


TD 2012/1EC - Compendium

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Ruling Compendium – TD 2012/1

This is a compendium of responses to the issues raised by external parties to draft TD 2011/D8 – Income tax: does a taxpayer’s purpose of ‘paying their home loan off sooner’ mean that Part IVA of the *Income Tax Assessment Act 1936* cannot apply to an ‘investment loan interest payment arrangement’ of the type described in this Taxation Determination?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

| Issue No. | Issue raised | ATO Response/Action taken¹ |
|------------------|--|--|
| 1. | <p>Inadequate consideration of the ‘ordinary’ provisions</p> <p>There has not been adequate consideration of how the ‘ordinary’ provisions could apply to these types of arrangements based on existing case law. The ATO appears to have ‘missed a step’ by going straight to Part IVA of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936).²</p> <p>The principles from the decisions in <i>Roberts and Smith</i>³ (regarding business assets) and <i>Jones</i>⁴ and <i>Brown</i>⁵ (regarding business losses) could be logically adapted for non-business assets such as rental properties in a manner that could resolve the current concerns about ‘excessive’ capitalised interest, without resorting to Part IVA. Consideration should be given to adopting a more objective approach.</p> | <p>The Commissioner agrees that the ‘ordinary’ provisions are first considered and could apply to deny the deduction for the interest on the line of credit in part or in full in some factual situations. We see no compelling reason to discuss the application of the ordinary provisions in a Determination that is considering the application of the general anti-avoidance provision (Part IVA) to an investment loan interest payment arrangement of the type described in the Determination.</p> <p>To ensure it is clear, the Ruling section has been modified to include the qualification that the interest is otherwise an allowable deduction (refer to paragraph 1 of the Determination).</p> |

¹ All references to the Determination in this compendium are to the final Determination, TD 2012/1 unless otherwise indicated.

² All legislative references in this compendium are to the ITAA 1936 unless otherwise indicated.

³ (1992) 37 FCR 240; 92 ATC 4380; (1992) 23 ATR 494.

⁴ *FCT v. Jones* [2002] FCA 204; (2002) 117 FCR 95; 2002 ATC 4135; (2002) 49 ATR 188.

⁵ *FCT v. Brown* [1999] FCA 721; 99 ATC 4600; (1999) 43 ATR 1.

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| Issue No. | Issue raised | ATO Response/Action taken ¹ |
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| 2. | <p>Lack of clear guidance</p> <p>The draft Determination is confusing as the Ruling section of the draft Determination simply concludes that taxpayer's purpose of 'paying off their home loan sooner' does not preclude the application of Part IVA to the loan arrangements, however in contrast the supporting 'Explanation' positively asserts that the arrangements it describes should attract the operation of Part IVA. The draft Determination should be limited to answering the question posed or expanded substantially to provide better clarity around what particular arrangements or features will cause the ATO to apply Part IVA and why.</p> <p>The breadth of the statement in paragraph 19 of the draft Determination may be interpreted as indicating that the Commissioner's view is that all arrangements resembling the investment loan interest payment arrangements, as described in the draft Determination, are schemes to which Part IVA applies. In the absence of features that are explicable only by their taxation consequences, such investment loan arrangements lack the requisite dominant purpose of obtaining a tax benefit that attracts Part IVA. Accordingly, the draft Determination needs to more clearly express the Commissioner's position.</p> <p>The draft Determination does little to clarify the law or provide certainty about the law. By indicating that Part IVA may apply without giving any clear guidance about the circumstances in which it will apply, increases uncertainty.</p> | <p>The question and Ruling section of the Determination have been simplified to give clear guidance in relation to the application of Part IVA to an investment loan interest payment arrangement of the type described in the Determination.</p> <p>The features of an investment loan interest payment arrangement are clearly set out in paragraph 3 of the Determination.</p> <p>It is well settled that the application of Part IVA requires careful consideration of the specific facts and circumstances of each case. It requires a conclusion in each factual circumstance as to the dominant purpose of one or more parties who entered into the actual scheme. Consequently, it is not possible to give certainty as to the application of Part IVA in the absence of each factual situation being fully examined.</p> <p>The Determination makes it clear that in the context of Part IVA, a taxpayer's purpose of 'paying their home loan off sooner' does not prevent the application of section 177F to an investment loan interest payment arrangement of the type described in the Determination.</p> <p>Taxpayers that require more certainty about how Part IVA applies to their particular circumstances may request a private ruling. A private ruling sets out the Commissioner's opinion about the way a tax law applies, or would apply, to a particular taxpayer in relation to a specified scheme. If a taxpayer relies on a private ruling that they receive, the Commissioner must administer the law in the way set out in the ruling, unless the ruling is found to be incorrect and applying the law correctly would lead to a better outcome for you.</p> |

