IT 2397 - Income tax : application of Division 10D where residential buildings used partly for income-producing purposes

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TAXATION RULING NO. IT 2397

INCOME TAX : APPLICATION OF DIVISION 10D WHERE RESIDENTIAL BUILDINGS USED PARTLY FOR INCOME-PRODUCING PURPOSES

F.O.I. EMBARGO: May be released

REF N.O. REF: L85/106-0 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1210773	DEDUCTIONS FOR CAPITAL EXPENDITURE ON RESIDENTIAL INCOME PRODUCING BUILDINGS	DIV. 10D

PREAMBLE The Taxation Laws Amendment Act 1986 (Act No. 46 of 1986, which received the Royal Assent on 24 June 1986) amended Division 10D of the Income Tax Assessment Act 1936 (the Act) to extend its application to capital expenditure ("qualifying expenditure") incurred on the construction of residential income-producing buildings, extensions, alterations or improvements where construction commenced after 17 July 1985.

2. Deductions are available in respect of residential income-producing property on broadly the same basis as applies under Division 10D in respect of non-residential income-producing property. Residential property may, however, attract deductions even though it is first used for non-income-producing purposes, whereas deductions are available in respect of non-residential property only if its first use is for income-producing purposes. Generally, the person who first owns the property, incurs the qualifying expenditure and uses the property for income-producing purposes is eligible for the deductions, with entitlement passing to the new owner where ownership changes hands. However, a lessee who incurs qualifying expenditure, or who obtains the lease on assignment from a lessee who incurred that expenditure, may be entitled to the deductions as if he or she were the owner. If an eligible lessee surrenders or otherwise terminates a lease, entitlement to deductions reverts to the owner.

3. In terms of section 124ZH of the Act, where the whole of a building, extension, alteration or improvement in respect of which qualifying expenditure has been incurred is used by the owner during the whole of the income year to produce assessable income, a deduction equal to 4% (2 1/2% for buildings, etc. the construction of which commenced after 19 July 1982 and before 22 August 1984) of the qualifying expenditure is allowable. There are, however, situations where only a proportionate deduction is allowable. This ruling discusses those situations and provides guidelines for determining the deduction to be allowed, in

accordance with sub-section 124ZJ(1) of the Act, where part of a building, etc. is not used for the purpose of producing assessable income or where a building, etc. (or part thereof) is used only partly for that purpose.

4. The ruling focuses primarily on residential property to which Division 10D applies but its general principles are applicable in respect of any Division 10D property. As noted, earlier, Division 10D applies in respect of residential buildings, extensions, alterations or improvements only where their construction commenced after 17 July 1985 and, as with Division 10D generally, construction is taken to have commenced on the date on which the first step in the construction stage (as distinct from preliminary steps such as site preparation) has commenced. The first step in the construction phase of a new building would be when the pouring of footings or the sinking of pilings, as appropriate, commenced.

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5. Under section 124ZH of the Act, where a taxpayer owns only part of a building, extension, alteration or improvement on which qualifying expenditure has been incurred and uses that part during the whole of an income year to produce assessable income, a proportion of the 4% (or 2 1/2%) maximum is allowable as a deduction, determined on the basis of the extent to which the qualifying expenditure is attributable to the part owned by the taxpayer. Where the whole of a building, etc. (or the part owned by the taxpayer) is used to produce assessable income during part only of the year, the deduction otherwise allowable is reduced in proportion to the number of days during the year for which it was used to produce assessable income.

6. Sub-section 124ZJ(1) provides that, where a deduction would otherwise be allowable under section 124ZH but, during the whole or a part of the year of income -

- part of the building, etc. is not used for the purpose of producing assessable income; or

- the building, etc. (or part thereof) is used only partly to produce assessable income,

the deduction otherwise allowable is to be reduced by such amount as the Commissioner of Taxation considers fair and reasonable.

7. It should be noted that, for Division 10D purposes, a residential building, etc. (or part thereof) is not to be taken to have been used for the purpose of producing assessable income for any period during which it is -

(a) used for display or exhibition purposes in connection with the sale or lease of the whole or part of that building or of any other building;

(b) residential accommodation and used or for use by the taxpayer or, unless pursuant to an "exempt agreement" (see paragraph 8 under), by an associate

of the taxpayer; or

(c) part of the taxpayer's home and used or for use by the taxpayer not as residential accommodation but as, for example, a "home office" (see paragraph 9 below).

8. In relation to point (b) above, even though property is used or for use as residential accommodation by an associate (as defined in sub-section 124ZF(1) of the Act) of the taxpayer, it may still attract Division 10D deductions if it is the subject of an "exempt agreement". In terms of sub-section 124ZF(1A) of the Act, an agreeement to which a taxpayer and an associate are parties is an exempt agreement only if the Commissioner of Taxation is satisfied, having regard to all relevant circumstances, that -

. the parties to the agreement could reasonably be expected to have entered into the agreement if they had been independent parties dealing with each other at arm's length; and

. none of the parties entered into the agreement for the purpose (or, by sub-section 124ZF(1B), a not merely incidental purpose) of obtaining a Division 10D deduction.

9. In relation to point (c) in paragraph 7 above, a deduction is denied in respect of a home office or similar area only where it is part of the taxpayer's home. A deduction is allowable in respect of an area which, although in the same building as the taxpayer's home, is a separate and distinct area used for income-producing purposes - for example, a self-contained area in which the taxpayer carries on his or her business.

10. Assuming the Division 10D qualifying expenditure was incurred in respect of the whole of the building in question, an example of a situation in which sub-section 124ZJ(1) would apply, on the basis that only part of the building is used for the purpose of producing assessable income, would be where certain rooms in a hotel are reserved wholly for use by the owner as residential accommodation. Another example would be where a home owner leases, on an arm's length basis, an identified part of his or her home (say, one bedroom) to a tenant. It may also be that other parts of the home are used partly for income-producing purposes and partly for private purposes (say, where the tenant also has access to general living areas), in which case there would be parts of the home that are -

. exclusively for the use of the owner;

. exclusively for use by the tenant;

. for common use by the owner and the tenant.

11. In such cases, the deduction allowable should, as a

general rule, be determined on a floor area basis - paragraph 10 of the Taxation Ruling No. IT 2167 describes the application of the floor area basis in cases such as the one illustrated in the second of the abovementioned examples. However, if there is evidence to show that a basis other than a floor area basis is more appropriate in the circumstances, that other basis should be adopted. For example, if a taxpayer could demonstrate that a floor area basis is inappropriate because, in fact, a larger proportion of the qualifying expenditure was attributable to the part of the building that is actually used for the purpose of producing assessable income (as could well be the case in a situation such as that illustrated in the first of the abovementioned examples), that expenditure basis should be accepted. Whatever basis is adopted, if the relevant part of the building was used for income-producing purposes during part only of the year of income, the deduction otherwise allowable would have to be further reduced in proportion to the number of days during the year that it was so used.

12. Of course, where Division 10D qualifying expenditure is incurred wholly in respect of an area actually used to produce assessable income (for example, where an existing residence is extended to provide a bedroom for the exclusive use of an arm's length tenant or where a hotel in which the owner resides is extended to provide further public areas), sub-section 124ZJ(1) would have no application and Division 10D deductions would, subject to section 124ZH, be allowable in respect of the full amount of the expenditure. Conversely, if the qualifying expenditure relates wholly to an area used exclusively for a purpose other than one of producing assessable income, no deduction would be allowable.

COMMISSIONER OF TAXATION
16 April 1987