An introduction to capital gains tax and how it affects you

Factsheet
July 2020

Introduced with effect on 20 September 1985, the capital gains tax (CGT) system broadly aims to subject part or all of the growth in value of assets to income tax – with tax normally applying in the year each contract to dispose of the asset is entered into. Here, we look at some CGT fundamentals, including the steps to calculate CGT, key terms and definitions to be aware of, and common exemptions that can apply to reduce CGT liability.

What is capital gains tax and what rate of tax will you pay?

Capital gains tax (CGT) is the tax you pay on any net capital gain that you make on the sale of certain assets (known as CGT assets). You must include any such gain in your annual income tax return and are taxed on your net capital gain at your individual income tax rate – it is not a separate tax, merely a component of your income tax.

In order to calculate your net capital gain, the following method statement is applied:

- Reduce your total capital gains for the financial year by the total capital losses you made during that financial year.
- Apply any unapplied net capital losses from earlier years to further reduce your capital gain for the financial year.
- Apply the CGT discount (if appropriate) to the reduced capital gain.
- Apply any small business CGT concessions (if applicable) to which you are entitled.

If your total capital losses for the year are more than your total capital gains, you make a net capital loss for that financial year. A net capital loss can be carried forward to later financial years to be deducted from future capital gains (per the 2nd bullet point above). **You cannot deduct capital losses or a net capital loss from your other income.**

Generally, there is no time limit on how long you can carry forward a net capital loss, however, capital losses may be 'lost' in certain circumstances. You apply your net capital losses in the order that you made them.

You make a capital gain or a capital loss if a CGT event happens. There are numerous CGT events defined in the income tax legislation. The disposal of an asset is an example of a CGT event. You can also make a capital gain if a managed fund or other trust distributes a capital gain to you.

Worldwide obligations

Australian residents can make a capital gain or capital loss if a CGT event happens to any of their assets anywhere in the world, in which case they are taxed in the same manner as Australian assets (although a tax offset may be available if foreign tax is also payable).

What are considered CGT assets?

A CGT asset is any kind of property, or legal or equitable right that is not property, that was acquired on or after 20 September 1985.

For example, the following are CGT assets:

- real estate
- shares, units and similar investments
- cryptocurrency
- leases, goodwill, licences, foreign currency, contractual rights, and major capital improvements made to land or pre-CGT assets
- collectables above a certain value (there are restrictions on using any capital losses from these items) – such as paintings, jewellery, antiques, coins and stamps
- personal use assets above a certain value (there are restrictions on using any capital losses from these items) – such as boats, furniture, and household items.

Exemptions

Some capital gains are exempt (that is, you don't include them in your assessable income). Also, you must disregard some capital losses (that is, you can't use them to offset a capital gain and therefore reduce your assessable income).

Exemptions include capital gains or losses from:

- your main residence (but there are exceptions)
- your car, motorcycle or similar vehicle
- personal use items acquired for less than $10,000
- collectables acquired for $500 or less, or worth $500 or less when acquired
- depreciating assets used solely for taxable purposes
- trading stock
- pre-CGT assets, being assets you acquired before 20 September 1985 (except for some pre-CGT shares in private companies, or pre-CGT interests in private trusts, where a combination of factors can in certain circumstances result in the interest converting to a post-CGT asset)
- a decoration awarded for valour or brave conduct, unless you paid or exchanged property for it
- assets used solely to produce exempt income or some types of non-assessable non-exempt income
- compensation or damages received for any:
  a. wrong or injury you suffered in your occupation
  b. wrong, injury or illness you or your relatives suffered
- winnings or losses from gambling, a game or a competition with prizes
- a CGT event happening to the segregated current pension asset of a complying super fund
- some payouts under a general insurance policy, life insurance policy or annuity instrument
- a payment you received on surrender of an insurance policy where you are the original beneficial owner of the policy
- shares of certain profits, gains or losses arising from disposal of investments by certain venture capital entities
- some types of testamentary gifts (gifts made through a will).

How to meet your CGT obligations

To ensure that you meet your CGT obligations and to calculate your net capital gain, the following steps should be undertaken:

- Step 1: Decide whether a CGT event has happened.
- Step 2: Work out when the CGT event occurred.
- Step 3: Calculate your capital gain or capital loss.
- Step 4: Consider the application of any rollovers or exemptions.

