IT 2343 - Income tax: limitation on deduction for interest on borrowings financing rental investments

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TAXATION RULING NO. IT 2343

INCOME TAX: LIMITATION ON DEDUCTION FOR INTEREST ON BORROWINGS FINANCING RENTAL INVESTMENTS

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I 1209812	ALLOWABLE DEDUCTIONS INTEREST DEDUCTION LIMIT FOR RENTAL INVESTMENT BORROWINGS RENTAL INVESTMENTS	82KZC - 82KZK 160ZA

PREAMBLE The Taxation Laws Amendment Act 1986 (Act No. 46 of 1986) inserted Subdivision G (sections 82KZC to 82KZJ) in Division 3 of Part III of the Income Tax Assessment Act 1936. The new Subdivision imposes a limit on the aggregate annual deduction allowable for interest on money borrowed and used to finance rental investments made after 17 July 1985. This interest is called "rental property loan interest".

2. Subdivision G limits a taxpayer's deduction for rental property loan interest to the amount of the taxpayer's income from such rental investments ("rental property income") net of other deductions, except building depreciation, related to that income ("eligible rental property deductions"). Rental property loan interest in excess of the deduction limit is carried forward under section 82KZE and treated as rental property loan interest incurred in the next year of income.

3. However, where a capital gain is realised on a rental investment made after 19 September 1985, any excess rental property loan interest is first set off against the gain under section 160ZA (inserted by the Income Tax Assessment Amendment (Capital Gains) Act 1986 (Act No. 52 of 1986) as part of new Part IIIA of the Income Tax Assessment Act, which provides for the determination of capital gains and capital losses). Only the balance is then carried forward to the next income year. This result was brought about by sections 12 to 14 of the Assessment Amendment Act just mentioned, which amended Subdivision G by substituting new sections 82KZE and 82KZG and modifying section 82KZF.

4. A further change to Subdivision G was made as a consequence of the introduction of the fringe benefits tax legislation. The Fringe Benefits Tax (Miscellaneous Provisions) Act 1986 (Act No. 41 of 1986) inserted section 82KZK to ensure that, where an employer provides a fringe benefit to

an employee in the form of a lease of rental property to which Subdivision G applies, the deduction limit for rental property loan interest is increased by the amount of the taxable value of the fringe benefit.

5. This Ruling provides interpretations of the provisions of Subdivision G. It does not seek to cover ground already covered in the explanatory memoranda that accompanied the amending Acts referred to above.

RULING Investments to which Subdivision G applies

- Acquisitions

6. Subdivision G does not apply in respect of a rental property investment if it was acquired by the taxpayer under a contract entered into on or before 17 July 1985 (paragraph 82KZC(5)(a)). That is the position even where settlement occurs after 17 July 1985 or the property is first used for rental purposes after that date.

7. Where a rental property is acquired after 17 July 1985, the Subdivision applies (subject to the provisions of the Subdivision itself) notwithstanding that a deduction may not be allowable under Division 10D of the Income Tax Assessment Act for capital expenditure on the construction of the building - for example, where a residential rental building is purchased after 17 July 1985 but construction of the building commenced on or before that date.

- Improvements

8. Where a taxpayer's rental investment consists of financing the making of an improvement to land (including the construction of the original building), the Subdivision applies only if construction commenced after 17 July 1985, but the definition of "post commencement date improvement" in sub-section 82KZC(1) ensures that the Subdivision does not apply if -

(a) construction takes place under a contract entered into before 18 July 1985; or

(b) both of the following circumstances exist -

. the taxpayer's interest in the land was held immediately before, or acquired under a contract entered into before, 18 July 1985; and

. construction is financed by borrowings wholly raised pursuant to a contract or contracts entered into before that date.

The exceptions apply notwithstanding that Division 10D deductions may be allowable in respect of capital expenditure on the construction of the building or improvement.

9. With regard to exception (a) in paragraph 8, an improvement that commenced after 17 July 1985 could be made under more than one contract, only one of which was entered into on or before that date. Provided each of the contracts covers work that is an integral part of the overall improvement project planned at the time the first contract was entered into, none of the interest incurred on borrowings financing any part of the project would be within Subdivision G. That would be so even where cost overruns occurred or where minor changes to the original improvement plan necessitated additional expenditure. However, if the changes to the plan fundamentally altered the nature of the project or constituted a separately identifiable improvement, Subdivision G would apply on the basis either that the original improvement was completed and a different improvement commenced to be made at the time of that fundamental alteration or that a separate improvement commenced with the change of plans so that two separate improvements then proceeded.

