

# ***PR 2017/3 - Income tax: tax consequences for a borrower being charged an 'Indexed Rate' of interest under a home loan***



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## Product Ruling

### Income tax: tax consequences for a borrower being charged an 'Indexed Rate' of interest under a home loan

| Contents                            | Para      |
|-------------------------------------|-----------|
| <b>LEGALLY BINDING SECTION:</b>     |           |
| <b>What this Ruling is about</b>    | <b>1</b>  |
| <b>Date of effect</b>               | <b>9</b>  |
| <b>Ruling</b>                       | <b>14</b> |
| <b>Scheme</b>                       | <b>15</b> |
| <b>NOT LEGALLY BINDING SECTION:</b> |           |
| <b>Appendix 1:</b>                  |           |
| <b>Explanation</b>                  | <b>20</b> |
| <b>Appendix 2:</b>                  |           |
| <b>Detailed contents list</b>       | <b>38</b> |

#### **! This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## No guarantee of commercial success

The Commissioner **does not** sanction or guarantee this product. Further, the Commissioner gives no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential participants must form their own view about the commercial and financial viability of the product. The Commissioner recommends a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

## Terms of use of this Product Ruling

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This Product Ruling has been given on the basis that the entity(s) who applied for the Product Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Product Ruling.

## What this Ruling is about

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1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling section apply to the defined class of entities who take part in the scheme to which this Ruling relates. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.
2. In this Product Ruling the scheme involves the application of software licenced to Index Mortgage Australia Pty Ltd (IMCO) which, in part, calculates a variable interest rate that is charged by a lender on the home loan of a borrower by reference to movements in the measure of an Index or Indexes.
3. This Product Ruling does not address:
  - the treatment of any costs, fees and expenses (other than interest) payable by the borrower in respect of their home loan
  - the deductibility of interest incurred by the borrower under their home loan in respect of any loan funds drawn down for a purpose other than to finance the acquisition of the borrower's principal place of residence or to refinance an existing loan used for that purpose
  - the borrower's tax obligations and benefits in relation to the acquisition, holding and sale of their principal place of residence, and
  - whether the scheme constitutes a financial arrangement for the purposes of Division 230 (Taxation of financial arrangements).

### Class of entities

4. This part of the Product Ruling specifies which entities can rely on the Ruling section of this Product Ruling and which entities cannot rely on the Ruling section. In this Product Ruling, those entities that can rely on the Ruling section are referred to as the borrower.

5. The class of entities who can rely on the Ruling section of this Product Ruling consists of those individuals who, as the borrower, enter into the scheme described in paragraphs 15 to 19 of this Product Ruling on or after the date this Product Ruling is made and on or before 30 June 2019.

6. The class of entities who can rely on the Ruling section of this Product Ruling does **not** include individuals who enter into this scheme before the date of this Ruling or after 30 June 2019.

### **Qualifications**

7. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 15 to 19 of this Ruling.

8. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled, and
- this Product Ruling may be withdrawn or modified.

### **Date of effect**

9. This Product Ruling applies prospectively from 19 April 2017, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 19 April 2017 until 30 June 2019, being its period of application. This Product Ruling will continue to apply to those entities even after its period of application has ended for the scheme entered into during the period of application.

10. However the Product Ruling only applies to the extent that there is no change in the scheme or in the entity's involvement in the scheme.

### **Changes in the law**

11. Although this Product Ruling deals with the income tax laws enacted at the time it was issued, later amendments may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to that extent, this Product Ruling will have no effect.

12. Entities who are considering participating in the scheme are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

## Note to promoters and advisers

13. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes such as this. In keeping with that intention the Commissioner suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling has issued.

## Ruling

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14. Subject to paragraph 3 of this Product Ruling and the assumptions in paragraph 19 of this Ruling:

- (a) Interest incurred by the borrower at the Base Rate under a home loan procured to fund the acquisition of the borrower's principal place of residence, or to refinance an existing loan used for that purpose, will not be deductible under section 8-1.
- (b) The extent to which interest incurred by the borrower at the Indexed Rate under a home loan procured for a purpose referred to in paragraph (a) above exceeds the amount of interest which they would have incurred at the Base Rate will not be deductible under section 8-1.
- (c) The extent to which interest incurred by the borrower at the Indexed Rate under a home loan procured for a purpose referred to in paragraph (a) above is less than the amount of interest which they would have incurred at the Base Rate will not be assessable income of the borrower under section 6-5.
- (d) The application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) depends on a careful weighing of all the relevant facts and circumstances of each case. Provided the scheme ruled on is entered into and carried out as described in this Product Ruling, the anti-avoidance provisions in Part IVA of the ITAA 1936 will not apply to the borrower.

