# *TR 2000/2 - Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities*

# Taxation Ruling
## Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities

Contents Para



***Preamble***

*The number, subject heading,* ***Class of person/arrangement, Date of effect*** *and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

## What this Ruling is about

**Class of person/arrangement**

1. This Ruling considers the deductibility of interest incurred by borrowers on moneys drawn down under line of credit facilities and moneys redrawn under other loans offering redraw facilities. It considers the operation of section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997') (formerly subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936')) **where the borrowed money has been applied for both income producing and non-income producing purposes.**

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

3. This Ruling applies only to line of credit facilities as described in paragraphs 4 to 8 below and redraw facilities as described in paragraphs 8 to 11 below. This Ruling does not deal with facilities that permit the capitalisation of interest or the applicability of the 'refinancing principle' for funds borrowed by business partnerships as discussed in Taxation Ruling TR 95/25.

***Line of credit facilities***

4. A line of credit facility is a credit facility taken out with a financial institution under which a borrower may draw down funds up to an agreed credit limit. There are a number of different facilities available. There may be one or more loan contracts and one or more

borrowers. The line of credit may be fully drawn, i.e., the taxpayer borrows up to the credit limit, or partly drawn, i.e., the taxpayer draws only some of the funds leaving credit available to be utilised at a later date. If the facility is fully drawn the taxpayer can only draw further funds if payments in excess of interest, fees and charges are made into the facility. Where the facility is partly drawn the taxpayer can draw down further funds up to the credit limit without making repayments of principal.

5. The facility may operate with one account that is used for all draw downs. Funds may be drawn down from a single line of credit account up to the full amount of the available credit limit and may be used for either income producing or non-income producing purposes or both.

6. Alternatively, the facility may be divided into a number of sub-accounts by agreement between the lender and the borrower. Some financial institutions allow the sub-accounts to be held by different borrowers. Some sub-accounts may be used for income producing purposes ('investment sub-account') and others may be used for non-income producing purposes ('private sub-account'). Some sub-accounts may be used for mixed income producing and non-income producing purposes (**'mixed purpose sub-account'**). Funds may be drawn down from each sub-account up to an allocated portion of the overall credit limit.

7. While the focus of this ruling is on mixed purpose sub-accounts, the same principles apply to single line of credit accounts used for mixed purposes.

8. In most cases, the lender requires the borrower to make a minimum monthly payment equal to the interest, fees and charges that have accrued on the facility. A payment into that facility in excess of the interest, fees and charges, is a repayment of principal. Under these facilities, the borrower is able to make payments to reduce the amount owing under the line of credit account or sub-account at any time. Any payments over and above the required minimum payments for interest, fees and charges increase the funds available to the borrower to draw down, subject to the agreed credit limit for that account or sub-account. Where a taxpayer makes a payment over and above the required minimum payment, the taxpayer can direct this payment to be allocated to a particular sub-account.

### *Redraw facilities*

9. There are a number of loan arrangements under which a borrower may redraw previous repayments of the loan principal. There may be one or more loan contracts and one or more borrowers. The loan may be for income producing purposes, non-income

producing purposes or mixed purposes. The lender prescribes a minimum payment that is due on the loan. This minimum payment is at least equal to the amount of interest, fees and charges that accrues on the loan, but more commonly is a principal and interest payment.

10. The redraw facility allows the borrower to make payments over and above the minimum payments required under the loan agreement, and then permits the borrower to redraw an amount equivalent to those payments in excess of interest, fees and charges at a later time. Those payments in excess of interest, fees and charges reduce the borrower's outstanding loan debt and money redrawn increases the outstanding loan debt.

11. A taxpayer may use the money redrawn for income producing purposes, non-income producing purposes or mixed purposes regardless of the use of the original borrowed funds. In some cases the consent of the lender is required to redraw funds and the redraw may be subject to other conditions affecting the amount and frequency of redraws. Redraws may also be subject to the consent of the loan guarantors.

# Ruling

### Line of credit facilities

12. Where a line of credit facility is divided into sub-accounts and each sub-account is used for a specific purpose, interest is fully deductible where funds drawn down on an investment sub-account continue to be used exclusively for an income producing purpose. Interest is not deductible where funds drawn down on a private sub-account are used for a non-income producing purpose.

