

EXPOSURE DRAFT

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General outline and financial impact

Extend the main residence capital gains tax exemption to compulsory acquisition of part of a main residence

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* to extend the main residence capital gains tax (CGT) exemption to a CGT event that is a compulsory acquisition (or similar arrangement) of part of a main residence, the part being some or all of its adjacent land or structure, without the compulsory acquisition (or similar arrangement) applying to the dwelling.

Date of effect: The measure applies to CGT events happening on or after the day this Bill receives the Royal Assent. However, taxpayers may choose to apply the measure to CGT events relating to them that happen in the period that starts with the 2004-05 income year and ends immediately before this Bill receives the Royal Assent.

Proposal announced: The measure was announced in the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs' Media Release No. 019 on 19 March 2009.

Financial impact: This measure will have an unquantifiable (but small) cost to revenue.

Compliance cost impact: These amendments are expected to have a low overall compliance cost impact. This comprises a low implementation impact and no expected change in ongoing compliance costs relative to the affected group.

Chapter

Extend the main residence capital gains tax exemption to compulsory acquisitions of part of a main residence

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the main residence capital gains tax (CGT) exemption to a CGT event that is a compulsory acquisition or other involuntary realisation (similar arrangement). The extended exemption will apply where part of a main residence, the part being some or all of its adjacent land or structure, is compulsorily acquired (or subject to a similar arrangement) without the dwelling itself also being compulsorily acquired (or subject to the similar arrangement).

1.2 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

Context of amendments

Compulsory acquisition CGT roll-over

1.3 The compulsory acquisition CGT roll-over allows a taxpayer to reduce or disregard a capital gain made as a result of a compulsory acquisition (or a negotiated sale made ‘in the shadow’ of a compulsory acquisition). The conditions and consequences of the compulsory acquisition CGT roll-over are set out in Subdivision 124-B.

1.4 If the taxpayer receives monetary compensation, the roll-over requires the taxpayer to purchase a replacement asset and use that asset for the same or a similar purpose to the purpose for which the taxpayer used the original asset (subsection 124-75(4)).

1.5 Although this requirement may be reasonable when an entire asset is compulsorily acquired, it is impractical for the compulsory acquisition of part of a main residence, the part being some or all of its

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adjacent land or structure. In many circumstances, a realistic replacement asset may be impossible or difficult to find.

CGT main residence exemption

1.6 The CGT main residence exemption disregards any capital gain or capital loss that arises from the disposal or other realisation of a taxpayer's dwelling and adjacent land up to a total of two hectares, provided the adjacent land is used primarily for private or domestic purposes.

1.7 The exemption does not apply to capital gains or losses made from adjacent land or structures (such as a garage) where the relevant CGT event does not also happen to the dwelling. For example, if a taxpayer chooses to subdivide their property and sell the vacant lot, the CGT main residence exemption will not apply to that disposal.

1.8 While this treatment is appropriate for voluntary disposals of part of a taxpayer's main residence, it is inappropriate when the taxpayer has no choice over the disposal or other arrangement. Given that capital gains made on a taxpayer's main residence are CGT exempt, capital gains made on compulsory acquisitions of part of a taxpayer's main residence should also be CGT exempt.

1.9 Other involuntary events such as the compulsory ending of some of the ownership rights relating to the adjacent land or structure of a main residence or the compulsory creation of rights over the adjacent land or structure of a main residence should also be CGT exempt.

Summary of new law

1.10 The amendments will allow a taxpayer to exempt any capital gains or losses made in relation to a compulsory acquisition (or similar arrangement) of part of the taxpayer's main residence, the part being its adjacent land or structure, without the dwelling itself also being compulsory acquired (or subject to the similar arrangement).

1.11 A partial CGT exemption will apply where the dwelling was:

- not used as a main residence during all of the relevant ownership period; or
- used for income-producing purposes.

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Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>A taxpayer will be able to disregard a capital gain or capital loss where there is a compulsory acquisition, or similar arrangement, of part (being adjacent land or structure) of the taxpayer's main residence without the dwelling itself also being compulsorily acquired or subject to the similar arrangement.</p> <p>A taxpayer may be able to exempt only part of a capital gain or capital loss where there is such a compulsory acquisition if the dwelling was not always used as a main residence or was used for income-producing purposes.</p>	<p>A taxpayer may not access the main residence CGT exemption where there is a compulsory acquisition, or similar arrangement, of part of the taxpayer's main residence, the part being its adjacent land or structure, without the dwelling itself also being compulsorily acquired or subject to the similar arrangement.</p>

Detailed explanation of new law

1.12 Schedule # inserts new provisions to extend the CGT main residence exemption to where there is a compulsory acquisition or similar arrangement of part of a taxpayer's main residence, the part being some or all of its adjacent land or structure, without the dwelling itself being compulsorily acquired or subject to the similar arrangement.

