their own issues and complexities. From this experience, we have sought to shed light on the top five mistakes to avoid for those in the property development industry.

LEGAL STRUCTURE:
HOW LEGAL STRUCTURES HAVE A FAR-REACHING IMPACT ON YOUR PROPERTY DEVELOPMENT

Determining the best structure for your property development can get complex. The success or failure of any good property development all starts with having strong footings and a solid foundation. If the foundation is defective, the construction that follows is undermined, and the costs to rectify are significant. Just as it applies when using concrete and steel, so too when using pen and paper. Metaphors aside, the key message here for property developers is to have a strong legal structure, and to get it right early!

Coming up with the right legal structure for property development is complex, and all too often specialist advice is not sought until it's too late. The types and combinations of entities used, how those entities are owned and controlled, who holds the assets, who bears the risks, the type or arrangements entered, and who derives the profits or incurs the losses are but a few of the various factors that need to be considered. Whilst there are many types of structures that are tried and tested, one size does not fit all, and the particular facts and circumstances of each developer need to be taken into account.

Having a defective legal structure can be a costly mistake. Be it over exposure to external parties like trade creditors or the bank, the unnecessary exposure of the risks associated with one asset to another, or multiple assets to the same market risks, having a defective legal structure may mean losing the lot, instead of weathering the storm. Unfortunately, the costs that come with a defective legal structure are not limited to when times are bad. A defective legal structure may result in a developer paying far more income tax, stamp duty or GST than is otherwise necessary had things been structured correctly.

> Fortunately, for property developers that may have defective structures, all is not lost!

Quite often, a defective legal structure can be 'restructured' into something far more effective. With the aim to mitigate risk, improve tax efficiency, and provide a solid foundation for further expansion and growth, restructuring can deliver those in the property game with a significant benefit.

> Importantly, just as specialist advice should be sought to come up with the right legal structure, specialist advice should also be sought to undertake a restructure.

Facts and circumstances permitting, provided the correct sequence of steps are taken, significant costs like income tax, stamp duty and GST that may arise when undertaking a restructure can be mitigated.

FUNDING:
HOW SHOULD YOUR PROPERTY DEVELOPMENTS BE FUNDED?

For many developers, the question that inevitably arises is how the development should be (or could be) funded. In answering this question, various factors need to be considered in the context of the particular facts and circumstances of each developer and the proposed development.

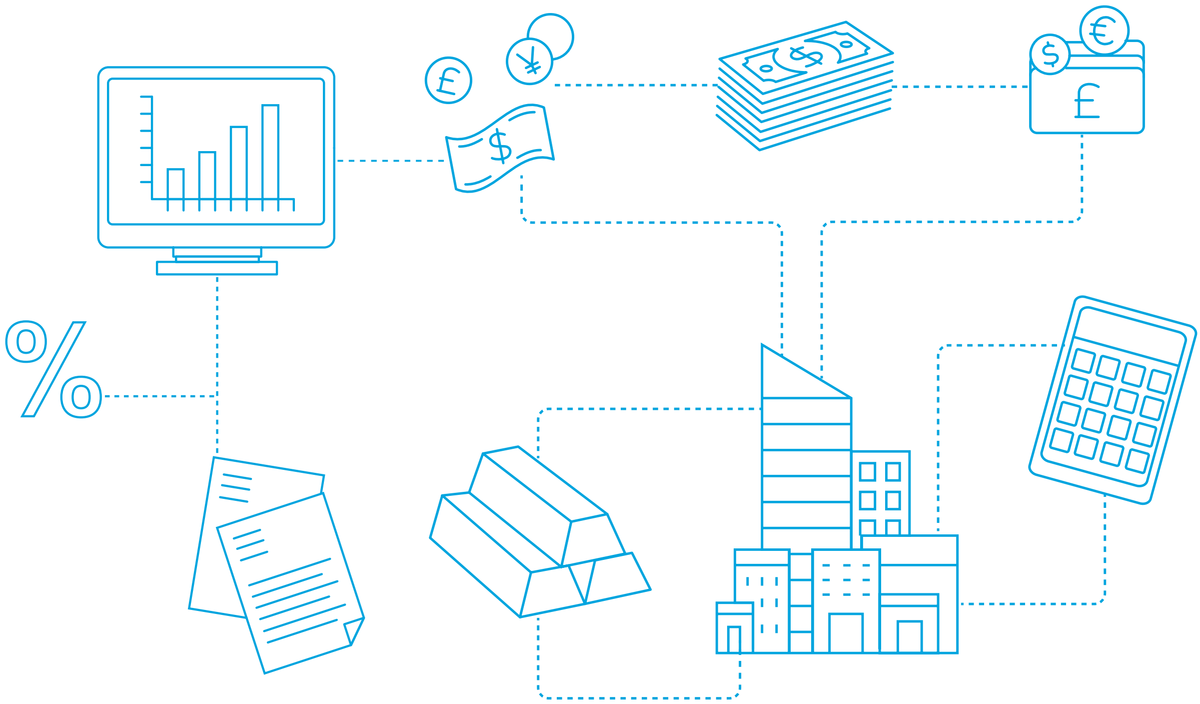
More often than not, developers will be well versed in the basic factors that need to be considered such as determining the appropriate mix between the developers own funds and funds that may be advanced by a third party.