10. The question has arisen, in respect of exception (b) in paragraph 8, whether pre 18 July 1985 borrowings would retain that status if the borrowed funds were first placed in a short-term investment before being applied towards the cost of construction. As a general rule, the need to trace borrowed funds through a short-term investment would not be a barrier to the application of the exception, as long as the taxpayer can establish that it was intended, at the time of contracting to borrow, that the borrowings would be used in the construction of the improvement. The use of, for example, an overdraft or other multi-purpose credit facility arranged before 18 July 1985 to finance the construction of an improvement commenced two years later would place a substantial onus on the taxpayer to provide evidence that, at the time the loan was contracted for, firstly, the taxpayer intended that it would be applied to the relevant extent in financing the improvement and, secondly, the improvement then planned did not differ materially from that which was ultimately constructed.

- Acquisition v improvement

11. For the purposes of Subdivision G, an improvement may be made on behalf of the taxpayer by another person on the taxpayer's land (paragraph 82KZC(5)(c)). That is, such an activity is still regarded as the making of an improvement, not as an acquisition. If the making of an improvement by another person on behalf of the taxpayer commenced on or before 17 July 1985, Subdivision G would not apply notwithstanding that the construction contract may not have been entered into until after 17 July 1985. This position is different from that which exists under the provisions governing the investment allowance (Subdivision B of Division III). Under those provisions, the construction of a unit of property for the taxpayer by another person on the taxpayer's premises is treated as an acquisition of the property (the principles applied in the investment allowance context are set out in Taxation Ruling No. IT 2142).

- Commencement of improvement

12. For the purposes of Subdivision G, the date on which the making of an improvement commences is the date on which the first step in the construction stage (as distinct from preliminary steps such as site preparation) has commenced. The first step in the construction stage of a new building would be when the pouring of footings or the sinking of pilings, as appropriate, commenced. The same principle applies in the context of the building depreciation provisions of Division 10D.

- Conversion of "old" investment to "new" investment

13. Any assessable income derived by a taxpayer by way of rent in respect of land to which a post 17 July 1985 improvement has been made is treated as rental property income for Subdivision G purposes. It follows that there may be an incentive under the Subdivision for taxpayers to make minor improvements to rental property acquired before 18 July 1985 if the rent derived after the improvement is made exceeds the sum of the rental property loan interest and eligible rental property deductions in respect of that property. The excess rental income could be used to preserve deductions for interest in respect of other post 17 July 1985 rental investments that would otherwise have been deferred to a later year by the operation of the Subdivision.

14. Similarly, a negatively geared pre 18 July 1985 rental property investment producing losses that are subject to the general seven-year write-off limitation could attract the unlimited write-off period available under Subdivision G for excess rental property loan interest if borrowings financing a post 17 July 1985 improvement to the property were consolidated with a loan refinancing the original acquisition (see also paragraphs 35 to 37 of this Ruling).

15. Taxpayers contemplating minor improvements to rent producing land would need to bear in mind that Part IVA would apply to any agreement, etc. for the making of an improvement that attracted the conclusion that it was entered into or carried out for the dominant purpose of enabling the taxpayer to obtain a tax deduction in relation to a year of income that would otherwise not have been allowable in relation to the year of income.

- The "75% of net worth" test

16. A trust estate is a rental property trust estate, within the meaning of sub-section 82KZC(6), in relation to a year of income if, at the end of the year of income, the net rental values of interests held by the trustee in rent producing land (whether held directly or through one or more interposed companies, partnerships or trust estates) total at least 75% of the net worth of the trust estate. Rent producing land is included in the test even if it was acquired or the building on the land commenced to be constructed before 18 July 1985. A similar test applies to companies and partnerships. In calculating net worth and the net rental values of interests in

rent producing land, the relevant assets are to be valued at their market value, not book value. Goodwill should be included in the valuation of net worth.

17. If borrowed money is used to acquire a beneficial interest in a trust estate after 17 July 1985 and that beneficial interest is held during a year of income in relation to which the trust estate is a rental property trust estate, Subdivision G applies to that investment. A case has arisen in which a taxpayer contracted to borrow money before 18 July 1985 and used the borrowed funds after that date to acquire units in a trust estate the assets of which included land that had been acquired by the trust estate before 18 July 1985. The funds were to be used to construct a building on the land for rental and the taxpayer owned a substantial proportion of the existing units in the trust before acquiring the further units.

18. It was decided that the Subdivision applied to the taxpayer's investment in the trust estate in respect of those periods when the trust estate was a rental property trust estate. It was not considered relevant that -

- the trust estate, if it had borrowed the money under a pre 18 July 1985 contract, would have been treated as not having made a "post commencement date improvement" (see paragraph 8 of this Ruling) in constructing the building; and

- the taxpayer would not have been within the Subdivision if the taxpayer, and not the trust estate, had acquired the land before 18 July 1985 and constructed the building.