## Scheme

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15. The scheme that is the subject of this Product Ruling is identified and described in the following:

- application for a Product Ruling as constituted by documents and information received on 29 November 2016 and 12 January 2017, and

- pro forma agreement amending lender's standard terms, received on 29 November 2016 (referred to as the 'pro forma terms' for the purposes of this Product Ruling).

**Note:** certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

16. For the purposes of describing the scheme to which this Ruling applies, and aside from the relevant loan and security documentation to be executed between the borrower and the lender, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which the borrower or any associate of the borrower, will be a party to, which are a part of the scheme. Capitalised terms in this Product Ruling take their meaning as per the pro forma terms referred to in paragraph 15 of this Product Ruling.

17. All Australian Securities and Investments Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

18. Following is a summary of the scheme:

- (a) As the exclusive Australian licensee of software that enables the computation of a loan interest rate in the manner described in paragraph 18(c) below, IMCO will administer any variable rate home loan that is:
  - offered, negotiated, documented, maintained and enforced by a lender on its own Standard Terms, and amended to incorporate clauses in or substantially in the form set out in the pro forma terms, and
  - used for the purpose of funding the borrower's acquisition of a principal place of residence, or refinancing an existing home loan used for that purpose.
- (b) The lender will be an existing mortgage lender or a special purpose trust established to fund loans referred to in paragraph 18(a) above by way of a residential mortgage-backed securities issue.
- (c) Pursuant to the pro forma terms and during a Non Index Period over which the rate of interest under the loan will be that defined by, or computed in accordance with, the Standard Terms (the Base Rate), the borrower (an individual) may (but need not) elect via a Link On Request to have the interest under the loan calculated at an Indexed Rate, being a rate computed in part by reference to movements in the measure of an Index or Indexes.

- (d) Indexed Rates are defined in the pro forma terms to mean, in respect of an Index Period, a series of rates derived by adjusting the Base Rates by applying a constant discount or premium solved for by IMCO using the Calculation Method. The Calculation Method engaged by IMCO to calculate Indexed Rates incorporates, amongst other things and in addition to changes in the measure of the relevant Index, Base Rates, Benchmark Rates and Participation Factors.
- (e) A Link On Request provided by the borrower to the lender must specify the Index or Indexes by reference to which the borrower wishes the Indexed Rate to be calculated (being any Index or Indexes identified by the lender as available for selection by the borrower for this purpose), and any factors by which movements in the Index or Indexes will be scaled.
- (f) The right and obligation of the lender to have changes in the measure of an Index taken into account in the calculation of interest charges under the loan is referred to by IMCO as Linking.
- (g) In the course of an Index Period the borrower may vary a Link as between Indexes via a Link Variation Request, or terminate all prevailing links to an Index (and engage Base Rates when calculating interest under the loan) via a Links Off Instruction.
- (h) Acceptance (or the extent of acceptance) of a Link On Request or a Link Variation Request is at the discretion of the lender.
- (i) Linking involves the calculation of the loan interest rate (the Indexed Rate) according to a series of equations which impute 'sufficiently positive' results to the borrower by way of a reduction in the loan interest rate (that is, a rate of interest below the Base Rate), enabling the loan to be amortised faster than would otherwise be the case. In this context 'sufficiently positive' means the performance of the Index exceeds a Benchmark Rate (such as, for example, the standard mortgage rate) nominated by the lender.
- (j) Conversely, if the Index performance isn't 'sufficiently positive' by virtue of it being below the Benchmark Rate nominated by the lender, the Indexed Rate charged to the borrower under the loan will be higher than it would otherwise have been at the Base Rate.
- (k) Pursuant to the pro forma terms the borrower acknowledges that:

- their right to have the Indexed Rate calculated and applied in the manner contemplated by the pro forma terms (as conferred by Linking) is a contractual right exercisable against the lender personally, and incapable of assignment
  - Linking does not confer upon the borrower any entitlement to money or property, and
  - the borrower has no proprietary or other legal or beneficial interest in the assets (if any) that correspond to the Index to which it has Linked.
- (l) The borrower's loan will not:
- be part of a linked or split loan facility as described in paragraphs 3 to 6 of Taxation Ruling TR 98/22 *Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities*, or
  - be part of an 'investment loan interest payment arrangement' as described in Taxation Determination TD 2012/1 *Income tax: can Part IVA of the Income Tax Assessment Act 1936 apply to deny a deduction for some, or all, of the interest expense incurred in respect of an 'investment loan interest payment arrangement' of the type described in this Determination?*.

