TR 98/22 - Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities

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Taxation Ruling

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

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Preamble

*The number, subject heading, and the **Class of person/arrangement**, **Ruling** and **Date of effect** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

*[**Note**: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

Class of person/arrangement

1. This ruling applies to persons who enter into certain linked or split loan facilities as described in paragraphs 3 to 6 of this Ruling. This Ruling considers whether Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) applies to disallow interest that would otherwise be deductible on these linked and split loan facilities. The ruling does not consider the deductibility of interest incurred under these facilities and whether the interest disallowed pursuant to Part IVA forms part of the cost base of assets financed by these facilities. See Taxation Determination TD 2005/33 for the Commissioner's view on whether the interest disallowed pursuant to Part IVA forms part of the cost base of assets financed by these facilities.

2. [Deleted]

3. For the purposes of this Ruling, a linked loan is a credit facility taken out with a financial institution under which there are two or more loans with an account being maintained in respect of each loan. A split loan is a credit facility taken out with a financial institution under which there is one loan with sub-accounts being maintained in respect of that loan.

4. 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 paragraphs 5 and 6 below. In this Ruling we refer to these loans as '**the facility**'.

5. The facility has a number of broad features. There may be one or more borrowers within that facility. A taxpayer borrows an amount or amounts of money ('**the loan amount**'). The contract/s between the taxpayer and the lender provides that the loan amount is allocated between two or more accounts or loans. The contract further provides that 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 payment at the amount required to pay back the loan amount on a principal and interest basis over the nominated period. The taxpayer applies the payments first to pay the principal and interest on the private account and, when the private account is extinguished, the payments are then made against the investment account. As a result, the taxpayer pays off the private account much faster, and the total amount of interest paid on the private account is less than would have been the case if the taxpayer had applied the payments to the separate accounts. Correspondingly, the investment account takes longer to pay off and more interest is payable on that account. The difference between the interest incurred on the investment account under the facility and the interest that would have been incurred if the taxpayer had applied the payments to the separate accounts is referred to as '**additional interest**'.

6. Interest in respect of the investment account is accumulated and capitalised during the period that the private account is being repaid. The interest calculation for each month uses a higher balance as its starting point. In consequence, the account balance grows at ever increasing rates as interest on principal and interest on interest is added to the loan. Generally, the additional interest (which is claimed to be tax deductible) that is payable on the investment account is equal to or approximate to the extra amount of non-deductible interest the taxpayer would have paid on the private account if a payment had not been redirected from the investment account to the private account. 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 payments are made in respect of the investment account.

7. Where a taxpayer does not make any payments on the investment account, interest accrues on both the unpaid principal sum and the unpaid interest. In this Ruling, we refer to the total interest that has accrued on the investment account during the period that all payments are directed to the private account as '**capitalised interest**',

and the portion of this interest that has accrued on the unpaid interest in the relevant year as '**the further interest amount**'.

Ruling

8. [Deleted]

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14. [Deleted]

Application of Part IVA

15. The general anti-avoidance provisions of Part IVA apply to disallow any additional interest incurred on the investment account that is deductible under s 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997): *FC of T. v Hart* [2004] HCA 26.

Identification of the scheme

16. Where a taxpayer enters into a facility, the scheme may vary from case to case, but the scheme **always includes**:

- entering into a facility with one lender;
- 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;
- application of any payments to the private account (until the private account is repaid) including those that would have otherwise been paid against the investment account;
- consequential incurring of an amount of additional interest (by reason of the process of capitalising interest) on the investment account;
- an understanding or agreement as to how the facility is to operate, including the linking of the private and investment accounts; and
- the overall indebtedness not exceeding the loan amount.

17. The scheme **may also include** some or all of the following:

- refinancing of an existing private loan arrangement or the advancing of funds for a private loan;
- refinancing of an existing business or investment loan or the advancing of funds for a business or investment loan;
- securing both loans or accounts by the same assets; and
- often, the charging of additional fees and interest.

18. While some of the features listed in paragraph 17 above may be common to other loan arrangements, when combined with the features listed in paragraph 16 above, they make up a scheme to which Part IVA may apply.

19. 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 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

20. 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 in the manner outlined in paragraphs 16 and 17 above.

21. The calculation of the tax benefit depends on the facts of a particular case. Where all of the interest incurred on the investment account in the relevant year is deductible under section 8-1, the tax benefit is greater than when the further interest amount is not deductible under section 8-1.

22. If all of the interest incurred on the investment account in the relevant year is deductible under section 8-1, the tax benefit is the difference between:

(i) the interest incurred on the investment account; and

(ii) the interest that would have been incurred on the investment account if the taxpayer had allocated the total minimum payment proportionally across both accounts (i.e., the portion of the total principal and interest payments that had been calculated with reference to the investment account were, in fact, allocated to the investment account).

This means the taxpayer would only be entitled to a deduction equal to the amount of interest that would have been incurred on the investment account if the taxpayer had operated the investment account as a separate conventional principal and interest loan in that year.

