TR 97/D7 - Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities

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Draft Taxation Ruling

Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities

other Rulings on this topic

TR 93/6;TR 95/33

contents para

What this Ruling is about 1
Class of person/arrangement 1
Ruling 7
Is the additional interest incurred deductible under subsection 51(1)? 7
Application of Part IVA 12
Identification of the scheme 13
The tax benefit test 15
Dominant purpose 18
Date of effect 20
Explanations 21
Application of Part IVA 21
Identification of the scheme 22
The tax benefit test 24
Dominant purpose 26
The matters referred to in paragraph 177D (b) 30
Alternative view 47
Examples 59
Your comments 74

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What this Ruling is about

Class of person/arrangement

1. This Ruling considers the taxation consequences for those taxpayers who enter into certain linked or split loan facilities. It considers what part of the interest incurred on the loans is deductible under subsection 51(1) of the *Income Tax Assessment Act 1936*, section 8-1 of the *Income Tax Assessment Act 1997* (from 1 July 1997). It also considers whether Part IVA of the ITAA would apply.

2. For the purposes of this Ruling, a linked loan is a facility which has two or more loans with an account being maintained in respect of each loan. A split loan is a facility which has one loan with sub-accounts being maintained in respect of that loan.

3. There are many different loan facilities available that could be described as linked or split loan facilities. This Ruling applies only to linked or split loan facilities as described in paragraph 4 below. In this Ruling we refer to these loans as 'the facility'.

4. The facility has a number of broad features. A taxpayer borrows an amount of money ('the loan amount'). The contract/s between the taxpayer and the lender provides that the loan amount is split between two or more accounts or loans. At least one account or loan is for private purposes ('private account') and the other/s is for business or income producing purposes ('investment account'). The lender sets the minimum loan repayment at the amount required to pay back the total loan on a principal and interest basis over the nominated period. The taxpayer applies the repayments first to repay the private account and then against the investment account. As a result, the taxpayer pays off

the private account much faster, and the related amount of interest paid is less than would have been the case if the taxpayer had applied the repayments to the separate accounts. Correspondingly, the investment account takes longer to pay off and more interest is payable. Interest in respect of the investment account is accumulated and capitalised during the period that the private account is being repaid. The taxpayer's total outstanding debt does not increase. In the early years of the facility the taxpayer claims a deduction for the capitalised interest even though no repayments are made in respect of the investment account.

5. In this Ruling, 'capitalising interest' refers to the process of adding any unpaid interest to the loan balance (generally monthly). The interest calculation for the following month uses this higher loan balance as its starting point. In consequence, the loan balance grows at ever increasing rates as interest on interest is added to the loan.

6. This Ruling is not intended to impact upon the ATO's views on interest incurred on negatively geared investments as outlined in Taxation Ruling TR 95/33 or the use of interest offset accounts as outlined in Taxation Ruling TR 93/6.

Ruling

Is the additional interest incurred deductible under subsection 51(1)?

7. Generally, interest deductibility depends on the use to which the funds are put: *Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613; *FC of T v. Energy Resources of Australia Limited* 96 ATC 4536; (1996) 33 ATR 52. The use to which the funds are put reflects the objective purpose for incurring the interest expense. Usually, no more is required for deductibility of the interest expense than the use of the loan funds for an income producing purpose: *Steele v. FC of T* 97 ATC 4239; (1997) 35 ATR 285.

8. There are special circumstances where subjective purpose may be relevant in determining the deductibility of the expense: *Magna Alloys and Research Pty Ltd v. FC of T* 80 ATC 4542; (1980) 11 ATR 276. For example, where the income produced is nil or disproportionately small relative to the amount of the expenditure, reference may be had to subjective purpose together with all the other relevant features of the case, in order to characterise the expenditure as being on revenue account, or incurred for a capital, domestic, or private purpose: *Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613; *Ure v. FC of T* 81 ATC 4100; (1981) 11 ATR 484.

9. In the circumstances of these arrangements, interest is incurred on the investment account This interest accrues and capitalises, therefore allowing interest payments which otherwise would have to be made on this account to be applied to the private account. While the interest incurred on the investment account is increasingly more than might otherwise be expected from a conventional facility or separate loans from separate financiers, its relationship with the income earned from the use of the loan funds depends on the facts of each case. In most cases, it is unlikely that there is such a disparity between the interest expense and the annual income produced such as to raise a question as to the characterisation of the interest expense.

