



Australian Government

The Board of Taxation

REVIEW OF GRANNY FLAT ARRANGEMENTS

the **board** of taxation
www.taxboard.gov.au

NOVEMBER 2019

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer following its review of the tax treatment of ‘granny flat arrangements’.

The Board’s review involved assessing the tax circumstances surrounding the making of formal, written and legally enforceable family arrangements where, at its simplest, older Australians transfer their home, or proceeds from the sale of their home (and/or other assets) to their adult children or other trusted persons in return for the promise of ongoing housing and care.

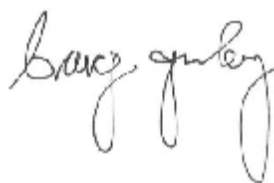
The Board appointed a Working Group led by Board member Mr Craig Yaxley, who chaired the review, and Mr Neville Mitchell and Mr Peter Quiggin, PSM. The Board’s former CEO, Ms Karen Payne also led project work at the outset of the review.

The Board would like to thank all those who participated in our consultation sessions, particularly members of the Elder Law and Succession Law Committee of the Law Council of Australia for their valuable assistance during the course of the review. We learned a great deal from them. We also thank the Department of Social Services, Department of Human Services, the Australian Taxation Office and the Treasury for their collaborative approach to this review.

The ex-officio members of the Board — the Secretary to the Treasury, Dr Steven Kennedy PSM, the Commissioner of Taxation, Mr Chris Jordan AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the observations and recommendations made in this report for advice to Government.



Dr Julianne Jaques
Acting Chair of the Board



Mr Craig Yaxley
Chair of the Working Group

EXECUTIVE SUMMARY

At its broadest, a ‘granny flat arrangement’ describes the situation when a person in their advancing years chooses to live with their adult child (or, less commonly, some other trusted person). This is not a new social phenomenon, but one which has taken on increasing significance in light of an ageing population and increasing pressures on the institutional aged care system.

Historically, granny flat arrangements have tended to be purely private and domestic in nature, based on concepts of trust and ‘natural love and affection’. However, there has been growing appreciation that such ‘informal’ arrangements present real risks. Namely that the older person transfers substantial money or property in return for a mere promise or expectation – there is nothing to show for the transferred assets. If the relationship breaks down, or other unforeseen circumstances arise, the older person can, in the worst case, be left homeless.

The central premise of the task given to the Board is that people contemplating these arrangements should be encouraged to formalise them. That is, to enter into a written and legally enforceable agreement setting out the parties’ rights and obligations.

The reasons for encouraging formality in arrangements are now well documented, particularly by the Australian Law Reform Commission (ALRC) in their 2017 review into elder abuse. It will not eliminate the risks altogether, but will have a positive impact by making disputes less likely to arise and easier to resolve when they do. However, to date, the policy reform discussion has largely examined the issue from the social security perspective, particularly the eligibility rules for the Age Pension. Until now, little attention has been given to another important behavioural driver – the tax implications of formality.

The central tax issue in this report is that formal, more commercial-type granny flat arrangements, as distinct from private and domestic promises, raise the spectre of taxable capital gains. Our consultations emphasised that this is a significant obstacle in the way of detailed, considered written agreements.

Our key recommendation is to provide exemptions for the various capital gain events that would otherwise arise over the life of a granny flat arrangement for all parties to the arrangement (Chapter Four). We offer a number of observations of how such a package can be best designed.

There are also other, less immediate, tax implications that may be acting as an impediment to formal granny flat arrangements. Most importantly, the adult child is at risk of losing part of their main residence CGT exemption when they later sell their home. Tax complications may also arise when the older person pays regular rent-type payments under the arrangement. We make recommendations to deal with both of these issues.

Overall, we expect that the main effects that our recommended approach will achieve will be behavioural ones. They will increase the propensity for families to formalise their arrangements, producing social benefits with minimal cost to revenue and without any net increase in red tape.

We consider that, while our proposed tax reforms will encourage the adoption of formal, written and legally enforceable arrangements, they are not a complete solution to the broader problem of elder abuse. In chapter 5 of the report, we address another challenge in encouraging formality – raising public awareness. We recommend the ATO and DHS jointly publish guidance material to explain granny flat arrangements and assist families contemplating such arrangements.

LIST OF RECOMMENDATIONS

RECOMMENDATION 1

As part of a broader response to the issues of tax and elder abuse, the Government should introduce legislative amendments to provide an exemption for capital gains that would otherwise arise from arrangements involving the creation of *granny flat interests* under 12A of the SSA.

The exemption should apply either to all CGT events or to a defined subset of those CGT events that are hypothetically capable of applying to granny flat arrangements.

The exemption should also extend to *subsequent* CGT events, for both the older person and the adult child, arising over the life of the granny flat arrangement.

RECOMMENDATION 2

The ATO and Department of Human Services should develop joint guidance material, targeted specifically to granny flat arrangements, clearly setting out:

- the tax treatment of regular payments made to the adult child (including payments labelled as rent);
- the circumstances in which Commonwealth Rent Assistance will be available.

RECOMMENDATION 3

For the purposes of the CGT main residence exemption, parties to a qualifying granny flat arrangement, residing at the same address, should be taken to occupy a single dwelling, even where they occupy different units of accommodation.

The ordinary main residence rules should apply to granny flat arrangements that do not involve co-living.

RECOMMENDATION 4

The proposed tax relief in Recommendation 1 for granny flat arrangements should:

- Apply to arrangements that meet a modified definition of *granny flat interest* in section 12A of the *Social Security Act 1991*.
- Be available where the older person is of Age Pension age. Further consideration should be given to extending tax relief to arrangements involving disability support pensioners, service pensioners and people not of Age Pension age.
- Be confined to written agreements between ‘family members’ and ‘family-like relationships’ under a broad definition of those terms.

RECOMMENDATION 5

The Board’s proposals, if adopted, present a valuable opportunity to improve access to educative and instructive information and assistance to families. The ATO and DHS should develop a joint publication that acts as a ‘one-stop-shop’ document for implementing granny flat arrangements.

GLOSSARY

The following abbreviations and acronyms are used throughout this report.

Abbreviation	Definition
ALRC	Australian Law Reform Commission
ATO	Australian Taxation Office
Board	Board of Taxation
CGT	Capital Gains Tax
DHS	Department of Human Services
DSS	Department of Social Services
GST	Goods and Services Tax
ITAA 1997	Income Tax Assessment Act 1997
SSA	Social Security Act 1991

CHAPTER 1: INTRODUCTION

Background

- 1.1 When the Government approached the Board to review the appropriate tax treatment of 'granny flat arrangements', it did so out of concern for older people and the very troubling type of financial abuse and exploitation that they may face, as laid out in the ALRC report: *Elder Abuse: a national legal response*.¹
- 1.2 A granny flat arrangement, especially when undertaken as part of a broader family agreement, can be a sensible long term living arrangement for older people. It often includes care and support and can have benefits for both parties to the arrangement, as well as society more broadly. However, certain aspects of granny flat arrangements may give rise to challenges for policy-makers.
- 1.3 The ALRC report identified that older people may be exposed to financial abuse and exploitation when they enter into these arrangements informally, usually with younger family members. The risk of abuse and exploitation generally arises when there is a breakdown in the relationship or other unforeseen circumstances arise, leaving the older person with the very difficult and costly, if not impossible, task of enforcing their rights to accommodation and care under their informal arrangement. In the worst case, such circumstances can render the older person homeless.
- 1.4 The ALRC made recommendations that sought to '*mak[e] it more likely that there will be some evidence of the [arrangement] in writing in the event that a dispute is brought before a tribunal*'.² Having a written agreement '*would reduce some of the complexity and evidentiary issues that need to be addressed by an older person making a claim in the tribunal*'.³
- 1.5 However, a formal agreement that evidences an intention to create legal relations and creates formal rights for the older person to occupy a space within the younger family member's home and land may bring about unexpected tax consequences, real or perceived. Under current tax laws, the younger family member in these circumstances may face an upfront CGT liability. There are potentially other tax consequences as well, as identified later in this report.