Step 1: Decide whether a CGT event has happened

CGT events are the different types of transactions or events that may result in a capital gain or loss.

You need to know which type of CGT event you're dealing with, because it affects how you work out your capital gain or loss and may determine the timing of the CGT event. If more than one CGT event happens, you generally apply the most specific CGT event to your situation and the income tax legislation explains how to work this out.

CGT events are grouped into the following categories:

Disposal (A)	Hire purchase and similar agreements (B)	End of a CGT asset (C)	Bringing a CGT asset into existence (D)
Trusts (E)	Leases (F)	Shares (G)	Special capital receipts (H)
Cessation of residency (I)	Rollovers (J)	Other CGT events (K)	Consolidations (L)

This factsheet deals with CGT event A – disposal of a CGT asset, which is the most common CGT event and will likely be a frequent CGT event that medical practitioners will encounter (e.g. when disposing of medical practices, shares or real estate).

Step 2: Work out when the CGT event occurred

The timing of a CGT event is important because it determines which financial year you need to declare your capital gain or capital loss in. The provisions in the tax legislation dealing with the specific CGT event contain the relevant information, but generally:

- If you sell or otherwise dispose of an asset to someone else, the CGT event happens when you enter into the contract of sale.
- If there is no contract, the CGT event happens when you stop being the asset's owner.
- If you received a distribution of a capital gain from a managed fund, you are taken to have made the capital gain in the income year shown on your statement from the managed fund.

Step 3: Calculate your capital gain or capital loss

The way you calculate a capital gain depends on the CGT event, but generally this is calculated by deducting the cost base of the CGT asset (i.e. what you paid for it and certain costs incurred in acquiring or holding the asset) from the capital proceeds received from the CGT event (i.e. sale price). If the proceeds exceed the cost base, you make a capital gain. If the proceeds are less than the cost base, there is a capital loss.

Simply put, cost plus expenses - proceeds = capital loss or gain.

Generally, if you have owned the CGT asset for at least 12 months then you can reduce your capital gain by 50% (which is known as the CGT discount).

In limited circumstances, the cost base can be indexed upwards in line with inflation, in order to tax the real gain rather than the nominal gain.

Capital proceeds

For most CGT events, the capital proceeds are the amount that you receive (or are entitled to receive) from the CGT event (whether money or other property). However, where you give away a CGT asset or dispose of it for less than market value in a non-arm's-length transaction (e.g. if you give or sell it to a family member or related party for less than its market value), the capital proceeds will instead be the market value of the CGT asset at the time of the CGT event.

There are modifications to this general rule in certain circumstances.

Cost base

The cost base of a CGT asset generally includes:

- the cost of the asset when acquired (the market value of the asset may be used instead where you receive the asset as a gift or acquire it for less than market value in a non-arm's-length transaction)
- incidental costs (non-tax deductible) associated with acquiring the asset (e.g. stamp duty, legal costs)
- costs (non-tax deductible) associated with owning the asset (e.g. rates, land tax)
- incidental costs associated with the CGT event (e.g. real estate costs, advertising costs, legal costs).

The reduced cost base (i.e. the cost base not including any costs for which you have claimed or could have claimed tax deductions) is generally the same with some modifications.

In certain situations, special rules will modify the cost base of a CGT asset. These include:

- where you receive certain assets as the beneficiary of a deceased estate
- where you start to use your principal place of residence to produce assessable income.

Step 4: Consider the application of any rollovers or exemptions

Once you have determined the capital gain arising from a CGT event, you should consider whether there are any rollovers or exemptions that would have the effect of the capital gain not being included in your assessable income in the financial year in which the CGT event occurred.

Rollovers

Rollovers generally have the effect of enabling a taxpayer to defer a capital gain (so payment of tax in respect of the capital gain is postponed to a later financial year).

For example, if a company in which you hold shares is taken over or merges with another company and you are required to dispose of your existing shares as part of that arrangement, this would ordinarily trigger CGT at that time. However, if you exchanged your existing shares for shares in the takeover company (rather than receiving cash as consideration), you may be able to defer or rollover some or all of your capital gain (but not a capital loss) until a later CGT event happens to your replacement shares. This is known as scrip-for-scrip rollover and there are various other rollover relief options available in the income tax legislation.

