

POST-INTERIM SUBMISSION

Housing supply regulation

Tax impediments to small-scale infill housing

Submitted by [Redacted]

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This is a personal submission. I do not claim specialist tax or development expertise.

Summary

I support the Productivity Commission's objective of enabling more homes in the places where people want to live. The interim report is particularly persuasive in distinguishing theoretical zoned capacity from commercially feasible capacity. My concern is that two features of Commonwealth taxation can materially reduce the feasibility of the small-scale infill development that broad-based upzoning is intended to encourage.

First, established homes are generally sold without GST, while dwellings built to replace them will generally be taxable supplies for which the seller must account for GST. Second, the Australian Taxation Office (ATO) advises that even a one-off development can be a profit-making activity taxed as ordinary income. Its guidance gives the example of an owner who subdivides a backyard, builds one house and sells it. The ATO treats the project as an ordinary-income activity because it is more complex than selling the vacant lot and is conducted in a businesslike way for profit. Characterisation will remain important under recent CGT reforms, which preserve a 50 per cent discount for qualifying new residential dwellings from 1 July 2027.

I recognise that taxation policy is outside the stated focus of this inquiry, but in practical terms it is unavoidable. Identifying impediments and recommending referral to the responsible policy agencies would respect the inquiry's scope.

Matters the Commission should Consider

I respectfully suggest the final report should (1) acknowledge GST and income-tax characterisation as interacting constraints on commercially feasible infill capacity; (2) ensure that feasibility analysis includes their effect; and (3) recommend that the Australian Government refer these issues to Treasury for a targeted review, including a clear capital-account safe harbour for qualifying one-off small-scale residential developments.

1. Connection with the interim report

The interim report says that development proceeds only when expected sale prices exceed development costs and that commercial feasibility is a necessary condition for zoned capacity to translate into actual supply. It recommends assessing reform by reference to commercially feasible capacity, not merely theoretical capacity. This is the correct lens.

The report's Sydney apartment cost stack includes state and local taxes and charges, land tax and stamp duty, but does not identify GST; nor does it consider how income-tax characterisation affects individual owners. Yet broad upzoning will rely on thousands of such owners, not only established developers.

Permission does not ensure construction. If the return after planning, construction, finance, market and tax risk is too low or uncertain, an owner will retain the existing dwelling and the additional capacity will remain on paper.

2. GST creates a new-versus-established housing wedge

The ATO explains that sales of existing residential properties are input taxed, whereas the sale of newly constructed residential property is a taxable supply. It also explains that new residential premises include buildings constructed to replace demolished buildings on the same land. This is the ordinary pattern of infill redevelopment in an established suburb.

Where available, the margin scheme generally calculates GST on the difference between acquisition and sale prices, and credits may be claimed for GST on construction inputs. GST should therefore not be described simply as ten per cent of gross sales.

A real wedge nevertheless remains: an established home acquired from a private owner ordinarily carries no creditable GST, but its replacement dwellings are taxable and compete with input-taxed established homes. On a marginal project, GST on the development margin can determine whether work proceeds.

Small projects have less ability than large projects to spread fixed professional, approval, finance and compliance costs. GST should therefore be included in estimates of commercially feasible capacity following upzoning.

Source: ATO, "Tax consequences on sales of property" and "GST and the margin scheme"; ATO, GSTR 2000/21.

3. A one-off project can be ordinary income

The ATO's public guidance deserves direct attention because it is written for ordinary property owners. Under the heading dealing with one-off development activities, it says that a single transaction can be taxed as ordinary income if it goes beyond the mere realisation of a capital asset and is carried out as a commercial transaction with a profit-making intention.

Indicators of ordinary income include acquiring land for subdivision and sale, seeking early approvals, making significant improvements, constructing buildings and undertaking a complex series of steps. A simple sale of an unimproved block is more likely to remain a capital gain.

The ATO's backyard example

“Claude” subdivides his backyard, engages a builder to construct a house and sells the completed property. The ATO concludes that he has undertaken a one-off profit-making development activity because it is more complex than selling the vacant lot and was conducted in a businesslike manner to make a profit. The net profit is included as ordinary income. The guidance also says GST registration will be required if the activity exceeds the GST turnover threshold.

This example illustrates the policy problem. Constructing an additional home necessarily involves approvals, professional advice, finance, a building contract, risk management and sale or leasing decisions. Those features may make the activity appear commercial, but they are also the minimum practical steps required to turn new planning capacity into a completed dwelling.

