TR 98/D7 - Income tax: the taxation consequences for taxpayers entering into certain linked or split loan facilities

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

other Rulings on this topic

TR 93/6; TR 95/33

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What this Ruling is about

Class of person/arrangement

1. This Ruling considers the taxation consequences for those taxpayers who enter into certain linked or split loan facilities. It considers what part of the interest incurred on the loans is deductible under subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936') or section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997'). It also considers whether Part IVA of the ITAA 1936 would apply. Finally, it considers whether a taxpayer would include any amounts of interest in the calculation of the cost base or indexed cost base of an asset financed by a linked or split loan facility for the purposes of Part IIIA of the ITAA 1936 (the capital gains tax provisions).

2. Whilst the cases cited in this Ruling consider deductibility under subsection 51(1) of the ITAA 1936, the decisions in these cases and the discussion in this Ruling have equal application to section 8-1 of the ITAA 1997. All references to subsection 51(1) should, therefore, be taken as including a reference to section 8-1, and vice versa.

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.

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 interest is added to the loan. Generally, the extra interest (which is claimed to be tax deductible) that is payable on the investment account is equal to or approximate to the amount of non-deductible interest that 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

Is interest incurred on the investment account deductible under section 8-1?

8. Where the funds advanced under the investment loan are used to purchase income producing property, interest which accrues on the original principal sum is deductible under section 8-1 for the period in which the property is used solely for income producing purposes.

9. However, we consider that, in the context of the facilities, there is no obvious commercial explanation for incurring the further interest amount. Therefore, in order to characterise the further interest amount, a wide ranging consideration of the whole set of circumstances surrounding the incurring of the further interest amount, including the direct and indirect advantages sought by the taxpayer, is called for.

10. The object of the facility is to enable the taxpayer to reduce the principal amount outstanding on the private account at a faster rate than would be the case in the absence of capitalisation on the investment account. To the extent interest on the investment account is capitalised, a corresponding reduction in the amount of principal outstanding on the private account is made.

11. The incurring by the taxpayer of a liability or liabilities comprising the further interest amount is a direct consequence of the capitalisation of interest on the investment account. The character of such liabilities is determined by reference to the advantages arising out of such capitalisation.

12. The advantage arising to the taxpayer on capitalisation of interest on the investment account is the reduction of the principal amount outstanding under the private account. Having regard to this advantage, we take the view that the further interest amount does not have the necessary character required for it to be deductible under section 8-1.

13. Alternatively, having regard to all the circumstances relating to the facility, we take the view that a single liability incurred in respect of interest on the investment loan in any particular period serves more than one end, activity or object. We consider that the further interest amount is incurred for the purpose of enabling a corresponding reduction in the private loan.

14. On this basis, an apportionment of the interest incurred on the investment loan in the relevant year is warranted. A fair and reasonable apportionment would be to allow as a deduction under section 8-1 the interest to the extent to which the interest incurred on

the investment account in that year exceeds the further interest amount.

Application of Part IVA

15. Part IVA is a provision of last resort. If any part of the additional interest incurred on the investment account is deductible under section 8-1, we would then consider whether the general anti-avoidance provisions of Part IVA are applicable. As the application of Part IVA depends on the facts, the observations below are necessarily subject to the facts of any particular case.

Identification of the scheme

16. 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. 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. Whilst 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.

Calculation of cost base or indexed cost base for capital gains tax purposes

27. Where a taxpayer sells an income producing asset to which Part IIIA applies that has been financed by the facility, the taxpayer needs to calculate the cost base or indexed cost base of that asset. Therefore, it is necessary to consider what amounts of interest, if any, incurred on the income producing asset, may be included in the cost base or indexed cost base.

28. When interest on an investment loan is capitalised, interest incurred on the investment loan accrues both in respect of the unpaid interest (the 'further interest amount' referred to in paragraph 7 above) and in respect of the original principal sum. All interest accruing retains its character as interest and never becomes part of the principal sum (see *Bank of New South Wales v. Brown (As Official Liquidator of Tom the Cheap (WA) Pty Ltd (In Liquidation))* (1983) 151 CLR 514 ('*Tom the Cheap*').