Another example of a rollover is when you transfer a CGT asset to your former spouse (married or de facto) as a result of a court order after a marriage or relationship breakdown. In this case, you do not make a capital gain or capital loss on the transfer. Your former spouse may make a capital gain or capital loss when a later CGT event happens to the asset (e.g. when they sell it).

A rollover is also available for some demergers of corporate or trust groups.

Exemptions

In contrast, exemptions generally apply to disregard or reduce a capital gain or capital loss. Whereas a rollover merely postpones payment of tax, exemptions can result in no tax being paid at all.

There are numerous exemptions in the income tax legislation. Below, we explain one of them, the main residence exemption (also known as the principal place of residence exemption).

Main residence – full exemption

Any capital gain or loss an individual makes from a CGT event that happens in relation to a dwelling they own or part-own is completely disregarded if the dwelling was their main residence, and was not used for income-producing purposes, throughout their ownership period. There are specific provisions that deal with a taxpayer's absence from their home (e.g. because they are renting a house somewhere else and living in it) and for how long the home will be treated as the taxpayer's main residence. Factors include the length of absence from the home and whether the taxpayer is renting their home during their absence (i.e. earning assessable income from it). It is also a relevant factor whether a taxpayer has moved overseas and is no longer an Australian tax resident. Generally, a person can only have one main residence. However, there are limited circumstances in which a taxpayer can have multiple main residences (normally limited to situations where a taxpayer has bought a new home but has not yet sold their old home) and rules for partial exemptions where the home was not the taxpayer's main residence during the entire ownership period.

CGT and deceased estates

Generally, CGT is not payable when you inherit an asset. However, it may be payable when you later sell or otherwise dispose of the inherited asset.

In this regard, special rules apply for determining the cost base of an inherited CGT asset which depend on whether or not the CGT asset was a pre-CGT (20 September 1985) or post-CGT asset, in the hands of the deceased. Generally, beneficiaries will inherit the cost base of the deceased for post-CGT assets but for pre-CGT assets the cost base will be adjusted to the market value at the date of death. This is a simplification – it will be also relevant as to whether any improvements/work has been undertaken since the CGT asset was inherited to increase the value of the asset and the timing of any such work will determine the tax treatment of any such increase in value.

There are also special rules about the application of the 50% CGT discount upon the disposal of inherited CGT assets, which once again depend on whether or not the CGT asset was a pre-CGT or post-CGT asset in the hands of the deceased.

There are further special rules about the disposal of the deceased's main residence by the executor of the deceased estate or any beneficiary who inherits the property. It may be exempt from CGT. It is noted that a 2-year time limit (from date of death) exists, in which the main residence must be sold for the exemption to remain available (which may be extended in certain circumstances) although the time limit does not apply if the property is occupied by:

- a person who was the spouse of the deceased immediately before the deceased's death (but not a spouse who was permanently separated from the deceased)
- an individual who had a right to occupy the dwelling under the deceased's Will
- a beneficiary of the property under the deceased's Will.

The application of these provisions may vary for foreign beneficiaries.

CGT for trusts

Disposal of a trust asset (or another CGT event) is likely to result in either a capital gain or loss for the trust (unless a beneficiary is absolutely entitled to the asset).

Capital gains and losses are taken into account in working out the trust's net capital gain or net capital loss for a financial year. As part of the net income of a trust, the net capital gain for the year is then allocated proportionately to beneficiaries based on their entitlements to trust income, unless:

- there is a beneficiary who has been made specifically entitled to the capital gain (in which case they are generally assessed on the gain), or
- the trustee (of a resident trust) chooses to be taxed on a capital gain (i.e. by accumulating, not distributing, the income).

Any presently entitled beneficiary who is eligible to receive the CGT discount can apply the 50% CGT discount to any capital gains distributed to that beneficiary from the trust.