¹ Australian Government, Australian Law Reform Commission, *Elder Abuse – A National Legal Response* (ALRC Report 131, 2017), chapter six.

² *Ibid*, paragraph 6.83.

³ *Ibid*.

- 1.6 The central issue in this report is whether the potential tax liabilities, or the *perception* of tax liabilities, associated with granny flat arrangements are preventing families from treating them with the seriousness they demand. The perception is that the tax consequences may be influencing families to keep the arrangement informal and ‘off-the-books’.
- 1.7 It should be noted at the outset that, consistent with the Terms of Reference, this report has a strong focus on the concept of ‘granny flat interests’ under the social security laws. It is true that tax issues can arise independently of social security implications. For example, a self-funded retiree would face the same tax issues as an Age Pensioner. However, we saw social security laws as critical because older people entering granny flat arrangements are likely to receive some Age Pension and therefore need to navigate both the tax and social security implications of their arrangement. Put simply, they want to maintain their pension and avoid a tax bill. We wished to explore how these two systems interact to influence how families structure their arrangements and, in particular, the degree of formality they adopt.
- 1.8 One challenge in conducting this review was the lack of statistical data relating to granny flat arrangements, particularly in relation to the practical operation of tax and social security laws. What is known is based on anecdotes and insights of professionals in the field.

OBSERVATION

There is a lack of reliable data regarding the prevalence of granny flat arrangements. The DHS (Centrelink) is uniquely placed to assist the Government by collecting and sharing data in relation to:

- The number of granny flat arrangements notified to Centrelink.
- The terms of each arrangement, including the nature of the living arrangement, and the values involved (for example, the ‘entry contribution’ paid and value of a *granny flat interest*).
- The numbers of granny flat arrangements qualifying for other entitlements, such as Commonwealth Rent Assistance.

- 1.9 It is important to note that we encountered limited evidence of tax being paid as a result of creating a *granny flat interest*.⁴ However, we learned in the course of the review that the perception of the tax treatment is distorting behaviour in ways that undermine social policy objectives. These behavioural impacts are the principal focus of this report.

⁴ In undertaking this review, we heard anecdotally that it is more likely that tax has been collected on rental income and on capital gains arising on a later disposal of the property.

Encouraging Australians to enter these arrangements with a level of formality and seriousness to which they devote to other once-in-a-lifetime financial arrangements may ultimately reduce instances of financial abuse and exploitation of older people – a worthy public policy objective.

- 1.10 Against this background, we lay out the current policy and tax settings and make recommendations to align the tax system with other government initiatives. Australia's tax settings should complement efforts across government in tackling abuse and exploitation of older people.

CHAPTER 2: GRANNY FLAT ARRANGEMENTS IN CONTEXT

KEY POINTS

- A 'granny flat arrangement' is a specific type of arrangement recognised in the social security law. It arises whenever a person gives money or property to another person in exchange for a lifetime right of accommodation.
- In practice, granny flat arrangements belong in a broader category of 'family arrangements' – these arise when an older person transfers title to their real property, or proceeds from the sale of their real property, or other assets, to a trusted person (or persons) in exchange for the promise of ongoing care, support and housing.
- Similar to a person's main residence, the value of a *granny flat interest* generally is exempt from the assets component of the means tested Age Pension.⁵
- Granny flat arrangements can be beneficial but can also leave the older person in a vulnerable position if relationships break down or if unforeseen circumstances arise. The risks can be reduced if the arrangement is backed by a comprehensive legal agreement. However, tax is perceived as a barrier to completing such agreements.

What are granny flat arrangements?

- 2.1 A 'granny flat' is a well understood and commonly-used real estate term, invariably describing stand-alone accommodation on someone's property. This common usage may colour what most people understand to be a 'granny flat arrangement'. A granny flat arrangement is something much broader than the real estate notion and, indeed, can be created in accommodation that is not a granny flat.
- 2.2 For the reasons explained in chapter one, in this report, 'granny flat arrangement' has a particular meaning. It is derived from '*granny flat interest*' – a defined statutory term that has had a role in Australia's social security legislation for the better part of three decades. It does not describe the type of accommodation, but rather an arrangement where a person obtains a life interest or a right to accommodation for life in a private residence that is to be their principal home, in return for valuable consideration.

⁵ If the entry contribution is less or equal to the 'extra allowable amount' (currently \$210,500), the granny flat interest will count as an asset but is not regarded as a financial investment under the income test deeming rules.

SOCIAL SECURITY ACT 1991

Section 12A:

- (2) A person has a granny flat interest in the person's principal home if:
- (a) the residence that is the person's principal home is a private residence; and
 - (b) the person has acquired for valuable consideration or has retained:
 - (i) a right to accommodation for life in the residence; or
 - (ii) a life interest in the residence.
- (3) A person is a granny flat resident if the person has a granny flat interest in the person's principal home.

**emphasis added.*

- 2.3 Granny flat arrangements come in many shapes and sizes and we have discovered in this review that various labels, such as 'family arrangements' or 'asset for care arrangements' are often used interchangeably to describe them.
- 2.4 The ALRC report uses the more generic term 'family agreement', describing it as '*typically made between an older person and a family member. The older person transfers title to their real property, or proceeds from the sale of their real property, or other assets, to a trusted person (or persons) in exchange for the trusted person promising to provide ongoing care, support and housing.*⁶ The ALRC points out that family agreements are also known as 'asset for care arrangements' because '*an exchange of property in return for long term care is at [their] centre*'.⁷
- 2.5 However, while there is overlap, granny flat arrangements and 'asset for care arrangements' are not one and the same. An important distinction is that a granny flat arrangement can arise irrespective of whether or not ongoing care or support is provided. Further, a granny flat arrangement can also arise irrespective of the relationship between the parties, the age of the parties, whether rent is payable, or even whether the parties are residing at the same address.⁸ In practice, however, granny flat arrangements tend to be a component of a broader arrangement that also involves the provision of long-term care and support.
- 2.6 The granny flat arrangement rules are part of the general framework of 'deprivation rules' (otherwise known as 'gifting rules') in the social security law. The deprivation rules are a

⁶ Ibid, paragraph 6.1.

⁷ Ibid.

⁸ Given the varying nature of granny flat arrangements, they can include a situation where the older person pays 'rent' to the younger family member (and may receive government benefits in the form of Commonwealth Rent Assistance depending on the application of special residence rules which determine whether a person is considered a 'home owner' or 'non-home owner' for social security purposes).

mechanism designed to target behaviour whereby people diminish their assets by gifting them to others in order to pass thresholds that restrict access to government benefits (the assets and income tests).