29. Interest on the principal sum is interest on a loan taken out to finance the acquisition of the asset, but the further interest amount is not. Therefore, the further interest amount does not form part of the cost base or indexed cost base.

30. Interest on the principal sum is deductible under section 8-1. Under section 8-1, the taxpayer is entitled to claim interest equal to that which would have been incurred under a conventional interest only investment loan. However, the Commissioner will seek to use Part IVA to disallow the difference between the interest allowable under section 8-1 and the interest the taxpayer would have incurred under a conventional principal and interest investment loan. Therefore, the interest disallowed under Part IVA includes an amount which is interest on principal (see paragraphs 22 and 23 above). This amount forms part of the cost base or indexed cost base.

31. Notwithstanding the absence of a Part IVA determination in a particular case, e.g., where the taxpayer has not claimed a deduction in the relevant tax return for that part of interest on principal described in the paragraph above, the amount that exceeds the further interest amount may be included in the cost base.

Date of effect

32. This Ruling applies to years commencing both before and after its date of issue. Whilst 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 that it may be inconsistent with this Ruling (see TR 93/1). However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of TR 92/20).

Explanations

Is interest on the investment account deductible under section 8-1?

33. For an expense or outgoing to be deductible under section 8-1 it must be characterised as an outgoing that is incurred for the purpose of gaining or producing assessable income or is necessarily incurred in carrying on a business of gaining or producing assessable income. Outgoings of interest draw their character from the use of the borrowed funds (see *Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613).

34. The term 'use' in this context does not necessarily require a strict tracing approach to the application of the borrowed money (see *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380; (1992) 23 ATR 494). Rather, the characterisation of interest on money borrowed is ascertained by reference to the advantages sought from the use of the borrowed funds.

35. Gibbs ACJ in *FC of T v. South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645 at 660; 78 ATC 4412 at 4420; (1978) 8 ATR 879 at 887 states:

> '... it is the advantage which the expenditure was intended to gain, directly or indirectly, for the taxpayer that is relevant in determining the character of the expenditure ...'

36. It is not possible to prescribe exhaustively all the factors which may be relevant considerations in determining the advantages sought from the use of the borrowing. A guide, however, is given by Brennan J in *Ure v. FC of T* 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 489 ('*Ure*') where he says 'the purpose for which money is paid

is an issue of fact, turning upon the objective circumstances which human experience would judge to be relevant to the issue'.

37. In *Ure*, Deane and Sheppard JJ noted at ATC 4109; ATR 494 that where an outgoing was voluntarily incurred, characterisation would ordinarily be determined by reference to the object the taxpayer had in view in the context of the relevant facts and circumstances. They, however, continued;

> 'In the ordinary case where the income which is expected to flow from an outgoing offers an obvious commercial explanation for incurring it the relevant characterization can readily be determined by reference to the gaining or producing of that income. In the more complex case however, where there is no such obvious commercial explanation, the solution of the problem of characterization must be derived from a weighing of the many aspects of the whole set of circumstances including direct and indirect objects and advantages which the taxpayer sought in making the outgoing.'

38. In a case where there is no obvious commercial explanation for incurring the liability, the weighing of all relevant advantages in this way determines if there is sufficient connection with the gaining of assessable income.

39. The character of interest on capitalised interest is not necessarily determined in accordance with the use made of the original borrowed funds. This is because interest, even when capitalised and added to the overall indebtedness of the borrower for the purpose of calculating future interest, continues to retain the character of interest (see *Tom the Cheap*).

40. The further interest amount is incurred on the additional liability which arises when interest is capitalised under the facility. The advantage which is obtained by the taxpayer when interest is capitalised under this facility is the reduction, by an equivalent sum, of the principal amount outstanding on the private account. In the absence of any commercial explanation for capitalising the interest on the investment loan, the further interest amount does not have the necessary character required under section 8-1.