10. Under these facilities, repayments are calculated by reference to the minimum payment required to repay the principal and interest required on both the private and investment accounts, and both loans are usually subject to the same security. In these cases it may be possible to have regard to the purposes of the taxpayer to characterise the interest expense for the reasons stated above.

11. As the matter may depend on all the circumstances of a particular case, we reserve the right to raise an argument based on subsection 51(1) in relation to these matters. We acknowledge, however, that the denial of deductions under subsection 51(1) to such cases is at best problematic.

Application of Part IVA

12. If the additional interest incurred on the investment account is deductible under subsection 51(1), we would consider whether the general anti-avoidance provisions of Part IVA are applicable.

Identification of the scheme

13. A prerequisite to the operation of Part IVA is the identification of a 'scheme' (section 177A). The Commissioner can identify alternative schemes for the purposes of Part IVA. Where a taxpayer enters into a facility, the scheme may vary from case to case, but includes some or all of the following:

- the refinancing of an existing private loan arrangement or the advancing of funds for a private loan;
- the refinancing of an existing business or investment loan or the advancing of funds for a business or investment loan;

- an understanding or agreement as to how the facility is to operate, including the linking of the private and investment accounts;
- securing both loans by the same assets;
- the overall indebtedness not exceeding the loan amount;
- often, the charging of additional fees and interest.

It always includes:

- the entering into of a facility with one lender;
- the acceptance by the lender of capitalisation of interest on the investment account on the basis that the lender receives another predetermined amount in reduction of the private account;
- the application of any repayments to the private account (until the private account is repaid) including those that would have otherwise been paid against the investment account; and
- the consequential incurring of an amount of additional interest (by reason of the process of capitalising interest) on the investment account.

14. The scheme involves taking steps to increase the tax deduction available on the investment account by means of a corresponding reduction of principal and, therefore, interest on the private account through a pre-ordained course of conduct. This course of conduct includes the redirecting of all payments made on the total debt outstanding under the facility to repay the private account while allowing additional interest to capitalise on the investment account.

The tax benefit test

15. A tax benefit arises because the deduction for interest actually incurred on the investment account is greater than the amount of interest (if any) that might reasonably be expected to have been allowable but for utilising the facility.

16. Where a taxpayer enters into a facility, the lender calculates the repayments based on the minimum payment required to repay the principal and pay the interest on both the private and investment accounts within the specified time period. In these circumstances, the tax benefit is the difference between the interest incurred on the investment account under the scheme and the interest that would have been incurred on the investment account if the minimum repayments

required to pay off the investment account within the specified period were, in fact, allocated to the investment account.

17. A tax benefit does not arise in relation to additional capital repayments made over and above the minimum payments required.

Dominant purpose

18. Some or all of the following factors are present in a case to which Part IVA applies:

- a planned course of conduct designed to produce a tax benefit;
- establishment fees associated with restructuring existing loan facilities;
- the structure of these facilities is directed at producing additional interest deductions;
- a marketing of the facility in a manner that emphasises the associated tax benefits;
- an accelerated repayment of the private account and a corresponding increase in the amount owing on the investment account;
- a lack of commercial reasons for capitalising the interest;
- the rates of interest charges on loans under the facilities may be higher than the rates available under a separate loan structure.

19. Having regard to these factors, when considered against the eight items listed in paragraph 177D(b), it is open to a reasonable person to objectively conclude that a taxpayer, who has entered into a scheme with some or all of the characteristics outlined in paragraphs 13 and 14 above, did so for the dominant purpose of enabling that taxpayer to obtain a tax benefit. In such a case, it would be appropriate for the Commissioner to determine that the whole or a part of the interest deduction otherwise allowable shall not be allowable to the taxpayer.

Date of effect

20. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Application of Part IVA

21. Part IVA operates where:

(i) there is a scheme as defined in section 177A;

(ii) there is a 'tax benefit' which in relation to deduction amounts is defined in paragraph (b) of subsection 177C(1) as a deduction being allowed to the taxpayer in relation to a year of income where the whole or part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to the year of income if the scheme had not been entered into or carried out;

(iii) having regard to the eight matters identified in paragraph (b) of section 177D, it would be concluded that there was the necessary dominant purpose of enabling the taxpayer to obtain the tax benefit;

(iv) the Commissioner makes a determination that the whole or part of the amount of the tax benefit which is referable to the deduction shall not be allowable: paragraph 177F(1)(b).

