TD 1999/66 - 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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Generated on: 28 June 2026, 04:56:40 AM

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

This Taxation Determination is a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and is legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Determination is a public ruling and how it is legally binding on the Commissioner.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

Date of effect

This determination applies to years commencing both before and after its date of issue. However, this Determination 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).

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 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 $50,000 to build the studio. On the basis that the interest on the $50,000 relates solely to the studio, Peter has claimed 100% deduction. In October 1999, Peter sells the property.

10. Because Peter first used his dwelling to produce income after 20 August 1996 he is taken by subsection 118-192(2) to have acquired it in October 1996 for its market value. Having regard to the market value acquisition cost Peter made a capital gain of $10,000 on the disposal of the property in October 1999.

11. As the dwelling was Peter's main residence for the whole period from October 1996 (when he is taken to have acquired the dwelling) to October 1999, apart from subsection 118-190(2) he would have been able to disregard the $10,000 capital gain, so that he would have made a capital gain of nil.

12. Subsection 118-190(2) requires Peter to increase the capital gain that he would have made 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). No

adjustment is made to take account of the use of the property prior to October 1996 because Peter is not regarded as having owned it before that time.

Example 3

13. Assume the same facts as in example 2 except that Peter commenced to use the premises for business in April 1996 and made a capital gain of $15,000 on the sale of the property (based on the actual acquisition cost).

14. In determining his capital gain Peter would take into account the fact that only 10% of the dwelling was used for income producing purposes and the fact that the income producing activity was carried out for only 42 of the 60 months in the period of ownership of the house. His capital gain would be $1,050 (42/60 x $1,500).

Commissioner of Taxation
15 December 1999

Previous draft:

Previously issued as TD 1999/D36

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)

Case references:

ATO references:
NO 99/10480-5
BO CGT main residence summit 1999
FOI Index Detail: I 1021041

ISSN: 1038-8982