1.13 The new provisions provide that a taxpayer can disregard a capital gain or capital loss from the CGT event resulting from a compulsory acquisition (or similar arrangement) that happens only to adjacent land or an adjacent structure where the relevant dwelling is the taxpayer's main residence. The guide to the main residence exemption provisions is amended to include appropriate references to the new provisions and a note is inserted in section 118-165 (separate CGT event for adjacent land or other structures) pointing out that there is a separate rule for a CGT event that is a compulsory acquisition (or similar arrangement) happening to a dwelling's adjacent land but not to the dwelling itself. [Schedule #, items 1, 2, 3, and 5, sections 118-100 and 118-105, subsection 118-110(1) and section 118-165]

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Adjacent land and adjacent structures redefined

1.14 The amendments repeal section 118-120, which extends the basic main residence exemption to adjacent land and structures, such as a garage or storeroom, that are associated with the dwelling. *[Schedule #, item 4, section 118-120]*

1.15 The amendments substitute a new definition of ‘adjacent land’ and a new definition of ‘adjacent structure’, which extend the basic main residence exemption to adjacent land and adjacent structures respectively. The new definitions retain the characteristics of the old definitions but present them in a different way allowing ‘adjacent land’ and ‘adjacent structure’ to be defined terms. *[Schedule #, item 4, subsections 118-120(1), (2), (5) and (6), and items 7 and 8, subsection 995-1(1)]*

1.16 The maximum exempt area of adjacent land that the existing main residence exemption can apply to is still two hectares less the area of land on which the dwelling is built. *[Schedule #, item 4, subsection 118-120(3)]*

1.17 However, a new provision is inserted to deal with situations where a taxpayer disposes of, or otherwise realises, their main residence and the taxpayer has previously disregarded a capital gain or loss for a compulsory acquisition (or similar arrangement) of adjacent land under the new exemption. This new provision applies only in particular circumstances but, where it does apply, the maximum area of adjacent land covered by the main residence exemption for the later realisation of the main residence is reduced (paragraphs 1.19 and 1.20 identify the particular circumstances). The reduced area is called the ‘maximum exempt area’, a defined term (see paragraphs 1.29 to 1.32 for how to calculate this area). *[Schedule #, item 4, subsection 118-120(4), and item 9, subsection 995-1(1)]*

Compulsory acquisitions of adjacent land only

1.18 Guide material is inserted to provide a sketch of the new provisions that allow a taxpayer to disregard a capital gain or capital loss for a compulsory acquisition of adjacent land without a compulsory acquisition of the relevant dwelling. *[Schedule #, item 6, section 118-240 and note]*

1.19 The amendments specify the conditions that must exist if a taxpayer is able to disregard a capital gain or capital loss from a CGT event in relation to land (‘the exempt land’) or their ownership interest in it. The conditions largely mirror those for the broader main residence

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exemption, but with some additional features to cover compulsory acquisitions or similar arrangements. The conditions are:

- the taxpayer is an individual;
- the exempt land is all or part of a dwelling's adjacent land at the time of the CGT event;
- the CGT event does not happen in relation to the dwelling or the taxpayer's ownership interest in the dwelling;
- one of the following applies:
 - the dwelling was the taxpayer's main residence during some or all of the period they owned it;
 - the taxpayer's ownership interest in the dwelling passed to them as a beneficiary in a deceased estate; or
 - the taxpayer owns the ownership interest in the dwelling as the trustee of a deceased estate;
- the new section dealing with compulsory acquisitions of adjacent land applies to the CGT event and the exempt land; and
- the sum of the following is two hectares or less:
 - the area of all of the dwelling's adjacent land at the time of the CGT event;
 - the area of land on which the dwelling is built; and
 - for each earlier disregarding of a capital gain or capital loss under this exemption, the area of adjacent land exempted at the time of the earlier CGT event if that involved reducing the area of the dwelling's adjacent land at the time of that earlier CGT event.

[Schedule #, item 6, subsection 118-245(1)]

1.20 The reference to 'CGT event' generally ensures that the new exemption can apply to all the relevant CGT events, which is broader than the CGT events for which the main residence exemption applies (see subsection 118-110(2)). As with the main residence exemption, because

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the land has to be ‘adjacent land’ the exemption applies to the extent that the land was used primarily for private or domestic purposes in association with the dwelling. *[Schedule #, item 4, subsection 118-120(2), and item 6, subsection 118-245(1)]*

1.21 Where a taxpayer satisfies all of the conditions in paragraph 1.19, any capital gain or capital loss arising from the compulsory acquisition (or similar arrangement) of adjacent land without the dwelling is automatically disregarded. *[Schedule #, item 6, subsection 118-245(1)]*

1.22 The last condition in paragraph 1.19 requires the sum of the following areas to be two hectares or less:

- all of the adjacent land at the time of the current compulsory acquisition (or similar arrangement);
- the land on which the dwelling is built;
- and any land that is subject to the new compulsory acquisition exemption for adjacent land or an adjacent structure where that compulsory acquisition involved a reduction in the area of the dwelling’s adjacent land before a further application of a new compulsory acquisition;
 - The formulation of this last component means that taxpayers will not be disadvantaged by double counting of the same area of land where, for example, a compulsory easement is created over land but the taxpayer retains ownership of the land affected by the easement albeit with diminished rights.