> This is the case even when those funds should constitute 'debt' (loans) or 'equity' (shares or trust capital), the terms and conditions associated with the funds advanced (costs, duration, repayment, share of profit), and the economic feasibility of the development thereon.

Additional considerations come into play at a higher level which are quite often overlooked. These considerations may include:

- the preferred structure of the debt and/or equity for both the developer and the third party (whom advances what to where, which entities within the development group are involved, and what is their scope under the arrangement);
- the security and recourse associated with the funds advanced;
- the type of instruments that may be used (preference shares, convertible notes, profit-participating loans, joint venture or property development agreements);
- the income tax or stamp duty considerations that may arise (thin capitalisation, debt/equity rules, withholding taxes, deductibility of interest, landholder duty); and
- the impact of these factors on overall risk, economic feasibility, and bottom-line profit.

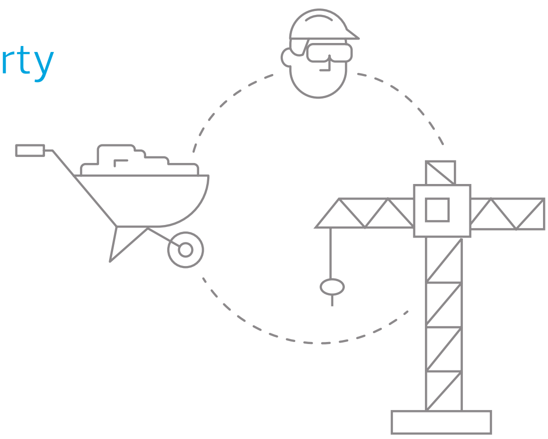
Whilst 'complex' does not always mean 'better', ignorance as to the different means of funding a development may lead to an outcome that is far from bliss. By ensuring that a developer is equipped with an arsenal of different funding options and strategies at their disposal, the chances of securing and completing a successful development are significantly increased.



CHANGES IN PURPOSE:
HOW TO STRUCTURE PROPERTY DEVELOPMENT

Typically, developers will aim to structure a property development with one of three desired outcomes in mind:

- develop, and sell all
- develop, sell some, and retain the rest
- develop, and retain all



Where this intention is known prior to undertaking the development, the legal structure and funding arrangements can be planned out well in advance to ensure the success of the desired outcome is optimised.

Complexity arises however when a developer has a change in intention partly through the development. Whilst this may arise as a result of personal preference, it is typically as a response to changes in market conditions (both positive and negative), changes in council policy, zoning or FSR, business performance, or demands from third parties (creditors, banks) or investors.

When such a change occurs, the level of risk can develop whilst many developers are well-versed in the immediate economic considerations, those that fail to obtain specialist advice typically find themselves running into lesser-known income tax, tax planning, GST or stamp duty hurdles that catch them off-guard. The changes in intention typically manifest in two different scenarios.

Firstly, where property that was acquired with the intention to 'develop and sell', due to changes in market conditions (decrease in sale price, purchaser defaults on completion and/or increase in rental yield), the intention changes to 'develop and retain', typically as a long-term investment.