13. Where interest accrues periodically on the outstanding balance of a **mixed purpose line of credit sub-account**, the deductibility of accrued interest is determined by considering the application of the borrowed funds for income producing and non-income producing purposes. The original application of the borrowed funds will not determine deductibility where funds borrowed under a line of credit facility have been recouped or withdrawn from the original use and are reapplied to a new use, e.g., upon sale of an asset purchased with borrowed funds.

14. Where borrowed money applied to a particular use is recouped and redirected to another use, it is necessary to examine that new application of those borrowed funds in considering the deductibility of interest. Where there are changes in the use of money borrowed under a line of credit facility, or in the amount of borrowed money used for a particular purpose, the deductibility of the interest accrued on that part of the outstanding debt will be determined by considering the advantages sought from that new application of those funds. Interest

will be deductible under section 8-1 to the extent that it is incurred on that part of the outstanding borrowed money used at that time for an income producing purpose.

15. Where a taxpayer has a mixed purpose sub-account, the interest needs to be apportioned between the income producing and non-income producing purposes. Apportionment must be made on a fair and reasonable basis. One approach that we accept as fair and reasonable in relation to the apportionment of interest that has accrued on a daily basis on a mixed purpose account is set out in the following paragraphs. We accept that this approach to apportionment is not the only approach that is fair and reasonable.

16. Where interest accrues daily under a mixed purpose sub-account, a taxpayer is entitled to a deduction in respect of that part of the interest that has accrued on the portion of the outstanding daily loan balance attributable to an income producing purpose. In calculating the portion of the outstanding daily loan balance attributable to an income producing purpose, any repayment of principal is applied proportionately against the outstanding balance of amounts applied to income producing and non-income producing purposes respectively, at the time the repayment is made. However, there are two exceptions.

*First Exception - Borrowed money recouped and repaid*

17. Where money borrowed and applied to a particular use (the 'relevant use') is recouped in whole or in part, in the sense that the amount or some part of it is recovered ( e.g., on the sale of an asset purchased with borrowed funds) that part of the outstanding balance of the mixed purpose line of credit debt which had been applied to the relevant use can no longer be regarded as continuing to be applied to that use. Where borrowed funds recouped are repaid to the mixed purpose sub-account in reduction of the outstanding balance, those funds have ceased to be outstanding funds used for any purpose. The effect of the repayment of the recouped funds to the mixed purpose sub-account is to reduce only that part of the outstanding line of credit debt applied to the previous use of those funds. The use of the balance of borrowed funds still outstanding is unaffected by the recoupment and repayment in these circumstances unless the amount of the sale proceeds paid into the mixed purpose sub-account exceeds the amount drawn down and applied to the relevant use (the 'relevant debt portion'). This would occur, for example, where the asset is sold at a profit and part or all of the recouped borrowed funds and profit are paid into the mixed purpose sub-account. To the extent that the payment exceeds the relevant debt portion, such excess amount (i.e., the profit component) will be taken to have reduced prorata the amounts borrowed and applied to uses other than the relevant use.

*Second Exception - Refinancing mixed purpose debt*

18. A taxpayer may choose to refinance a debt outstanding on a mixed purpose sub-account by borrowing an equivalent amount under two separate accounts or sub-accounts. If the sums borrowed under those two separate accounts are equivalent to the respective income producing and non-income producing parts of the existing outstanding debt, we accept that interest accrued on the debt incurred in refinancing the income producing portion of the mixed purpose debt will be deductible.

*Apportionment calculations*

19. Where interest on borrowed money accrues daily, we accept that it would be unnecessarily onerous to require a manual daily apportionment calculation. We accept that the interest accrued in a month is deductible under section 8-1 where it is calculated using an apportionment approach based on the average outstanding principal used that month for income producing purposes. The deductible portion of interest accruing in each month is calculated as follows:

total interest accrued for the month X deductible interest percentage figure

20. The deductible interest percentage figure is calculated as follows:

$$\frac{(A + B)}{(C + D)} \quad \times \quad 100$$

where

A = opening balance (beginning of month) of outstanding principal used for income producing purposes;
B = closing balance (end of month) of outstanding principal used for income producing purposes;
C = opening balance of total outstanding principal;
D = closing balance of total outstanding principal;
Note: the closing balance for one month is the opening balance for the next month.