[Schedule #, item 6, paragraph 118-245(1)(f)]

Example 1.1

Assume all of the transactions in this example occur after 1 July 2010.

Nadine owns a main residence on two hectares of land, which includes the land on which the dwelling is built. The dwelling has always been Nadine’s main residence while she owned it and she has never used it for income-producing purposes and has always used the adjacent land for private or domestic purposes.

The State government compulsorily acquires 0.2 hectares of the adjacent land but does not acquire the dwelling. This is the only

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compulsory acquisition (or similar arrangement) that has happened to Nadine's main residence while she has owned it.

Nadine satisfies all of the conditions outlined in paragraph 1.19 and any capital gains or capital loss relating to the compulsory acquisition of the adjacent land is automatically disregarded because the sum of the relevant areas specified in the last condition listed in paragraph 1.19 is not more than two hectares.

1.23 Where a taxpayer satisfies all of the conditions in paragraph 1.19 apart from the last condition (that is, where the sum of the relevant areas of land is more than two hectares), there is no longer an automatic disregarding of any capital gain or capital loss arising from the compulsory acquisition (or similar arrangement). *[Schedule #, item 6, subsection 118-245(2)]*

1.24 In these circumstances, the taxpayer can choose to disregard so much of the capital gain or capital loss that relates to an area of adjacent land that is compulsory acquired (or subject to the similar arrangement) that is not more than the maximum exempt area (see paragraphs 1.27 to 1.32 for a discussion of maximum exempt area). The choice is provided because applying the new exemption reduces the area of a dwelling's adjacent land that could be covered under a later application of the new exemption or the main residence exemption itself.

- The choice is also consistent with a taxpayer being able to choose, under the main residence exemption, the area of adjacent land to which to apply the exemption where the total area of adjacent land exceeds two hectares.

[Schedule #, item 6, subsection 118-245(2)]

1.25 This choice is provided in a separate provision to the one that contains the conditions outlined in paragraph 1.19. However, all of the conditions in that paragraph apart from the last still have to be satisfied for the taxpayer to be able to make such a choice. This means that, among other things, the exempt land must be land that is adjacent land to the relevant dwelling at the time of the relevant CGT event and the new section listing the types of compulsory acquisitions (or similar arrangements) must apply to the CGT event and the exempt land. *[Schedule #, item 6, section 118-245]*

Example 1.2

Assume all of the transactions in this example occur after 1 July 2010.

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Jamal owns a main residence on 1.8 hectares of land. The dwelling has always been Jamal's main residence while he owned it and he has never used the dwelling for income-producing purposes and has always used the adjacent land for private or domestic purposes.

The State government compulsory acquires 0.3 hectares of the adjacent land but does not acquire the dwelling. This is the second such compulsory acquisition that has happened when Jamal has owned the main residence.

On the first occasion, the State government acquired 0.5 hectares of adjacent land but did not acquire the dwelling. Jamal did not satisfy the last condition in paragraph 1.19 in relation to this compulsory acquisition because the sum of the areas specified in that condition is 2.3 hectares so there was no automatic disregard of the capital gain or capital loss arising from that compulsory acquisition. However, Jamal chose to disregard the resultant capital gain or capital loss.

For the second compulsory acquisition the sum of the areas specified in paragraph 1.19 is again 2.3 hectares being the sum of the area of the current adjacent land including the area of land on which the dwelling is built (1.8 hectares) and the area of adjacent land at the time of the earlier compulsory acquisition covered by the new exemption (0.5 hectares).

Again there is no automatic disregarding of the capital gain or capital loss. Therefore, Jamal can choose to disregard any capital gain or capital loss arising from the second compulsory acquisition if the 0.3 hectares of land is within his maximum exempt area.

1.26 Taxpayers with two hectares or less of adjacent land (including the land under the dwelling and any land previously subject to the new exemption for adjacent land) at the time of the compulsory acquisition are not provided with a choice because they would typically be expected to have less than two hectares of adjacent land that could be covered under a later application of the new exemption or the main residence exemption itself.

Maximum exempt area

1.27 Paragraph 1.17 introduced the concept of 'maximum exempt area' in relation to the main residence exemption and where 'maximum exempt area' applies the maximum area of adjacent land that can be covered by the main residence exemption is reduced.