Secondly, where property that was acquired with the intention to 'develop and retain', due to changes in market conditions (increase in sales price and/or decrease in rental yield), changes in zoning, an increase in FSR, or as a result of pressure from creditors, banks or investors, the intention changes to 'develop and sell' Under each of these scenarios some of the following more common income tax, GST and stamp duty considerations may come into play.

Capital v revenue

Property that was acquired with an intention to develop and sell will typically be held on 'revenue account', meaning that any profit or loss on disposal may give rise to ordinary business income, or an allowable deduction.

Alternatively, property that was acquired with an intention to develop and retain will typically be held on 'capital account', meaning that any gain or loss on disposal may give rise to a capital gain or capital loss. Where the intention for the property subsequently changes, it is often the case that the character of the property from an income tax standpoint also changes. That is, property that was held on revenue account may now be held on capital account or vice versa.

Distinguishing between gains and losses on revenue account or capital account is important. Whilst revenue gains are taxed as ordinary business income, capital gains may be eligible for capital gains tax (CGT) concessions or discounts (such as the 50% CGT discount available to individuals and trusts). Similarly, whilst losses on revenue account can typically be applied against all forms of revenue gains and capital gains, capital losses can only be applied against capital gains. That is, capital losses cannot be applied to reduce revenue gains. The main issues that manifest as a result of the above are that:

- gains that were going to be made on capital account may now be made on revenue account, with the result being that capital gains tax concessions or discounts are no longer available (or only available in part)
- gains that will now be made on capital account may be made by an entity that is not eligible for a CGT discount (e.g. a company)
- or losses that now arise on capital account may be of no use if future gains are likely to be made on revenue account

To address the above, options may be available to developers to restructure the ownership of property at the time that a change of intention occurs to ensure that tax-preferred outcomes can be achieved in the future. As alluded to above, specialist advice should be sought prior to undertaking any restructure.

GST and residential property

Where new residential property has been developed for resale, GST can typically be claimed on the costs incurred to undertake the development (known as credible acquisitions). Should the developer subsequently decide to retain the residential property and apply it to derive residential rent (being an input taxed supply), a 'change in creditable purpose' may arise, with the unfortunate consequence that some of the GST previously claimed in relation to the development of the property is required to be repaid to the ATO.

> If the new residential property is retained and solely used for the purpose of deriving residential rent for a continuous period of five years, it is likely that the entire amount of GST claimed in relation to the development will be required to be repaid to the ATO.

Clawbacks of exemptions for foreign person of surcharge purchaser duty and land tax

As many developers would be aware, a 'foreign person' (including a company or trust) that acquires residential property (including vacant land that is zoned or otherwise designated to be used for residential purposes) in NSW may be required to pay an additional 8% surcharge purchaser duty in addition to the standard transfer duty that applies. Similarly, foreign persons that hold residential land in NSW may also be subject to an additional 2% surcharge land tax.

In 2017, amendments were made to provide 'Australian-based developers' who are 'foreign persons' with an exemption from both surcharge purchaser duty and surcharge land tax. To be eligible for the exemption, the Chief Commissioner must be satisfied that the land will be used for the purpose of 'construction and sale of new homes', or the 'subdivision and sale for new home construction.

AS WITH ALL EXEMPTIONS, THE DEVIL IS IN THE DETAIL.

To satisfy the requirements under the 'construction and sale of new homes', the new home must not be used and occupied for any purpose (other than a display home) before the completion of the sale.

Putting this in context, should an Australian-based developer who is a foreign person initially receive an exemption from surcharge purchaser duty in respect of a property purchase subsequently decide to retain the newly developed home and use it to derive residential rent, it appears that the above requirement will not be met, as the new home will be used and occupied for the purpose of deriving residential rent. As such, the exemption may be revoked resulting in the developer subsequently being hit with both surcharge purchaser duty and surcharge land tax.

DEALING WITH GST:
TAXABLE SUPPLY FOR COMMERCIAL AND RESIDENTIAL PROPERTY

For most businesses operating in Australia, GST is fairly straight forward. As many clients are quick to remind us, 'you just add 10%.' Unfortunately, as those operating in the property development sector will know, the application of GST to property transactions can become highly complex, and given the quantum of the figures involved, getting the GST treatment wrong can have a significant effect.