The decisive facts were, firstly, that the legislation includes all rent producing land in the test of whether a trust estate is a rental property trust estate, irrespective of when the land was acquired, and, secondly, that the taxpayer made the investment in the trust estate after 17 July 1985.

- The "75% test" : Banks and other financiers

19. Subdivision G applies to post 17 July 1985 loans to, as well as equity investments in, rental property companies, partnerships and trust estates. It is appreciated that the task of carrying out a separate accounting for all loan investments of this kind could be an onerous one for taxpayers such as banks and other financial institutions. Having regard to the statement at page 26 of the explanatory memorandum on the Taxation Laws Amendment Act 1986 that the extension of the Subdivision to loans to rental property companies, etc. is an anti-avoidance measure, it has been decided that, if a taxpayer's principal business consists of the lending of money at arm's length and the taxpayer can establish that the part of the business that consists of lending to rental property companies, partnerships and trust estates has not been run at a loss for that year of income, the taxpayer need not include the details of those investments in Schedule N. However, the

taxpayer would be expected to provide an explanation of the basis on which it is sought to establish that fact. It would suffice, for example, if the taxpayer provided evidence of a uniform loans policy of producing a taxable surplus in respect of each year of the term of every loan. Alternatively, a bank, for example, with a number of loans to rental property companies, etc. that would, taken individually, attract the operation of the Subdivision, might submit evidence that establishes that other post 17 July 1985 loans to rental property companies, etc. have produced a sufficient taxable surplus to absorb the excess interest. Should such a taxpayer wish to apply a net positive result from loan investments in rental property companies, etc. against a negative outcome from the taxpayer's other post 17 July 1985 rental property investments, the actual details of those loan investments would have to be included in Schedule N.

- Interests of mortgagees in land

20. The term "interest in land" is defined widely in sub-section 82KZC(1) and includes any legal or equitable interest in land, such as an interest held by a mortgagee in land used by the mortgagor to derive rental income. However, if the mortgagee used borrowed money to make the relevant loan to the mortgagor, interest incurred on those borrowings would not be "rental property loan interest", as defined, except where the mortgagor was a rental property company, partnership or trust estate. That is because the mortgagee's borrowings would have been used to acquire the rights under the loan to the mortgagor, not to acquire the interest in the land. Similarly, the mortgagee would not normally derive assessable income by way of rent in respect of the land that could be treated as rental property income for the purposes of the Subdivision (in the exception case just mentioned, of course, the interest received by the mortgagee would be rental property income).

Partial ownership changes

21. It has been suggested that sub-section 82KZJ(1) cannot apply where there is a change in ownership of majority underlying interests in land on which an improvement has been constructed, being a construction that commenced before 18 July 1985. The basis of the suggestion is that the sub-section refers only to "property acquired" and not to improvements.

22. An improvement to land forms part of the land. The "property" to which the sub-section refers is the land (including any building on the land) and not the building itself. If the land was acquired before 18 July 1985, sub-section 82KZJ(1) is capable of applying to a change of ownership of majority underlying interests in the land, whether or not the land has been improved and irrespective of when any improvement was made.

23. It has also been suggested that property acquired by a taxpayer before 18 July 1985 that is producing net rents (i.e.

an excess of rental property income over eligible rental property deductions) in excess of any interest on related borrowings can be "converted" to a property to which Subdivision G applies (and so absorb excess interest relating to post 17 July 1985 rental investments) by simply transferring it to a company or trust owned by the taxpayer. That is not correct. If majority underlying interests continue in the same hands and the new entity does not borrow more to acquire the property than the amount outstanding at the time of the transfer on the borrowings used by the taxpayer to originally acquire the property, the property will be deemed to have been acquired by the new entity before 18 July 1985 and, therefore, be outside the Subdivision (sub-section 82KZJ(4)). If additional borrowings were arranged in order to attract the Subdivision, consideration would need to be given to the possible application of Part IVA.

24. A case has arisen in which two taxpayers, as partners in the proportions 1/4 : 3/4, acquired rental property before 18 July 1985 and after 25 September 1985 changed the partnership shares to 1/2 : 1/2. As it had only the one property, the partnership was a rental property partnership. The acquiring partner borrowed to acquire the additional partnership interest but the partnership borrowings were not increased. Because more than one half of the beneficial ownership (in fact, 100%) continued to be held by the same persons, sub-section 82KZJ(4) applied to deem the partnership to have acquired the property before 18 July 1985 (section 82KZH having first deemed the property to have been acquired at the time of the change of interests) so that interest incurred by the partnership on its original borrowings was not brought within the Subdivision. However, as the partnership was a rental property partnership, interest incurred by the acquiring partner on borrowings used to acquire the additional partnership interest was rental property loan interest and that partner's share of the partnership net income was rental property income for the purposes of the Subdivision.