41. This approach is predicated on the basis that one can determine the deductibility of the further interest amount in isolation from the balance of the interest which accrues in respect of the investment account in the relevant year.

42. An alternative approach is to consider the deductibility of a single liability representing interest which accrues on the investment account in respect of the relevant period and to determine the extent to which the interest qualifies as a deduction under section 8-1.

43. Because these facilities always involve the capitalisation of interest on the investment account and the direction of all payments in reduction of the private account, it is open to conclude that a taxpayer who, in the relevant period, incurs a single liability representing interest on the investment account has sought to obtain more than one advantage. In these circumstances, an apportionment of the total expense is warranted.

44. Where an amount equal to the interest capitalised in a particular period is applied in reduction of a private borrowing, a fair and reasonable apportionment of the interest liability as between the two or more advantages sought would result in a deduction being allowed to the extent to which that interest exceeds the further interest amount.

45. In effect, the taxpayer is allowed a deduction for interest equal to that which would have been incurred if the taxpayer had entered into a conventional interest only investment loan.

46. We accept the arguments in relation to section 8-1 are finely balanced. Our arguments are based on the view that the facilities are arrangements which are out of the ordinary.

Application of Part IVA

47. Part IVA operates where:

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

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

Identification of the scheme

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

The tax benefit test

49. 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 that there should be no assumption involved in the hypothesis or that all alternatives must be disproved or that 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.

50. 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

51. 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, ATC at 5206; ATR at 188, that:

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

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

> '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 matters referred to in paragraph 177D(b)

(i) the manner in which the scheme was entered into or carried out

53. These facilities involve pre-ordained steps which 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

54. 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.

55. The substance of the scheme is that 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.

56. 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.

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

58. These facilities may have other commercial advantages but, on balance, we consider that, in many cases, the acquisition of these advantages are 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

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

60. 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

61. 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.

62. 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.

63. 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.

64. 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

65. 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.

66. 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.

67. Any extra repayments made, as outlined in paragraph 62 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

68. 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)

69. 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.

Calculation of cost base for capital gains tax purposes

70. Paragraph 160ZH(1)(ba) has the effect of including the amount of non-capital costs to the taxpayer of the ownership of the asset in the cost base of the asset.

71. Paragraph 160ZH(6A)(a) states that the amount of non-capital costs to the taxpayer of the ownership of the asset includes any expenditure to the extent to which it was incurred by way of interest on a loan taken out to finance the acquisition of the asset.

72. Paragraph 160ZH(6B) provides that the non-capital costs to a taxpayer do not include any amount that has been allowed or is allowable as a deduction.

73. Because interest always retains its character as interest, it never forms part of the principal sum. It is only the principal sum borrowed that can be said to be 'a loan taken out to finance the acquisition of the asset'. Therefore, it is only the interest which accrues in relation to that principal sum that can be said to be 'interest on a loan taken out to finance the acquisition of the asset'. The further interest amount is not interest which accrues in relation to the principal sum. It is interest which accrues in relation to unpaid interest. This is the case notwithstanding that the terms of the loan agreement permit interest to be calculated on the basis that the capitalised interest and principal sum form part of the capital indebtedness of the borrower.

74. Authority for this view is to be found in *Inland Revenue Commissioners v. Oswald* [1945] AC 360, where Lord Macmillan said at 373:

> 'The unpaid interest never ceases to retain its character as interest, although it has from time to time been added to the capital indebtedness and has carried interest in turn.'

75. This observation was approved of by the High Court in *Tom the Cheap* at 522, 531, 545 and 554.

Further, at 555 Dawson J said:

> 'The sum added by way of interest remained discernible in its original character as interest. Even if the total sum formed by the addition of interest might be said to have been capital, that does not mean that it did not include amounts which were identifiable in their origin as interest and remained identifiable as such. Indeed, compound interest is properly described as interest upon interest and so to describe it is to assume the continued identity of the component parts upon which interest is calculated from time to time.'