Identification of the scheme

22. The term 'scheme' is defined very broadly in section 177A as follows:

'(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct'.

23. We consider that the circumstances described in paragraphs 13 and 14 above would fall within the above definition.

The tax benefit test

24. The tax benefit test in subsection 177C(1) requires a predication as to what would have been, or what might reasonably be expected to have been, the case in the absence of the scheme. The High Court in *FC of T v. Peabody* 94 ATC 4663; (1994) 28 ATR 344 stated that a reasonable expectation is more than a possibility.

25. Where a taxpayer enters into and utilises a facility in the manner described in paragraphs 4, 13 and 14 above, it might reasonably be expected that, if the taxpayer had not utilised the facility in this manner, the taxpayer would have applied that part of the overall repayment referable to the investment account to that account rather than the private account.

Dominant purpose

26. Section 177D provides:

> 'This Part applies to any scheme ... where -'
>
> '(b) having regard to -'
>
> ... [the matters specified in subparagraphs 177D(b)(i) to (viii) inclusive] ...
>
> 'it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme ...'

27. The purpose under section 177D involves the objective determination of the taxpayer's purpose. In arriving at this conclusion the Commissioner must have regard to each and every one of the eight matters listed in subparagraphs 177D(b)(i) to (viii), weighed one against the other. Subsection 177A(5) requires this purpose to be the dominant purpose.

28. The High Court in *FC of T v. Spotless Services Limited & Anor* 96 ATC 5201; (1996) 34 ATR 183 ('*Spotless*') considered the meaning of 'dominant purpose'. The majority said, ATC at 5206; ATR at 188, that:

> 'In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose.'

29. A person may enter into or carry out a scheme, within the meaning of Part IVA for the dominant purpose of obtaining a tax

benefit, where that dominant purpose is consistent with the pursuit of commercial gain: see *Spotless* ATC at 5206; ATR at 188. Further, the High Court stated, ATC at 5206; ATR at 188, that:

> 'A particular course of action may be, to use a phrase found in the Full Court judgments, both "tax driven" and bear the character of a rational commercial decision.'

The matters referred to in paragraph 177D(b)

(i) the manner in which the scheme was entered into or carried out

30. These facilities involve pre-ordained steps which have the effect of producing additional tax deductions over and above those available under separate principal and interest loan arrangements. The facilities are marketed using material that emphasises the tax benefit: see examples at paragraph 60 and onwards. A taxpayer who has entered a facility will often have been made aware of computer projections that highlight the additional tax deductions available from that loan facility. A taxpayer might also incur higher interest charges or fees in renegotiating loans or other additional costs associated with choosing a particular loan facility over another facility. Taxpayers often pay additional fees to intermediaries to enter into these facilities.

(ii) the form and substance of the scheme

31. The inherent structure of these facilities is an overall principal and interest payment arrangement provided by one financier, incorporating the form of two separate loans or loan accounts. The facilities have a commercial purpose (i.e., the provision of funds to borrowers to assist in the acquisition of an investment). However, they contain additional steps that are contrived in the context of the arrangement (the capitalisation of interest and redirection of repayments) that are principally designed to produce a tax benefit for the taxpayer.

32. The substance of the scheme is that the interest payable on the total loan funds advanced is to the greatest extent possible converted into deductible interest. Interest that would normally relate to the private account, generally a home loan, is, in effect, transferred to the investment account, thereby becoming tax deductible. In reality, there is a conversion of non deductible interest to tax deductible interest. In many cases, the scheme purports to enable taxpayers to 'own their homes' more quickly. However, in the majority of cases, the home remains security for the total borrowing.

33. The before tax financial position of the taxpayer and lender is substantially the same as where there are separate principal and

interest loans. From the lender's perspective, the loan amount is the same as if there were separate loans. The security and the borrower are also the same. The lender requires repayments which would represent the aggregate of repayments required to repay each loan or the total loan amount. The taxpayer has no greater liquidity under the facility than under a conventional principal and interest loan with similar terms apart from any resulting additional income tax deductions.