- 2.7 Under the deprivation rules, a person may give away up to \$10,000 in a single year, but no more than \$30,000 over five years, before their entitlement is affected. Any amount over these thresholds is treated as a 'deprived asset' for five years from the date of the gift and assessed to earn income under the income test deeming rules (the same treatment as financial assets).
- 2.8 Granny flat arrangements operate as a concession in that the value of the *granny flat interest* is generally exempted from the deprivation rules. The concession comprises valuation rules that have the effect of providing a full or partial exemption. A full exemption is automatically granted if the valuable consideration in the arrangement is one of the following:
- the person transfers the title of their home,
 - the person pays for the construction and fit out of a premises, or
 - the person purchases property in another person's name for everyone to live in.
- 2.9 Variations on these three arrangements are subject to a reasonableness test which compares the value of the consideration given and the value of the *granny flat interest*, and treats the excess as a deprivation.⁹
- 2.10 At its core, a granny flat arrangement provides a person with a legal or equitable life interest, or a contractual right for life, in a place that is to be their main residence.

The policy history of granny flat arrangements

- 2.11 The policy behind the *granny flat interest* is discovered by reference to its first form in the social security law. Though not called a *granny flat interest*, a provision¹⁰ of identical language was introduced at the same time the assets test re-entered the social security

⁹ For example, if the consideration for the *granny flat interest* comprises a transfer of title *and* additional property, or a payment for construction and fit out *and* additional property, then the reasonableness test will apply. The reasonableness test is a quasi-actuarial test whereby the value of the *granny flat interest* is worked out by multiplying the combined annual partnered pension rate by a reasonable conversion factor.

¹⁰ The relevant provision was subparagraph 6AA(1)(a)(iv) of the *Social Security Act 1947*, introduced by the amending act *Social Security and Repatriation (Budget Measures and Assets Test) Act 1984*.

framework in 1984.¹¹ Part of the policy of reinstating the assets component of the means test was to exempt the pensioner's principal home that they owned and occupied.

- 2.12 The policy extended the 'principal home' exemption to other circumstances where the older person had security of tenure. At the time of introduction, the Minister for Social Security noted that *'[t]here are a wide variety of arrangements under which people enter aged persons' homes. Where such a home is a principal residence and pensioners have acquired a right or interest in relation to the home, such as a right to accommodation for life, they will be allowed the homeowner's exemption, and any charge or donation paid to obtain such accommodation or equity in the home would be exempt.'*¹²
- 2.13 The relevant provisions giving effect to that policy were considered in the Federal Court case *Secretary, Department of Social Security v Cummane*.¹³ In the context of an Age Pension entitlement, the case contemplated the transfer of title of Mrs Cummane's home to her son but her retention of a lifetime right to live in the purpose-built upstairs extension. The Court found that the value of Mrs Cummane's life interest was exempt from the assets test for the purposes of determining her pension entitlement
- 2.14 Subsequently, the rules became known as the 'granny flat' provision¹⁴, which was entrenched in the rewrite of the social security law in 1991 with the statutory label of *'granny flat interest'*.¹⁵

Why do people enter granny flat arrangements?

- 2.15 The *granny flat interest* provision in the SSA is broadly defined and the reasons for entering granny flat arrangements are many and varied. However, our consultations highlighted that granny flat arrangements are most commonly entered into by an older person and a trusted carer, usually their adult child.
- 2.16 We understand that an older person and their trusted carer might enter a granny flat arrangement:
- because it allows the older person to remain in their home when they can no longer maintain it themselves, as an alternative to an aged care facility,

¹¹ The assets component of the means test was removed in 1976, leaving only an income test. Subsequently, there was concern about inequities and distortions associated with asset-rich people receiving social security benefits, leading to the reinstatement of an assets test.

¹² Commonwealth, *Parliamentary Debates*, Senate, 6 September 1984, 523-527 Senator the Hon Donald Grimes (Minister for Social Security).

¹³ 93 ALR 566.

¹⁴ See *Social Security Reporter*, no. 48, April 1989, 624-5.

¹⁵ See the outline to the Explanatory Memorandum to the Social Security Bill 1991. The rewrite of the 1947 Act did not involve any major policy initiatives. Rather it refreshed the existing policy (as reflected in the 1947 legislation) using a 'clear English' drafting style and format.

- to live with family and help to raise grandchildren,
- to access capital tied up in their home while retaining a place to live,
- for general companionship, and
- to keep assets within the family.

2.17 The arrangements may be particularly beneficial for older people as their health deteriorates (but not to the point of needing advanced care) and/or after the loss of a spouse. The *granny flat interest* concession ensures that older people entering the arrangements are not disadvantaged.

When things go wrong

2.18 While granny flat arrangements are generally viewed as socially desirable, we heard they also expose the parties to considerable risk when families are not fully aware of the implications or are otherwise reluctant to think about and address issues at the outset. We heard many anecdotes of granny flat arrangements that broke down. These did not always involve ill-will on the part of the adult child, but rather because unforeseen circumstances arose which the parties had failed to contemplate or formally address at the outset.

2.19 Many of the examples of unsuccessful granny flat arrangements involved the families failing to consider such contingencies as the adult child pre-deceasing the older person, divorcing, or being subject to bankruptcy proceedings. In other cases, they did not contemplate who would pay for residential aged care upon the older person's serious and terminal decline in health. This is understandable in the context of loving and trusting relationships between family members, whereby most people do not conceive of a reason that would cause the relationship to irretrievably break down.

Documenting, in a written agreement, a loving, caring or supportive personal relationship, for example, is probably anathema to many Australians.¹⁶

2.20 In circumstances where these issues are left unaddressed and/or reliant on the divergent memories of each party, the older person is placed in a very vulnerable position in trying to enforce their rights to accommodation. As pointed out in the ALRC's report, it is not

¹⁶ Brian Herd, *The Family Agreement – A Collision Between Love and the Law* (2002) 81 Australian Law Reform Commission Reform Journal 23.

the case that the older person is left without remedy altogether. Rather, the older person is required to bring an equitable action to establish unconscionable conduct, undue influence, a resulting trust, a constructive trust or equitable estoppel. Such actions are notoriously difficult and costly to pursue. It generally requires a Supreme Court action, something which is often beyond the reach of a would-be plaintiff who is typically elderly and of limited means.

2.21 As implied in our Terms of Reference, the risks associated with granny flat arrangements can be reduced through formal, written and legally enforceable agreements. Stakeholders in our consultations, while acknowledging that formal agreements are not a panacea, were strongly in favour of promoting formality. They stressed that detailed, considered formal agreements make dispute resolution easier because they provide a clear statement of the parties' rights and obligations. And more importantly, they make disputes less likely to arise, because they force family members to confront the realities of their undertaking and to plan for various contingencies.

Understanding the issue

2.22 Whatever the reason people enter granny flat arrangements, they are most commonly carried out by the older person:

- transferring title to their home to the other trusted party,
- selling their home and using the proceeds to make a large cash payment to the trusted party (which is often applied against the trusted party's mortgage),
- selling their home and using the proceeds to construct a separate 'granny flat' at the other trusted party's home, or
- selling their home and using the proceeds to buy a suitable home for themselves and the other trusted party and their family. The home is registered in the other party's name.¹⁷

2.23 In all of these scenarios, the granny flat arrangement generally results in the older person giving up their legal and indefeasible title to property and swapping it for something less, whether it be an enforceable right or, as seems to be common, an informal expectation or understanding that accommodation will be provided for life.

2.24 In deciding how to structure their granny flat arrangement the older person will, in most cases, want to ensure that no deprivation arises for social security purposes. We were

¹⁷ Seniors Rights Victoria, *Assets for care: A guide for Lawyers to Assist Older Clients at Risk of Financial Abuse*, page 9.

therefore interested in exploring whether section 12A of the SSA requires that the older person obtain, at a minimum, a legally enforceable right to accommodation for life.