21. Where a taxpayer makes repayments over and above the required minimum payment and the line of credit facility comprises one mixed purpose sub-account only, the taxpayer cannot choose to

notionally allocate the repayments to a particular portion of the total debt, e.g., the non-income producing portion.

**Redraw facilities**

22. The deductibility of interest on a further borrowing of money under a redraw facility depends upon the use to which the redrawn funds are put.

23. Where the original borrowing is for non-income producing purposes and the taxpayer uses the redrawn funds wholly or partly for income producing purposes, that part of the accrued interest attributable to the redrawn funds used for income producing purposes is deductible.

24. Similarly, where the original borrowing is for income producing purposes and the taxpayer uses the redrawn funds wholly or partly for non-income producing purposes, that part of the accrued interest attributable to the redrawn funds used for non-income producing purposes is not deductible.

25. Where a taxpayer uses redrawn funds for a different purpose to the original borrowing in circumstances described in paragraphs 23 or 24, the loan account becomes a mixed purpose account and the same principles discussed above in relation to mixed purpose line of credit sub-accounts will apply to the mixed purpose loan account. There is an ongoing need to apportion interest on a mixed purpose loan account. That apportionment needs to be made on a fair and reasonable basis. Subsequent repayments are apportioned between the outstanding debt used at that time for income producing and non-income producing purposes. However, the two exceptions for borrowed money recouped and repaid and for the refinancing of a mixed purpose debt, discussed above at paragraphs 17 and 18 in relation to mixed purpose line of credit sub-accounts, are equally applicable to mixed purpose loan accounts.

## Date of effect

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

# Explanations

27. The nature of an interest expense was recently considered by the Full High Court in *Steele v. DC of T* 99 ATC 4242; 41 ATR 139. The Court said, at 99 ATC 4242 at 4248; (1999) 41 ATR 139 at 148, that:

> '… interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T* it is therefore ordinarily a revenue item.'

28. Although interest is ordinarily a revenue expense, it will only be deductible under subsection 8-1 if the expense can be characterised as an outgoing that is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income and must not otherwise be excluded from being deductible, e.g. an outgoing of a private or domestic nature.

29. The character of interest is determined by the purpose of the borrowing. Generally, the purpose of a borrowing can be determined from the use of borrowed funds and outgoings of interest ordinarily draw their character from that use (see *Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613). It is recognised that it may be appropriate to distinguish between the purpose of the taxpayer in borrowing the money and the use to which the borrowed funds are put in an appropriate case (see *Steele v. DC of T* 99 ATC 4242, at 4251; (1999) 41 ATR 139, at 150).

30. 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 borrowed money (and the purpose of the borrowing) is ascertained by reference to the advantages sought from the use of the borrowed funds. In *Kidston Goldmines Ltd v. FC of T* 91 ATC 4538 at 4545-6; (1991) 22 ATR 168 at 176-7, Hill J. stated:

> 'In most cases, the purpose of the borrowing will be ascertained from the use to which the borrowed funds were put…
>
> To be deductible the outgoing, or in a case of apportionment a part of an indivisible outgoing, must be seen to be incidental and relevant to the activity which is directed to the gaining or production of assessable income. In the normal case, the fact that funds borrowed have been borrowed for the purpose of

> that activity and can still, in the year of income in which the deduction is claimed, be seen as having that purpose, will lead readily to the conclusion that the interest will be incidental and relevant to the income producing activity. Again, in the usual case the application of funds for an income producing purpose will demonstrate the relevant connection between the outgoing and the income producing activity. Indeed there is much to be said for the view that the tests of purpose and application of funds are but two sides of the one matter.'

31. However, the original purpose of the borrowing and use of the borrowed funds will not always determine the deductibility of interest. Where borrowed money has been used to purchase an income producing asset and that asset subsequently has been sold, the original use of that money will not necessarily determine the character of the interest expense accruing on those borrowed funds. In such a case the question of the deductibility of interest '… must be resolved by determining whether the essential character of the interest outgoings after the sale … was such that it can be said that those outgoings were incurred by the respondent in the course of the gaining or production of assessable income or, having regard to the business then carried on by it, they were necessarily incurred by the respondent in carrying on that business.' (*F.C. of T. v. Riverside Road Pty. Ltd. (in liq.)* 90 ATC 4567 at 4576; 21 ATR 499 at 509).