34. Invariably there is an agreement or understanding reached between the taxpayer and the lender as to the steps designed to produce a tax benefit.

35. Lenders have argued that these facilities have other commercial advantages, e.g., they allow a client to combine private and investment loans under the one facility while the client receives separate statements allowing them to see the reduction in the home loan and the ability to manage cash flow. It remains unclear to us how the facility benefits the management of cash flow. Even if it did, these features do not explain the additional steps in the structure of the facility. In any event, we consider, on balance, that the acquisition of these advantages would not be the prevailing or most influential purpose for entering into the scheme.

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out

36. This depends on the facts of each case. Once the structure is put in place it will be utilised over a number of years. The tax benefits from effectively converting the private interest to deductible interest (by increasing the debt on the investment account) continue beyond the stage of paying out the home loan until the taxpayer repays the total debt.

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme

37. Subject to the possible arguments canvassed above, a tax deduction under subsection 51(1) would be allowable for all of the interest incurred on the investment account, which is greater than the interest that would be deductible if the loan accounts had not been linked.

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme

38. In some cases, the taxpayer incurs higher fees and higher interest rates in respect of the facility than would be the case in a conventional principal and interest loan arrangements.

39. Often the taxpayer applies against the private account any funds generated through the lodging of a section 221D variation or any extra taxation refund paid to the taxpayer that was referable to the extra interest deductions claimed on the investment account. This additional cash flow may help to reduce overall interest paid on the facility. In short, the taxpayer is financially better off because of the tax deduction.

40. The capitalising of interest can be a legitimate commercial arrangement between borrowers and lenders. A major commercial reason put forward for borrowers to choose to capitalise interest charges is to free up their liquidity so that funds that would normally be expected (in the absence of an agreement to accrue interest on a capitalisation basis) to be used in paying monthly interest charges can be redirected to another use. Under this facility, the taxpayer has no additional liquidity where the funds which would otherwise have been paid or applied to the investment account are credited or paid to the private account. *Prima facie*, this is not explicable by reason of ordinary commercial dealings.

41. If the interest is accruing at the same rate, the extra interest paid on the investment account equals the reduction in the interest that would otherwise have been paid on the private account.

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or might reasonably be expected to result, from the scheme

42. From the lender's perspective, the financial benefit, if any, relates mainly to commercial fees and charges and in some cases increased interest where the interest rates are higher than conventional loans. The lender is indifferent to the type of interest it receives because the interest is assessable to it. The characterisation of the interest is, however, relevant from the taxpayer's perspective.

43. The lender is receiving repayments calculated by reference to the total indebtedness over the term of the loan. If the interest is accruing at the same rate, the extra interest paid on the investment account equals the reduction in the interest that would have been paid on the private account. Therefore, it generally receives the same cash flow as

it would have received if the loans were not linked. However, this depends on the terms of the facility.

44. Any extra repayments made, as outlined in paragraph 39 above, may have the effect of reducing the total interest received by the lender (and the term of the loan/s).

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out

45. The taxpayer finalises the private account in a substantially shorter time than would otherwise have been the case. However, the debt on the investment account grows at an increasing rate during this time. The mortgage on the private home, where the home is security, generally remains in place until the taxpayer clears the total liability.

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi)

46. We would not expect there to be any connection between the taxpayer and the lender beyond the commercial relationship of lender and borrower. In circumstances where both the lender and borrower benefit from the arrangement because of the tax advantages it may be possible to argue that the parties have not dealt with each other at arm's length: see *Collis v. FC of T* 96 ATC 4831; (1996) 33 ATR 438. For example, the borrower is prepared to pay higher charges or interest rates where the lender agrees to enter into an arrangement which is directed at securing greater tax benefits for the taxpayer than might otherwise have been the case. Where there is a relevant connection, e.g., where the taxpayer is an employee or associate of the lender, this connection may also be a relevant consideration.

Alternative view

47. All the interest accrued on a capitalising basis on the investment account is fully deductible under the terms of subsection 51(1). After an objective examination of all relevant circumstances surrounding the capitalisation of interest on the facility, the provisions of Part IVA should not apply to deny any interest deduction accrued on the investment account.

