Granny Flats
"The Good the Bad and the Ugly"

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There are many companies peddling the benefits of adding a Granny Flat to your main residential home and the additional income it may generate. Whilst that may be true, it could also create some unexpected Capital Gains tax consequences. In this article we look at three different Granny flat scenarios and their consequences in relation to turning your tax exempted residential home into a capital gains tax asset.

Example One

Homer and Marge have been living in their home for 15 years. They purchased the home for $100,000 in the year 2000 and have recently had the house valued at $500,000. Living at home is also their two teenage children Bert and Ernie. Bert and Ernie have outgrown the room they share so Homer and Marge decide to build a Granny flat with two additional rooms and a kitchen. The boys still eat and socialise as they did previously in the main house.

In this situation, the original home and Granny Flat will be covered under the main residence exemption as it is integrated into the family's daily life and therefore they will be regarded as one dwelling. As a consequence no tax consequences will occur.

Example Two

Bert and Ernie have now finished university and left the family home. The year is 2020 and the combined home and Granny flat is valued at $700,000. Homer and Marge decide to rent out the Granny flat to Lisa to earn some extra income. Lisa lives independently in the self contained Granny flat.

The main residence and the Granny flat up to this point have been covered under the main residence tax exemption as it is considered part of the family home and not a separate dwelling. Consequently by renting the Granny flat to Lisa, a portion of the home now will now be subject to a capital gain / loss tax amount on sale.

The positive from this scenario is that the cost base for calculating the capital gain is based on market value from the date the Granny flat is first rented out. This means the $600,000 capital gain ($700,000 - $100,000) will not be subject to capital gains. Secondly if the Granny Flat is not rented out in the future, it will still be covered by the main residence exemption.

Example Three

If we assume the same facts as the first example except Homer and Marge build the Granny flat and immediately rent the property to earn an income. By doing this the main residence exemption is not available and the granny flat will be subject to capital gains tax. The sting in the tail with this scenario is that the capital gains cost base will include a portion of the initial land value from the original purchase date in 2000. Therefore unlike option 2, a significant capital gain will be generated as the cost base is much lower.

Whilst the income generated may be beneficial in the short term the above examples show that you can have significant tax differences depending how you implement a Granny flat strategy. Before building a Granny flat you should check with your accountant to assess the benefits of a Granny flat for your individual situation to ensure you don't get caught with an unwanted tax bill.

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