### **Assumptions**

19. This Product Ruling is made on the basis of the following assumptions:

- (a) the borrower is an Australian resident for taxation purposes
- (b) the borrower does not use their principal place of residence for business or any other income producing purpose
- (c) the scheme will be executed in the manner described in the Scheme section of this Product Ruling, and
- (d) all dealings between the borrower, the lender and IMCO will be at arm's length.

## Appendix 1 – Explanation

**❶** *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

### **Interest not deductible under section 8-1**

20. Expenditure, including interest on money borrowed, is deductible under section 8-1 if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce a taxpayer's assessable income, provided that the expenditure is not of a capital, private or domestic nature.

21. The essential character of interest on money borrowed is a question of fact to be determined by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower (*Federal Commissioner of Taxation v. Munro* (1926) 38 CLR 153).

22. Interest paid on a borrowing used to acquire an asset is generally not treated as deductible under section 8-1 where it is not expected that assessable income would be derived from the investment.

### **Base Rate**

23. Interest incurred by a borrower at the Base Rate under a home loan used to fund the acquisition of their principal place of residence which (as assumed at paragraph 19(b) of this Product Ruling) is not being used for business or any other income producing purpose does not have sufficient connection with the gaining of assessable income to be deductible under section 8-1.

### **Indexed Rate**

24. Linking merely confers a right to have the rate of interest under the loan computed in part by reference to relative movements in the measure of an Index (that is, at the Indexed Rate). Any increase or decrease in the interest rate attributable to a change in the measure of that Index in turn results in a relative increase or decrease in interest charged under the loan, but the character of the expenditure incurred by the borrower nevertheless does not change.

25. Therefore, for the reason set out in paragraph 22 above, any increase in the amount of interest incurred by the borrower at the Indexed Rate as compared to that which would have been incurred by them at the Base Rate is also not deductible under section 8-1.

***Refinancing an original loan***

26. The interest expense on a new loan will be deductible if the new loan is used to repay an existing loan which, at the time of the second borrowing, was being used in an assessable income producing activity (see paragraph 42 of Taxation Ruling TR 95/25 *Income tax: deductions for interest under section 8-1 of the Income Tax Assessment Act 1997* referring to *Federal Commissioner of Taxation v. Roberts*; *Federal Commissioner of Taxation v. Smith* (1992) 92 ATC 4380; (1992) 23 ATR 494 at ATC 4388.

27. Alternatively, the interest expense on a new loan will not be deductible if the new loan is used to repay an existing loan which, at the time of the second borrowing, was not being used in an assessable income producing activity. It follows that interest incurred on any refinanced home loan of the borrower used to repay an existing home loan procured to fund the acquisition of their principal place of residence (irrespective of whether that interest accrues at the Base or Indexed Rate) will also not be deductible under section 8-1.

**Reduction of interest not assessable as ordinary income under section 6-5**

28. Section 6-5 includes income according to ordinary concepts (ordinary income) in assessable income. Whether or not a particular amount is income according to ordinary concepts depends on the nature and character of the receipt in the hands of the taxpayer.

29. Ordinary income may be said to be derived pursuant to subsection 6-5(4) which provides that an amount of ordinary income will be taken to be received as soon as it has been applied or dealt with in any way on behalf of or as directed by the taxpayer.

30. Any reduction in the amount of interest incurred by the borrower at the Indexed Rate as compared to that which would have been incurred by them at the Base Rate is not an amount paid or credited to the borrower, nor an amount which is applied or dealt with on behalf of the borrower or as the borrower directs.

31. As an amount represented by the reduction in interest that will otherwise be payable by the borrower on the loan at the Base Rate will not be received by, or credited to the borrower (either directly or as deemed by subsection 6-5(4)), that amount will not be subject to tax pursuant to section 6-5.