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| 2. cont | <p>The arrangement as described in the draft Determination is a typical arrangement for many taxpayers with a mortgage, whether they have a rental property or not. The issue appears to be one of what is reasonable for the taxpayer to pay off the rental property line of credit (LOC) when no repayment is actually required. The statement that they should meet the interest payments from their other cash flows is counter to case law and the principle that it is not for the ATO to tell taxpayers how to manage their money. If the ATO is going to continue to not respond to private ruling requests and issue retrospective rulings, then this ruling needs to provide far more detail and consider many more cash flow situations. (Please do not respond with 'each case turns on its own set of facts' because taxpayers have to operate under self assessment and the ATO's history of answering private ruling requests on the topic is that no one will get an answer). If the ATO proposes to rule that a strategy to pay your home loan off sooner can be caught under Part IVA, then you need to give taxpayers strict guidelines on just how and when and on what they can spend their money. Anything less will create uncertainty in a self assessment regime.</p> | |
| 3. | <p>Capitalisation of interest</p> <p>There may be valid commercial reasons for capitalising interest on investment loans in a manner similar to the one outlined in the draft Determination. For example, first time investors may use such an arrangement to facilitate the purchase and holding of a property and to generate profits that would otherwise not be a possibility to certain taxpayers. Should an investor seek a private ruling prior to undertaking such an arrangement?</p> | <p>It is acknowledged that one of the features of the investment loan interest payment arrangement of the type described in the Determination may include the capitalising and compounding of interest in the LOC. It should not be considered in isolation.</p> <p>It is also acknowledged that compound interest, in some cases, will be deductible under 'ordinary' provisions.</p> <p>The application of Part IVA depends on a careful weighing of all the relevant facts and surrounding circumstances of each case.</p> <p>The Commissioner's view as set out in TR 2000/2 is not regarded as inconsistent with the view in the Determination.</p> |

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| 3. cont | <p>The Commissioner is trying to return to a position of non-deductibility of capitalised interest that has been rejected by four justices of the Federal Court as outlined in the Hart's cases⁶ (<i>Hart</i>). We believe he will need to consider withdrawing Taxation Ruling TR 2000/2 <i>Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities</i> as it would be inconsistent with his position as outlined in the draft Determination.</p> | |
| 4. | <p>Wider implications</p> <p>The draft Determination only requires the interest to be paid not the other rental property expenses that go through the LOC. How does the deduction for interest differ from the deduction for other expenses, given that the ATO has already issued a ruling based on <i>Hart</i> that capitalised interest takes on the exact same character as original interest?</p> <p>Practical application of the draft Determination may give rise to significant issues for many investors and businesses entering into varying arrangements such as:</p> <ol style="list-style-type: none"> 1. No LOC, investment loan has an upper limit of \$100k over the drawn amount. Would the situation be different if the taxpayer directed their rental income to his non deductible debt and the investment interest compounded? 2. Same as 1 but taxpayer does not have a non deductible loan and simply chooses to spend the rent on lifestyle. What gives the ATO the power to direct taxable income (rent) toward a loan payment if the taxpayer chooses to spend it instead? How would this affect the deductibility of the loan? 3. If the rent is directed toward the private expenditure due to financial difficulty and the interest on the investment loan is compounding the dominant purpose is not to obtain a tax benefit. | <p>The Determination is limited to the potential application of Part IVA to cancel the deduction for some, or all, of the interest expense incurred in respect of an investment loan interest payment arrangement of the type described the Determination. The features of the investment loan interest payment arrangement are set out in paragraph 3 of the Determination.</p> <p>Arrangements that do not exhibit all or most of the features set out in paragraph 3 of the Determination are outside the scope of the Determination.</p> <p>The application of Part IVA depends on a careful weighing of all the relevant facts and surrounding circumstances of each case.</p> |

⁶ *Hart v. FCT* [2002] FCAFC 222, 2002 ATC 4609, (2002) 50 ATR 369. See also *Hart v. FCT* [2001] FCA 1547, 48 ATR 317, 2001 ATC 4708 and *FCT v. Hart* [2004] HCA 26.