25. Sub-section 82KZJ(5) provides for changes in beneficial ownership of property on account of death to be ignored. The sub-section achieves this by treating the person who acquires the deceased person's interests in the property as having held those interests at any time when the deceased held them. Where a person, A, dies and leaves interests in property to B, then B dies and those same interests devolve upon C, the sub-section has the effect that C is deemed to have held those interests at any time either A or B held them. In other words, the word "held" following the reference to "the deceased person" in sub-section 82KZJ(5) is regarded as impliedly including the words "or was deemed by a previous application of this sub-section to have held".

- Property settlements

26. Where property acquired before 18 July 1985 by two persons is owned by them as joint tenants or as equal tenants in common, and one tenant disposes of his or her interest in the

property to the other after 25 September 1985 - for example, pursuant to a family law settlement - the Subdivision applies as if the continuing owner acquired the whole of the property on the date on which the change of ownership occurred (section 82KZH). Because majority underlying interests will not have continued in the same hands, sub-section 82KZJ(4) does not treat the continuing owner as having acquired the property before 18 July 1985. The Subdivision can therefore apply if, after the acquisition, the property is used for rent producing purposes. In applying the Subdivision in such a case, any rents received after the ownership change are treated as rental property income.

27. If, as part of the arrangement under which the above ownership change occurred, the continuing owner assumed liability for a loan on which both parties were previously jointly and severally liable, interest incurred on the loan would not be rental property loan interest - although it would be an "eligible rental property deduction", as defined. The reason for this is that the relevant borrowings would not have been used to acquire the property after 17 July 1985 and, being borrowings on which the continuing owner was already fully liable, would not be borrowings "taken over" from another person to which sub-section 82KZC(3) would apply. Of course, if the continuing owner used additional borrowings to finance a payment to the other person to secure release of that person's interest in the property, interest incurred on the additional borrowings would be rental property loan interest - that is, interest incurred on money borrowed and used to acquire after 17 July 1985 an interest in rental property.

Rental property loan interest

-"In respect of money borrowed and used..."

28. The question has arisen whether the expression "money borrowed and used by the taxpayer to acquire", as used in the various paragraphs of the definition of "rental property loan interest" in sub-section 82KZC(1), contemplates that money must be borrowed for the purpose of acquiring the particular rental investment which it is used to acquire or that money may be borrowed for any purpose and, having been borrowed, must simply be used for the purpose of acquiring the particular rental investment. Subdivision G is to be applied on the basis of the latter interpretation .

29. This issue is central to the basic concept of Subdivision G that borrowed funds are capable of being traced into the rental investment (i.e., they are "used by the taxpayer to acquire" the rental investment). It is not essential that the rental investment in question be the first use to which the relevant funds are put in order that the Subdivision applies. As indicated in a different context at paragraph 10 above, the need to trace borrowed funds through a short-term investment would not prevent a conclusion that a rollover of that investment into a rental property investment involved the use of those borrowed funds to acquire that rental investment. Of

course, the greater the period from borrowing to relevant use and the greater the number of times the relevant funds are rolled over through intermediate investments, the lesser would be the onus on the taxpayer to show that the funds were not used to acquire a rental investment.

30. If a company is able to establish that shareholders' funds have been used to acquire a rental investment, the Subdivision would not apply. For example, if a savings bank were able to show as a matter of fact that a particular investment had been funded from shareholders' funds in accordance with the Banking (Savings Bank) Regulations and investment pattern tolerances set by the bank's board of directors, so that there was no interest expense attributable to the investment, Subdivision G would not apply.

-Use of the land for rent producing purposes

31. Paragraphs (a) and (b) of the definition of "rental property loan interest" bring interest within the Subdivision to the extent to which (see paragraph 33 under) it is incurred in respect of the use of the land by the taxpayer for rent producing purposes. Paragraph 82KZC(4)(a) makes it clear that land (which includes any building on the land) is to be taken to be so used notwithstanding that the land is also used, or held ready for use, for another purpose. The explanatory memorandum on the Taxation Laws Amendment Act 1986 explains that the relevant words in that paragraph ensure that the condition is met where only part of the land is used for rent producing purposes. The paragraph also has the effect that the condition would be met notwithstanding a taxpayer's claim that the land was being held for the purpose of sale and that the rental activity was only a temporary one pending sale, or that the land was held as trading stock.