For property developers, depending on the type of property in question and the particular facts and circumstances of the vendor and purchaser, the GST treatment applied to the purchase or sale of property may be as follows:

GST applies	GST does not apply
▪ a taxable supply ▪ a taxable supply to which the margin scheme has been applied (GST applies in part)	▪ not a taxable supply ▪ an input taxed supply ▪ A GST-free supply of farmland ▪ a GST-free supply of a going concern

Complexity arises in firstly determining the default GST treatment to be applied, secondly in determining whether an alternate treatment may be available that yields a better result, and thirdly, in considering any subsequent GST, stamp duty, or income tax considerations that may arise as a result of the choice made. For the most part, many developers will be across the abovementioned complexities, however, all too often property transactions may be entered into without seeking specialist advice.

Some of the more common examples of mistakes made include:

- acquiring a property as a fully taxable supply with the intention to develop and sell as new residential property. The fact that the property was acquired as a fully taxable supply will often prevent the developer from applying the margin scheme on the subsequent sale.
- acquiring a commercial property as a taxable supply (and thus paying GST on top of the purchase price), where instead the purchase of the commercial property may be eligible as a GST-free going concern.
- selling a new residential property as a fully taxable supply on the mistaken belief that you are ineligible to apply the margin scheme as the initial purchase included a taxable supply in part.

Example

If Lot A was acquired by the developer as a taxable supply, and Lot B was acquired as an input taxed supply, the subsequent amalgamation, subdivision, and sale of the subdivided lots will often be eligible for the margin scheme (albeit that some GST adjustments may be required).

- acquiring a property as a going concern and not tracing through to the vendor's purchase price in determining the amount of the margin to be applied on the subsequent sale by the developer under the margin scheme.
- as stamp duty on the purchase of property is often calculated on the GST inclusive purchase price, a considerable stamp duty saving may be available if the property is acquired under a GST treatment in which no GST applies (not taxable, input taxed, GST-free) or in which the amount of GST is reduced (margin scheme).

With the above in mind, the key takeaway should be that when it comes to seeking specialist advice in relation to GST and property, 'just add 10%' isn't going to cut it.

ISSUES WITH NSW STAMP DUTY:
HOW CAN DEVELOPERS AVOID PAYING STAMP DUTY TWICE ON THE SAME PROPERTY?

Having surveyed those in the property development industry for many years, the only thing that developers seem to dislike more than paying stamp duty, is paying stamp duty twice on the same property.

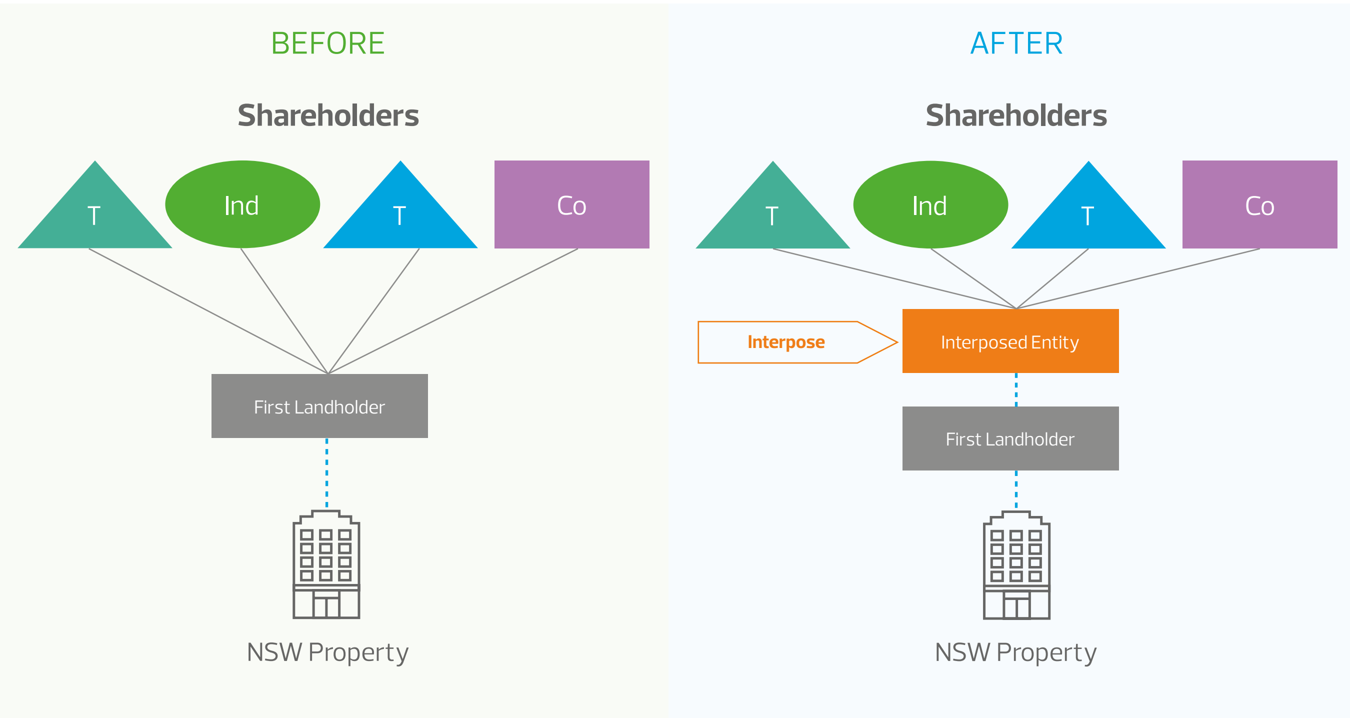
Although this may arise in a variety of circumstances, the most common is when a developer that has completed the purchase of property in one entity wishes to subsequently transfer that property to another entity. This often occurs when:

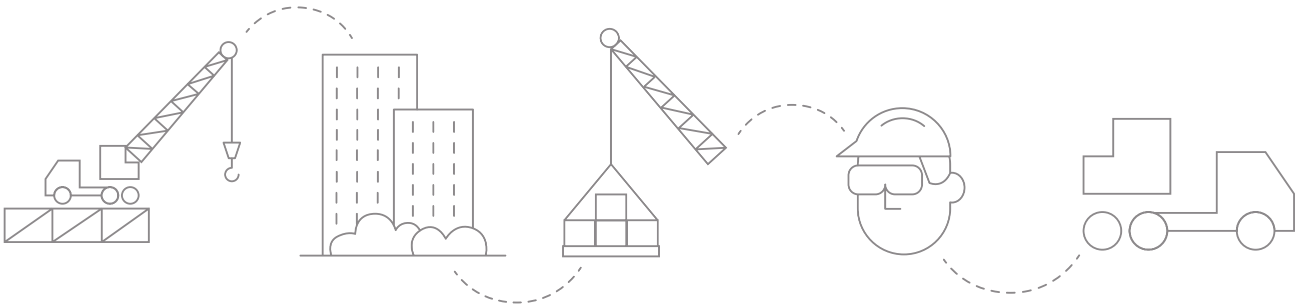
- a developer moves quickly to acquire a property and uses an existing entity which they later decide may have too many inherent risks (historical trading etc), or
- the entity used already owns existing property and putting all their eggs in one basket is an unnecessary gamble.

Fortunately (if the developer has an appropriate legal structure in place), an exemption from NSW stamp duty may be available for both the transfer of property and the transfer of interests in property (shares or units) between entities that ultimately have the same owners. As with all exemptions, the devil is in the detail and understanding the sequence of steps required to give effect to the transfer is vital. The exemptions are known as 'corporate consolidation' and 'corporate reconstruction' transactions.

Corporate consolidation

The corporate consolidation exemption allows a new company or unit trust to be interposed between an existing company or unit trust that owns land in NSW and the shareholders of that existing company or unit trust.