- 2.25 We understand that DHS administers section 12A on the basis that it does not require an intention to create legal relations. Accordingly, an informal arrangement in which the parties have an 'expectation' or 'understanding' that accommodation will be provided, but do not intend for a legally enforceable obligation to exist will not give rise to a deprivation for social security purposes.
- 2.26 The fact that informal arrangements satisfy section 12A is important because the most significant tax impediments arise only when formal and legally enforceable rights are created. This interaction between tax and social security may be contributing to the decision by families to opt for very loose, often undocumented, arrangements that create risk for both parties to the arrangement, even when they do seek professional advice. Put simply, by having an informal arrangement, the older person can satisfy the social security rules and avoid adverse tax consequences. However, the absence of a legally enforceable agreement leaves the older person at significant financial risk.
- 2.27 The tax exposures and complexities associated with a formal and legally enforceable granny flat agreement are explored in the following chapter.

CHAPTER 3: TAXING GRANNY FLAT ARRANGEMENTS

KEY POINTS

- Granny flat arrangements give rise to four significant tax issues:
 - the homeowner (adult child) may realise a large CGT liability that is neither eligible for the main residence CGT exemption or the 50 percent CGT discount,
 - the potential CGT consequences when the granny flat interest is varied (for example, change of location) or terminated (for example, older person enters aged care),
 - there is a perception that any ongoing, regular payments made to the adult child may be assessable as rental income, and
 - the arrangement may affect the adult child's ability to claim the main residence exemption on subsequent disposal of their property.

3.1 To date, the discussion of tax impediments of granny flats has primarily focussed on one issue: the possible triggering of a CGT liability for the homeowner (adult child) of a *granny flat interest*. More specifically, the concern has centred on the application of a specific CGT provision, the so-called 'CGT event D1'.

3.2 The perceived CGT implications arising from the creation of a *granny flat interest* are undoubtedly the most significant tax issue and, we understand, are viewed as a 'deal breaker' in formalising arrangements. However, granny flat arrangements typically involve a series of transactions, each of which may potentially have tax consequences. We consider that there are in fact four important tax considerations that well-informed parties would be expected to factor into their decision on whether to enter into a formal granny flat arrangement, and what form it should take. They are:

- the application of the CGT provisions to the creation of the *granny flat interest*,
- the potential CGT consequences when the granny flat interest is varied, terminated or otherwise comes to an end;
- the income tax treatment of any regular payments made under the granny flat arrangement in addition to the initial contribution, and

- the effect that a granny flat arrangement may have on the adult child's ability to claim the CGT main residence exemption on a subsequent disposal of the property.

Creation of the granny flat interest

- 3.3 CGT is a comprehensive regime for taxing capital gains that come home to a taxpayer in a realised form. The CGT provisions in the ITAA 1997 operate by categorising the various types of CGT triggers into transaction types, known as 'CGT events', each of which has its own rules as to timing, the amount of any gain or loss, and whether exemptions or concessions are available.¹⁸
- 3.4 The CGT event most commonly associated with granny flat arrangements is known as 'CGT event D1'. It is triggered 'if you create a contractual or other legal or equitable right in another entity'.¹⁹ By definition, an arrangement involving the creation of a *granny flat interest* will, provided it involves the creation of legally enforceable rights, meet this requirement.
- 3.5 The key tax consequences arising from an application of CGT event D1 are:
- Most importantly, the CGT liability falls on the person who grants the granny flat interest, which invariably is the adult child or equivalent in the arrangement.
 - The amount of the capital gain arising from CGT event D1 is the 'capital proceeds' from the event less the 'incidental costs' such as legal expenses.²⁰ Unlike most other CGT events, it does not employ the concept of a CGT cost base.
 - The capital proceeds from a CGT event are generally the amount of money and market value of property received or entitled to be received from the event happening. However, a granny flat arrangement, being typically a non-arm's length arrangement, is likely to be subject to market value substitution rules under which the capital proceeds are taken to be the value of the right created in the other person.
 - A capital gain from CGT event D1 is not eligible for the general 50 per cent discount.²¹
 - A capital gain from CGT event D1 is never eligible for the CGT main residence exemption, even if the right is to enjoy a property created in the adult child's main residence.²²

¹⁸ ITAA 1997, Division 104.

¹⁹ Ibid, Subsection 104-35(1).

²⁰ Ibid, subsection 104-35(3).

²¹ Ibid, paragraph 115-25(3)(a).

²² Ibid, subsection 118-110(2).

CAMEO – BASE CASE

Nelly is a widow in her early sixties. She lives in her own home in the Brisbane suburbs and receives the Age Pension. The current market value of her home is \$1 million.

Nelly's son Michael, an only child, lives nearby with his young family. Michael is currently renting an apartment and does not own his own home.

After seeking professional advice and talking to Centrelink, Nelly and Michael decide to enter into a granny flat arrangement. Under the terms of the arrangement, Nelly will transfer title to her home to Michael. Nelly realises a capital gain on this disposal but the main residence exemption applies.

In consideration for the transfer, Michael will guarantee Nelly's right to continue to live there with him and his family for the rest of her life and to provide ongoing care and support.

As a result of entering into the arrangement, CGT event D1 happens. Michael is taken to have a capital gain equal to his capital proceeds less his incidental expenses. Prima face, his capital proceeds are the market value of the home, \$1 million. However, as Michael and Nelly did not deal at arm's length, his capital proceeds are substituted by the market value of the asset that is the subject of the CGT event: the rights acquired by Nelly. Michael obtains an expert valuation which determines that the value of Nelly's rights is \$275,000.

Michael's capital gain for the year when he signs the agreement is:

Capital proceeds	\$275,000
<i>Less incidental expenses comprising</i>	
Legal fees	(\$10,000)
Valuer's fees	(\$15,000)
<hr/> Capital gain	<hr/> \$250,000

- 3.6 It is noted that the example assumes that the value of the rights given to Nelly are readily capable of being ascertained. In fact, the nature of the rights typically generated in granny flat arrangements is such that this would rarely be the case. While the accommodation component may be capable of being determined objectively, other rights – such as the right to receive care – would be highly subjective. Reasonable minds could be expected to differ widely as to their estimation of the value of such rights. Establishing the market value of the rights imposes a high compliance burden on the adult child and is costly for the Commissioner to administer.
- 3.7 A common misconception about CGT event D1 is that it only applies to written agreements. Actually, it is concerned with the creation of legally enforceable rights. An enforceable right arising under a verbal agreement is still capable of enlivening CGT event D1. Admittedly, the absence of written evidence of the arrangement may make it difficult for the Commissioner to support the raising of an assessment for the capital gain.

CGT events other than D1

- 3.8 An issue that is sometimes overlooked is that CGT event D1 is a CGT event of last resort that, generally speaking, only applies if all other CGT events have been excluded. The view that D1 applies is based on an assumption that the agreement involves the creation of a purely contractual right or licence, a 'mere personal right to occupy a property for life'.²³ This appears to be the standard or 'vanilla' arrangement.
- 3.9 However, granny flat arrangements under the definition in the SSA can vary significantly and produce different tax outcomes. For example, the arrangement might involve the creation, not of a mere contractual right, but of a property right comprising a legal or equitable life interest. If so, the relevant CGT event may be A1 (about the disposal of assets) or E1 (about the creation of trusts). Importantly, both of these events may give the taxpayer access to either the general CGT discount or the main residence exemption.

Subsequent CGT Events

- 3.10 Another overlooked fact is that, over the life cycle of granny flat arrangements, subsequent CGT events may arise for both the adult child *and* the older person. For example, the 'ending' of the right to accommodation, whether it occurs by mutual agreement or termination, triggers the realisation of a CGT asset in the hands of the older person.²⁴
- 3.11 A significant variation to an arrangement may bring about the ending of the original rights and the creation of new replacement rights. This could have CGT consequences for both the older person, due to the ending of the original rights, and could trigger a subsequent CGT event D1 in the hands of the adult child. This might commonly arise if the adult child moves house and re-establishes the *granny flat interest* at the new premises.

