


IT 2640 - Income tax: Division 10D - qualifying expenditure

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**CAPITAL EXPENDITURE
SPECULATIVE BUILDINGS
QUALIFYING EXPENDITURE**

**124ZG(1)
124ZG(2A)
124ZH
DIVISION 10D**

OTHER RULINGS ON THIS TOPIC: IT 2254, IT 2397

TITLE: INCOME TAX: DIVISION 10D - QUALIFYING EXPENDITURE

- NOTE:**
- . Income Tax Rulings do not have the force of law.
 - . Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

This Office has been asked to provide advice on whether, and to what extent, persons buying completed buildings from "spec" builders or property developers are entitled to any deduction in respect of qualifying expenditure in terms of Division 10D of Part III of the Income Tax Assessment Act 1936 ("the Act").

2. Section 124ZH authorises a deduction in respect of qualifying capital expenditure incurred on the construction, extension or alteration of certain income-producing buildings. Qualifying expenditure is defined in section 124ZG and, generally speaking, means expenditure of a capital nature in respect of the construction of a building, or a prescribed part of a building, where, at the time of completion of construction, the building:

- (a) is used, or is maintained ready for use, for income-producing purposes by the person who incurs the capital expenditure;
- (b) is for disposal by that person to another person who uses it for income-producing purposes;
- (c) is for residential use (provided construction commenced after 17 July 1985); or
- (d) is for use by or on behalf of the person who incurs the capital expenditure for the purpose of carrying on research and

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development activities (provided construction commenced after 21 November 1987).

3. The rate of deduction is dependent on the time construction of the building commenced and can be summarised as follows:

<u>Date Construction Commenced</u>	<u>% of Qualifying Expenditure</u>
Prior to 20 July 1982	Nil
20 July 1982 to 21 August 1984	2.5%
22 August 1984 to 15 September 1987	4%
After 15 September 1987	2.5%

4. Normally it is the owner of the building who incurs construction costs and is therefore eligible for the deduction. However, if a lessee incurs qualifying expenditure it may claim the deduction so long as it remains a lessee and uses the building for income producing purposes. Any subsequent lessee by assignment can then claim the deduction. A lessee can also claim the deduction where the lessor has made an election under section 160ZSA in connection with a long-term lease (i.e., a lease with a term of 50 years or more).

RULING

5. Qualifying expenditure is based on the actual cost incurred in respect of constructing the building or extension. The cost of construction includes preliminary expenses such as architect's fees, engineering fees and the cost of foundation excavations. This Ruling overrides paragraph 4 of Taxation Ruling IT 2397 in relation to the cost of foundation excavations. Capital expenditure on land (on which the building is to be constructed), including clearing, demolition and landscaping costs, is not part of qualifying expenditure (see Taxation Ruling IT 2254). These expenses are clearly incurred either prior to construction of the building or, in the case of landscaping, after construction is completed. Similarly, capital expenditure in respect of the construction of driveways and detached carparks is not part of qualifying expenditure as they are not part of the building. The cost of constructing an atrium will, however, be included in qualifying expenditure where the atrium is clearly an integral part of the building.

6. Subsection 124ZG(3) provides that qualifying expenditure does not include expenditure on plant or articles that qualify for depreciation (such as lifts and air conditioning plant). Similarly, qualifying expenditure does not include expenditure which is deductible under section 73A (scientific research), section 73B (research and development), section 75B (conserving or conveying water), section 124JA (timber milling), Division 10

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(general mining), Division 10AAA (transport of certain minerals) or Division 10AA (prospecting and mining for petroleum).

7. The operation of Division 10D can best be seen by considering the 4 basic types of cases to which it applies:

(i) where an owner-builder either personally constructs a building from the ground up or contracts with a builder, architect, and/or various tradespeople to perform part or all of the work, and the building is then used for one of the purposes listed in paragraph 2 above;

(ii) where a partly completed building is purchased from a "spec" builder or property developer during construction and is subsequently completed, and used by the new owner as in Example (i);

(iii) where a completed building is purchased from a "spec" builder or property developer and used for one of the purposes listed in paragraph 2 above;

(iv) where a building on which Division 10D deductions are available is sold to a second, or subsequent, purchaser.

Example (i) - Full Construction by an Owner-Builder

8. Where the owner-builder described in paragraph 7(i) has contracted out the whole of the construction work, the amount of the qualifying expenditure under Division 10D is the contract price, including the profit made by the person contracted by the owner-builder to do the work, but excluding clearing, demolition and landscaping costs.