32. In some circumstances, for example where the loan contract imposes a continuing obligation to pay interest for a specified period, the sale of income producing assets purchased with those borrowed funds may not necessarily result in the immediate cessation of the relevant connection with the income earning activity. For example, in *Riverside Road* the Full Federal Court held at 90 ATC 4567 at 4576; (1990) 21 ATR 499 at 509 that:

> ' It seems to us that it does not follow from *De Bavay's case*… that the mere fact that the land and buildings were sold necessarily results in the conclusion that as and from the date of sale the whole of the interest incurred was not deductible. The respondent, pursuant to the contractual arrangements it had entered into, was obliged … to pay interest until 1 May 1979. Had it sought to discharge its obligation to the mortgagee, it could have been required to pay interest to this date.'

33. In the circumstances of that case, the contractual obligation to pay interest for a fixed period meant that the sale of the assets did not alter the essential character of the interest payments incurred until that loan was discharged.

34. The deductibility of interest under the loan agreement considered by the Court in *Riverside Road* is distinguishable from the

deductibility of interest under a line of credit facility.
The observations of the Full Federal Court in *FC of T v. Brown* 99 ATC 4600 at 4608; (1999) 43 ATR 1 at 10 provide support for this view. The Full Federal Court stated at 99 ATC 4608; 43 ATR 10 that:

> 'Had the loan agreement in question been a "roll over" business loan facility which entitled the taxpayer conducting the business, on the date of each monthly payment, to elect to repay the principal and thereby avoid incurring liability for interest or to "roll over" the loan and continue to be liable for interest, that may have been a different situation. In that circumstance there may be considerable force in the contention that the *occasion* of the liability was the election to "roll over" the loan on each monthly payment date, rather than any liability arising under the terms of the original loan agreement establishing the terms of the "roll over" facility. In such a case the cessation of business or sale of the income-producing asset acquired with the borrowed funds might properly be regarded as breaking the nexus in much the same way as certain post cessation interest payments were not allowed in *Riverside Road*.'

35. While the Full Federal Court did not express a concluded view on this issue, their comments suggest that in determining the deductibility of interest under a 'roll over' debt facility, the 'occasion' of the liability to pay interest was to be found in the circumstances concurrent with the accrual of the liability to pay interest which arose on each recurring monthly interest date.

36. We believe the same principle will apply to a line of credit facility where interest accrues daily and the outstanding debt can be repaid at any time. The obligation to pay interest under the terms of, and for the period of, the original borrowing can not be regarded as the 'occasion' of the interest liability which accrues in a subsequent period after a taxpayer has made an election not to repay the outstanding principal under a line of credit facility. A line of credit debt has a continuing opportunity for repayment which distinguishes it from the type of loan debt considered in *Brown*.

37. Where the funds borrowed under a line of credit remain outstanding, we believe the deductibility of interest is to be determined by considering the ongoing application of those borrowed funds. Interest is considered to be the cost of retaining the use of the outstanding line of credit funds in the period in which that interest accrues. Where borrowed funds are recouped from the sale of an income producing asset purchased with that money, the connection between the interest expense and the income producing use of that asset will be broken when the asset is sold. Interest on those borrowed funds will only be deductible after that time if it can be established

that the accrued interest continues to be incurred in the course of deriving assessable income or in carrying on a business. For this to be the case under a line of credit, there would need to be a sufficient connection between the accrual of interest in a period and any new application for income producing purposes of those recouped borrowed funds. Deductibility of interest on those borrowed funds will be determined by a consideration of the advantages sought from that new use to which those funds are redirected.

38. Taxation Ruling TR 95/25 also outlines some general principles governing deductibility of interest.

### Further borrowings

39. Where a loan facility allows for redraws of extra repayments, we consider those redraws constitute new borrowings of funds that cannot be traced to the extra repayments. In this regard the term 'redraw' is a misnomer. It is in effect a new borrowing of funds. Similarly, a draw down on a line of credit that has not been fully drawn is a new borrowing of funds.

40. In our view, it is not correct to characterise the reduced loan balance as comprising the previous loan balance with a notional offset credit available in respect of extra repayments as if those extra repayments were standing to the credit of the borrower in a separate account in the books of the lender. The extra repayments do not create a debt due by the lender to the borrower. Those funds used to make extra repayments simply cease to exist as an asset of the borrower after being used to discharge part of the loan debt. In our view, the redraw facility does not involve separate loan and deposit accounts of the type discussed in paragraphs 6 to 8 of TR 93/6.

