

# ***TR 93/6 - Income tax and fringe benefits tax: loan account offset arrangements***

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## Taxation Ruling

# Income tax and fringe benefits tax: loan account offset arrangements

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### other Rulings on this topic

IT 2546

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the Taxation Administration Act 1953, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

## What this Ruling is about

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**1. This Ruling is concerned with those arrangements which are used to reduce the interest payable on a customer's loan account. These are commonly referred to as 'interest offset arrangements' but are called 'loan account offset arrangements' in this Ruling. These products are generally structured so that no interest is derived by the customer and therefore the customer is not liable to pay income tax in respect of the benefit arising from the account. This Ruling:**

- . outlines the manner in which acceptable loan account offset arrangements usually operate; and**
- . explains the limits on acceptable arrangements.**

## Ruling

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### How do acceptable loan account arrangements operate?

**2. An acceptable loan account offset arrangement must operate in one of the following two ways.**

#### Single Accounts

**3. The customer is granted a line of credit. Interest is payable only on the amount which has been drawn down, with the customer able to deposit funds in the account at any time to reduce the balance of the loan. (That is, every repayment which is in excess of the interest owing on the drawn-down amount is a**

repayment of the principal.) There is usually no entitlement to receive interest when the balance of the account is in credit.

4. If there is an entitlement to interest on credit balances in the account then the full amount of that interest is assessable income to the customer. Additionally, the account while it is in credit will not be an acceptable loan account offset arrangement. However, this does not mean that the interest on the deposit account cannot be offset against any interest on a loan account. It simply means that during the period in which the account is in credit the taxation advantages usually associated with a loan account offset arrangement do not apply. Once the account is in debit it may qualify as a loan account offset arrangement.

5. An acceptable arrangement may also involve a deposit account with an overdraft, or a credit or debit card facility.

## Dual Accounts

6. The customer operates two accounts - a loan account and a deposit account. To be acceptable, it is essential that there be no entitlement, either in law or in equity, to receive interest payments or payments in the nature of interest on the amounts credited to the deposit account. The only benefit arising in the deposit account should be the right of the customer to ensure that the interest payable on the loan account is reduced in the way described in paragraph 7.

7. The reduction in the loan account interest referred to in paragraph 6 should be achieved by offsetting the balances of the two accounts. That is, the interest payable on the loan account should be calculated by dividing the outstanding loan principal into two components. A reduced rate of interest (often the lending rate less the ordinary deposit account rate) is charged on an amount equal to the balance of the deposit account. The reduced interest rate can never be a negative, ie. the deposit rate used cannot exceed the loan rate used. In those cases where the deposit rate would exceed the loan rate the deposit rate actually used in the calculation must be limited to the loan rate (see Example 3, paragraphs 31 and 32). The usual lending rate of interest on loans of this type is charged on the remainder of the loan principal.

8. If an account is made up of a series of sub-accounts, some of which are used for deposits and some for loans, then the sub-accounts will be treated, for the purposes of this Ruling, as separate accounts. Consequently, a loan offset account arrangement involving such accounts will fall for consideration

under the principles applying to dual accounts (paragraphs 6 and 7).

What limits are imposed on acceptable loan account offset arrangements?

9. The following questions and answers should illustrate which loan account offset arrangements we will accept.

*(i) What happens in a dual account arrangement if the computer systems used by a financial institution cannot be adapted to calculate the interest payable on the loan account in exactly the same way as described in paragraph 7?*

10. This Office accepts that the computer systems of many financial institutions are not adapted to effect an interest calculation in exactly the way described in the paragraph 7.

11. Accordingly, we will accept a calculation based on a set-off of a notional amount of interest accruing on each of the accounts, provided that the balance used to calculate the notional interest on the deposit account does not exceed the balance of the loan account. That is not to say that if the balance of the deposit account exceeds that of the loan account, the set-off cannot occur. It simply means that the balance used in calculating the notional interest arising on the deposit account must not exceed the balance of the loan account.

12. This method of calculation is accepted because it produces the same result as that achieved by a balance offset calculation. But, any loan account offset arrangement which does not impose the limit on the balance used to calculate the set-off benefit will not be accepted.

13. We also accept that these calculations of notional interest might occur on the basis of different periods, say, daily balances for the deposit account but monthly balances for the loan account.

*(ii) Is there a limit on the kind of loan account that can be linked with a deposit account?*

14. No. There is no limit on the nature of the loan account which may be made the subject of loan account offset arrangement provided that the loan and deposit accounts are with the same financial institution.

*(iii) Is there a limit on the number of loan accounts or savings accounts which may be linked?*

15. No, provided that all the accounts are with same financial institution. The financial institution must ensure that the loan account interest calculation is as described above.

*(iv) Is the arrangement unacceptable simply because the interest calculated also includes a service or administration fee?*

16. A loan account offset arrangement does not become unacceptable simply because the interest calculated in respect of either the debit balance in a single account or the loan in dual account arrangement also includes an amount which is attributed to an administration fee.

*(v) What happens if the interest is deductible?*

17. If the loan account offset arrangement links a savings account with a loan on which the interest is deductible, the deduction allowable to the customer for the interest cannot exceed the reduced amount of interest (i.e., the interest payable after the offset has been taken into account) actually incurred by the customer.

*(vi) What happens in a dual account arrangement if it tries to offset present deposits and future loans?*

18. A loan account offset arrangement which attempts to link a deposit account which presently exists with a loan account which might be taken out at some future time is not acceptable.

