TD 1999/D22 - Income tax: do the principles set out in Taxation Ruling TR 98/22 apply to line of credit facilities?

This document has been finalised by TD 1999/42.

Draft Taxation Determination

Income tax: do the principles set out in Taxation Ruling TR 98/22 apply to line of credit facilities?

Preamble

Draft Taxation Determinations (DTDs) present the preliminary, though considered, views of the Australian Taxation Office (ATO). DTDs may not be relied on; only final TDs are authoritative statements of the ATO.

1. Yes. The principles and reasoning set out in Taxation Ruling TR 98/22 'The taxation consequences for taxpayers entering into certain linked or split loan arrangements' will apply to line of credit facilities that are operated as follows:

- there are two or more sub-accounts within the line of credit;
- at least one sub-account is used for non-income producing purposes and at least one sub-account is used for business or investment purposes;
- there is one overarching credit limit;
- the lender requires a minimum payment which is equal to the amount of interest that accrues on the whole of the outstanding liability, including the investment sub-account;
- no part of the minimum payment is applied to the investment sub-account;
- the whole of the minimum repayment is directed to the non-income producing sub-account; and
- where a taxpayer does not make any payments on the investment sub-account, interest accrues on both the unpaid principal sum and the unpaid interest.

2. In this Determination, we refer to the total interest that has accrued on the investment sub-account during the period that all payments are directed to the non-income producing 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**'.

Application of section 8-1

3. The advantage arising to the taxpayer on capitalisation of interest on the investment sub-account is the reduction of the principal amount outstanding under the non-income producing sub-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 of the *Income Tax Assessment Act 1997* ('ITAA 1997').

4. 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 sub-account 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 non-income producing sub-account.

5. On this basis, an apportionment of the interest incurred on the investment sub-account 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 sub-account in that year exceeds the further interest amount.

Application of Part IVA

6. If any part of the further interest amount incurred on the investment sub-account is deductible under section 8-1, we would then consider whether the general anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936') are applicable. As the application of Part IVA will depend on the facts, the observations below are necessarily subject to the facts of any particular case.

Identification of the scheme

7. We consider that the scheme would have the same features as those set out in paragraphs 16 to 19 in TR 98/22.

Tax benefit

8. The tax benefit will be the difference between the deductible interest incurred on the investment sub-account under the scheme and the deductible interest that would have been incurred on the investment sub-account if payments equivalent to the interest accrued on the investment sub-account were, in fact, allocated to that sub-account. The tax benefit equals that part (if any) of the further interest amount which would have been deductible under section 8-1.

Dominant purpose

9. Each case must be considered on its own merits. However, having regard to the eight items listed in paragraph 177D(b) of the ITAA 1936, it is open to a reasonable person objectively to conclude that a taxpayer, who has entered into a scheme with the characteristics outlined in TR 98/22 and paragraph 1 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 the cost base for capital gains tax purposes

10. The further interest amount cannot be included in the cost base or indexed cost base for the purposes of the Parts 3-1 and 3-3 of the ITAA 1997 (the capital gains tax provisions).

11. We discuss the application of relevant principles and authorities in detail in Taxation Ruling TR 98/22.

Example one

Patricia is looking to purchase an investment property. She has recently noticed advertisements in newspapers promoting the advantages (including tax advantages) associated with linking non-income producing and investment loans, thereby allowing investment interest to be capitalised creating increased deductible interest.

Patricia takes out a line of credit facility with GHI Pty Ltd. She pays a $600 application fee and then opens two sub-accounts. One is to refinance her home and has an opening balance of $100,000. It also has a limit of $100,000. The other sub-account is to purchase an investment property and it also has an opening balance of $100,000. It has a limit of $150,000.

Patricia is required to pay $1,300 per month to cover the interest, fees and charges on both sub-accounts. She receives $550 rent per month from the investment property. She pays this plus $750 to the line of credit each month. She directs that all of this payment be applied to her home loan sub-account.
After a period of time Patricia reaches her limit on the investment sub-account. She approaches Rod, the manager at GHI Pty Ltd, who agrees that he will increase the credit limit on the investment sub-account by the amount of unused limit available on the non-income producing sub-account. He also agrees to continue to do this until the non-income producing sub-account is reduced to nil.

How does section 8-1 apply?

The advantage arising to Patricia on capitalisation of interest on the investment account is the reduction of the principal amount outstanding under the non-income producing account. Therefore, the further interest amount does not have the necessary character to be deductible under section 8 1. Patricia is entitled to claim only the interest she would have incurred if she had not redirected payments and capitalised interest, i.e., equal to that she would have incurred under an interest only investment loan.
Alternatively, Patricia incurred the liability to 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 non-income producing loan more quickly. In such circumstances, apportionment is required on a fair and reasonable basis. In this case, the amount of interest that would be disallowed is the further interest amount.
Where the further interest amount is not an allowable deduction under section 8-1 there would be no 'tax benefit' for the purposes of Part IVA. Where some part of the further interest amount is deductible under section 8-1, we would also consider whether Part IVA would apply.

How does Part IVA apply?

Applying Part IVA, Patricia 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 Patricia had applied that part of the payment referable to the investment loan against the investment loan account rather than the non-income producing loan account, is not allowable. The 'tax benefit' would be equal to that part of the further interest amount which would otherwise have been deductible under section 8-1.

Calculation of the cost base for capital gains tax purposes

When Patricia disposes of the investment property, CGT event A1 occurs. Patricia needs to calculate the cost base or indexed cost base of the asset for the purpose of calculating whether a capital gain or capital loss is made in terms of Parts 3-1 and 3-3. In calculating the cost base, the further interest amount is not included in the third element of the cost base.

Example Two

Patricia enters into the same arrangement as set out in ***Example one*** *above. However, Patricia receives $800 per month rent. She pays this plus $750 per month to the line of credit. Although Patricia is paying more than the minimum payment required, the amount of interest that is not deductible under either section 8-1 or Part IVA will be the same as in* ***Example one****, i.e., the further interest amount.*

Your comments

12. If you wish to comment on this draft Determination, please send your comments promptly by 14 May 1999 to:

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Commissioner of Taxation
14 April 1999

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 98/22

Subject references:

Anti avoidance measures; avoidance and evasion; borrowings and loans; home loan interest expenses; interest expenses; negative gearing; rental property loan interest expenses; tax avoidance; tax benefits under tax avoidance schemes; tax planning

Legislative references:

ITAA36 Pt IVA; ITAA36 51(1); ITAA36 177D(b); ITAA36 177F; ITAA97 8-1; ITAA97 Pt 3-1; ITAA97 Pt 3-3; ITAA97 110-25(1)ITAA97 110-25(4); ITAA97 110-25(7)

Case references:

ATO References:
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