Section 51

48. In the case of interest expenditure, the necessary nexus between the loss or the outgoing can be found in the purpose for which the borrowed funds are used. The primary test of deductibility of interest is the objective use to which the funds are put, although a rigid tracing of funds is not always necessary or appropriate: *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380; (1992) 23 ATR 494. However, regard must had to all the circumstances, including the objective purpose of the borrowing and the nature of the transactions or series of transactions of which the borrowing of funds is an element.

49. Where borrowed funds are used *bona fide* for the production of future assessable income the fact that the income fails to materialise for some years (if ever) does not necessarily render the interest on the loan non-deductible: *FC of T v. Total Holdings (Australia) Pty Ltd* 79 ATC 4279; (1979) 9 ATR 885.

50. We acknowledge that the argument based on subsection 51(1) is problematic, and may depend on the circumstances of the particular borrower. Also, the cases cited above do not consider the factual matrix associated with the facility.

Part IVA

51. Part IVA operates when a taxpayer enters into a scheme and as a result obtains a tax benefit in circumstances where it can be objectively determined that the dominant purpose of any party entering the scheme was to secure the tax benefit to the taxpayer.

52. The view is put forward that the most influential and prevailing or ruling purpose of these arrangements is not the obtaining of a tax benefit but the entering into a financial plan that is aimed at increasing wealth by way of cash flow management and investment in income producing property. The financial plan resolves around the premise that investment in the underlying property produces a positive income return and capital growth. On this basis the more invested in such assets, the greater the financial return to the investor.

53. In general, it is argued that the arrangement enables the investor to access 'the equity' in the home to acquire more income generating investments. Such arrangements would not be entered into if they did not offer long term income generation and capital growth potential through the purchase of investment assets.

54. The fact that a taxpayer deposits all receipts into the private account rather than the investment account should not of itself attract the operation of Part IVA. The private account is presumably repaid

in preference to the investment loan due to the fact the interest on the private account is not tax deductible. This is not enough to conclude that the arrangement viewed as a whole was entered into for the purpose of obtaining a tax benefit. The step of choosing to repay non-deductible debt before deductible debt is a normal commercial consideration.

55. Even if such a step did constitute a scheme, it is not reasonable to conclude that the monies would have been used to repay the investment loan instead. That is, it is not reasonable to conclude that any less of a deduction for interest would have been available.

56. For these reasons it is argued that the Commissioner should not seek to apply the provisions of Part IVA to the arrangement.

57. Utilising the facility has the character of a rational commercial decision. There is a range of interrelated features of the facility which precludes a reasonable person from concluding that the arrangement is predominantly tax driven.

58. We accept that in the absence of other considerations, the choice of repaying non-deductible debt before deductible debt is a normal commercial decision.

Examples

59. The following examples are based on sanitised versions of materials made available to the public by the providers of these facilities.

Example one

60. Fred has a home with an outstanding mortgage of $100,000. Fred also has a rental property which is financed by a loan of $150,000. Both loans are with Lender A. The interest rate on Fred's home loan is 9.3% and the rate on his investment loan is 9.4%.

61. Fred sees a segment on television by a well known financial commentator which outlines a facility which 'may enable you to change your non deductible home loan to a tax deductible one'. Fred goes to his accountant who has a brochure on one of these facilities offered by Lender B. His accountant tells him that the product 'lets [him] combine [his] home loan and investment loan under one umbrella facility which, depending on the circumstances, may lead to a reduction in tax payable'. He suggests that Fred visit the lender to discuss the product further. Fred visits the lender and the manager takes him through a computer projection which compares his current

separate loan structure with the umbrella facility and highlights the possible net savings and increased tax deductions for interest as follows:

Marginal tax rate - 48.5%

SEPARATE LOANS STRUCTURE

	Home Loan	Investment Loan
Loan amount	$100,000	$150,000
Interest rate	9.3%	9.4%
Term	25 years	20 years
Monthly repayment	$860.35	$1,389.25

Total repayment amount	$592,304.34
Total interest charged	$341,948.67
Total possible tax reduction	$89,030.65

(These calculations include some changes.)