41. In the case of a repayment of principal on a line of credit, the borrower acquires a contractual right to borrow a further amount equal to the difference between the reduced drawn-down amount and the available credit limit. That right to borrow further funds is a contractual right under the loan agreement permitting the borrower to draw down funds up to the agreed credit limit. The available credit is not an asset of the borrower and the available credit limit can be varied by the lender upon review.

42. Similarly, under a redraw facility, the loan agreement gives the borrower the right, subject to restrictions in some cases, to borrow a further amount up to the balance of the loan debt that would have been outstanding if the minimum loan repayments required under the loan agreement had been made. The extra repayments do not create a debt payable by the lender to the borrower and are not an asset of the borrower after they have been used to discharge part of the loan debt.

43. We consider a draw-down from a line of credit account or sub-account, or a redraw from a loan account, is a separate borrowing. Therefore, the deductibility of the interest on that separate borrowing depends on whether the interest is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. To the extent borrowings are used for income producing purposes, that part of the accrued interest attributable to those borrowings is deductible. Conversely, that part of the accrued interest attributable to borrowings used for non-income producing purposes is not deductible.

44. The balance outstanding on a mixed purpose line of credit sub-account or a mixed purpose loan account is an undivided single debt owed by the borrower to the lender. When repayments of principal are made, it is not considered possible to direct those payments to only that part of the borrowed funds used for a particular purpose as if it were a separate debt. While it may be possible to trace the uses to which different parts of the borrowed funds are put, it is considered repayments of principal need to be applied proportionately to reduce the balance of the outstanding principal attributable to income producing use and non-income producing use respectively, e.g., if 70% of an outstanding line of credit sub-account debt is used for income producing purposes, 70% of any repayment would be in respect of that part of the outstanding debt. However, there are two exceptions.

*First Exception – Borrowed money recouped and repaid*

45. Where money borrowed and applied to a particular use is recouped, e.g., on the sale of an asset purchased with borrowed funds, that part of the outstanding balance of the mixed purpose debt can no longer be regarded as applied to that use. Where the borrowed funds recouped are paid into the mixed purpose account or sub-account, those funds have ceased to be outstanding funds used for any purpose. The effect of the repayment of the recouped funds to the mixed purpose sub-account is to reduce only that part of the outstanding line of credit debt applied to the previous use of those funds. **Example four, at paragraph 66 of this ruling, outlines the practical application of these principles**.

*Second Exception – Refinancing mixed purpose debt*

46. A taxpayer may choose to refinance a mixed purpose debt by borrowing an equivalent amount under two separate accounts or sub-accounts. Where a mixed purpose line of credit sub-account debt is replaced by two new debts and the advantage sought by these borrowings is the refinancing of the respective parts of the previous

debt used at that time for income producing and non-income producing purposes, we consider that a strict tracing approach is not appropriate. It is relevant to bear in mind the comments of Dixon CJ. in *Hallstroms Pty. Ltd. v. FC of T* (1946) 72 CLR 634, cited with approval by Hill J in *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380, at 4391; (1992) 23 ATR 494, at 507, that the question of characterisation depends on:

> '… what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of legal rights…'

47. The sole purpose of the borrowing used to refinance money used at that time for income producing purposes is to continue to have the use of those funds for income producing purposes. Similarly, the sole purpose of the borrowing used to refinance money used at that time for non-income producing purposes is to continue to have the use of those funds for non-income producing purposes. Therefore, we accept that interest accrued on the debt incurred in refinancing the income related portion of the previous mixed purpose debt will be deductible.

## Alternative views

48. It has been suggested that if funds were originally borrowed for income producing purposes and there is no requirement to repay those funds, the occasion of the interest liability remains the income producing activities of the taxpayer. The decision in *FC of T v. Brown* 99 ATC 4600; 43 ATR 1 is cited in support of this proposition. However, the comments made in that case in relation to 'roll over' loan facilities support our view of the law outlined above.