1.28 Paragraphs 1.19 and 1.23 outlined the conditions where maximum exempt area applies to a dwelling's adjacent land that is

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compulsory acquired (or subject to a similar arrangement) without the dwelling being compulsorily acquired (or subject to the other involuntary realisation).

1.29 If maximum exempt area applies, the amount of a dwelling's adjacent land that may be exempted under the new exemption for compulsory acquisitions (or similar arrangements) or under the main residence exemption if the relevant CGT event also applies to the dwelling, and is one of the CGT events listed in subsection 118-110(2), is calculated using a new method statement inserted by the amendments. *[Schedule #, item 4, subsection 118-120(4) and item 6, section 118-255]*

1.30 Where the maximum exempt area applies to an application of the new exemption or the main residence exemption, the maximum area of a dwelling's adjacent land that is available to be covered is two hectares less the total of the area of adjacent land at the time of each earlier application of the new exemption that was covered by such earlier applications (that is, the total of the exempt land under each earlier application). *[Schedule #, item 6, section 118-255]*

1.31 However, areas of (then) adjacent land covered by the new exemption at the time of each earlier application are included in the total area of land to be subtracted from the two hectares only where the taxpayer lost rights to the substantial use and enjoyment of that land either completely or for at least 10 years. *[Schedule #, item 6, section 118-255]*

1.32 This rule ensures that taxpayers are not disadvantaged by having to reduce their maximum exempt area where they have lost only insubstantial rights to the use and enjoyment of the exempt land. This means that such land could be covered by a later application of the new exemption or the main residence exemption. It also ensures that taxpayers are similarly not disadvantaged where they lose substantial rights to the use and enjoyment of the exempt land but only for a short term such as under a short-term lease. Setting a 10-year limit reduces the opportunity for taxpayers to exploit this aspect of the new exemption by selling land via granting long-term leases rather than selling the land.

- Where taxpayers lose substantial rights to the use and enjoyment of the exempt land for at least 10 years, they have to reduce the maximum exempt area by the amount of adjacent land exempted under the new exemption.

[Schedule #, item 6, section 118-255]

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Example 1.3

Further to Example 1.2.

As noted at the end of Example 1.2, Jamal can choose to disregard any capital gain or capital loss arising from the second compulsory acquisition if the 0.3 hectares of land is within his maximum exempt area.

Jamal's maximum exempt area is 2 hectares less the total area of land that was previously compulsorily acquired (or subject to a similar arrangement) and was exempted under the new exemption.

Because the first compulsory acquisition involved the permanent acquisition of rights to the substantial use and enjoyment of the relevant land, Jamal has to subtract 0.5 hectares from 2 hectares to calculate his maximum exempt for the second compulsory acquisition.

Therefore, Jamal's maximum exempt area for the second compulsory acquisition is 1.5 hectares. As 0.3 hectares is not greater than 1.5 hectares, Jamal can choose to disregard any capital gain or capital loss in relation to the compulsory acquisition of the 0.3 hectares of adjacent land.

Example 1.4

Assume all of the transactions in this example occur after 1 July 2010.

Indira owns a main residence on 4 hectares of land. The dwelling has always been Indira's main residence while she owned it and she has never used the dwelling for income-producing purposes and has always used the adjacent land for private or domestic purposes.

Indira wants to sell her main residence. Four years earlier the State government compulsorily acquired subsurface land under her main residence at the time of the compulsory acquisition. The subsurface land mapped to 0.1 hectares of surface land. However, Indira did not use or enjoy the subsurface land and the compulsory acquisition did not result in Indira losing rights to the substantial use and enjoyment of the surface land.

At that time of the compulsory acquisition of the subsurface land, the sum of the areas specified in paragraph 1.19 was 4 hectares being the sum of the area of the then adjacent land and the area of land on which the dwelling was built as there had not been any earlier applications of the new exemption in relation to adjacent land to Indira's main residence.

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This means that there was no automatic disregarding of the capital gain Indira made on the adjacent land but Indira chose to disregard the capital gain.

Two years after the first compulsory acquisition, the State government compulsorily acquired 0.2 hectares of land that was adjacent land to her main residence at the time of the compulsory acquisition.

At the time of the second compulsory acquisition, the sum of the areas specified in paragraph 1.19 was again 4 hectares being the sum of area of the then adjacent land and the area of land on which the dwelling was built as the earlier compulsory acquisition did not result in a reduction of the area of adjacent land.

When Indira calculated her maximum exempt area at the time of the second compulsory acquisition, she did not have to subtract any area from 2 hectares because the first compulsory acquisition did not result in Indira losing rights to the substantial use and enjoyment of her main residence's adjacent land.

So Indira's maximum exempt area for the second compulsory acquisition was 2 hectares. Because 0.2 hectares is not greater than 2 hectares, Indira chose to disregard under the new exemption the capital gain made on the compulsory acquisition of the adjacent land.

