# Producing an income from your PPOR

***Michael Quinn*, lawyer, accountant and director of The Quinn Group, explains the impact that renting out part of your principal place of residence – to a tenant or to yourself to run a business – will have on your tax bill**

Generally speaking, your principal place of residence (PPOR) is usually exempt from capital gains tax (CGT) liability upon its disposal.

However, various provisions exist that mean the full exemption may not apply, or that you may be eligible for only a partial exemption. These provisions may apply in circumstances where the property wasn't the owner's PPOR for the entire period of ownership, as well as the six-year rule that allows the owner 'temporary absences'. Another example where the owner may be eligible for a partial CGT exemption is if the PPOR, or part thereof, is used for all or part of the ownership period to produce income. The three criteria that must be satisfied in order to qualify for this particular partial CGT exemption are:

1. The property was acquired and used as your main residence on or following 20 September 1985. CGT was introduced on this date. Any assets purchased prior aren't liable for CGT – they're known as pre-CGT assets, **and**
2. You generated income using any part of the residence for all or part of the period of time you owned the property. 'Generating income' refers to both rental income and operating a business (the two most common ways to generate income from your PPOR), **and**
3. You're entitled to deduct interest payable on monies borrowed to purchase the residence. On the assumption that you borrowed monies to purchase the residence, the interest deductibility test can be applied.

### CGT discounts

A CGT discount is available for any assets that were acquired on or after 11.45am on 21 September 1999 and held for at least 12 months. For individuals, the discount is such that only 50% of their capital gain is added to their assessable income. For regulated or complying superannuation funds, there's a 33% discount rate, but companies don't receive this discount at all.

For assets acquired before 11.45am on 21 September 1999 and held for at least 12 months, the owner may choose to utilise either the 50% discount method or the indexation method – whichever method gives the best outcome. The indexation method simply sees the 'cost base' indexed against the relevant indexation factors for the period. No other discounting is permitted with this method.

It's important to note that if the capital losses are greater than the capital gains for the same year, it isn't possible to use the loss against other income. In this instance, the losses are carried forward and used to reduce any future capital gains.

Using the purchase example (see box below), we can compare the results achieved by using the 50% discount method and the indexation method. In this example, it's wise for Julie to use the 50% discount method, as her capital gain is significantly less, and, as a result, so too will be her liability for CGT.

### Purchase example

**Julie purchased a property on 1 January 1998 for $200,000. The property was sold on 31 December 2003 for $350,000. This is a capital gain of $150,000. In simple terms:**

**Selling price – cost base = capital gain**
**$350,000 – $200,000 = $150,000**

**50% discount method**
Using the 50% discount method, Julie's capital gain is now $75,000.

**Capital gain x 50% = discounted taxable portion**
**$150,000 x 50% = $75,000**

**Indexation method**
Using the indexation method, Julie's capital gain is now $144,800. The cost base is indexed using the relevant indexation factors for the acquisition and sale periods.

As acquisition occurred on 1 January 1998, the relevant index is 120.3.
As sale occurred after 21 September 1999, the relevant index is 123.4.

$$\frac{\text{Sale index}}{\text{Acquisition index}} = \text{index factor} \qquad \frac{123.4}{120.3} = 1.026$$

Index factor x cost base = indexed cost base

**1.026 x $200,000 = $205,200**
**Sale price – indexed cost base = capital gain**
**$350,000 – $205,200 = $144,800**

### The interest deductibility test

On the assumption that you've borrowed money in order to acquire your PPOR, then you may be eligible for a partial CGT exemption under the 'interest deductibility test'.

If part of your PPOR is rented to external parties – for example, a room is rented to a tenant – then you're entitled to a deduction for part of the interest that you're required to pay on monies borrowed to acquire the residence.

Similarly, if part of your PPOR is used to operate a business (or professional practice) then you're also entitled to a deduction for part of the interest that you're required to pay on monies borrowed to acquire the residence. If you're operating a business from your PPOR, then you can only claim the deduction if:

1. Part of the residence is able to be clearly identified as a place of business and is exclusively set aside as such, and
2. That exclusive part of the property isn't readily adaptable for private use.

It's important to note that it isn't possible to deduct interest expenses for activities such as using the 'study room' in your PPOR to complete work that is usually performed at your place of business.

The amount of capital gain that isn't exempt from CGT is calculated using the percentage of property floor space that's dedicated to producing income, whether it's from rental or business activities. You should be aware that you can't simply get a CGT exemption for that area by not claiming the interest as a deduction, nor can the interest be included in the cost base when calculating the capital loss or gain.

For practical purposes, it's necessary to assume that the following example properties were purchased prior to 11.45am on 21 September 1999, sold after that time and held for at least 12 months, as there are a different set of processes used to calculate the taxable portion if this isn't the case. If this is the case, the method of calculating the taxable portion of a capital gain where income has been produced in the PPOR through renting or operating a business can be practically demonstrated in the following examples.

**Example: Renting to a tenant**

Using the example from the box on the previous page, Julie purchased a property on 1 January 1998 for $200,000. The property was sold on 31 December 2003 for $350,000. This is a capital gain of $150,000.

The property was Julie's PPOR for the entire ownership period. Similarly, for the entire period Julie produced income by renting out one of the bedrooms, which was calculated as occupying 15% of the property. Julie's tenant also shared the kitchen and laundry, which represented 10% of the property.

> If you've borrowed money to acquire your principal place of residence, then you may be eligible for a partial CGT exemption under the 'interest deductibility test'

As a result, 20% of Julie's capital gain (15% for the bedroom and 5% for using shared facilities) isn't exempt from CGT. Julie's taxable portion of her capital gain would be calculated at $30,000:

**Capital gain x percentage of floor area not exempt = taxable portion**

**$150,000 x 20% = $30,000**

**Example: Operating a business**

In this example we'll also consider the fact that income may not be produced for the entire period.

Again, Julie purchased a property on 1 January 1998 for $200,000. The property was sold on 31 December 2003 for $350,000. This is a capital gain of $150,000.

The property was Julie's PPOR for the entire ownership period. However, instead of taking on a tenant, Julie produced income by transforming one bedroom so that she could operate her nutrition consultancy business out of it. It was calculated that this room occupied 20% of the total property floor space.

As a result, 20% of Julie's capital gain isn't exempt from CGT. After three years, Julie's business moved to a new location and was no longer operating from her home. Julie's taxable portion of her capital gain is calculated at $18,000 as follows:

**(Capital gain x percentage of floor area not exempt) x percentage of period of ownership that this area wasn't used as PPOR = taxable portion**

**($150,000 x 20%) x 60% = taxable portion**

**$30,000 x 60% = $18,000**

In both examples, Julie is eligible for a further CGT discount. Because of the purchase and sale dates, she's entitled to apply either the 50% discount or indexation method to her taxable portion, whichever will result in the best outcome.

The CGT exemptions and examples that are outlined above demonstrate only a portion of the complex legislation and the many variables that can affect the process and outcome of each individual situation. This is particularly pertinent in regards to details such as the date the property was purchased and when income was first produced, as different criteria are applied depending on this information.

This information and these examples are intended to provide an introduction and general overview of CGT in relation to utilising your PPOR to produce income. It's important that if you're producing income from your PPOR, you seek the professional advice of a lawyer and/or accountant in order to ensure that you aren't only getting the maximum return owed to you but also that you're complying with the necessary legal requirements. ■

*Michael Quinn, director of The Quinn Group, is an experienced lawyer, accountant and educator. For further information or assistance, contact Michael and the team of legal and accounting professionals at The Quinn Group on 1300 QUINNS or visit their website: www.quinns.com.au*