Income tax treatment of rent payable under the granny flat arrangement

- 3.12 In our consultations, stakeholders told us that in some granny flat arrangements, the older person agrees to make regular, ongoing payments which they describe as 'rent'. The social security laws contain special residence rules that determine whether a person is

²³ Australian Taxation Office, Taxation Ruling TR 2006/14, paragraph 194.

²⁴ Specifically, CGT event C2 in section 104-25 of the ITAA 1997 happens whether the ownership of an intangible asset ends by, relevantly, redemption, cancellation, release, discharge, expiry, abandonment, surrender or forfeiture.

considered a 'home owner' or 'non-home owner' for social security purposes. In certain circumstances where a person is considered a non-home owner they may be eligible for Commonwealth Rent Assistance.²⁵

- 3.13 The payments of 'rent' may give rise to tax issues. Rent payments might be included in the assessable income of the adult child who may also be entitled to deductions for expenses (such a mortgage interest) incurred in relation to earning that rental income. Further, the derivation of rental income could also have implications for the adult child's access to the CGT main residence exemption for capital gains on subsequent disposal of their property.

ELIGIBILITY FOR COMMONWEALTH RENT ASSISTANCE

The approach taken in the assessment of eligibility for Commonwealth Rent Assistance for age pensioners that have created a granny flat arrangement is consistent with approach taken for retirement village residents under social security special residence rules.

An Age Pension recipient may be assessed as a 'non-homeowner' for social security purposes if the principal sum ('entry contribution') he or she paid for the *granny flat interest* is equal to or less than a prescribed amount ('the extra allowable amount'). That amount is currently \$210,500.

Commonwealth Rent Assistance will be available as long as the older person makes regular rent-type payments such as maintenance fees and charges, or board and lodging, above a specified threshold, and qualifies for some of the Age Pension.

The amount of rent assistance differs depending on the circumstances of the recipient. For example, a single person paying rent of \$310 per fortnight would qualify for the maximum rent assistance of \$138 per fortnight.

Where the older person makes a regular payment for board and lodging, Commonwealth Rent Assistance is only available in respect of the lodging component. We understand that, in most cases, the entry contribution for granny flat arrangements is above the \$210,500 threshold such that the older person is not eligible for Commonwealth Rent Assistance.

- 3.14 Payments of 'rent' under granny flat arrangements raise a number of difficult tax law questions. What is the 'character' of the payments? Are they in fact rent or are they wholly or partly for something else? And if so, what? For example, are they board, contributions to household expenses or payments for the provision of care or other services? And how does the proper characterisation of the payment affect the tax treatment? Should it form

²⁵ DSS advised us that Commonwealth Rent Assistance is payable to eligible non-home owners for regular rent-type payments such as maintenance fees that the older person has agreed to make to the adult child as part of the terms of the granny flat arrangement.

part of the assessable income of the recipient and what allowable deductions is the recipient entitled?

- 3.15 In practice, regular payments made under granny flat arrangements, while sometimes labelled as rent, are likely to be of private and domestic nature, such as payments for care and associated services, or contributions for the cost of meals and other household expenses. As such, they are more akin to board payments. Having regard to relevant authorities, and consistent with the ATO view as set out in IT 2167, the payments will not be included in the assessable income of the adult child and will not give rise to allowable deductions for expenses incurred in generating the income. It will also not limit the adult child's ability to claim the main residence exemption on later disposal.

Main residence exemption on sale of the property

- 3.16 When the adult child subsequently sells the relevant property, he or she must determine the effect (if any) of the granny flat arrangement on the availability of the main residence exemption. One or more of three overlapping issues may arise.
- 3.17 The first issue arises if the older person pays rent to the adult child. As noted above, we consider that rental income for tax purposes would rarely, if ever, arise under a granny flat arrangement. This analysis is only included for completeness only.
- 3.18 Where rental income for tax purposes is derived, the adult child will only be entitled to a partial main residence exemption. Working out the extent of the exemption will often involve difficult calculations based on the percentage of the property occupied by the older person and the length of the granny flat arrangement taken as a proportion of the adult child's total ownership period. In many cases, the adult child will also be required to establish the market value of the property at the time the granny flat arrangement commences.
- 3.19 The second, more pertinent, issue arises in arrangements where the *granny flat interest* is in relation to a separate 'unit of accommodation' – a granny flat in the traditional sense that is separate from the adult child's main home. In this case, the adult child will only be entitled to the full main residence exemption if the granny flat forms part of their 'dwelling'.
- 3.20 Whether separate units of accommodation comprise a single dwelling is determined by reference to all of the facts and circumstances. The test looks at the degree of integration between the two places of abode. For example, if an older person lives independently and self-sufficiently, dines separately, and is separately responsible for costs such as utilities, he or she is likely to be living in a separate dwelling. However, where the older person's activities are closely integrated into those of the adult child by, for example,

sharing meals and spending significant time in the 'main house', the two units of accommodation are more likely to comprise a single dwelling.²⁶

EXAMPLE – SINGLE DWELLING

Mr and Mrs Brown reside with their three children in a suburban house. Mrs Brown's mother (Dora) resides in a detached granny flat built for her in the backyard. Although the flat is fully self-contained, and Dora eats and sleeps there, Dora's daily life and activities are closely integrated with those of the Browns. She spends considerable time in the main house and family members regularly spend time in Dora's flat. In the circumstances, having regard to the proximity of the flat and the integration of activities, the house and the flat are the Browns' dwelling for the purposes of section 118-115.

Source: Taxation Determination TD 1999/69

EXAMPLE – SEPARATE DWELLINGS

The applicant agreed to build a granny flat to the rear of his dwelling for his elderly parents to provide support to them (granny flat).

The applicant's parents paid for the construction costs of the granny flat which was built for an unspecified amount.

The local Council treated both the dwelling and granny flat as two separate rateable properties. The applicant's parents paid the rates in respect to the granny flat.

The granny flat was the parents' main residence and the supply of gas, electricity and other services was separately metered from the dwelling and paid for by the parents.

In all of the circumstances, the applicant's home and the granny flat were regarded as two separate dwellings for CGT main residence purposes.

Source: ATO Ruling no. 1051298750843

- 3.21 It should be noted that the degree of integration between two units of accommodation is not necessarily static; it may change over time as circumstances change. This is quite likely in a granny flat arrangement scenario. For example, the older person may die and the adult child may repurpose the granny flat as a rumpus room, a place for storage or as a spare bedroom. There is uncertainty about how the main residence rules operate when two separate dwellings are reintegrated into a single dwelling before being sold.

²⁶ Australian Taxation Office, TR 1999/69.

- 3.22 The third issue arises in relation to granny flat arrangements that do not involve co-living. By this, we mean that the older person and adult child reside at separate addresses. For example, the older person may transfer property to his or her adult child subject to an undertaking that he or she will continue to live there with the permission of, or licence from, the adult child, who lives separately. We understand that this arrangement is permissible under the social security law and that it is a common scenario.
- 3.23 Arrangements involving separate addresses give rise to complexity in relation to the application of the main residence exemption rules. However, on its face, the main residence exemption may not be available to the adult child in respect of the later disposal of the transferred property. Among other reasons, the adult child appears not to reside at the relevant property.