When Indira sells her main residence, the sum of the areas specified in paragraph 1.19 is 4 hectares being the sum of the area of the current adjacent land including the area of land on which the dwelling is built (3.8 hectares) and the area of adjacent land at the time of the second compulsory acquisition covered by the new exemption that resulted in a reduction in Indira's adjacent land (0.2 hectares).

When she sells her main residence Indira has to calculate her maximum exempt area because Indira previously *chose* to disregard the capital gain made on the 0.2 hectares of the then adjacent land under the new exemption. If the capital gain had been automatically disregarded, Indira would not have to calculate her maximum exempt area.

Indira's maximum exempt area at the time she sells her main residence is 1.8 hectares (2 hectares less 0.2 hectares). Therefore, the maximum area of the 3.8 hectares of adjacent land that can be covered by the main residence exemption is 1.8 hectares.

Compulsory acquisition or other event

1.33 A key requirement for a taxpayer to be eligible for the new exemption is that there must be a CGT event involving a compulsory

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acquisition or similar arrangement happening to a main residence's adjacent land (or adjacent structure) but not to the dwelling itself. The compulsory acquisition or similar arrangement must be by, or result from, action by an Australian government agency (that is, by the Australian, a State or a Territory government or by an authority of the Australian, a State or a Territory government) or non-government entity authorised to do so under a power conferred by an Australian law. *[Schedule #, item 6, paragraph 118-245(1)(e), and section 118-250]*

1.34 A compulsory acquisition or similar arrangement also includes where it occurs in the shadow of a compulsory acquisition or similar arrangement. Under the shadow of a compulsory acquisition or similar arrangement is where the acquisition or similar arrangement occurs after a notice was served by or on behalf of an entity inviting negotiations with a view to the entity acquiring, or other similar arrangement happening to, the adjacent land by agreement. *[Schedule #, item 6, paragraphs 118-250(1)(b), (2)(b) and (3)(b)]*

1.35 The notice needs to inform the recipient that if the negotiations are unsuccessful, the adjacent land would be compulsorily acquired, or compulsorily subject to the similar arrangement, by the entity. It is also a requirement that the compulsory acquisition or similar arrangement would have been under a power of compulsory acquisition or ability to enforce a similar arrangement conferred by an Australian law. *[Schedule #, item 6, paragraphs 118-250(1)(b), (2)(b) and (3)(b)]*

1.36 'Similar arrangement' involves any of the following:

- the taxpayer's ownership interest in the exempt land being compulsorily cancelled (however described) or varied (however described) by an Australian government agency or an entity empowered to do so under an Australian law;
- the taxpayer's ownership interest in the exempt land being surrendered (however described) or varied (however described) under the shadow of compulsion;
- an interest or right in or relating to the taxpayer's exempt land being compulsorily conferred on an Australian government agency or an entity under a power conferred by an Australian law;
- the taxpayer conferring on an entity an interest in or right in or relating to the taxpayer's exempt land under the shadow of compulsion; or

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- where the taxpayer's ownership interest in the exempt land was conferred on them by an Australian government agency for a limited, but renewable period of operation, and that ownership interest was not renewed by that agency (for example, a Crown lease).

[Schedule #, item 6, subsections 118-250(2)-(4)]

1.37 The use of the words in parentheses 'however described' means that, if a taxpayer's ownership interest in exempt land is compulsorily terminated or revoked, it will be taken to have the same effect for the amendments in this Schedule as if the interest had been compulsorily cancelled. *[Schedule #, item 6, subsection 118-250(2)]*

1.38 A compulsory acquisition may occur where, for example, a specially constituted State or Territory government authority acquires subsurface land in a residential area for constructing an underground road transport tunnel. These activities are governed by the applicable legislation permitting compulsory acquisitions of land or resumptions of land in the various State and Territory jurisdictions, that is the activities are governed by Australian law. The amendments do not provide an exemption for the compulsory acquisition, or similar arrangement, of adjacent land or a structure where the dwelling to which they relate is outside Australia. *[Schedule #, item 6, section 118-250]*

1.39 Examples of a similar arrangement include the compulsory creation of an easement over a dwelling's adjacent land and the compulsory variation of rights owned by the taxpayer in relation to a dwelling's adjacent land. These similar arrangements may also be voluntarily entered into by the owner of the adjacent land if they do so under the shadow of compulsion. *[Schedule #, item 6, subsections 118-250(2) and (3)]*

Partial exemption for disposal of adjacent land or structure only

1.40 Where there is a compulsory acquisition (or similar arrangement) of adjacent land without the dwelling being compulsorily acquired (or subject to the similar arrangement), a partial CGT exemption applies to the extent that the dwelling was:

- not always a main residence for the relevant period; or
- used for the purpose of producing assessable income during the relevant period.