Importantly, for the exemption to apply:

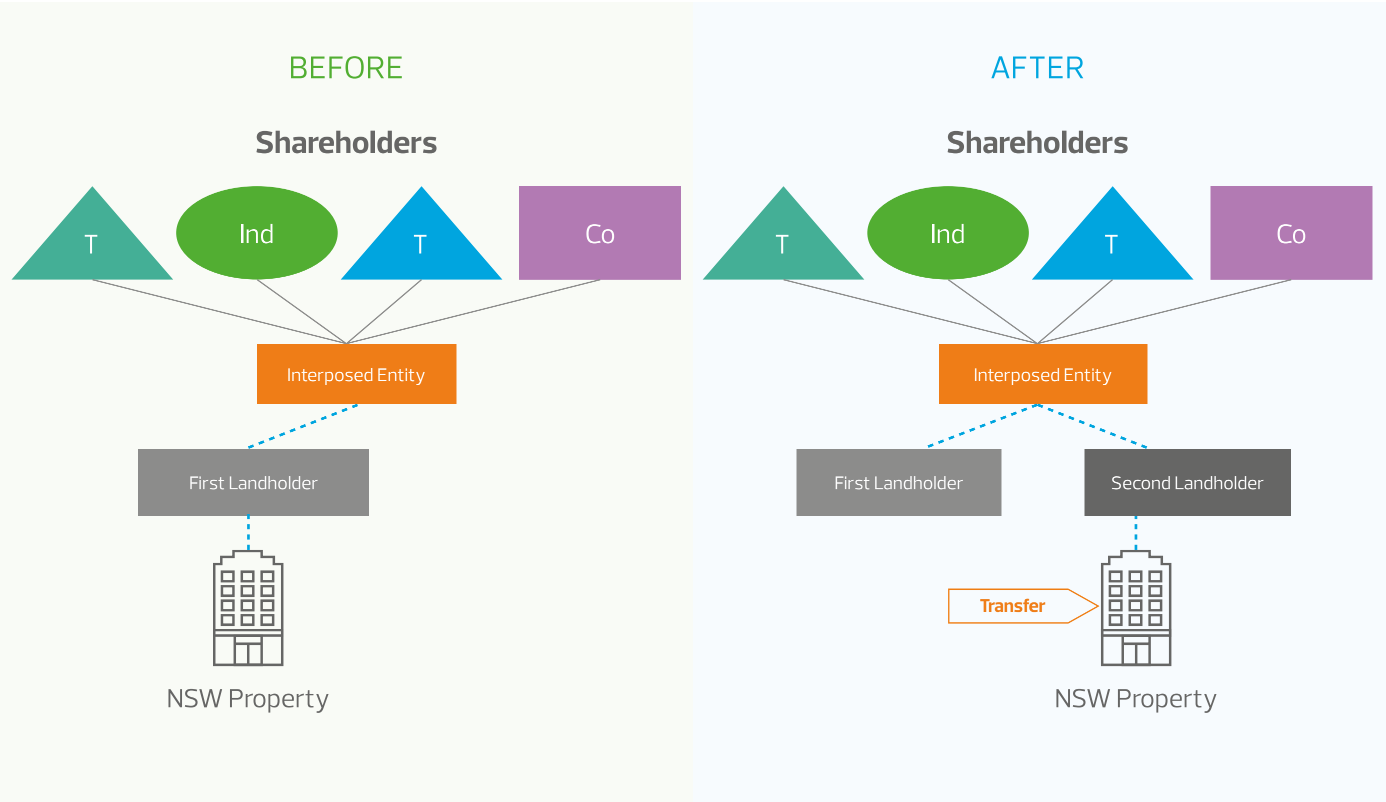
- the interposed entity must not hold any dutiable property, or a vehicle or an interest in a corporation immediately before the transaction; and
- the only consideration given by the interposed entity to the shareholders for the purchase of the existing entity is the issue or transfer of shares or interests in the interposed entity; and
- the same shareholders must hold the shares or interests in the interposed entity in the same proportion as those they held in the existing entity; and
- an application must be made to the Chief Commissioner for relief to apply for the exemption.

Corporate reconstruction

The corporate reconstruction exemption allows dutiable property (including real property and interests in real property such as shares or interest in unit trusts) to be transferred between members of the same corporate group.

Importantly, for the purposes of the exemption, a 'corporate group' includes a head entity (company or unit trust) and any of its subsidiary entities in which it directly or indirectly holds at least 90% of the shares or interests in the subsidiary entity. Similar to a corporate consolidation transaction, an application must also be made to the Chief Commissioner for relief to apply for the exemption.