SPLIT LOAN FACILITY

	Home Loan	Investment Loan
Loan amount	$100,000	$150,000
Interest rate	9.65%	9.65%
Term	4 yrs, 8 mnths	23 yrs, 4 mnths

Total repayment amount	$629,500.57
Total interest charged	$379,500.57
Total possible tax reduction	$172,300.94
Possible net saving	$46,074.06

62. The manager explains that under the facility $355,259.67 of the $379,500.57 interest paid would be claimed by Fred as a tax deduction. Under the separate loan structure, only $183,568.35 of $341,948.67 interest paid would be claimed. He explains that whilst Fred pays $37,196.23 more in repayments by utilising the facility, he gets an increased tax deduction of $171,691.32. At a marginal tax rate of 48.5%, this results in a net saving to Fred of $46,074.06. He also

explains that both properties will be required as security for the duration of the facility.

63. Fred decides to enter into the facility. He pays the establishment fee and pays out his separate loans with Lender A using the funds provided by Lender B. Fred uses the facility as set out in the computer projection. His minimum repayment is $2,249.60 which is the same as the total monthly repayments under the separate loan structure. Fred applies the whole of his repayment to the home account and allows interest on the investment account to capitalise. Fred claims a deduction for the interest on the investment loan account which has been shown on his financial statement from the lender. The interest calculation for the first two years is as follows:

Investment Loan Account

	Debit	**Credit**	**Balance**
	$	**$**	**$**
Loan Funds			150,000.00
Year 1	15,132.69	nil	165,132.69
Year 2	16,659.36	nil	181,792.05

Private Loan Account

	Debit	**Credit**	**Balance**
	$	**$**	**$**
Loan funds			100,000.00
Year 1	8,861.90	26,995.20	81,866.70
Year 2	7,032.54	26,995.20	61,904.04

64. Fred is not entitled to a deduction for all the interest charged on the investment loan under the facility. In each year the difference between the interest actually incurred on the investment loan and the interest that would have been incurred if Fred had applied that part of the repayment referrable to the investment loan account ($1,349.76 per month) against the investment loan rather than the private loan, is not allowable. If the repayments had been applied in this way the financial statement for the investment account would show:

Investment Loan Account

	Debit	Credit	Balance
	$	$	$
Loan funds			150,000.00
Year 1	14,396.76	16,197.12	148,199.64
Year 2	14,215.12	16,197.12	146,217.64

65. In the above example Fred would be entitled to a deduction in year 1 of $14,396.76. He would not be entitled to a deduction for the extra $735.93 charged to the investment account. In year 2, he would be entitled to a deduction for $14,215.12 but not for the extra $2,444.24 charged on the investment account.

Example two

66. Mary is buying her home on which she has an outstanding mortgage debt of $100,000. At the same time she has considerable equity in the home. She sees an ad in her local paper for a seminar on negative gearing. She attends the seminar and is given a brochure by Lender X entitled 'A less taxing way to pay off your home-investment loan'. This brochure sets out the details of a facility where 'you pay off your home loan portion many years sooner, and you increase the negative gearing benefits on your investment property'. Mary visits her financial adviser, who recommends that she see Lender X with a view to purchasing a rental property utilising the facility.

67. Mary approaches Lender X about borrowing the funds and is offered two options. She could borrow the $100,000 at the current rate for investments. Alternatively, she could take advantage of the split loan facility. Under the facility Lender X would lend Mary $200,000 which would be divided into two sub-accounts. $100,000 would be used to pay out her current home loan (which is at the same variable rate) and $100,000 would be used to acquire the investment property. The term of the loan would be 25 years and the interest rate on both the private and investment loan accounts would be 7.5% being the current variable home loan interest rate.

68. Mary would be required to make minimum monthly repayments of $1,477.98 which represent $738.99 principal and interest referable to each loan account. Under the facility she would be given the option of applying the total minimum repayment against the private loan and allowing the interest on the investment loan to capitalise. She would be required to provide the certificates of title on both properties as

security and these would be held until the total funds advanced were repaid in full.

69. Lender X provides Mary with an example which illustrates the advantages of utilising the facility in this way compared to a separate loan structure at the same interest rates.

70. The example shows that the total amount repaid over the 25 years would be the same, i.e., $443,396.07. The total interest charged is $243,396.07 of which $212,999.24 would relate to the investment loan account and could be claimed as a tax deduction. This is $91,301.89 more than under a separate loan structure with the same interest rate. Assuming Mary's marginal tax rate is 48.5% the total tax saving over the period of the loan would be $44,464.02.