49. It has also been suggested that funds withdrawn from a loan account or a line of credit account which can be attributed to the extra repayments made, simply represent a withdrawal of funds temporarily 'parked in the loan'. This view depends upon a characterisation of the extra repayments as effectively remaining an asset of the borrower, available to the borrower by virtue of the contractual right to redraw them. As discussed above, we believe this view is not correct. The extra repayments have been used to discharge part of the loan or line of credit debt and the subsequent redraw or draw down is funded by a subsequent increasing of the loan or line of credit debt. In our view, the redraw or draw down is a new borrowing of money. The deductibility of the interest payable on those new borrowings depends upon the advantages sought from the use of those funds.

50. It has been further suggested that the taxpayer can allocate a repayment to that portion of borrowed moneys used for a particular purpose. The decision in *FC of T v. Carberry* 88 ATC 5005; (1988)

20 ATR 151, is cited in support of this view. In *Carberry* a husband and wife borrowed money to acquire undivided real estate comprising a private residence and a kindergarten business and premises. The taxpayers applied the proceeds of sale of a previous private residence towards the purchase of the new property. The proceeds from the sale of the previous residence exceeded the cost attributable to the purchase of the new residence. In the circumstances, the Administrative Appeals Tribunal held at first instance that the whole of the funds borrowed to finance the acquisition of the property was used by the partnership to purchase the kindergarten.

51. The decision in *Carberry* is relevant to establishing the original use of the borrowed funds. On the facts of that case it was open to the tribunal to conclude that the whole of the borrowed funds were applied to an income producing use. In reaching this conclusion, the Tribunal did not apply a strict tracing approach to the borrowed funds. However, as recognised by Davies J in that case on appeal to the Federal Court, an apportionment of interest would have been required if the Tribunal had found as a matter of fact that the borrowed funds had been applied to both income producing and private purposes.

52. The decision in *Carberry* is not inconsistent with the basis of apportionment outlined in this ruling in relation to cases involving borrowed funds applied to both income producing and non-income producing purposes.

## Examples

### Example one

53. Barry has a line of credit with the XYZ Bank. His credit limit is $100,000 and when that facility is established on 1 April he draws down $80,000 to invest in income producing shares. Barry's net salary of $4,000 per month is paid directly into the line of credit account on the last day of the month and interest and charges are debited on the same day. Barry redraws $2,000 per month on the first day of the month for living expenses. On 30 April, Barry makes a lump sum repayment of $20,000 from the proceeds of the sale of a private yacht, in addition to the $4,000 repayment from his salary. On 1 June, Barry draws down a further $20,000 for home renovations, in addition to the $2,000 draw down for living expenses.

Barry's transactions are summarised below:

| Date | Borrowings and Interest | Payments | Account Balance | Income Portion (see below) | Non-income Portion (see below) |
|---|---|---|---|---|---|
| 1 Apr | 80,000 | | 80,000 | 80,000 | NIL |
| 30 Apr | 400 | 24,000 | 56,400 | 56,400 | NIL |
| 1 May | 2,000 | | 58,400 | 56,400 | 2,000 |
| 31 May | 292 | 4,000 | 54,692 | 52,819 | 1,873 |
| 1 Jun | 22,000 | | 76,692 | 52,819 | 23,873 |
| 30 Jun | 383 | 4,000 | 73,075 | 50,328 | 22,747 |

54. The repayments of $20,000 and $4,000 made on 30 April first pay the accrued interest of $400 and then reduce the outstanding principal used at that time for income producing purposes to $56,400.

55. The interest of $400 accrued in April is wholly attributable to borrowed funds used for income producing purposes and is therefore fully deductible.

56. The $4,000 repayment on 31 May first pays the accrued interest of $292 and then proportionately reduces the outstanding principal used at that time for income producing purposes and for non-income producing purposes. The proportionate reduction in the outstanding principal attributable to income producing purposes will be $3,708 x 56,400/58,400 = $3,581, giving a balance of the outstanding principal used for income producing purposes at that time of $52,819. The proportionate reduction of principal attributed to non-income producing purposes will be $3,708 x 2,000/58,400 = $127. The balance of the outstanding principal used for non-income producing purposes at that time, therefore, will be reduced by $127 to $1,873.

57. The interest of $292 accrued in May is related partly to the outstanding principal used that month for income producing purposes and partly to the outstanding principal used that month for non-income producing purposes. The amount of interest Barry can claim as a deduction for May is calculated as:

$$292 \quad \times \quad \text{Deductible interest percentage}$$

$$= 292 \quad \times \quad \frac{(56{,}400 + 52{,}819)}{(56{,}400 + 54{,}692)} \quad \times \quad 100$$

$$= 292 \quad \times \quad 98.3\%$$

$$= 287$$

Barry can claim a deduction of $287 for interest for the month of May.