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[Schedule #, item 6, subsection 118-260(1)]

1.41 A taxpayer applies a partial exemption in these circumstances by increasing the capital gain or capital loss the taxpayer would have made before applying the partial exemption rule by an amount that is reasonable having regard to the two factors listed in paragraph 1.40. A partial exemption adjustment is required if one or both of the factors listed in the previous paragraph applies to the taxpayer's dwelling. *[Schedule #, item 6, subsection 118-260(1)]*

1.42 In determining what is a reasonable increase in the capital gain or capital loss for a partial exemption, the taxpayer should have regard to the principles applying for a partial exemption in Subdivision 118-B assuming the taxpayer disposed of the main residence. In particular, the rules in sections 118-185, 118-190, 118-192, 118-195, 118-200, 118-205 and 118-210 are useful for working out a partial exemption for a range of situations covering how the taxpayer acquired their interest in the main residence and what they did with it. *[Schedule #, item 6, subsection 118-260(2)]*

1.43 Having regard to the principles applying for a partial exemption in Subdivision 118-B, assists a taxpayer in working out what is the 'relevant period' in paragraph 1.40. The 'relevant period' is specified in the principles applying for a partial exemption in Subdivision 118-B. A taxpayer's 'relevant period' will depend on their individual circumstances.

- Where a taxpayer owns a dwelling that they did not acquire as a beneficiary, or as a trustee, of a deceased estate and the dwelling has not always been their main residence, the relevant period is the taxpayer's ownership period.
- Where the dwelling is acquired from a deceased estate and section 118-195 does not apply, the relevant period for working out a partial exemption has to take account of periods where the dwelling was not the main residence of an individual referred to in item 2, column 3 of the table in section 118-195, as specified in section 118-200, which may be modified by section 118-205.

Example 1.5: Partial exemption — main residence for part of ownership period

On 1 July 1990 Ming bought a house on 1.5 hectares of land. The house was rented until Ming moved in on 1 July 2000, and it has been his main residence since then. The land adjacent to the house is landscaped, and has been used as though it were part of the dwelling.

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A State government agency is to compulsorily acquire 0.5 hectares of Ming's land on 30 June 2010, and he will make a capital gain of \$20,000 as a result.

If Ming were to sell his house on 30 June 2010 and he made a capital gain, 50 per cent of the capital gain could be disregarded under the main residence exemption. That is, the house will have been his main residence for half of his ownership period from its acquisition until the disposal (using section 118-185, the percentage of non-main residence days to days of ownership is 50 per cent).

All of the conditions outlined in paragraph 1.19 are satisfied in relation to the adjacent land. Therefore, it is reasonable under the new exemption for there to be an automatic disregarding of an amount of \$10,000 (that is, 50 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of Ming's land, leaving a capital gain of \$10,000. There is an automatic disregarding because the sum of the relevant areas specified in the last condition of paragraph 1.19 is not more than two hectares.

Example 1.6: Partial exemption — use of dwelling for producing assessable income

On 1 July 1990 Nan bought a house on 1.5 hectares of land. She moved into the house immediately after settlement, and it has been her main residence since then. The land adjacent to the house is landscaped, and Nan has used it as though it were a part of the dwelling.

During all of her ownership period Nan has used 25 per cent of the house for her architectural drafting business, and she has been entitled to claim a deduction for 25 per cent of the interest paid on the money she borrowed to buy the house.

A State government agency is to compulsorily acquire 0.5 hectares of Nan's land on 30 June 2010, and she will make a capital gain of \$20,000 as a result.

If Nan's house were sold on 30 June 2010 and she made a capital gain, 75 per cent of the capital gain could be disregarded under the main residence exemption (this is a reasonable outcome using section 118-190).

All of the conditions outlined in paragraph 1.19 are satisfied in relation to the adjacent land. Therefore, it is reasonable under the new exemption for there to be an automatic disregarding of an amount of \$15,000 (that is, 75 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of Nan's land, leaving a capital gain of

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\$5,000. There is an automatic disregarding because the sum of the relevant areas specified in the last condition of paragraph 1.19 is not more than two hectares.

Example 1.7: Partial exemption — combination

On 1 July 1990 David bought a house on 1.5 hectares of land. The house was rented until David moved in on 1 July 2000, and it has been his main residence since then. The land adjacent to the house is landscaped, and David has used it as though it were a part of the dwelling.

After he moved in, David used 25 per cent of the house for his information technology business, and he has been entitled to claim a deduction for 25 per cent of the interest paid on the money he borrowed to buy the house.

A State government agency is to compulsorily acquire 0.5 hectares of David's land on 30 June 2010, and he will make a capital gain of \$20,000 as a result.

If David's house were sold on 30 June 2010 and he made a capital gain, under section 118-185 of the main residence exemption he could disregard 50 per cent of the gain (representing the period that the house was his main residence).