76. For a taxpayer to include an amount in the cost base or the indexed cost base, it must be interest genuinely incurred at an arm's length interest rate on money borrowed to acquire an asset.

77. The amount of interest disallowed because of the application of Part IVA represents the 'tax benefit' as defined in subsection 177C(1). This amount exceeds the further interest amount (see paragraphs 22 and 23 above) and is interest on a loan taken out to finance the acquisition of an asset. Therefore, it can be included in the cost base or indexed cost base.

Alternative view

78. It has been submitted that all the interest accrued on a capitalising basis on the investment account is fully deductible under the terms of section 8-1. This is because the interest has the necessary connection with the acquisition of the income producing asset. It is only where there is a disproportion between the income and the interest that regard can be had to wider objects (see *Fletcher*). It has also been submitted that after an objective examination of all relevant circumstances surrounding the capitalisation of interest on the facility, the provisions of Part IVA should not apply to deny any interest deduction accrued on the investment account.

79. This is because:

(a) the mere presence of a planned course of conduct is not necessarily indicative that a borrower has the requisite dominant purpose. The facilities are merely designed to facilitate the choice of the taxpayer to pay off personal debts in preference to business or investment debts;

(b) many of the features of the scheme are common to ordinary private business and investment loans in the market place and that there are significant commercial purposes for entering into the facilities, e.g., administrative savings from combining two separate loans; and

(c) the most influential purpose of these arrangements is to enter a financial plan that will increase wealth by way of cash flow management and investment in income producing property. In general, it is argued that the dominant purpose of the arrangements is to pay off the private debts more quickly or to allow investors to access the equity in the home to acquire more income generating investments.

80. It is argued that it is not 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.

81. It has been suggested that a taxpayer could get around the application of Part IVA by using more than one lender. Whilst 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.

82. We accept that 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 that they are not ordinary arrangements and that they bear the stamp of tax avoidance.

Calculation of cost base for capital gains tax purposes

83. There is an alternative view that the further interest amount is capable of falling within the description 'interest on a loan taken out to finance the acquisition of the asset'.

84. The argument is that amounts of capitalised interest are simply added to the original principal sum and that the whole amount then becomes the principal of the loan. Under this view, 'loan' includes both the original borrowing and any amount accruing on that same account as between borrower and lender.

85. In our view, there is no reason to conclude that the terminology which is used in paragraph 160ZH(6A)(a) was intended to confer a meaning which is inconsistent with the accepted common law distinction between loan capital and interest.

Example

86. The application of both section 8-1 and Part IVA depends on all the facts of a case. A shorthand example is unlikely to provide

adequately the full factual context on which to determine the possible application of section 8-1 or Part IVA. However, the circumstances below illustrate a case where the full amount of interest may not be deductible under section 8-1. Alternatively, if section 8-1 allowed a deduction for the full amount of interest on the investment sub-account, it would be reasonable to conclude under Part IVA that the dominant purpose of entering into the arrangement below would be the gaining of a tax benefit.

Facts

87. Mary is buying her home on which she has an outstanding mortgage debt of $100,000. At the same time she has considerable equity in the home. She sees an advertisement in her local paper for a seminar on negative gearing. She attends the seminar and is given a brochure by Lender X entitled 'A less taxing way to pay off your home-investment loan'. This brochure sets out the details of a facility where 'you pay off your home loan portion many years sooner, and you increase the negative gearing benefits on your investment property'. Mary visits her financial adviser, who recommends that she see Lender X with a view to purchasing a rental property utilising the facility.

88. Mary approaches Lender X about borrowing the funds and is offered two options. She could borrow the $100,000 at the current rate for investments. Alternatively, she could take advantage of the split loan facility. Under the facility Lender X would lend Mary $200,000 which would be divided into two sub-accounts. $100,000 would be used to pay out her current home loan (which is at the same variable rate) and $100,000 would be used to acquire the investment property. The term of the loan would be 25 years and the interest rate on both the private and investment loan accounts would be 7.5% being the current variable home loan interest rate.