*(vii) In a dual account arrangement, what happens if a second person's deposit account is linked to the loan account offset arrangement of another person?*

19. A loan account offset arrangement which seeks to link the deposit account of customer B (who is not a party to the loan) with the loan account offset arrangement of customer A is not acceptable. For example, a loan account offset which links a parent's deposit account with a daughter's loan account is not acceptable. On the other hand a loan account offset which links a husband and wife's mortgage account with the wife's deposit account is acceptable.

*(viii) What happens if a loan account offset arrangement is provided to an employee?*

**20.** If a financial institution offers a loan account offset arrangement only to its employees, the reduction in the interest charged to the employees is a loan fringe benefit under section 16 of the *Fringe Benefits Tax Assessment Act 1986* (the FBTAA). Whether this benefit is taxable will be determined by comparing the actual interest charged on the loan with the interest chargeable using the statutory benchmark interest rate (s.18, subs.136(1) of the FBTAA). The taxable value of this benefit must be determined for each loan to each employee every year.

**21.** Conversely, if the financial institution offers the loan account offset arrangement to all of its customers, irrespective of whether or not those customers are also its employees, a loan fringe benefit does not arise. But it should be noted that the terms of the loan account offset arrangement as it is offered to the employees should be on the same terms and conditions as those offered to other customers. However, the fact that a lower rate of interest is paid on an employee's loan will not, by itself, be sufficient to make an otherwise acceptable account unacceptable.

**22.** If a financial institution, in addition to allowing all its customers (including its employees) to use a loan account offset arrangement, charges its employees a reduced rate of interest, the fringe benefits tax liability is determined only by reference to the interest chargeable under the reduced interest rate. (The further reduction of the loan interest as a result of the offset is not a loan fringe benefit if the employee is able to use the loan account offset arrangement in the same way as any other customer of the bank.) However, the amount actually charged is relevant if only employees of the financial institution are able to use loan account offset arrangements or if the terms of an employee's loan account offset arrangement differ materially from those of other customers.

*(ix) Can two separate financial institutions link a deposit account held by a customer with one of them with the loan account of the same person held with the other?*

**23.** The ATO does not accept any arrangement of this kind.

*(x) Is there a tax avoidance arrangement to which Part IVA applies?*

24. In the acceptable loan account offset arrangements described in paragraphs 3 to 7, Part IVA does not apply. Although there may be a tax benefit in the arrangement, we consider that the conclusion required by paragraph 177D(b) cannot be made. That is, having regard to the matters listed in subparagraphs (i) to (viii) of paragraph 177D(b), the conclusion that the customer opened the account or accounts for the sole or dominant purpose of obtaining the tax benefit cannot be drawn.

## Date of effect

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25. This Ruling applies to years commencing both before and after its date of issue. To the extent that this Ruling differs from any private ruling given by this Office to a financial institution offering a loan account offset arrangement, this Ruling will only apply to customers of that institution from 1 July 1993.

## Examples

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### Example 1 - An acceptable loan account offset arrangement

26. The XYZ Building Society offers its customers a dual account offset arrangement called the Loan Extinguisher Account. Customers are invited to deposit funds into the Loan Extinguisher Account with no right to interest. In return XYZ gives a reduction in the interest charged on the loan account. The customer's only entitlement is to the reduction in the interest charged on the home loan.

27. The XYZ Building Society uses a two-step calculation of the interest payable on the Loan Account.

28. Step 1 is to charge a reduced rate of interest on that part of the balance of the Loan Account which equals the amount credited as the balance of the Loan Extinguisher Account. The rate charged on this part is the difference between the current Loan Account lending rate and the rate of interest payable on such a balance in an ordinary deposit account. Step 2 is to charge the normal lending rate against the balance of the Loan Account.

### Example 2 - An unacceptable single account offset arrangement

**29. Big Bank Australia (BBA) wants customers to reduce the number of accounts they have so that BBA can reduce its own transaction costs. It decides to market a new account - the Do It All Account. This account is designed as an interest bearing deposit or overdraft account which can be linked to a credit or debit card facility. It is also designed to operate on a net interest basis.**

**30. That is, BBA propose to operate the account so that there is only one interest liability at the end of, say, each quarter. Therefore, they develop a system whereby the interest earned on the account when it is in credit is offset against any interest chargeable to the customer on a debit balance. The net income is either credited or debited to the customer's account each quarter.**

**31. This arrangement is not an acceptable loan account offset arrangement.**

**Example 3 - How does the concessional rate of interest charged against a loan to an employee affect the operation of a dual account loan offset arrangement?**

**32. Suppose an employee of a financial institution is granted a \$100,000 loan at the concessional interest rate of, say, 5% per annum (at a time when the usual lending rate offered to the institution's other customers is 10%) and the employee has \$20,000 to deposit with the institution. Suppose also that \$20,000 deposit, if deposited in an interest-bearing account rather than a loan account offset arrangement, would attract an interest rate of 6% per annum. Can the financial institution allow a loan account offset arrangement to operate on a notional interest set-off basis in the way described in paragraphs 9 to 12?**

**33. Our view is that a simple notional set-off of interest is not acceptable. If the balances of the accounts are offset, the result is that the employee will be liable to pay interest of 5% on \$80,000. Therefore, as in paragraph 10, the financial institution must impose a limit in determining the notional interest set-off. However, in this case, the limit to be imposed must restrict the interest rate used to calculate the notional interest payable on the deposit to the same rate of interest used to calculate the interest on the loan.**

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**Commissioner of Taxation**

**18 March 1993**

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