**Application of Part IVA**

32. Part IVA of the ITAA 1936 is a general anti-avoidance rule which gives the Commissioner the power to cancel all or part of a tax benefit that has been obtained, or would, but for section 177F of the ITAA 1936, be obtained, by a taxpayer in connection with a scheme to which Part IVA applies.

33. In broad terms, Part IVA of the ITAA 1936 will apply where the following requirements are satisfied:

- there is a 'scheme' as defined in section 177A of the ITAA 1936
- there is a 'tax benefit' that, in relation to omitted assessable income, is defined in paragraph 177C(1)(a) of the ITAA 1936 as an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out
- having regard to the eight objective matters identified in subsection 177D(2) of the ITAA 1936, it would be concluded by a reasonable person that there was the necessary dominant purpose of enabling the taxpayer to obtain the tax benefit in connection with the scheme, and
- the Commissioner makes a determination that the whole or part of the amount of the tax benefit that is referable to the omitted assessable income shall be included: paragraph 177F(1)(a) of the ITAA 1936.

### ***Identification of the scheme***

34. The term 'scheme' is defined very broadly in section 177A of the ITAA 1936 to mean:

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- (b) any scheme, plan, proposal, action, course of action or course of conduct.

35. The precise description of a scheme for the purposes of Part IVA of the ITAA 1936 will depend on the facts of the particular case. The circumstances described in paragraphs 15 to 19 of this Product Ruling constitute a scheme for the purposes of the definition set out in section 177A of the ITAA 1936.

### ***The tax benefit test***

36. A tax benefit can arise to the borrower in relation to a year of income where their assessable income of a year of income, as a result of not having included an amount equivalent to a reduction in interest which accrues under the loan at the Indexed Rate, is less than that which the borrower would have derived, or might reasonably be expected to have derived, but for entering into a scheme.

37. Whilst the borrower will not include in their assessable income an amount equivalent to any reduction in interest accrued under their loan at the Indexed Rate, they would not be expected to include an amount in their assessable income but for entering into the scheme described in paragraphs 15 to 19 of this Product Ruling, that is, in the event they had only incurred interest under the loan at a higher Base Rate. A tax benefit should therefore not arise to the borrower in relation to a year of income in connection with this scheme.

## **Appendix 2 – Detailed contents list**

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38. The following is a detailed contents list for this Ruling:

|                                                                           | <b>Paragraph</b> |
|---------------------------------------------------------------------------|------------------|
| <b>What this Ruling is about</b>                                          | <b>1</b>         |
| Class of entities                                                         | 4                |
| Qualifications                                                            | 7                |
| <b>Date of effect</b>                                                     | <b>9</b>         |
| Changes in the law                                                        | 11               |
| Note to promoters and advisers                                            | 13               |
| <b>Ruling</b>                                                             | <b>14</b>        |
| <b>Scheme</b>                                                             | <b>15</b>        |
| Assumptions                                                               | 19               |
| <b>Appendix 1 – Explanation</b>                                           | <b>20</b>        |
| Interest not deductible under section 8-1                                 | 20               |
| <i>Base Rate</i>                                                          | 23               |
| <i>Indexed Rate</i>                                                       | 24               |
| <i>Refinancing an original loan</i>                                       | 26               |
| Reduction of interest not assessable as ordinary income under section 6-5 | 28               |
| Application of Part IVA                                                   | 32               |
| <i>Identification of the scheme</i>                                       | 34               |
| <i>The tax benefit test</i>                                               | 36               |
| <b>Appendix 2 – Detailed contents list</b>                                | <b>38</b>        |

## References

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### *Previous draft:*

Not previously issued as a draft

### *Related Rulings/Determinations:*

TR 95/25; TR 98/22; TD 2012/1

### *Legislative references:*

- ITAA 1936
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C(1)(a)
- ITAA 1936 177D (2)
- ITAA 1936 177F
- ITAA 1936 177F(1)(a)
- ITAA 1997
- ITAA 1997 6-5

- ITAA 1997 6-5(4)
- ITAA 1997 8-1
- ITAA 1997 Div 230
- TAA 1953

### *Case references:*

- Federal Commissioner of Taxation v. Munro (1926) 32 ALR 339; (1926) 38 CLR 153; [1926] HCA 58
- Federal Commissioner of Taxation v. Roberts; Federal Commissioner of Taxation v. Smith (1992) 37 FCR 246; (1992) 108 ALR 385; (1992) 23 ATR 494; 92 ATC 4380

### ATO references

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