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| 4. cont | <p>4. If I had a business I may choose to meet the interest payments on an investment loan from my overdraft whilst banking the cash in an interest bearing account. This could potentially affect thousands of business.</p> <p>5. In many cases taxpayers want to pay off their private home as quickly as possible. The investment property is not as important as little or no emotion is involved. As is the case with many investment properties the rent is not sufficient to cover the interest payments. How will the ATO view a situation where the rent is \$1,000 and the interest is \$1,500 per month? The shortfall of \$500 is paid from a LOC. The taxpayer simply cannot afford to make up the shortfall.</p> <p>The draft Determination does not consider the unintended impact and the many possibilities that may arise under these scenarios and the effect it will have on the simple battling mum and dad investors with one property.</p> <p>How far does non acceptability of paying off your home loan sooner go?</p> <ul style="list-style-type: none"> • Does it extend to a taxpayer who only has an offset account or LOC on their home loan into which all income is deposited? • Does it apply to home owners with the dominant purpose of paying off their home loan sooner who use a separate LOC to meet cash flow shortfall on their rental property (rent is paid into the LOC)? <p>The LOC is in fact an insurance policy that can be called on at any time of need. For example families relying upon one in their planning for redundancies, accident and illness, longer than expected maternity leave.</p> <p>The draft Determination is very general in its wording and will alarm people into thinking that all lines of credit are 'bad'. Is it possible to insert something into the draft Determination to assure people that not all arrangements using a LOC will be caught by this draft Determination?</p> | |

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| 4. cont | <p>The counterfactual argument that the taxpayer would have or could have met the interest payments on the investment loan out of their own cash flow and therefore obtains a tax benefit could be extended. The same argument to deny deductions being proposed by this draft Determination could be used if investors could have funded deductible capital investments out of cash flow. The argument being: 'Where it not for the investment loan the taxpayer would have met the investment amount from their cash flow.' On the same basis this investor is carrying out a scheme by using the investment loan to pay for the investment.</p> | |
| 5. | <p>Methods used to market and promote certain financial products may influence a taxpayer's decision to participate in them.</p> <p>The marketing of certain financial products by financial institutions may impact upon the application of Part IVA. For example, if a product is marketed as offering a tax benefit, an inference may be drawn that the customer in deciding whether or not to take advantage of the financial product was influenced by the promotional and marketing material prepared by the financial institution, particularly where there are a range of financial products on the marketplace offered to suit people in the same circumstances (some offering tax benefits and some not). Given that there are other financial products available that would suit the taxpayer's needs, a reasonable person could conclude that the dominant purpose for entering into the investment loan interest payment arrangement was to obtain a tax benefit.</p> | <p>The application of Part IVA depends on a careful weighing of all the relevant facts and surrounding circumstances of each case. As such, the Commissioner would consider any marketing and promotional material when considering the dominant purpose of a participant for entering into an investment loan interest payment arrangement of the type described in the Determination.</p> |
| 6. | <p>Paragraph 3(h)</p> <p>The statement: 'the taxpayer(s) cash inflows (including that which the taxpayer(s) otherwise might reasonably be expected to use to pay the interest on the investment loan) ...' requires further definition. It is vague and does not explain what a taxpayer needs to do to avoid Part IVA. It is unsatisfactory that the ATO dictate that money be paid into the investment loan even though the loan agreement does not require it.</p> | <p>Paragraph 3(h) points to one feature that may be exhibited in an investment loan interest payment arrangement of the type described in the Determination. It should not be considered in isolation. Cash flows is considered to be a generally accepted term to represent a taxpayer's actual revenue.</p> |

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| 7. | <p>Paragraph 4</p> <p>The draft Determination states: ‘This results in interest on the investment loan, in effect, being capitalised and thus its payment deferred.’ Using loan funds to make the interest payment is no more a deferral than using loan funds to make a capital purchase.</p> <p>Lacks any validity when you consider that repayments are not required to be made. It is the ATO directing people how to manage their money.</p> | <p>The statement in paragraph 4 of the draft Determination has been moved to the list of general observations that are made in the context of applying paragraph 177D(b) to an investment loan interest payment arrangement of the type described in the Determination. It has been altered slightly.</p> |
| 8. | <p>There is no scheme</p> <p>Taxpayers who do not own a rental property enter into the same arrangements as suggested in this draft Determination in relation to their home loan. There is no scheme in the way the rental loans are set up; they are loans with a LOC to ensure payments are met on time regardless of cash flow.</p> <p>The ATO should specify what is unique about the arrangement that means Part IVA will apply.</p> <p>The words ‘paying their home off sooner’ has been twisted into some sort of scheme, when in reality that is why home owners run a LOC for their home loan or attach an offset account. Their dominant purpose is to keep as much money in offset as they can, reducing their interest charge and ultimately paying their home loan off sooner. To say that adding a rental property turns the arrangement into a scheme caught by Part IVA is taking the counterfactual too far.</p> | <p>The definition of scheme is very broad. It encompasses not only a series of steps which together constitute a scheme but also the taking of just one step.</p> <p>The Commissioner is of the opinion that the key elements of the investment loan interest payment arrangement of the type described in the Determination constitute a scheme in the context of Part IVA.</p> <p>The scenario raised (without a rental property) is outside the scope of this Determination.</p> |