71. Mary enters the loan facility and applies the repayments to the private loan account. She continues to do this until the private account is repaid. In the meantime interest charged to the investment loan account is capitalised. Mary claims a deduction for interest on the investment loan account which has been shown on her financial statement from the lender. The interest calculation for the first two years is as follows:

Investment Loan Account

	Debit	**Credit**	**Balance**
	$	**$**	**$**
Loan funds			100,000.00
Year 1	7,763.26	nil	107,763.26
Year 2	8,365.94	nil	116,129.20

Private Loan Account

	Debit	**Credit**	**Balance**
	$	**$**	**$**
Loan funds			100,000.00
Year 1	7,140.71	17,735.76	89,404.95
Year 2	6,318.19	17,735.76	77,987.38

72. Mary is not entitled to a deduction for all the interest charged on the investment loan under the facility. In each year the difference between the interest actually incurred on the investment loan and the interest that would have been incurred if Mary had applied that part of

the repayment referrable to the investment loan ($738.99 per month) against the investment loan account rather than the private loan account, is not allowable. If the repayments had been applied in this way the financial statements for the investment account would show:

Investment Loan Account

	Debit	Credit	Balance
	$	$	$
Loan funds			100,000.00
Year 1	7,451.98	8,867.88	98,584.10
Year 2	7,342.06	8,867.88	97,058.28

73. In the above example Mary would be entitled to a deduction in year 1 of $7,451.98. She would not be entitled to a deduction for the extra $311.28 charged to the investment loan account. In year 2, she would be entitled to a deduction for $7,342.06 but not for the extra $1,023.88 charged on the investment loan account.

Your comments

74. If you wish to comment on this draft Ruling please send your comments by: 15 August 1997

to:

Contact Officer: Ms Kathy Dennis

Telephone: (060) 587 330 or mobile ph. 0418 610077

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subject references
- anti avoidance measures
- borrowings and loans
- expenses of borrowing
- home loan interest expenses
- interest expenses
- negative gearing
- tax avoidance
- tax benefits under tax avoidance schemes
- tax planning, avoidance and evasion

legislative references
- ITAA97 8-1

- ITAA36 51(1)
- ITAA36 Pt IVA
- ITAA36 177A
- ITAA36 177A(5)
- ITAA36 177C(1)
- ITAA36 177D(b)
- ITAA36 177D(b)(i)
- ITAA36 177D(b)(ii)
- ITAA36 177D(b)(iii)
- ITAA36 177D(b)(iv)
- ITAA36 177D(b)(v)
- ITAA36 177D(b)(vi)
- ITAA36 177D(b)(vii)
- ITAA36 177D(b)(viii)
- ITAA36 177F(1)(b)
- ITAA36 221D

case references
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- FC of T v. Energy Resources of Australia Limited 96 ATC 4536; (1996) 33 ATR 52
- FC of T v. Peabody 94 ATC 4663; (1994) 28 ATR 344
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- FC of T v. Total Holdings (Australia) Pty Ltd 79 ATC 4279; (1979) 9 ATR 885
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ADDITIONAL INFORMATION

The draft Ruling focuses on certain packaged facilities. Due to time constraints, it has not been possible for us to address the taxation issues arising from all the financial facilities that have been made available by financiers to the general public (e.g., line of credit facilities). We will continue to consult with industry representatives and the tax profession in forming our view in relation to these facilities. We will release this view as soon as possible. In the meantime, affected taxpayers may seek a private ruling on their own particular circumstances.

The ATO's position in the draft Ruling does not stop taxpayers using their homes as security against their borowings. Interest on a conventional business or investment loan secured against a home will still be tax deductible.

Nor does the ATO's position prevent taxpayers from choosing to pay off personal debts in preference to business or investment debts. The draft Ruling deals only with certain fully drawn loan products that are deliberately structured to create bigger tax deductions for interest than conventional loans.

The draft Ruling will apply both prospectively and retrospectively. It is common for the ATO to apply a Ruling to transactions that occur both before and after the release of the Ruling where there has been no change to the law and where there has not been a previous public position stated by the ATO. This is especially the case where the ATO is dealing with arrangements that seem to have as their dominant purpose the gaining of a tax benefit.