89. Mary would be required to make minimum monthly repayments of $1,477.98 which represent $738.99 principal and interest referable to each loan account. Under the facility she would be given the option of applying the total minimum payment against the private loan and allowing the interest on the investment loan to capitalise. She would be required to provide the certificates of title on both properties as security and these would be held until the total funds advanced were repaid in full.

90. Lender X provides Mary with an example which illustrates the advantages of utilising the facility in this way compared to a separate loan structure at the same interest rates.

91. The example shows that the total amount repaid over the 25 years would be the same, i.e., $443,396.07. The total interest charged is $243,396.07 of which $212,999.24 would relate to the investment loan account and could be claimed as a tax deduction. The purported deductible amount of $212,999.24 is $91,301.20 more than it would be under a separate loan structure with the same interest rate. Assuming Mary's marginal tax rate is 48.5% the total tax saving over the period of the loan would be $44,281.08.

92. Mary enters the loan facility and applies the repayments to the private loan account. She continues to do this until the private account is repaid. In the meantime interest charged to the investment loan account is capitalised. Mary claims a deduction for interest on the investment loan account which has been shown on her financial statement from the lender. The interest calculation for the first two years is as follows:

Investment Loan Account

	Debit (interest and charges)	**Credit (payments)**	**Balance**
	$	**$**	**$**
Loan funds			100,000.00
Year 1	7,763.26	nil	107,763.26
Year 2	8,365.94	nil	116,129.20

Private Loan Account

	Debit	**Credit**	**Balance**
	$	**$**	**$**
Loan funds			100,000.00
Year 1	7,140.71	17,735.76	89,404.95
Year 2	6,318.19	17,735.76	77,987.38

How does section 8-1 apply?

93. Mary incurred the liability for interest to achieve two ends, one of which was to acquire an investment property and derive assessable income, and the other to enable her to pay off her private loan more quickly. In such circumstances apportionment is required on a fair and

reasonable basis. In this case, the amount of interest which would be disallowed is the further interest amount.

94. If Mary had paid the interest incurring on the investment account each month she would have incurred $7,500 in interest in years 1 and 2. The amount of interest which would be disallowed is $263.26 in year 1 and $865.94 in year 2.

95. In the case where the further interest amount has been disallowed under section 8-1, we will still consider whether Part IVA would apply to disallow any of the remaining interest that is deductible under section 8-1. Alternatively, if the full amount of interest was deductible under section 8-1, we would also consider whether Part IVA would apply.

How does Part IVA apply?

96. Applying Part IVA, Mary is not entitled to a deduction for all the interest charged on the investment loan under the facility. In each year the difference between the interest actually incurred on the investment loan and the interest that would have been incurred if Mary had applied that part of the payment referrable to the investment loan ($738.99 per month) against the investment loan account rather than the private loan account, is not allowable. This amount exceeds the further interest amount.

97. Mary would be entitled to a deduction in year 1 of $7,451.98. She would not be entitled to a deduction for the extra $311.28 charged to the investment loan account. In year 2, she would be entitled to a deduction for $7,342.06 but not for the extra $1,023.88 charged on the investment loan account.

98. If section 8-1 had disallowed the further interest amount, i.e., $263.26 in year 1 and $865.94 in year 2, Part IVA would apply to disallow the balance of the additional interest, i.e., $48.02 in year 1 and $157.94 in year 2.

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Your comments

100. If you wish to comment on this Draft Ruling, please send your comments by: **24 July 1998**

to:

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101. Please comment only on paragraphs 8 to 14 and 27 to 31 in the **Ruling** part and paragraphs 33 to 46 and 70 to 77 in the **Explanations**

part. These paragraphs relate to section 8-1 of the ITAA 1997 and the CGT cost base, and are essentially the only new material in this Draft Ruling. Comments on the previous Draft Ruling (TR 97/D7) on this topic have already been received and will be taken into account when we finalise both Draft Rulings.

Commissioner of Taxation

24 June 1998

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legislative references
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- ITAA36 Pt IIIA
- ITAA36 Pt IVA
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