TD 2005/D4 - Income tax: does expenditure - which is a non-capital cost of ownership of a CGT asset - form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Part IVA of the Income Tax Assessment Act 1936 apply?

This cover sheet is provided for information only. It does not form part of *TD 2005/D4 - Income tax: does expenditure - which is a non-capital cost of ownership of a CGT asset - form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Part IVA of the Income Tax Assessment Act 1936 apply?*

This document has been finalised by TD 2005/33.

Draft Taxation Determination

Income tax: does expenditure – which is a non-capital cost of ownership of a CGT asset – form part of the cost base of the asset, if it is a tax benefit in connection with a scheme to which the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* apply?

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. No. It does not form part of the cost base of the CGT asset unless the Commissioner has made a determination for a compensating adjustment to that effect under subsection 177F(3) of the *Income Tax Assessment Act 1936* (ITAA 1936).

Explanation

2. The cost base of a CGT asset, acquired after 20 August 1991, includes the 'non-capital costs of ownership' of the asset you incurred: subsection 110-25(4) of the *Income Tax Assessment Act 1997* (ITAA 1997). These costs include:

- interest on money you borrowed to acquire the asset;
- costs of maintaining, repairing or insuring it;
- rates or land tax (if the asset is land);
- interest on money you borrowed to refinance the money you borrowed to acquire the asset; and
- interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value.

3. However, these costs do not form part of the cost base to the extent that you have deducted it or can deduct it: subsection 110-40(2) and subsection 110-45(1B) of the ITAA 1997.

4. If any of these non-capital costs of ownership that are allowable deductions are tax benefits that have been obtained, or which would but for section 177F of the ITAA 1936 be obtained, in connection with a scheme to which Part IVA applies, the Commissioner may make a Part IVA determination under paragraph 177F(1)(b) of the ITAA 1936 in relation to the deductions that they are not allowable to the taxpayer ('the disallowed amount').

5. Where such a determination is made, the following consequences arise:

- the Commissioner is authorised to take such action as considered necessary to give effect to that determination, for example assess the taxpayer, or amend an assessment, in accordance with that determination (subsection 177F(1)); and
- the Commissioner may make a determination for a compensating adjustment and take such action as considered necessary to give effect to that determination (subsection 177F(3)).

6. A determination for a compensating adjustment can be made where, in the opinion of the Commissioner, had the scheme not been entered into or carried out, an amount:

- would not have been or would not be included in assessable income;
- would have been or would be allowable as a deduction;
- would have been or would be incurred as a capital loss; and
- would have been or would be allowable as a foreign tax credit.

7. The Commissioner must also be of the opinion that it is fair and reasonable that the compensating adjustment be made.

8. The existence of a tax benefit to which Part IVA applies entitles the Commissioner to make a Part IVA determination, to make a compensating adjustment, and to take action to give effect to either. It does not disturb the application of the income tax law unless, and only to the extent that, the Commissioner makes a Part IVA determination, and acts to give effect to it, or to give effect to a compensating adjustment that the Commissioner may also have made. The scheme of the anti-avoidance provisions is that in the absence of a determination by the Commissioner the law continues to apply on the basis that the scheme has been carried out, and not as if it were not carried out.

9. Accordingly, a Part IVA determination under subsection 177F(1) to disallow a deduction for a non-capital cost of ownership, such as interest, will not of itself affect the calculation of the amount included in the assessable income for net capital gains unless a compensating adjustment is made under subsection 177F(3). The amount of the capital gain is therefore to be calculated using the cost base of the asset as determined in accordance with Subdivision 110-A of the ITAA 1997. Thus a non-capital cost of ownership of a CGT asset that is ineligible for inclusion in the cost base of the asset because it has been or can be deducted will continue to be ineligible for inclusion in the cost base even after an assessment is amended to give effect to a Part IVA determination to deny a deduction for the disallowed amount, unless the Commissioner makes a compensating adjustment and takes action necessary to give effect to that adjustment.

10. Whether a compensating adjustment can, and should, be made in respect of the calculation of the cost base of a CGT asset needs to be considered on the facts of each case, and the requirements of subsection 177F(3) must be satisfied. A compensating adjustment can only be made if the disallowed amount would have been included in the cost base of the relevant CGT asset had the scheme not been entered into or carried out (and therefore, there is an additional amount included in assessable income that would not

have been included, or there would have been a larger capital loss incurred, had the scheme not been entered into or carried out). In some cases it will be reasonable to suppose that the amount might have been included in the cost base of a different CGT asset (or no asset at all). In these cases the net capital gain would not have been less if the scheme had not been carried out. Therefore a compensating adjustment could not be made in respect of the net capital gain included in the assessable income.

Example

11. *Jorg enters into a split loan arrangement which provides funds for the purchase of both a rental property and a home. Under the arrangement, additional interest is incurred in respect of a rental property compared to an ordinary loan. Split loan agreements are dealt with in Taxation Ruling TR 98/22 and FC of T v. Hart [2004] HCA 26; (2004) 2004 ATC 4599; (2004) 55 ATR 712. The additional interest is an allowable deduction that is obtained in connection with the scheme; it is therefore not included in the cost base of the investment property. The Commissioner makes a Part IVA determination that the additional interest is to be disallowed. The investment property is disposed of, and as a result the taxpayer derives assessable income by way of a net capital gain. In calculating the amount of the net capital gain the disallowed interest does not form part of the cost base of the rental property for capital gains tax purposes unless the Commissioner makes a compensating adjustment to that effect.*

12. *In the Commissioner's opinion, a compensating adjustment is not available because the disallowed amount would not have been included in the cost base of the rental property had the scheme not been entered into. This is because the disallowed interest would not have been incurred in relation to the rental property had the scheme not been entered into: it would have been incurred in relation to the domestic residence (or to some extent not at all).*

Date of effect

13. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

14. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation
4 May 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/20; TR 98/22

Subject references:

- CGT asset cost base

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 177F
- ITAA 1936 177F(1)
- ITAA 1936 177F(1)(b)
- ITAA 1936 177F(3)
- ITAA 1197 Subdiv 110-A
- ITAA 1997 110-25(4)
- ITAA 1997 110-40(2)
- ITAA 1997 110-45(1B)
- TAA 1953 Pt IVAAA

Case references:

- FC of T v. Hart [2004] HCA 26; (2004) 2004 ATC 4599; (2004) 55 ATR 712

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