The interaction with the main-residence exemption creates further complexity. If Claude merely sold the newly subdivided vacant block, the sale might remain on capital account, although the block would generally not receive the main-residence exemption when sold separately from the dwelling. If he moved into the new house and sold the original home, the exemption might apply to one or both properties for particular periods under the construction and moving-home rules, but it would not automatically exempt both gains in full.

Similarly, an owner who demolished a long-held home and constructed two replacement dwellings would not necessarily lose the exemption altogether. One dwelling might qualify if it became the owner's main residence and the statutory conditions were met; the other would ordinarily remain outside the exemption. The broader concern is that substantially different tax outcomes can depend on occupancy, timing and transaction structure rather than simply on the owner's long association with the land or the project's contribution to housing supply. These distinctions are difficult for an ordinary owner to anticipate and reinforce the case for clear, prospective rules.

Many owners would not expect one redevelopment to convert their return from a capital gain to ordinary income. They may discover the distinction only after incurring advice, design or approval costs. The deterrent is therefore uncertainty and compliance risk as well as the possible tax difference.

Sources: ATO, “Tax consequences on sales of property”, including the worked example concerning Claude; ATO, “Building or renovating your home”; ATO, TD 2000/13.

4. The historical setting warrants reconsideration

Taxation Ruling TR 92/3 sets out the ATO's approach to profits from isolated transactions. It applies to transactions outside the ordinary course of an existing business and to transactions entered into by non-business taxpayers. The ruling states that a profit from an isolated transaction will generally be ordinary income where the taxpayer had a profit-making purpose and the transaction was entered into, and the profit made, in carrying on a business or carrying out a business operation or commercial transaction.

The threshold is broad. Profit need not be the sole or dominant purpose, and it will ordinarily be significant where an owner accepts construction risk. The organised activities required by planning and building can also make the project appear commercial.

The historical context is important. TR 92/3 principally applies the High Court's reasoning in *Federal Commissioner of Taxation v The Myer Emporium Ltd.* Although Myer was decided in 1987, the receipt under consideration was assessed in the income year ended 30 June 1981. Other foundational authorities concerning property development and the distinction between a profit-making scheme and the mere realisation of a capital asset also arose before comprehensive CGT.

Before comprehensive CGT, capital characterisation could place a gain outside the income-tax base. For post-20 September 1985 assets, the practical issue is generally not whether a gain is taxed, but whether it is taxed under the CGT rules or as ordinary income.

TR 92/3 itself expressly says that it does not consider the capital gains provisions then contained in Part IIIA. The ruling understandably states the ordinary-income doctrine it administers; it does not ask whether the combined operation of that doctrine and the later CGT architecture remains appropriate for a housing policy that now seeks distributed, homeowner-led infill development.

The 2026 CGT reforms sharpen the issue

The Treasury Laws Amendment (Tax Reform No. 1) Act 2026 changes the comparison from 1 July 2027. For most assets, the general 50 per cent CGT discount for individuals and trusts is replaced by inflation-based cost-base indexation and a minimum 30 per cent tax rate on relevant capital gains. Gains accruing before that date are protected through transitional rules.

Crucially for this submission, Parliament preserved a 50 per cent discount for qualifying new residential dwellings, with an option to use indexation instead. The detailed requirements for a dwelling to qualify are to be specified under the legislation and were still being implemented when this submission was prepared. The legislation expressly contemplates matters such as whether the taxpayer was the builder, whether the dwelling was created through substantial renovation or replaced a demolished dwelling, and whether it genuinely adds to housing supply.

This creates a sharper policy question. Parliament has chosen to retain favourable CGT treatment for qualifying new homes in order to support additional supply. But if the same one-off project is characterised as an ordinary-income profit-making activity under TR 92/3, the owner cannot access a concession that applies only to capital gains. The general gap between capital and revenue treatment may have narrowed, but its application to new housing remains material.

The distinction also persists outside the new-dwelling exception: capital treatment may provide indexation, and capital and revenue losses remain subject to different rules. The CGT rules prevent double taxation of ordinary-income profits but do not extend CGT concessions to them.

This is not a criticism of the ATO for administering current law. It is a reason for Parliament and Treasury to consider whether current law draws the boundary in the right place for genuinely one-off, small-scale housing projects.