CHAPTER 4: REMOVING THE TAX IMPEDIMENTS

KEY POINTS

- Capital gains arising from granny flat arrangements should be eligible for a targeted exemption.
- The CGT exemption should:
 - : not be confined to CGT event D1 but to a broader range of CGT events;
 - : apply to CGT events for the adult child *and the homeowner* over the life of the granny flat arrangement;
 - : be subject to eligibility rules, including the relationship between the parties and a requirement that the agreement be in writing.; and
- The need to change the tax law related to the treatment of 'rent' derived under a granny flat arrangement is less clear, along with any impact on the adult child's ability to later claim the main residence exemption. We believe that this issue can be dealt with via ATO guidance.
- Where the adult child and older person reside in separate units of accommodation at the same address, they should be taken to occupy a single 'dwelling' for the purposes of the main residence exemption.
- Law clarification will allow families to make properly informed decisions and to plan for tax outcomes.
- The revenue cost of reform is likely to be minimal and any new compliance costs arising from reform will be offset by the removal of existing compliance costs including the requirement to value rights and to apportion the main residence CGT burden.

Policy disharmony and the case for reform

- 4.1 Australia's social security law has long recognised the public policy benefits of granny flat arrangements. Since 1984, the *granny flat interest* concession (in various forms) has ensured that older people can put in place a sensible living arrangement in their later life without jeopardising their entitlement to the Age Pension.
- 4.2 As a general proposition, the concern with the taxation of granny flat arrangements is that the prospect of a tax liability is having an adverse behavioural effect by encouraging

families to opt for very loose, often undocumented, arrangements that create risk and uncertainty.

- 4.3 In our consultations, stakeholders echoed the sentiment expressed in the ALRC's recommendations that a formal, written granny flat agreement may go some way to preventing instances of financial abuse and exploitation of older people. They believed that removing tax impediments may increase the prevalence of such agreements.
- 4.4 The tax system has previously been used as a lever for giving effect to social policy outcomes. In this case, we consider that there are compelling policy reasons why any perceived economic gain derived by the adult child from a granny flat arrangement should (at least in some cases) not be subject to tax.
- 4.5 First, taxes are imposed on economic activity as an effective means to raise revenue to fund government expenditure. If the intent of the SSA exemption for granny flat arrangements is to recognise the various circumstances older people occupy a principal home, then imposing tax on those arrangements is counterproductive and inconsistent with a joined-up policy framework.
- 4.6 Second, although they do not meet the existing technical requirements for the main residence exemption, granny flat arrangements are often, at least tangentially, related to a main residence owned by the adult child. That is, as a matter of substance they typically involve the derivation of a profit from a main residence (albeit not to the strict degree required by the CGT provisions). Accordingly, it is arguable that the policy of exempting the family home from CGT should extend to granny flat arrangements.
- 4.7 Third, while granny flat arrangements involve the creation of enforceable rights, they are nevertheless, essentially private and domestic arrangements. Exempting the gain would be aligned with the policy of exempting gains from 'personal use assets'.²⁷
- 4.8 Finally, granny flat arrangements are an example of CGT event D1 applying in a manner that is arguably inconsistent with its policy. Prima facie, CGT event D1 has a very broad reach, hence the need for a number of exceptions to confine it to its core purpose, which is to tax the profit component of a capital receipt. It is arguable that an adult child in a granny flat arrangement has not 'profited' in the true sense of that term.
- 4.9 In light of these considerations, we believe there is merit in a targeted, conditional tax relief package for granny flat arrangements. Such relief could operate as a powerful 'nudge' to encourage the adult child to enter formal, written and legally enforceable arrangements, ensuring that the interests of the older person are protected and minimising the risk of elder abuse. It can be designed in a way that has application, not

²⁷ ITAA 1997, section 108-20.

only to Age Pension recipients, but also self-funded retirees and other individuals who for reasons such as disability, would benefit from a granny flat arrangement.

Addressing the tax issues

Capital gains arising from the granny flat arrangements

- 4.10 As outlined in the previous chapter, the CGT implications arising from the creation of a *granny flat interest* are undoubtedly the most significant tax issue. The taxable capital gain arises for the adult child as a result of the creating the right to accommodation for life or life interest. It was noted that these arrangements typically trigger CGT event D1, but could involve other events if a life interest were created.
- 4.11 Life interests can be distinguished from a mere contractual right or licence to occupy property in that they are proprietary in nature and endure for his or her lifetime. We believe that the parties to an arrangement through their trusted advisers should not be inhibited from exploring the feasibility of granny flat arrangements involving life interest as they may provide the older person with far greater security than a mere licence or contractual right to reside. Accordingly, we consider that there should be a broad exemption applicable to all CGT events (or to an identified class of CGT events theoretically capable of being enlivened.).
- 4.12 The exemption should also extend to CGT events that arise as a result of subsequent dealings in the *granny flat interest*, such as when it is varied, terminated or is otherwise brought to an end. This aspect of the exemption should extend to both the older person and the adult child.

RECOMMENDATION 1

As part of a broader response to the issues of tax and elder abuse, the Government should introduce legislative amendments to provide an exemption for capital gains that would otherwise arise from arrangements involving the creation of *granny flat interests* under 12A of the SSA.

The exemption should apply either to all CGT events or to a defined subset of those CGT events that are hypothetically capable of applying to granny flat arrangements.

The exemption should also extend to *subsequent* CGT events, for both the older person and the adult child, arising over the life of the granny flat arrangement.

Rental income from a granny flat arrangement

- 4.13 The second important tax issue to address concerns the tax treatment of any regular, ongoing payments received from the older person under the granny flat arrangement.
- 4.14 As outlined in chapter three, the characterisation of 'rent' under granny flat arrangements may differ for tax and social security purposes, with the Board considering that assessable rental income would arise rarely, if ever. One way forward would be for the Government to provide an exemption for all purported 'rental' payments, made under complying granny flat agreements. Such an exemption would operate largely for the avoidance of doubt, given the unlikelihood that such payments would be assessable in the absence of an exemption. Its main advantage would be to provide families contemplating granny flat arrangements, and their trusted advisers, with greater certainty as to the tax consequences.
- 4.15 We consider that, while it may have some advantages, the case for a rental income exemption for granny flat arrangements is not clear. This is on the basis that increased certainty can be provided to families contemplating granny flat arrangements through administrative guidance rather than introducing additional complexity in the tax law. Additionally, we are concerned about possible adverse behavioural effects if such an exemption were to be enacted. It may distort decisions around the charging of 'rent' under granny flat arrangements.
- 4.16 While we do not believe a rental income exemption is required, we understand that there is a clear need for families contemplating granny flat arrangements to have ready access to unambiguous guidance targeted specifically to the granny flat scenario. Ideally, such guidance would address both the tax and social security implications of regular payments, including providing clarity to families as to when Commonwealth Rent Assistance is available for the granny flat arrangements and their tax consequences.

RECOMMENDATION 2

The ATO and Department of Human Services should develop joint guidance material, targeted specifically to granny flat arrangements, clearly setting out:

- the tax treatment of regular payments made to the adult child (including payments labelled as rent);
- the circumstances in which Commonwealth Rent Assistance will be available.

Extending the main residence exemption

- 4.17 As outlined above, concerns have been raised that a granny flat arrangement may reduce the adult child's ability to claim the main residence exemption in two ways. The first is where the adult child charges ongoing rent and thereby uses his or her dwelling to derive assessable income. As discussed, we consider that rental income for tax purposes will

rarely arise under granny flat arrangements and therefore will not impair the adult child's ability to claim the main residence exemption on a subsequent disposal of the property.

