TD 1999/D36 - Income tax: capital gains: what factors should be taken into account in determining the 'amount that is reasonable' in applying subsection 118-190(2) of the Income Tax Assessment Act 1997?

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This document has been finalised by TD 1999/66.

Australian Taxation Office

Draft Taxation Determination

TD 1999/D36

Draft Taxation Determination

Income tax: capital gains: what factors should be taken into account in determining the 'amount that is reasonable' in applying subsection 118-190(2) of the *Income Tax Assessment Act 1997*?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office (ATO). DTDs should not be relied on; only final Taxation Determinations represent authoritative statements by the ATO.

1. Subsection 118-190(2) provides that a capital gain or capital loss that you would have made apart from section 118-190 from a CGT event which happens in relation to your dwelling is increased if you used it at any time for the purpose of producing assessable income. The capital gain or capital loss is increased by an amount that is reasonable having regard to the extent to which interest would have been deductible if you had borrowed money to acquire the dwelling. This is a hypothetical test which assumes that you had borrowed money to acquire the dwelling and had incurred interest on the money borrowed.

2. You are entitled to a deduction for interest to the extent to which you use the dwelling as a place of business or use part of it to derive rental income.

3. If you use part of a dwelling for income producing purposes, an interest deduction is normally allowed on the basis of the percentage of the floor area used for income producing purposes.

4. In most cases it is appropriate to increase the capital gain or capital loss that would have been made apart from section118-190 on this basis of floor area, taking into account also the time that the area has been used for income producing purposes.

5. In some cases, an interest deduction is allowed on other than a floor area basis. This may be the case if you can show that the value of the income producing part of the dwelling as a proportion of the value of the entire dwelling is greater or less than the proportion of the income producing part calculated on an area basis. Here, the capital gain or capital loss will be increased having regard to the interest that would have been able to be deducted on the basis of value, taking into account also the time that the area has been used for income producing purposes.

6. If an amount actually borrowed relates exclusively to the part of the dwelling that is income producing the deduction allowable is 100%. However, the capital gain or capital loss will be

increased by an amount that is reasonable on the facts having regard to the interest deduction that would have been allowed if you had borrowed money to acquire the dwelling and incurred interest rather than the amount of interest actually allowed.

Example 1

7. John, a carpenter, has lived in his home for 10 years and he owns it. He has used the garage as a workshop for his carpentry business for the whole 10 years. Based on the area of the dwelling occupied by the garage, John estimates the workshop is 20% of the area of the whole dwelling. This is the basis on which John would have claimed an interest deduction if he had a mortgage on the property. John sells the home and makes a capital gain of $25,000 from that CGT event.

8. Apart from section 118-190, as the dwelling was John's main residence he would have been able to disregard the whole capital gain of $25,000. However, applying subsection 118-190(2) John has a capital gain of $5000 (20% of $25, 000) to be included in his assessable income.

Example 2

9. Peter owns a home that he has lived in since October 1994. In October 1995 after taking a redundancy package he extended the rear of the home and built a studio for his photography business. He has conducted business from these premises since October 1996. Peter borrowed $50000 to build the studio. On the basis that the interest on the $50000 relates solely to the studio, Peter has claimed 100% deduction. In October 1999, Peter sells the property and makes a capital gain of $10,000.

10. As the dwelling was Peter's main residence for the whole period he owned it, apart from subsection 118-190(2) he would have been able to disregard the $10,000 capital gain, so he is taken to have a capital gain of zero. Subsection 118-190(2) requires Peter to increase the capital gain by an amount that is reasonable having regard to the amount of interest he would have been able to deduct had he borrowed to acquire the whole house, including the studio, and incurred interest. The interest Peter actually incurred on the money he borrowed to build the studio is irrelevant. Under the hypothetical test, assuming that the studio is 10% of the floor space of the house, the proportion of the hypothetical interest deduction is 10%. Peter would increase the capital gain from nil to 10% of the capital gain made on the disposal of the house (10% of $10,000, being $1,000). He would then make an allowance for the fact that the income producing activity was carried out for only three fifths of the period of ownership of the house, thus reducing the $1,000 capital gain to $600.

Your comments

We invite you to comment on this Draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination. If you want your comments considered, please provide them to us within this period.

Comments by Date: **25 August 1999**
Contact Officer: **Lyn Peatfield**
E-Mail address: **lyn.peatfield@ato.gov.au**
Telephone: **(08) 820 81337**
Facsimile: **(08) 820 81399**
Address: **Australian Taxation Office**
GPO Box 800
ADELAIDE SA 5001

Commissioner of Taxation

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Related Rulings/Determinations:
IT 2673

Subject references:
Business; capital gains; CGT event; dwelling; deduction; exemptions; income producing; interest; main residence; reasonable

Legislative references:
ITAA 1997 118-190; ITAA 1997 118-190(2)

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