If there is no beneficiary presently entitled to income (or specifically entitled to the capital gain) the trustee is generally taxed on the capital gain at a special rate (equivalent to the highest individual income tax rate) and is not entitled to the CGT discount. However, in certain circumstances, such as deceased estates, the Commissioner can apply the normal resident individual income tax rates (and the CGT discount will also apply) where it would be unreasonable to apply the special rate.

Capital losses made by a trust cannot be distributed to the trust's beneficiaries but they can be carried forward and applied against the trust's capital gains when they are realised in future years.

Small business CGT concessions

In addition to the CGT exemptions and rollovers available more widely, there are four concessions that allow a taxpayer who runs a small business to disregard or defer some or all of a capital gain from an active asset (an active asset is generally one you own for use in the course of carrying on a business):

- 15-year exemption – If your business has continuously owned an active asset for 15 years, you are aged 55 or over and are retiring or permanently incapacitated, you will not have an assessable capital gain when you sell the asset.
- 50% active asset reduction – You can reduce the capital gain on an active asset by 50% (in addition to the 50% CGT discount if you have owned it for 12 consecutive months or more).
- Retirement exemption – Capital gains from the sale of active assets are exempt up to a lifetime limit of $500,000. If you are under 55, the exempt amount must be paid into a complying super fund or a retirement savings account.
- Rollover – If you sell an active asset, you can defer all or part of a capital gain for two years, or longer if you acquire a replacement asset or incur expenditure on making capital improvements to an existing asset.

These concessions are available when you dispose of an active asset and any of the following apply:

- You are a small business with an aggregated annual turnover of less than $2 million.
- Your asset was used in a closely connected small business.
- You have net assets of no more than $6 million (excluding personal use assets such as your home, to the extent that it has not been used to produce income).

There are:

- other basic eligibility conditions that you must meet to qualify for any of the concessions, and
- additional conditions you must meet to apply the concessions when you dispose of shares in a company or units in a trust.

You can apply as many concessions as you are entitled to until the capital gain is reduced to nil. There are rules about the order in which you apply the concessions, any current financial year or prior financial year capital losses, and the CGT discount.

Eligibility

There are three steps in applying the concessions:

- A CGT event giving rise to a capital gain must occur.
- The taxpayer must either be a Small Business Entity (SBE) or must satisfy the maximum net asset value (MNAV) test.
- The CGT asset must be an active asset (the active asset test). If the CGT asset is a share in a company or an interest in the trust:

  a. the company or trust must have a significant individual, and

  b. the CGT concession stakeholder test must be satisfied.

You should seek appropriate tax and structuring advice to ensure that you can take advantage of these concessions when setting up your business.

Self-managed super funds and CGT

The CGT provisions in the tax legislation apply to complying superannuation funds in the same way as they apply to other taxpayers, with some important modifications.

Accumulation phase

The trustee of a complying superannuation fund is entitled to a CGT discount percentage of 33 ⅓ on any realised capital gain on an asset held for longer than 12 consecutive months. Therefore, where a self-managed super fund (SMSF) held a CGT asset for at least 12 months prior to disposal, only two-thirds of any realised capital gain must be included in the fund's assessable income. By contrast, as discussed above, a discretionary trust that accumulates capital gains does not get the benefit of the 50% CGT discount.

A complying superannuation fund is taxed at 15% on its investment earnings in accumulation phase so there is an effective 10% tax rate for a realised capital gain on an asset held for more than 12 months (i.e. ⅔ x 15%).

For assets acquired prior to 21 September 1999, an SMSF may instead choose to use the indexed cost base method for calculating the capital gain, in which case the CGT discount mentioned above will not apply. There are also special rules for other assets acquired earlier than this.

Super funds do not obtain the benefit of the pre-CGT assets being exempt from CGT (in comparison to other types of taxpayers).

Pension phase

Any capital gains or capital losses made on segregated current pension assets are disregarded. Therefore, any capital gains made on segregated current pension assets are tax-free. However, this also means any capital losses on these assets cannot be carried forward to future financial years.

Get advice that suits your situation

CGT is a complex area of taxation and this factsheet is a guide only. The team at Doctors Wealth Management can review your situation and recommend a solution for your individual circumstances.

You can find additional resources and information about Doctors Wealth Management at **avant.org.au/doctorswealthmanagement** or call **1800 128 268**.