- 4.18 However, the adult child may also partially lose the main residence exemption if the older person resides in a separate 'dwelling' to that of the adult child. Accordingly, we recommend that where the conditions for a CGT exemption are met, the adult child and older person should be deemed to occupy the same dwelling for the life of the granny flat arrangement. To ensure necessary integrity, this would only apply where both parties reside at the same address. For granny flat arrangements not involving co-living, the ordinary main residence rules would apply.

RECOMMENDATION 3

For the purposes of the CGT main residence exemption, parties to a qualifying granny flat arrangement, residing at the same address, should be taken to occupy a single dwelling, even where they occupy different units of accommodation.

The ordinary main residence rules should apply to granny flat arrangements that do not involve co-living.

Design Considerations

- 4.19 The provision of a CGT exemption raises a number of important design considerations relating to what types of arrangements should be eligible for relief and the critical issue of what should be the formal requirements of a tax exempt arrangement.

Defining the arrangements

- 4.20 Defining the type of arrangements that would qualify for the proposed CGT exemption is a challenging task that should necessarily be subject to further consultation in a detailed law design phase. However, we offer the following observations to assist in this task.
- 4.21 The definition of *granny flat interest* in the SSA provides a useful starting point for defining the scope of a proposed CGT exemption. However, on its face, that definition is broad. Simply extending CGT relief to, for example, 'arrangements involving the creation of a *granny flat interest* under section 12A of the SSA' may open up tax planning opportunities by extending relief to commercial and quasi-commercial arrangements that should properly be taxable.
- 4.22 To ensure that relief is targeted, the proposed CGT exemption could be based on a modified test derived from section 12A of the SSA. It could also be sufficiently linked to the broader problem identified at the outset, the financial abuse and exploitation of older people. Accordingly, on our preferred model, relief would be available for arrangements involving the creation of a *granny flat interest* that is acquired by a person of Age Pension age. This would include self-funded retirees.

- 4.23 In conducting this review in accordance with its terms of reference, we have focused on older Australians and the risks of elder abuse. However, it has been suggested that there are other parts of the community for whom tax relief may also be justified. Two obvious categories are people with a disability and certain veterans who are not of Age Pension age. It was also suggested that older people under the Age Pension age should also qualify. Although outside the scope of this review, these suggestions have obvious merit and should also be considered as part of the implementation of these recommendations.

OBSERVATION

As part of the implementation of these recommendations the Government may wish to extend relief to other sections of the community including people with a disability and certain veterans.

- 4.24 We considered whether the proposed tax relief should also be confined to ‘co-living’ arrangements where the adult child and older person reside at the same address. However, in our view, tax relief should not be limited in this way. Arrangements where the older person lives at a separate address from the adult child are permissible under social security law. Our view is that families with these type of arrangements would be better served by having a formal, written and legally enforceable agreement in place. However, as we have noted in 4.18, parties in this type of arrangement should continue have the normal main residence rules apply.
- 4.25 Another key issue to be considered is the scope of the relationship between the parties for the purposes of the proposed CGT exemption. We think that individuals with family-like relationships should qualify for the exemption. In its report on elder abuse, the ALRC considered this question in relation to their recommendation that all state and territory tribunals should be given jurisdiction to resolve disputes involving granny flat arrangements. Similarly, we consider that a granny flat-specific modification to the broad definition of ‘family’ in the Victorian *Family Violence Protection Act 2008* could serve as a useful starting point.

Documenting the arrangements

- 4.26 We understand that the interests of the older person are best served when they seek specialist legal advice and enter into a *detailed* agreement that is tailored to their specific circumstances. A properly drawn agreement would not only provide the older person with a certain right to accommodation but would also deal with a range of ancillary matters including the older person’s expectations of care and support.
- 4.27 We do not consider, however, that a detailed legal agreement should be a condition of the proposed tax relief. Imposing overly prescriptive requirements would undoubtedly have the unintended effect of encouraging families to opt instead for an informal arrangement which leaves all parties, but especially the older person, at risk. Accordingly,

we consider that there should be only a minimum level of formal requirements, namely that the arrangement be in writing.

- 4.28 We do, however, recommend that the Government continues to educate the community about the risks associated with granny flat arrangements and provide tools to allow them to take *voluntary* steps to reduce those risks. Our ideas for an education strategy are outlined in the next chapter.

RECOMMENDATION 4

The proposed tax relief in Recommendation 1 for granny flat arrangements should:

- Apply to arrangements that meet a modified definition of *granny flat interest* in section 12A of the *Social Security Act 1991*.
- Be available where the older person is of Age Pension age. Further consideration should be given to extending tax relief to arrangements involving disability support pensioners, service pensioners and people not of Age Pension age.
- Be confined to written agreements between ‘family members’ and ‘family-like relationships’ under a broad definition of those terms.

The cost of reform

- 4.29 We have considered the cost of these reforms, both in terms of its impact on tax revenues and on the compliance burden on families who enter into granny flat agreements. While these issues have not yet been formally costed, we consider that the reforms are likely to have an overall positive impact.
- 4.30 In terms of the revenue impact, anecdotal evidence suggests that CGT collections from the creation of granny flat interests are likely to be very low, if not nil. This may be explained by the strong preference for informal agreements and low levels of compliance.
- 4.31 The position with respect to the main residence CGT exemption is less clear. However, we consider it likely that the loss of main residence exemption would only arise in a small minority of cases. The more common scenario is that the homeowner derives no rent for tax purposes and occupies the same ‘dwelling’ as the older person, even if there are two separate units of accommodation. It should also be noted that any revenue that may arise from the payment of rent, would be offset by significant deductions that might be available to the homeowner.
- 4.32 Based on our observations, we consider that the introduction of a targeted CGT exemption removing tax impediments to formal, written granny flat agreements is unlikely to lead to any appreciable loss of tax revenue.

- 4.33 A more significant issue is whether the reform would expose families to compliance costs or 'red tape'. We propose that the gateway entry criteria to the CGT exemption will impose an additional compliance obligation in that arrangements will need to be documented. However, the overall package of reforms will also lead to significant red tape reduction in other areas. From a CGT perspective, families will no longer be required to value rights for CGT purposes or apportion the proceeds of sale on a reasonable basis between two separate places of abode. Similarly, recommendations to provide additional administrative guidance are expected to reduce compliance cost.
- 4.34 Overall, it is expected that the main effects that the reforms will achieve will be behavioural ones. That is, they will increase the propensity for families to formalise their agreements. We consider that this will produce significant *social* benefits, with minimal cost to revenue and without any net increase in red tape.

Conclusion

- 4.35 Whatever position is reached on the case for changing the law in the areas identified in this chapter, we consider that families contemplating a granny flat arrangement should be able to make their decision on the basis of complete and accurate information on the possible tax implications. At present, however, there is insufficient education and guidance, and a lack of clarity as to operation of the law in key areas. In the following chapter, we outline a strategy for addressing the information gap.

CHAPTER 5: PUBLIC EDUCATION AND ASSISTANCE

KEY POINTS

- There is considerable complexity and uncertainty surrounding granny flat arrangements.
- Implementing our proposed CGT exemption presents an opportunity for the public service to provide greater clarity, certainty and assistance to families entering granny flat arrangements.
- DHS and the ATO should develop a joint publication on granny flat arrangements that serves as a valuable source of information and guidance to families. It should include a pro-forma granny flat agreement.