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| 9. | <p>No tax benefit arises from the scheme</p> <p>Scenario provided (broadly):</p> <p>One month a taxpayer uses his income to pay living expenses and due debts and has no excess income. His LOC is within terms, no repayments are required and interest is capitalised onto his LOC.</p> <p>The next month he has surplus cash after paying his living expenses and due debt, his LOC is within terms and no repayments are required. What does he do with the extra cash? He could make an extra payment on his home loan or investment loan, take a holiday, pay for a medical procedure etc.</p> <p>We do not believe that it is for the Commissioner or courts to impute a tax benefit reasoning for the taxpayer taking any other course other than a repayment of the investment loan, when all loan commitments are within terms.</p> <p>A purpose of a tax benefit is open to be applied where compulsory loan repayments are required and the repayments are directed to the non deductible portion first, as in <i>Hart</i>.</p> <p><i>Tweddle v. FC of T</i> (1942) 180 CLR 1 provides support for this position. The fact that a taxpayer may be financially worse off by taking a particular course of action, does not leave it open to the Commissioner to infer that the taxpayer's actions are 'generally explicable only by taxation consequences'. It is possible, and highly probable that there are other features of the product attracted the taxpayer to this particular product.</p> <p>In regards to voluntary repayments on lines of credit, we bring to the Commissioners attention his comments in TR 2000/2, and in particular paragraph 8 of that Ruling.</p> <p>Scenario continued:</p> <p>The next month the taxpayer's income just covers his living expenses and due debts. However, the interest charged on his LOC takes his loan above the agreed limit and he must make a repayment which he does by taking a cash advance on his credit card. Therefore, to the extent that the funds drawn down on the LOC have been used for a deductible purpose, any interest incurred on his credit card would be deductible. Is there any suggestion that the interest was incurred on the credit card to obtain a tax benefit?</p> | <p>Paragraph 3(g) of the Determination provides that a typical feature of the investment loan interest payment arrangement is the line of credit is drawn down to pay the interest on the investment loan.</p> <p>In the Determination the Commissioner has described what might reasonably have been expected to occur if the investment loan interest payment arrangement had not been entered into or carried out. A clear tax benefit is discernable when the taxation consequences of the 'investment loan interest payment arrangement' are compared with the taxation consequences that would have arisen under the reasonable alternative.</p> <p>The Commissioner's view as set out in TR 2000/2 is not regarded as inconsistent with the view in the Determination.</p> |

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| 10. | <p>Choice/Ordering of expenditure</p> <p>The counterfactual argument appears to set out how and in what order a taxpayer would/should spend their after tax income (own cash flow). Prioritising the expenditure of after tax income is not determined by current legislation nor is it reasonable to assume that taxpayers should adopt a particular order to maximise their tax payable in order to avoid Part IVA rather than alternative priorities. Applying Part IVA in situations as set out in this draft Determination is to deny the taxpayer the purpose of choosing how they spend their after tax income because doing so is ‘tax avoidance’.</p> <p>The assumption being made here is that a taxpayer’s after tax cash flow has a connection to an outflow ‘expense of type of expenses’. The legislation would no more support this than cash flows should firstly be applied to particular capital items such as income earning assets.</p> <p>It is not for the ATO to tell people how to organise their finances. The counterfactual attempts to rule that once income earned has paid a family’s living expenses, it must next be used to pay interest payments on deductible debt. This is absurd and in conflict with case law (Case No F17, <i>Tweddle, Tooheys Ltd</i>).</p> <p>The nature of the loan refers to the purpose for which it was used. The taxpayer has deferred the payment of the capital component of the home loan by initially borrowing the funds. The taxpayers dominant purpose is to use their after tax income to pay for their lifestyle expenditures (both capital and expenses). If the taxpayer has additional surplus funds they may choose to pay other investment capital and expenditure. The fact that less tax is paid is secondary to putting food on the table, paying for the roof over their head and paying for the kid’s education.</p> <p>What if instead of a separate home loan, the LOC acted as the home loan where all income and private expenses were cleared? No repayments are required on the home LOC or investment property LOC. Is it the ATO’s formula that interest repayments on the investment LOC must be made first?</p> | <p>It is acknowledged that it is not for the ATO to tell taxpayers how to spend their money. However Part IVA requires the Commissioner (and the Courts) to consider the taxation consequences that might reasonably have been expected to occur if a scheme had not been entered into or carried out. In doing so it is necessary to consider what other course of action might reasonably have been available to the relevant taxpayer.</p> <p>The ATO considers that an investment loan interest payment arrangement of the type described in the Determination is capable of attracting the operation of Part IVA. The Determination also makes it clear that in the context of Part IVA, a taxpayer’s purpose of ‘paying their home loan off sooner’ does not prevent the application of section 177F to an investment loan payment arrangement of the type described in the Determination.</p> <p>While it is not for the ATO to tell taxpayers how to spend their money, Part IVA may operate in such a way as to cancel a tax benefit that would otherwise have been available as a result of a taxpayers spending choices.</p> <p>Arrangements that do not exhibit all or most of the features set out in paragraph 3 of the Determination are outside the scope of the Determination.</p> |