Under section 118-190 of the main residence exemption, it would be reasonable to increase the residual capital gain after the application of section 118-185 to the hypothetical sale of David's house by 25 per cent of the disregarded capital gain to account for the proportion of his house that was used for producing assessable income.

This would result in 62.5 per cent (that is, $0.5 + (0.5 \times 0.25)$) of the capital gain made on the hypothetical sale of David's house being taxable. Equivalently, David could disregard 37.5 per cent of the capital gain made on the hypothetical sale of his house.

All of the conditions outlined in paragraph 1.19 are satisfied in relation to the adjacent land. Therefore, it is reasonable under the new exemption for there to be an automatic disregarding of an amount of \$7,500 (that is, 37.5 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of David's land, leaving a capital gain of \$12,500. There is an automatic disregarding because the sum of the relevant areas specified in the last condition of paragraph 1.19 is not more than two hectares.

Calculation (based on sections 118-185 and 118-190):

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The house was David's main residence for 10 of the 20 years of his ownership period to the date of the compulsory acquisition of part of his land. Therefore, on that basis \$10,000 (that is, 50 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of his land would be automatically disregarded, leaving a residual capital gain of \$10,000.

During the period that the dwelling was his main residence, David used 25 per cent of the dwelling for producing assessable income. Therefore, on that basis it would be reasonable to increase the residual capital gain of \$10,000 by an amount of \$2,500 (that is, 25 per cent) of the \$10,000 disregarded capital gain derived from the proportion of the time the dwelling was David's main residence while he owned it.

Therefore, David's capital gain made from the compulsory acquisition of part of his land is \$12,500 (that is, \$10,000 + \$2,500).

Example 1.8: Deceased estate — scenario 1

On 1 July 2000 Manuel bought a house on 1.5 hectares of land. He moved into the house immediately after settlement, and it was always his main residence. The land adjacent to the house is landscaped, and has been used as though it were a part of the dwelling.

Manuel died on 30 June 2005, and ownership of the house passed to his son Pedro. The property was left vacant for one year and it has been rented out since 1 July 2006. Pedro has never occupied the house.

A State government agency is to compulsorily acquire 0.5 hectares of Pedro's land on 30 June 2010, and he will make a capital gain of \$20,000 as a result.

If Pedro sold the house on 30 June 2010, under the main residence exemption he could disregard 50 per cent of the resultant capital gain.

All of the conditions outlined in paragraph 1.19 are satisfied in relation to the adjacent land. Therefore, it is reasonable under the new exemption for there to be an automatic disregarding of an amount of \$10,000 (that is, 50 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of Pedro's land, leaving a capital gain of \$10,000. There is an automatic disregarding because the sum of the relevant areas specified in the last condition of paragraph 1.19 is not more than two hectares.

Calculation (based on 118-200):

EXPOSURE DRAFT

$$\begin{aligned} \text{Capital gain} & \times \frac{\text{non-main residence days}}{\text{total days}} \\ & = \$20,000 \times \frac{1825}{3650} \\ & = \$10,000 \end{aligned}$$

Example 1.9: Deceased estate — scenario 2

On 1 July 2000 Kazuko bought a house on 1.5 hectares of land. She moved into the house immediately after settlement, and it was always her main residence. The land adjacent to the house is landscaped, and has been used as though it were a part of the dwelling.

Kazuko died on 30 June 2005, and ownership of the house passed to her daughter Kumiko. The property was left vacant for a year before Kumiko moved in on 1 July 2006. It has been Kumiko's main residence since then, and she used 25 per cent of the house for her dental practice. If Kumiko had borrowed money to buy the house, she would have been entitled to claim a deduction for 25 per cent of the interest payable on the notional loan.

A State government agency is to compulsorily acquire 0.5 hectares of Kumiko's land on 30 June 2010, and she will make a capital gain of \$20,000 as a result.

Assume Kumiko sold her house on 30 June 2010.

To work out, under section 118-190 of the main residence exemption, what would be a reasonable increase in the capital gain made on the sale of Kumiko's house as a result of her using 25 per cent of it for her dental practice, it is necessary to apply section 118-200 separately to decompose the disregarded proportion of the capital gain into two components: one for Kazuko's period of ownership; and one for Kumiko's period of ownership.

Under section 118-200 of the main residence exemption, Kumiko could firstly disregard 50 per cent of the capital gain from the sale of her house. This 50 per cent represents the period that the house was Kazuko's main residence (that is, 5 out of 10 years). Kumiko could also disregard 80 per cent of the remaining 50 per cent of the capital gain, which computes to another 40 per cent of the capital gain being disregarded. This 40 per cent represents the period that the house was her main residence (that is, 4 out of 5 years). Overall, this results in 90 per cent of the capital gain from the sale of the house being disregarded and 10 per cent being taxable.