9. Where only part of the work was contracted out, the qualifying expenditure is:

(a) the full contract price for each part of the construction work contracted out; and,

(b) any other costs incurred by the owner-builder in the process of actually erecting the building, but not including any amount in respect of the

owner-builder's
efforts.

own

10. If all of the construction work is done personally by the owner-builder, the qualifying expenditure is limited to expenditure incurred on such things as architect's fees, the cost of materials and the hire of tools and equipment. The owner-builder is not entitled to include any amount for his or her own time, nor any amount in respect of profit.

Example (ii) - Purchase of Partly Completed Building

11. The purchase of a partially finished building that is then completed by the new owner and used for one of the purposes listed in paragraph 2 gives rise to qualifying expenditure. The amount of qualifying expenditure is the sum of:

(a) the amount it has cost the original builder to partially construct the building, including architect's fees, the cost of materials and payments to subcontractors - but not including the original builder's own profit (because that is not part of the cost of construction as no expenditure has been incurred by the original builder in this regard); and

(b) the total amount paid by the purchaser after the date of purchase which represents the cost of construction as described in paragraphs 8, 9 and 10 in relation to Example (i).

Example (iii) - Purchase of a Completed Building From a "Spec" Builder

12. Where a completed building is purchased from a "spec" builder or property developer and subsequently used by the purchaser for one of the purposes listed in paragraph 2, there is no qualifying expenditure if a literal interpretation of subsection 124ZG(1) and subsection 124ZG(2A) is taken. This is because:

(a) the "spec" builder or property developer incurs expenditure of a revenue nature rather than capital expenditure in respect of the construction of the building; and

(b) the purchaser of the building, who does incur capital expenditure, does not own or use the building at the time of completion of construction for one of the purposes listed in paragraph 2.

Such a result could be said to be manifestly absurd or unreasonable, because the purchaser of an incomplete building does incur qualifying expenditure and therefore would gain a substantial taxation advantage over the purchaser of a completed "spec" building.

13. When there is a genuine doubt about the proper interpretation of a statutory provision subparagraph 15AB(1)(b)(ii) of the Acts Interpretation Act 1901 provides that extrinsic material can be used to assist in determining the meaning of the provision. The subparagraph applies if the ordinary meaning conveyed by the text of the provision, taking into account its context in the Act and the purpose or object underlying the Act, leads to a result that is manifestly absurd or is unreasonable.

14. Division 10D was inserted by Act No.14 of 1983. The accompanying Explanatory Memorandum states at page 81 that:

"Similarly, a building constructed "on spec" will be capable of giving rise to qualifying expenditure. In these circumstances deductions would become available to the person who acquires the building from the builder and uses it for eligible income producing purposes."

15. It is clear, therefore, that Parliament intended that purchasers of buildings from "spec" builders or property developers should be entitled to a Division 10D deduction regardless of whether the building was purchased during construction or after completion.

16. Therefore, it is accepted that where a completed building is purchased from a "spec" builder or property developer and used for one of the purposes listed in paragraph 2, the purchaser is entitled to a Division 10D deduction. The amount of qualifying expenditure is the amount that it costs the builder to construct the building and does not include any amount of builder's profit.

Example (iv) - Where Building Qualifying Under Division 10D is On-Sold

17. Where a building on which Division 10D deductions are available is sold to a second or subsequent purchaser, the new owner is entitled to the deduction under Division 10D provided, of course, that the building continues to be used for one of the purposes listed in paragraph 2. The amount of qualifying expenditure is the original owner's cost of construction as outlined in Examples (i), (ii) and (iii) above. In the year of sale, the deduction is apportioned between the vendor and the purchaser.

Estimates of Qualifying Expenditure Permitted Where Actual Cost Unavailable

18. Sometimes it is virtually impossible for the purchaser of a building described in examples (ii) (iii) and (iv) to obtain the actual cost of the building, particularly in circumstances where the builder or previous owner becomes bankrupt or is unable, or unwilling, for other reasons to provide the information.

19. Where, in cases of these kinds, a taxpayer is genuinely unable to precisely determine the actual cost of the building for the purposes of Division 10D, a building cost estimate by a quantity surveyor or other independent qualified person may be used.

COMMISSIONER OF TAXATION
27 June 1991