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| 10. cont | <p>Where a taxpayer has a home loan and investment loan and a surplus cash flow after paying the minimum requirements for both loans, will Part IVA be applied if they decide to use the extra funds to pay off their home loan rather than their investment loan or use it to buy shares? Can the finalised Determination cover these implications? The fundamental principle seems to be that a taxpayer has a choice of where they deposit their cash; the key difference is the tax outcome.</p> | |
| 11. | <p>Counterfactual almost impossible to put into practice</p> <p>The comment seems heavily reliant on the counterfactual, that taxpayers would not have made payments to their home loan had the LOC not been used and that there is some identifiable connection between the money used to pay off the home loan. The draft Determination is heavily reliant on an implied assumption that the taxpayer has no other income producing assets, other than the investment property.</p> <p>Unless you can rule out all of the above, the conclusion drawn in paragraph 18(c) of the draft Determination would be virtually impossible in a number of circumstances including:</p> <ul style="list-style-type: none"> • taxpayer has other investments that they want to retain and use the LOC as a means of avoiding selling those investments • taxpayer's motivation to reduce debt on family home is for legitimate family reasons, including to remove that property from the combined mortgage facility leaving only the investment property as the sole secured property • placing funds into a withdrawable mortgage offset facility makes commercial sense where funds are then available to support potentially lean times in their business | <p>In order to determine if there is objectively a 'tax benefit' it is necessary to identify what might reasonably have been expected to happen if the scheme had not been entered into.</p> <p>A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.⁷</p> <p>Consequently, it is necessary to consider all the relevant facts and circumstances of the particular situation in order to determine what might reasonably have been expected to have happened. The description of the relevant facts and circumstances in the Determination takes into account the ATO's practical experience in considering a significant number of individual factual situations.</p> <p>In the context of applying Part IVA to an investment loan interest payment arrangement of the type described in the Determination, it is the opinion of the Commissioner that the counterfactual might reasonably be expected to have happened if the scheme had not been entered into or carried out.</p> |

⁷ *Federal Commissioner of Taxation v. Peabody* (1994) 181 CLR 359 at 385; 123 ALR 451 at 461; 94 ATC 4663 at 4671; 28 ATR 344 at 353.

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| 11. cont | <ul style="list-style-type: none"> • if, prior to entering into the LOC arrangement, the taxpayer always deposited all income into the mortgage offset account and used it as a 'working capital' account, it would be difficult to conclude that the counterfactual is what would have occurred • the taxpayer is seeking to maximise the total return on their personal equity. One way of legitimately doing this is to minimise the equity required for each investment. They are maximising the return on equity in relation to the investment by entering into the LOC arrangement because it reduces the total equity involved in that investment, and makes equity available for other investments in the future • the taxpayer is seeking to obtain a commercial profit from the investment property with the least cash flow directed towards it to enable the taxpayer to maintain his current lifestyle objectives. <p>The counterfactual in the draft Determination is simply one of any number of inferences which could be drawn about what might have happened, and no more compelling than any of the 'counterfactual' hypothesis. Except in rare circumstances, it seems unlikely that one could 'conclude' having regard to the factors in Part IVA that the counterfactual is what would otherwise have occurred but for the scheme.</p> <p>Whilst I accept that the draft Determination itself is sound, the draft Determination in effect says no more than that Part IVA could potentially apply to a hypothetical set of circumstances. Given in real life it would be difficult to rely on the counterfactual, then it will be hard to demonstrate the dominant purpose required.</p> | |