Sources: ATO, TR 92/3; Income Tax Assessment Act 1997, ss 6-5 and 118-20 and Parts 3-1 and 3-3; Treasury Laws Amendment (Tax Reform No. 1) Act 2026.

5. Older owners and long-held residential land

The owners of larger residential lots suitable for modest infill may often be retired or approaching retirement, particularly where the property has been held for many years. This should not be assumed in every case, and the safe harbour proposed below should not depend on age. It is nevertheless relevant to how owners respond to development opportunities.

An owner approaching retirement may have limited appetite or borrowing capacity for planning, construction, market and tax risk. Redevelopment could allow that owner to move into or retain a smaller dwelling on the site, remain in the local community, sell the additional homes and use the proceeds to support retirement. It can therefore create new supply while also facilitating downsizing and releasing underused residential land.

The tax system already recognises an analogous principle for small-business owners. Subject to detailed eligibility and active-asset tests, the small-business 15-year exemption may disregard a gain where an owner aged at least 55 retires, while the small-business retirement exemption can disregard eligible gains up to a lifetime limit. These concessions recognise that a long-held productive asset may function as retirement savings.

Most privately held residential land will not obtain those concessions. A principal residence is ordinarily not used in carrying on a business, and a conventional rental property is generally excluded from the active-asset rules because its main use is to derive rent. If a redevelopment profit is ordinary income rather than a capital gain, the CGT concessions are unavailable in any event.

The analogy does not justify identical concessions. It shows, however, that tax policy can recognise retirement reliance on long-held assets. Predictable capital treatment for a genuinely one-off small project could unlock homes without treating an older owner as a recurrent developer.

Sources: ATO, “Small business concessions”; Income Tax Assessment Act 1997, Division 152, including the active-asset rules.

6. A clear safe harbour for small one-off developments

A statutory safe harbour should provide that the proceeds of a qualifying one-off small-scale residential development are treated on capital account, notwithstanding the approvals, finance, construction, project management and sale activities reasonably necessary to complete the project. It should replace a subjective and retrospective characterisation exercise with an objective rule that an owner can understand before committing capital.

In my view, all genuinely one-off small-scale projects meeting the statutory definition should qualify. Eligibility should not depend on proving that profit was an insignificant purpose: that would reproduce the uncertainty the safe harbour is intended to remove. Nor should an owner lose protection merely because the work was organised competently or because completed dwellings, rather than vacant lots, were sold.

Possible boundaries

- A maximum physical scale, such as no more than four dwellings in total or no more than three net additional dwellings on the original site.
- A frequency rule applying to the taxpayer and associates, for example no other completed development within the preceding ten years.
- Aggregation of adjoining land, related parties and interdependent stages so that a larger project cannot be artificially fragmented.
- No acquisition of additional adjoining sites as part of the project, subject to tightly defined practical exceptions.
- Continuation of the general anti-avoidance rules and exclusion of arrangements whose dominant purpose is to obtain the safe harbour by fragmentation or the use of nominees.
- Clear rules for inherited property, joint owners, relationship breakdown, disability and other circumstances in which rigid ownership tests could produce arbitrary results.

Dwelling numbers are a better primary boundary than sale-value or cost caps, which vary by location and require indexation. The precise threshold and period should be settled through consultation; the essential feature is certainty before a project begins.

The safe harbour would not exempt the gain from tax. It would determine the appropriate division of the income-tax system under which the gain is assessed. It would also preserve ordinary-income treatment

for recurrent, aggregated or larger-scale development and leave GST obligations to be determined under the GST legislation.

7. Requested treatment in the final report

I respectfully ask the Commission to take three limited steps consistent with its terms of reference:

- Acknowledge that GST and the ordinary-income characterisation of one-off development profits can affect the conversion of zoned capacity into commercially feasible housing supply.
- Ensure that feasibility modelling and any proposed developable-land measure account for these Commonwealth tax settings, rather than treating planning permission and pre-tax feasibility as sufficient.
- Recommend that the Australian Government refer the interaction between federal taxation and small-scale infill housing to Treasury, including consideration of the safe harbour described above and the GST treatment of genuine net additions to housing supply.

Upzoning remains important, but it will deliver less housing than planning maps suggest if ordinary owners face tax consequences that are difficult to predict. The ATO's backyard example makes the problem concrete. If small-scale infill is to become a normal source of housing, its tax treatment should be clear, proportionate and knowable before an owner proceeds.

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