Demystifying granny flat arrangements

- 5.1 In the course of our consultations and closely examining granny flat arrangements, we have observed a significant amount of uncertainty and misinformation. For example, there are a number of GST issues that are perceived as tax impediments to formal agreements but are, in our view, so unlikely to arise in practice as to not be issues at all. There are other issues which arise that should be clarified through formal ATO guidance.
- 5.2 In the following section, we clarify the position in relation to the most common complexities we encountered. However, we think that the implementation of our recommendations will create a valuable opportunity to better educate and inform the community about the risks of granny flat arrangements such that families enter them with their eyes wide open.

Goods and Services Tax

- 5.3 One tax issue we encountered is the perceived application of GST on the supply of accommodation under a granny flat arrangement. In practice, GST is so unlikely to ever be an issue that we consider it a tax myth.
- 5.4 First, a 'supply' of the right to reside for life under a granny flat arrangement is made by family members in a private arrangement with no expectation of profit or gain. Accordingly, such activity is excluded from being an 'enterprise' for GST purposes. Importantly, a formalised granny flat agreement between family members would not change that conclusion. Even if it were conceivable for an adult child or other trusted carer

to be carrying on an enterprise in respect of the supply of accommodation, they would only be required to be registered for GST if their GST turnover threshold of \$75,000 is met. In that unlikely circumstance, the supply is most likely to be input-taxed, further limiting any GST consequence. It is certainly not something that affects the mainstream community and should not be impeding anyone from entering a formal arrangement.

- 5.5 Likewise with the supply of care, it is difficult to conceive of circumstances where, under a granny flat arrangement, it would constitute an activity that is carried on in the form of a business or concern in the nature of trade. It is even more difficult to see how it would have any application in the context of our proposed exemption and its design parameters outlined in chapter four.

Rent

- 5.6 We have noted the tax consequences of regular, ongoing payments made by the older person to the adult child under a granny flat arrangement in chapters three and four and recommended joint ATO and DHS guidance.

Separate dwelling main residence

- 5.7 We have noted the impact of granny flat arrangements on the adult child's main residence in chapters three and four and recommended exemptions and clear ATO guidance.

'Granny Flats Explained'

- 5.8 Some great work has been done to demystify granny flat arrangements. For example, Senior Rights Victoria has produced two guidance products, one for families and one for lawyers which includes a model agreement.²⁸ We understand that organisations such as 'Aged Care Gurus' and 'Legalwise' provide seminars to legal and accounting professionals that forms part of their continuing professional development. Lawyers have also devised some inventive approaches to protect the interests of other family members in the older person's estate affected by a granny flat arrangement.²⁹
- 5.9 Nonetheless, it has become clear to us that families' access to timely, accurate and easily-understood information could be improved. Removing the tax barriers to formal

²⁸ See https://seniorsrights.org.au/wp-content/uploads/2014/03/Care-For-Your-Assets_guide-for-older-people-on-money-ageing-and-family.pdf and <https://assetsforcare.seniorsrights.org.au/assetsforcare/wp-content/uploads/Assets-for-Care.pdf>.

²⁹ For example, amortising loan agreements. Under this arrangement, the older person pays for the *granny flat interest* by making an 'amortising loan' on terms that the balance will reduce over time according to an agreed formula as the adult child discharges his or her obligations.

agreements, as proposed in this report, would create a valuable opportunity for the public service to disseminate the kind of educative and instructive information that is needed.

- 5.10 The ATO and DHS have undertaken to jointly develop and publish a guidance booklet on granny flat arrangements. We envisage such a publication would be a 'one-stop-shop' document that does a number of things. First, it would alert families to the risks associated with granny flat arrangements, how they can be managed, and what alternatives are available.³⁰ Secondly, it would canvass the proposed tax relief (if adopted) and demystify the tax complexity of granny flat arrangements, with a focus on the matters identified in this report. These would include the conditions for tax relief, the treatment of regular rent-like payments, and the operation, the main residence rules, and the GST tax myths.
- 5.11 In addition, the ATO and DHS are considering ways in which the publication could help families document their arrangements. One approach for doing this would be to incorporate a pro-forma agreement that families could use to document their arrangement. The pro-forma agreement would comprise two components: The first would operate as a safe harbour and contain the minimum terms necessary to enliven our proposed tax exemption. The second part would be an optional section that includes other fundamental issues that families should turn their minds to.
- 5.12 While a pro forma approach received some support from our stakeholders, others thought that, given that each family's circumstances are unique, they do not lend themselves to a pro forma agreement. In addition, a pro-forma agreement may expose the Commonwealth to liability where disputes arise between the parties.
- 5.13 As an alternative, stakeholders suggested that a checklist may be a better approach. We anticipate that either approach would be developed in consultation with elder Law specialists, particularly the Elder Law and Succession Committee of the Law Council of Australia, and may draw on the good work already done by organisations like Seniors Rights Victoria.
- 5.14 A 'one-stop-shop' publication would be an efficient and tailored way to both educate families and to help them put in place effective arrangements. If families are told what they need to know right from the start, and it is made as easy and as comprehensive as possible (including a pro-forma agreement that highlights common risks to which families should turn their minds), it will act as a powerful incentive for families to follow through with formal arrangements. Indeed, in many instances, people receiving the Age Pension may not be in a position to afford professional advice and the public service is in a position to help those most in need put in place basic formal arrangements. The ATO and DHS have

³⁰ For example, co-ownership of the home by the older person and the adult child in shares proportionate to their respective financial contributions to its acquisition.

already been working in partnership through the course of this review. We applaud that work and think that momentum should continue.

- 5.15 Importantly, a very high proportion of the affected community has an interaction with DHS, including self-funded retirees through the provision of the Seniors Health Care Card. As at December 2018, over 2.5 million older Australians aged 65 years and older qualified for at least a partial pension, representing 66 percent of older people.³¹ We were advised that in most cases, a family's first exposure to social security rules about granny flat arrangements starts with a discussion with DHS (Centrelink). Accordingly, DHS is a logical dissemination point for information and assistance that could lead to a greater take-up of formal arrangements.

RECOMMENDATION 5

The Board's proposals, if adopted, present a valuable opportunity to improve access to educative and instructive information and assistance to families. The ATO and DHS should develop a joint publication that acts as a 'one-stop-shop' document for implementing granny flat arrangements.

³¹ Over 2,580,000 people receive the Age Pension or Disability Pension. DHS also interacts with over 380,000 self-funded retirees through the provision of the Senior Health Care Card.

APPENDIX A: TERMS OF REFERENCE

The Morrison Government has requested the Board of Taxation undertake a review of the tax treatment of granny flat arrangements and recommend any potential changes.

This review is in response to the 2017 Australian Law Reform Commission's Report: Elder Abuse - a National Legal Response, which identified the development of formal and legally enforceable family agreements as a measure to prevent elder abuse.

Under current tax laws, a homeowner may have to pay capital gains tax where there is a formal agreement for a family member to reside in their home – for example, when an older parent lives with their child either in the same dwelling or a separately constructed dwelling.

In some cases, the tax consequences have been a deterrent to families establishing a formal and legally enforceable family agreement, which leaves no protection of the rights of the older person if there is a breakdown in the agreement.

The review will consider and make recommendations on the appropriate tax treatment of these arrangements, while considering the interactions between the current tax laws and treatment of 'granny flat interests' under the social security rules.

In making the recommendations, the review will consider how any changes could raise awareness and provide incentives for older people and their families to enter formal and legally enforceable family arrangements.

The Board is expected to commence the review in early 2019, including broad consultation with stakeholders, with a final report due to the Government in the second half of 2019.

The Government is committed to protecting the rights of older Australians. We have committed an additional \$22 million over the next four years to increase front-line services to support those seeking help with elder abuse and we are working with State and Territory Attorneys-General to develop a National Plan to respond to the abuse of older Australians.