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| 12. | <p>Dominant purpose not to obtain a tax benefit</p> <p>The draft Determination does not consider the possibility that a taxpayer may have a dominant purpose other than obtaining a tax benefit, for example, asset protection (particularly single income families). In such a scenario the dominant purpose is not the tax benefit but rather to ensure that the family home is unencumbered in case the sole income earner is sued or needs to give up work; to ensure they can remain in the family home. They are not concerned about the higher debt levels on the investment property as this could always be sold to repay the outstanding debt on it. The draft does not take into account section 177D in its entirety when analysing the sole or dominant purpose.</p> <p>In many cases the perceived tax benefits obtained by paying off the non deductible loan faster are not the sole or dominant purpose of the taxpayer, as they may end up owing more money in total.</p> <p>There is general agreement with the position taken in the draft Determination. The Commissioners position that the investment loan interest payment arrangement (as described in the draft Determination) may attract the operation of Part IVA is supported by the decision in <i>FC of T v. Hart & Anor</i>,⁸ in which Part IVA applied to the taxpayers split loan arrangement. It is agreed that a taxpayer's objective purpose of wanting to 'pay off their home sooner' may not be considered to be the dominant purpose of entering such arrangements and that regard must be had to the factors set out in section 177D.</p> | <p>The dominant purpose is determined having regard to the eight matters specified in paragraph 177D(b). It looks at whether it can be objectively concluded that the person, or any other person entered into the scheme or carried out the scheme, or any part of it, for the sole or dominant purpose of obtaining the tax benefit.</p> <p>As noted in paragraph 13 of the Determination, the presence of a commercial decision does not determine the answer to whether Part IVA applies.</p> <p>The conclusion reached is the conclusion of a reasonable person. That is, the test is concerned with an objectively determined purpose rather than the actual subjective purpose of any of the participants in the scheme.</p> <p>The ATO considers that an investment loan interest payment arrangement as described in the Determination is capable of attracting the operation of Part IVA. Thus, the Determination states that Part IVA is capable of applying if the interest is otherwise an allowable deduction.</p> |

⁸ [2004] HCA 26.

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| 12. cont | <p>Whilst there is agreement that Part IVA may apply where the dominant purpose of the arrangement is to convert non-deductible interest into deductible amounts, it is considered that the particular facts and circumstances of each arrangement must be considered on its own merits. In particular, Part IVA should not apply where loan arrangements are set up for legitimate purposes, such as maximising leverage on income producing items, where the arrangement is not entered into for the dominant purpose of obtaining a tax benefit. For example, if a taxpayer borrowed funds to acquire shares and additional funds to acquire a home, the fact that the bank allows the taxpayer to pay off the home loan and just accrue the interest on the investment loan should not attract the operation of Part IVA. In this regard it is noted by Counsel for the ATO that Part IVA should not apply in such a case in the course of the hearing for <i>Hart</i>.</p> <p>There needs to be an examination of what is the dominant purpose of the arrangement. If the arrangement (depositing all cash flows into the home loan or offset account) is no different to the arrangements of a taxpayer without a rental property, then the ATO must find something more to determine dominant purpose of a tax benefit.</p> | |
| 13. | <p>Paragraphs 3(c) and 18(a) of the draft Determination: Higher line of credit rate for generally explicable reasons other than taxation consequences</p> <p>It can make sense for a taxpayer to use a LOC with a higher interest rate than the home loan to fund repayments of that home loan, for example:</p> <ul style="list-style-type: none"> • a strategy to pay their salary into their LOC, pay all of their expenses on their credit card, then repay the credit card at the end of the interest-free period from their LOC, • a business owner or professional on irregular income who wants the ability to make repayments when they have the cash and to easily redraw when they don't, • an investor who deposits earnings and then redraws the equity to acquire another investment. | <p>The feature in paragraph 3(c) of the Determination which recognises that the interest rate on the LOC is typically (but not always) higher by a small margin (for example 0.15%) is one of many features that may or may not be exhibited in an investment loan interest payment arrangement of the type described in the Determination.</p> <p>In applying Part IVA, consideration is given to the facts and circumstances of each case including the loan arrangements and documentation. No one feature alone is decisive of a tax benefit, nor whether Part IVA will have application.</p> |

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| 13. cont | <p>Just because a loan has a higher interest rate which could suggest that the taxpayer is financially worse off, does not automatically mean that the perceived tax benefits are the reason for taking on that loan arrangement.</p> <p>Different credit products carry different rates of interest because of the varying risks to the finance providers. A LOC carries more risk to a finance provider because there are generally no principal repayments required. Refer to the remarks of Sackville and Finn JJ in <i>FC of T v. Firth</i>.⁹</p> <p>How far would the Commissioner take this argument that taking out a loan with a higher interest rate indicates a tax benefit purpose? Is it limited to different products at the same financier (for example, the same interest rate applying to a standard variable loan as the LOC, or will it apply to interest differentials between financiers for the same product (for example standard variable loan from 'A' Bank at 8.3% compared to a standard variable loan from 'B' Home Loans at 6.59%).</p> <p>A taxpayer may be confused with all the products available from a large number of finance providers in the market. Their choice is more likely influenced by what the finance provider can convince them is the best. The choice may be what is best for the finance provider rather than the taxpayer. The Commissioner should provide guidance on a benchmark interest, and loan terms that he considers acceptable as not falling foul of Part IVA.</p> <p>Most LOCs have a higher interest rate to bring them into line with other loans because the interest is calculated differently. The effective rate of interest is the same once timing and frequency are taken into account. Accordingly, a taxpayer is not actually worse off by shifting debt to a LOC.</p> <p>Most banks these days do not charge extra for a LOC facility, so this factor should be ignored.</p> | <p>The observation in paragraph 18(a) in the draft Determination has been moved to paragraph 17(a) in the final Determination. It should be read in light of paragraph 3(c) of the final Determination.</p> |

⁹ [2002] FCA 413; (2002) 120 FCR 450; 2002 ATC 4346; (2002) 50 ATR 1.