Furthermore, for the exemptions to apply, the transaction (or series of transactions) must be undertaken for the purpose of changing the structure of the corporate group and/or changing the holding of assets within a corporate group. They must not be undertaken for a purpose of avoiding or reducing NSW stamp duty on another transaction. Additionally, they must not be undertaken for the sole or dominant purpose of avoiding or reducing a liability for tax under a law of another Australian jurisdiction.



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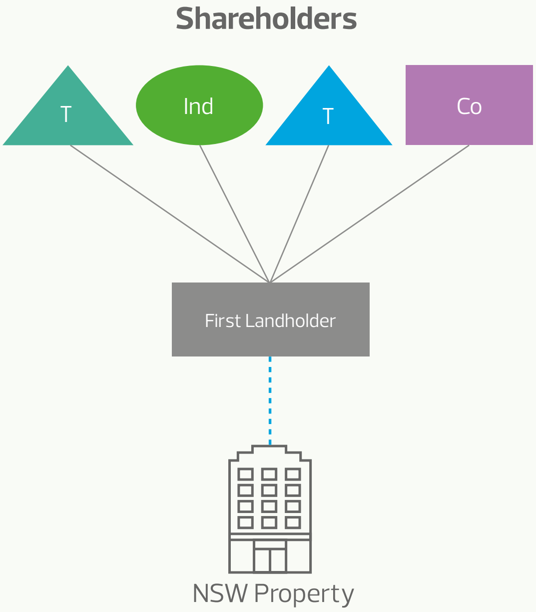
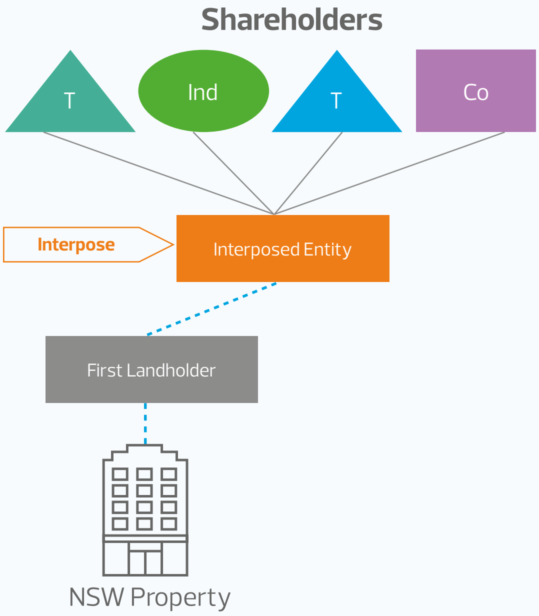
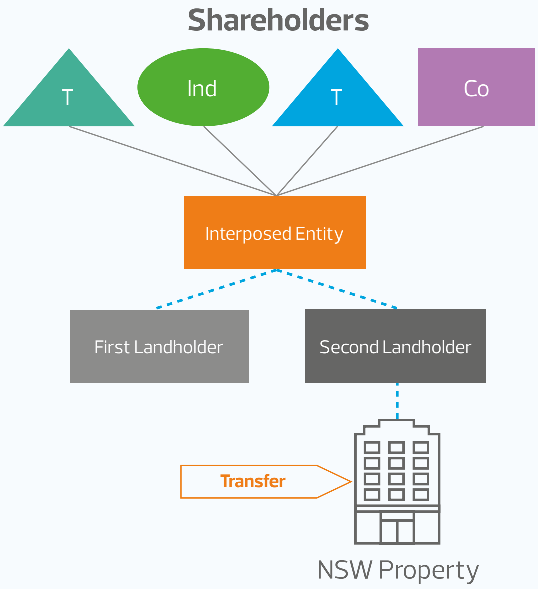


Corporate Consolidation



Corporate Reconstruction



Practical application

As an example, where a developer had acquired a property in one entity (First Landholder) and then sought to transfer that property to another entity (Second Landholder – whilst still maintaining ultimate ownership), the transaction may be undertaken by:

- Firstly, undertaking a corporate consolidation to interpose a new entity (Interposed Entity) between the shareholders and the First Landholder, and
- Secondly, undertaking a corporate reconstruction to incorporate the Second Landholder as a subsidiary of the Interposed Entity and subsequently transferring the property from the First Landholder to the Second Landholder.