23. If the further interest amount is not deductible under section 8-1 in the relevant year (i.e., the taxpayer is only entitled to a deduction for interest as if the taxpayer had operated the investment account as a conventional interest only loan), the tax benefit is the difference between:

(i) the interest the taxpayer would have incurred on the investment account if the taxpayer had a conventional interest only investment loan; and

(ii) the interest the taxpayer would have incurred on the investment account if the taxpayer had operated the account as a separate conventional principal and interest loan in that year.

24. A tax benefit does not arise in relation to additional repayments of principal made over and above the minimum payments required on the facility.

Dominant purpose

25. Some or all of the following factors are present in a case to which Part IVA might apply:

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

26. Each case must be considered on its own merits. However, having regard to the factors listed above, when considered against the eight items listed in paragraph 177D(b), it is open to a reasonable person objectively to conclude that a taxpayer, who has entered into a scheme with some or all of the characteristics outlined in paragraphs 16 and 17 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 exercise his discretion under section 177F to determine that the whole or a part of the interest deduction otherwise allowable shall not be allowable to the taxpayer.

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33. [Deleted]

Date of effect

34. This Ruling applies to years commencing both before and after its date of issue. While we have issued a small number of favourable responses to taxpayers in relation to these types of facilities, we do not consider this to constitute 'communicating consistently to a wide range of taxpayers' in terms of paragraph 16 of Taxation Ruling TR 92/20. Taxpayers who have a favourable private ruling and who have begun to carry out the arrangement to which it applies, may rely on the private ruling, notwithstanding it may be inconsistent with this Ruling (see Taxation Ruling TR 93/1). However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of TR 92/20).

Note: The Addendum to this ruling that issued on 11 August 2004 applies from 11 August 2004.

Explanations

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Application of Part IVA

49. Part IVA operates where:

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

(ii) there is a 'tax benefit' that, in relation to allowable deductions, 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 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 that is referable to the deduction shall not be allowable: paragraph 177F(1)(b).

Identification of the scheme

50. 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. The term 'scheme' is defined very broadly in section 177A. We consider the circumstances described in paragraphs 16 and 17 above fall within this definition.

The tax benefit test

51. 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. This does not mean there should be no assumption involved in the hypothesis or all alternatives must be disproved or all areas of doubt removed. Where different scenarios produce different results a view needs to be taken as to which is the most likely outcome.

52. Subject to all the facts, where a taxpayer enters into and utilises a facility in the manner described in paragraphs 16 and 17 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 payment referable to the investment account to that account rather than to the private account.

Dominant purpose

53. 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 at ATC 5206; ATR 188:

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

54. 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* at ATC 5206; ATR 188. Further, the High Court stated at ATC 5206; ATR 188:

> 'A particular course of action may be, to use a phrase found in the Full Court judgements, 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

55. These facilities involve pre-ordained steps that 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. A taxpayer who has entered a facility often has 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

56. 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 on the investment account and redirection of repayments to the private account) that are principally designed to produce a tax benefit for the taxpayer.

57. The substance of the scheme is 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.

58. 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.

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

60. These facilities may have other commercial advantages but, on balance, we consider, in many cases, the acquisition of these advantages is not the prevailing or most influential purpose for using these facilities in this way.

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

61. This depends on the facts of each case. Once the structure is put in place it is 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

62. Subject to the arguments canvassed above in relation to section 8-1, a tax deduction 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

63. 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 arrangement.

64. 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.

65. 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 funds that would normally be expected 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 that 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.

66. 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

67. 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.

68. 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.

69. Any extra repayments made, as outlined in paragraph 64 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

70. 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)

71. We would not expect there to be any connection between the taxpayer and the lender beyond the commercial relationship of lender and borrower. 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.

72. [Deleted]

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76. [Deleted]

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78. [Deleted]

Alternative view

79. [Deleted]

80. [Deleted]

81. It is argued it is not always appropriate or correct when calculating the tax benefit for us to assume that principal and interest payments would have been paid off the investment loan.

82. It has been suggested a taxpayer could get around the application of Part IVA by using more than one lender. While the Ruling is directed at facilities offered by one lender, we will consider whether Part IVA applies where a taxpayer has a similar arrangement but operates it through two lenders who are associates or members of the one group and achieves the same outcome.

83. We accept each case must be considered on its merits and, in the absence of other considerations, the choice of repaying non-deductible debt before deductible debt is a normal commercial decision. However, we have examined the way these particular facilities are structured and have concluded they are not ordinary arrangements and they bear the stamp of tax avoidance.

84. [Deleted]

85. [Deleted]

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100. [Deleted]

101. [Deleted]

Detailed contents list

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- FC of T v. Peabody 94 ATC 4663; (1994) 28 ATR 344
- FC of T v. JD Roberts; FC of T v. Smith 92 ATC 4380; (1992) 23 ATR 494
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