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| 14. | <p>Paragraph 18(c)</p> <p>The taxpayer is better off as they have a better method of tracking their deductible expenditure and are not at risk of turning their rental LOC into a mixed purpose loan. These are normal banking accounts promoted for their flexibility, not their tax benefit.</p> | <p>The analysis of Part IVA has been amended in the Determination to include further clarification of this observation.</p> <p>Paragraph 18(c) of the draft Determination is paragraph 17(c) of the final Determination.</p> |
| 15. | <p>Paragraph 18(d)</p> <p>This may be the case, however in many instances the home is not cross collateralised with the investment property. The ATO should also take into account the capital growth of the investment property.</p> <p>This point should be disregarded. It misunderstands the statement ‘to own their home sooner’, which is about having as much money as possible sitting in the home loan LOC or offset account for as long as possible that reduces the interest charged and attributes more to the principle.</p> | <p>In applying Part IVA, consideration is given to the facts and circumstances of each case. If the home is cross collateralised then it is a relevant fact that should be considered in the context of section 177D(b).</p> <p>Paragraph 18(d) of the draft Determination is paragraph 17(f) of the final Determination.</p> |
| 16. | <p>Paragraph 18(e)</p> <p>Why is this sentence included? The discussion relates to the taxpayer’s purpose, not the banks.</p> | <p>Paragraph 18(e) of the draft Determination has been removed from the final Determination.</p> |
| 17. | <p>Part IVA analysis is incomplete and beyond the policy intent of Parliament</p> <p>Paragraph 18 of the draft Determination sets out five ‘general observations’ regarding an investment loan interest payment arrangement. On the basis of those five observations, paragraph 19 of the draft Determination states that a reasonable person could conclude that the scheme was entered into for the dominant purpose of obtaining a tax benefit in connection with the scheme.</p> | <p>The analysis in the Determination leading to a conclusion as to the application of Part IVA to an investment loan interest payment arrangement of the type described in the Determination has been expanded.</p> <p>There is nothing in the language of Part IVA which limits its application to artificial or contrived arrangements.</p> |

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| 17. cont | <p>To the extent that paragraph 19 of the draft Determination is intended to indicate that the ATO considers Part IVA applies to investment loan interest payment arrangements, notwithstanding the absence of any material features besides those described in paragraph 3 of the draft Determination, we consider it is incorrect.</p> <p>A crucial element is lacking from the analysis on why the conclusion that a dominant purpose of obtaining a tax benefit exists in connection with the arrangement has been drawn. With the exception of those arrangements involving a LOC that has a higher interest rate than the other loans, the draft Determination fails to identify any features that are explicable solely by their tax consequences to support such a conclusion.</p> <p>As explained in the judgement of Gleeson CJ and McHugh J in <i>Hart</i>, Part IVA may have no application, notwithstanding that realising a tax benefit is the operative reason for a transaction. What is required to attract the application of Part IVA is something further, which evidences a dominant purpose (that is, a ruling, prevailing or most influential purpose, as described in <i>Spotless</i>)¹⁰ of obtaining a tax benefit. Gleeson CJ and McHugh J in <i>Hart</i> referenced the following comments from the judgement in <i>Spotless</i>:</p> <p style="padding-left: 40px;">.....viewed objectively, it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme.</p> <p>Per Gummow J and Hayne J's in <i>Hart</i>:</p> <p style="padding-left: 40px;">There could be no doubt in these matters that the terms on which the loan was made available were explicable only by the taxation consequences for the respondents.</p> <p>Per senior counsel for the Commissioner in <i>Spotless</i>:</p> <p style="padding-left: 40px;">.....the inquiry (having regard to the eight matters [in paragraph 177D(b)]) must necessarily be whether the scheme is so attended with elements of artificiality or contrivance primarily directed to the obtaining of the tax benefit that any commerciality of the scheme is overshadowed.</p> | <p>It is widely accepted that Part IVA can apply to commercial arrangements and familial dealings. <i>FC of T v. Spotless Services Ltd</i> (1996) 186 CLR 404 at 415 and 416; 141 ALR 92 at 97 and 98; 96 ATC 5201 at 5206; 34 ATR 183 at 187 and 188:</p> <p style="padding-left: 40px;">A person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.</p> <p style="padding-left: 40px;">...</p> <p style="padding-left: 40px;">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 presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a 'tax benefit'.</p> |

¹⁰ *FC of T v. Spotless Services Ltd & Anor* [1996] HCA 34; (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183.