Providing the various requirements under the act have been met and applications approved by Revenue NSW, both the transfer of shares in the First Landholder to the Interposed Entity and the subsequent transfer of the property from the First Landholder to the Second Landholder may be exempt from NSW duty.

Importantly, whilst the above concessions deal with NSW duty, other rollovers or exemptions will need to be considered for purposes of income tax and GST. As with all transfers that may be subject to duty, it is important to seek specialist advice. When it comes to undertaking corporate consolidations and reconstructions, 'it is better to ask permission, than to seek forgiveness'.

If you have any questions about the content contained in this article please get in touch with your local RSM property and construction expert or contact:

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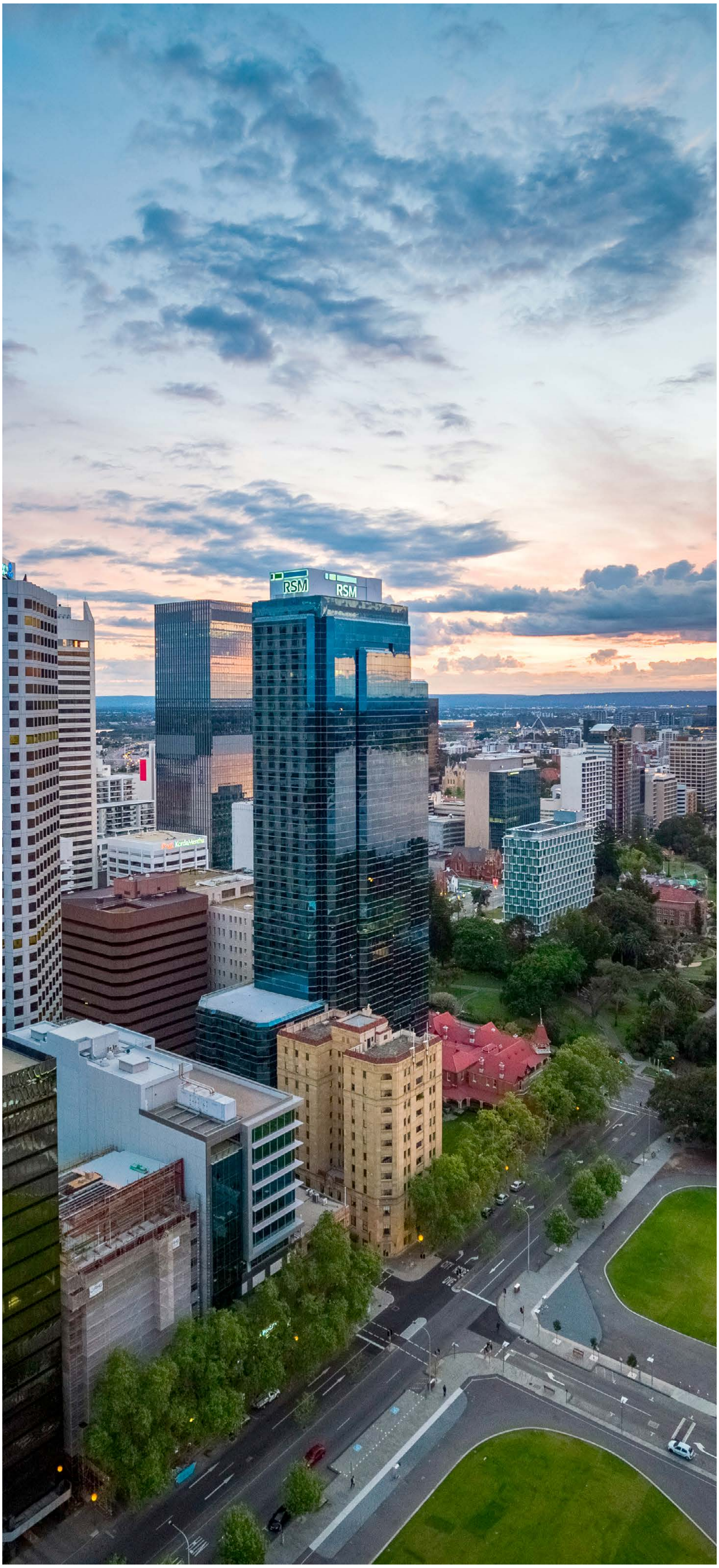
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