32. Land that is held ready for use for rent producing purposes would ordinarily be treated as being used for rent producing purposes even where part of a building on the land is temporarily let rent-free - for example, where the first tenants in a new shopping centre are offered rent-free leases in the short term to help attract rent-paying tenants to the centre. On the other hand, the land would not be so used prior to the time at which the building on it was capable of being certified as ready for occupancy under the relevant building code, or to the extent that a building on the land was being refurbished and was not available for renting.

-"To the extent"

33. As indicated at paragraph 31 above, where a building is used partly for rent producing purposes and partly for other purposes, the Subdivision requires an apportionment of the interest on the loan used to acquire or construct the building in order to ascertain the extent to which the interest is referable to the rent producing use. Interest apportionments can be required to be made not only between income producing and non-income producing areas of a building but also between rent

producing and other income producing areas. For example, where borrowings were used to acquire a building that was used primarily as a professional office by the owner, but with an identified part leased to a tenant, Subdivision G would apply to the interest on the borrowings only to the extent that it was referable to the leased part of the building.

34. Ordinarily, a floor area basis should be used to apportion interest. For example, Subdivision G would be applied to one-half of the interest on borrowings used to acquire< 7 a building after 17 July 1985 where one-half of the building (on a floor area basis) was used for rent producing purposes. There may, however, be cases where interest should be apportioned on some other basis - for example, where a taxpayer demonstrated that a floor area basis would be inappropriate and apportionment should be on an expenditure basis because a larger part of the capital cost of constructing a building was referable to the part of the building used for non-rent producing purposes.

-Refinancing of rental investments

35. For the purposes of Subdivision G, borrowings used to repay a loan that was used to acquire rental property before 18 July 1985 are taken to have been used for that same acquisition. Interest on such a replacement loan is not within the Subdivision's scope. The legislation does not require the replacement loan to be made by the original lender or in the original currency; nor does it require the terms and conditions of the loans - such as the interest rates, the repayment periods and the arrangements for repayment of the principal - to be the same. In a time of devaluation of the Australian dollar, an Australian dollar replacement loan could exceed the Australian dollar equivalent, at the date of borrowing, of the outstanding balance of a foreign currency loan it replaces. The refinancing process could involve the amalgamation or splitting of loans, and successive refinancing arrangements would be capable of qualifying as replacement loans.

36. However, where post 17 July 1985 replacement finance is borrowed under the same contract as additional finance that is used after 17 July 1985 to make an improvement to, or to acquire a further interest in, the relevant rental property, the whole amount of the borrowings is treated as borrowings used to make the improvement or acquire the further interest, as the case may be. All of the interest on such a loan is therefore rental property loan interest to which the Subdivision applies. If additional finance so obtained is not used for one of the two purposes just mentioned, the replacement finance does not attract the operation of the Subdivision.

37. The act of "redrawing" against a loan facility under which the original finance for the acquisition of property was obtained would be treated as the obtaining of additional finance, not as a replacement loan. Assume, for example, that a taxpayer, who drew down the whole of a $100,000 loan facility and used it before 18 July 1985 to acquire a rental property,

had reduced the loan by $50,000 by 1 July 1986. If, at that time, the taxpayer then drew down against the same loan facility to the extent of, say, $20,000, that $20,000 would not be treated as having been used to acquire the rental property, notwithstanding that that further loan may have been secured by the rental property.

Separate leasing of land and chattels

38. Where a building is leased together with its plant and fittings, Subdivision G includes all of the rental income as rental property income and treats as eligible rental property deductions all deductions related to that income, other than building depreciation and rental property loan interest. In particular, eligible rental property deductions include -

- depreciation allowable under section 54 of the Income Tax Assessment Act on the leased property; and

- interest on so much of the borrowings financing the land, building, plant and fittings as is not interest on borrowings used to acquire the land and building (including fixtures) after 17 July 1985 or to finance a post 17 July 1985 improvement to the land.

39. Because these two types of deduction reduce the deduction allowable for rental property loan interest, taxpayers can be expected to arrange their affairs so as to lease the building and the chattels therein under separate lease agreements. It should, however, be borne in mind that items that fit the description "plant or articles" for the purposes of section 54 of the Income Tax Assessment Act may nevertheless form part of the land (e.g., certain swimming pools). Consequently, the income from the leasing of any such item forming part of the land (and any other items comprising the subject matter of the same lease, whether or not also forming part of the land) would be rental property income. The other consequences set out in paragraph 38 would also ensue.

COMMISSIONER OF TAXATION
28 July 1986