EXPOSURE DRAFT

Under section 118-190 of the main residence exemption, it would be reasonable to increase the residual taxable capital gain after the application of section 118-200 to the hypothetical sale of Kumiko's house by 25 per cent of the component of the capital gain that is disregarded due to the house being Kumiko's main residence. This translates to an increase in the capital gain of 25 per cent of 40 per cent, which computes to 10 per cent.

This results in 20 per cent of the capital gain made on the hypothetical sale of Kumiko's house being taxable. Equivalently, Kumiko could disregard 80 per cent of the capital gain made on the hypothetical sale of his house.

All of the modified conditions outlined in paragraph 1.19 are satisfied in relation to the adjacent land. Therefore, it is reasonable for there to be an automatic disregarding under the new exemption of an amount of \$16,000 (that is, 80 per cent) of the \$20,000 capital gain made from the compulsory acquisition of part of Kumiko's land, leaving a capital gain of \$4,000. There is an automatic disregarding because the sum of the relevant areas specified in the last condition of paragraph 1.19 is not more than two hectares.

Extension to adjacent structures

1.44 The new exemption applies to an adjacent structure (for example, a garage or a storeroom) of a flat or home unit in a corresponding way to the way it applies to a dwelling's adjacent land. For an adjacent structure, the relevant provisions of the new exemption need to be read with appropriate modifications so that adjacent structures are accommodated within the new provisions. *[Schedule #, item 6, section 118-265]*

Example 1.10

Juan owns a home unit and the total area of his adjacent land, his share of the land on which the home unit is situated and his share of the land on which a storeroom is located is 0.4 hectares. The home unit has always been Juan's main residence while he owned it and he has never used the dwelling for income-producing purposes and has always used the adjacent land and structure for private or domestic purposes.

A State government agency is to compulsorily acquire the storeroom and Juan's share of the land on which it is built (0.09 hectares is Juan's share) on 30 June 2010, and he will make a capital gain of \$5,000 as a result. This is the only compulsory acquisition (or similar arrangement) that has happened to Juan's main residence while he has owned it.

EXPOSURE DRAFT

All of the conditions (modified as necessary to accommodate an adjacent structure) outlined in paragraph 1.19 are satisfied in relation to the adjacent structure and the \$5,000 capital gain made from the compulsory acquisition of the storeroom is automatically disregarded under the new exemption.

Application and transitional provisions

1.45 The amendments made by this Schedule apply in relation to CGT events happening on or after the day on which this Act receives the Royal Assent (the commencement day). *[Schedule #, subitem 10(1)]*

1.46 However, taxpayers are provided with a transitional choice to apply the amendments to CGT events relating to them that happen during the period:

- starting at the start of the 2004-05 income year; and
- ending immediately before the commencement day.

This allows taxpayers who have had adjacent land or an adjacent structure compulsorily acquired without the relevant dwelling being acquired in this period to qualify for the relief. Providing taxpayers with a choice to apply the amendments retrospectively ensures that they will do so only if it is to their advantage.

[Schedule #, subitem 10(2)]

1.47 A taxpayer who makes a choice as described in paragraph 1.46 must do so:

- by the day they lodge their income tax return for the income year that includes the commencement day; or
- within further time allowed by the Commissioner.

[Schedule #, subitem 10(3)]

1.48 The way a taxpayer prepares their income tax return for the applicable income year is sufficient evidence of them making a choice as described in paragraph 1.46. *[Schedule #, subitem 10(4)]*

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1.49 However, this does not preclude a taxpayer from making a choice or providing evidence of a choice in a way other than the way they prepare their income tax return for the applicable income year.

- For example, a taxpayer lodging an objection to an assessment in the relevant period would also be sufficient evidence of them making a choice if the basis of the objection were to apply the amendments to CGT events happening in the period identified in paragraph 1.46.

1.50 Taxpayers must keep records of every act, transaction, event or circumstance that can be reasonably expected to be relevant to working out whether they have made a capital gain or loss from each CGT event even if the capital gain or loss was disregarded as a result of an exemption.

1.51 Section 170 of the *Income Tax Assessment Act 1936* is amended to extend the amendment period in cases where a taxpayer wishes to amend their assessment, but their amendment period has expired, to take advantage of the amendments introduced by this Schedule where:

- the assessment was made before the commencement day;
- the amendment is made within 2 years after the start of the commencement day; and
- the amendment is made for the purpose of giving effect to this Schedule.

This means that if a compulsory acquisition occurs in the period described in subitem 10(2) and the taxpayer's amendment period has expired for the income year in which the relevant compulsory acquisition occurred, there is a two-year time limit from Royal Assent in which the taxpayer can seek an amended assessment as a result of making a choice under subitem 10(2).

[Schedule #, subitems 10(2),(3) and (5)]