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| 17. cont | <p>Accordingly, it is considered that the analysis in the draft Determination requires revision. It should identify particular features that the ATO has observed in conjunction with investment loan arrangements, which are considered artificial or contrived, so as to be solely explicable by their tax consequences.</p> <p>Simply choosing to pay off a lower interest loan (non-deductible) with existing cash flow and borrowing at a higher interest rate (deductible) for another purpose should not attract Part IVA. That is, the courts have given weight to whether steps or features of a transaction are 'ordinary' transactions in attempting to delineate between acceptable and abusive tax planning (refer <i>Hart</i>).</p> <p>The 'investment loan investment arrangements' in <i>Hart</i> were caught by Part IVA as there was an element of artificiality in the bifurcation of a single loan into notional accounts. No artificial or contrived features exist in the arrangements described in paragraph 3 of the draft Determination. There is no inference in the draft Determination that the borrowing arrangements are anything but ordinary commercial transactions, in fact these lending facilities are very common.</p> <p>The draft Determination focuses on the fact that 'it makes little (if any) financial sense' for the taxpayer to borrow at an interest rate which is higher than that applicable to a loan which is being repaid with surplus cash flow. More is needed than this for Part IVA to apply.</p> <p>The Commissioner is going beyond the intent of the Parliament when it enacted Part IVA in that it is attacking an arrangement of a normal business or family kind, and that it is not of a blatant, artificial or contrived nature. It will also cast unnecessary inhibitions on normal commercial transactions.</p> | |

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| 18. | <p>Determination to apply retrospectively</p> <p>It is inappropriate to apply this Determination retrospectively because the ATO in the past has issued a private ruling (PBR 94265), stating that as the taxpayer's dominant purpose was to pay their home loan off sooner Part IVA would not apply. Since that ruling issued three years ago, hundreds of taxpayers have applied for private rulings on the matter and the ATO has refused to answer the rulings. Under self-assessment, these taxpayers have had to make a decision for themselves as to whether Part IVA applied or not. All they could do was rely on PBR 94265 in the absence of any guidance from the ATO. It is an abuse of power in a self assessment system for the ATO to refuse to answer taxpayers' questions for the last two years and then retrospectively apply the law counter to its only public statement on the issue.</p> | <p>The Commissioner is of the view that Part IVA was always capable of applying to an investment loan interest payment arrangement, of the kind described in the Determination. In this regard, the Determination is only clarifying the law for an investment loan interest payment arrangement of the kind described in the Determination.</p> <p>A decision in a private ruling is binding on the Commissioner only in regard to the applicant. It is decided on the specific facts and circumstances of the particular scheme, and therefore only applies to the particular scheme that it describes.</p> <p>If there is a material difference between the scheme described and what actually occurs, the private ruling is ineffective.</p> |
| 19. | <p>Edited versions of private rulings</p> <p>Private rulings 93707, 94713, 94313 and 93035 should be reviewed as part of the feedback process of this draft Determination, although they do largely relate to shares.</p> <p>Private ruling 79002 states: 'Based on the foregoing, entering into the LOC facility to meet business expenses whilst utilising the business income to reduce the home loan will constitute a scheme. However no tax benefit arises under the proposed scheme because of the absence of a counterfactual against which the tax benefit could be measured. A counterfactual does not exist in the circumstances where a sole trader enters into a LOC facility to meet business expenses whilst utilising business income to repay the home loan completely.'</p> <p>How does this draft Determination affect the advice given in private rulings 69725, 81797 and 94265?</p> | <p>The ATO publishes edited versions of private rulings (and other written binding advice) to enhance the integrity and transparency of the private ruling system.</p> <p>Practice Statement Law Administration PS LA 2008/4 <i>Publication of edited versions of written binding advice</i> makes it clear that the version of a private binding ruling available on the register is edited to protect the secrecy and privacy of the person or entity to which is was provided. It is a historical document that is not updated to reflect changes in the law, withdrawal of advice or any other changes.</p> <p>Paragraphs 4 and 5 of PS LA 2008/4 clearly state:</p> <p>4. The Commissioner is not bound by an edited version in relation to any taxpayer. An edited version is not:</p> <ul style="list-style-type: none"> • intended to provide taxpayers with advice or guidance, or • a publication approved in writing by the Commissioner. |

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| 19. cont | | 5. Accordingly, a taxpayer that relies on information contained in an edited version is not protected from: <ul style="list-style-type: none">• tax that would otherwise be payable or repaying an otherwise overpaid entitlement• interest, or• penalty. |
| 20. | Insufficient time to respond 30 days response time is insufficient as the ATO's legal database has been out of action for 80% of that time. | 30 days to respond is the generally applicable timeframe for Determinations. |