58. The borrowings on 1 June of $20,000 for home renovations and $2,000 for living expenses were for non-income producing purposes. The outstanding principal used for non-income producing purposes at 1 June will, therefore, be $1,873 (see paragraph 33 above) + $22,000 = $23,873.

59. The $4,000 repayment on 30 June first pays the interest accrued that month of $383 and then proportionately reduces the outstanding principal used at that time for income producing purposes and for non-income producing purposes. The proportionate reduction in the outstanding principal used at that time for income producing purposes will be $3,617 x 52,819/76,692 = $2,491, giving a balance of the outstanding principal used at 30 June for income producing purposes of $50,328. The balance of the outstanding principal used for non-income producing purposes at 30 June will, therefore, be reduced by $1,126 to $22,747.

60. The interest of $383 accrued in June is related partly to the outstanding principal used that month for income producing purposes and partly to the outstanding principal used that month for non-income producing purposes. The amount of interest Barry can claim as a deduction for June is calculated as:

$$383 \quad \times \quad \text{Deductible interest percentage}$$

$$=383 \quad \times \quad \frac{(52{,}819 + 50{,}328)}{(54{,}692 + 73{,}075)} \quad \times \quad 100$$

$$=383 \quad \times \quad 80.7\%$$

$$=309$$

Barry can claim a deduction of $309 for interest for the month of June.

### Example two

61. Bill is a computer programmer. He is offered a job in Darwin and decides to relocate his family there. He borrows $200,000 from the bank and purchases a house in Darwin. He makes the minimum monthly payment of $1650. After two years the balance on Bill's home loan is $186,000.

62. Bill receives a $50,000 windfall and decides to pay this money off his home loan. This reduces the balance to $136,000.

63. Bill is then offered a job in Perth. He decides to take the job and relocate his family. He decides to rent out the house in Darwin and borrow to purchase a new residential property in Perth. Bill redraws $50,000 from the Darwin loan and uses this as a deposit for the new home in Perth.

64. Bill can deduct the interest accrued on the outstanding loan principal of $136,000 that is related to the Darwin house from the date that property is available for rental. Those borrowed funds are used at that time for income producing purposes. As the new borrowing of $50,000 is used as a deposit on the residence in Perth, the interest on that borrowing will not be deductible as it is incurred for a non-income producing purpose.

### Example three

65. Rod has a mixed purpose line of credit debt comprising $5,000 used for investments in income producing shares and $5,000 used for holidays. Rod refinances the income producing and non-income producing components of this mixed purpose debt with borrowings under two new line of credit sub-accounts. The interest accrued on the line of credit sub-account used solely to refinance the borrowed money used for investments in income producing shares will be fully deductible. The interest accrued on the line of credit sub-account used solely to refinance the borrowed money used for holidays will not be deductible.

### Example four

66. Bob has a mixed purpose line of credit sub-account debt of $30,000 with $20,000 applied to the purchase of a private vehicle and $10,000 applied to purchase income producing shares in company XYZ. Bob sells half the XYZ shares for $6,000 and pays that amount into the mixed purpose sub-account.

67. The debt outstanding after the repayment is related to the $20,000 applied to the purchase of the private vehicle and $5,000 of

borrowed funds applied to purchase that half of the income producing XYZ shares still held by Bob.

68. The $5,000 of borrowed funds previously applied to purchase that half of the XYZ shares that were sold is no longer applied to that use after being recouped and repaid on the sale of those shares. The previously outstanding debt related to the XYZ shares is therefore reduced to $5,000 when that portion of the borrowed money recouped is repaid to the mixed purpose sub-account.

69. When the additional amount of $1,000 obtained from the sale of half the XYZ shares is paid into the mixed purpose sub-account, it is apportioned between the outstanding funds used for income producing and non-income producing purposes. That is, the payment into the mixed purpose sub-account of $1,000, in addition to that portion of the borrowed funds recouped on the sale of half the XYZ shares, reduces the outstanding debt applied to the XYZ shares still held by $200 to $4,800 and reduces the debt applied to the private vehicle by $800 to $19,200.

**Example five**

70. All facts are the same as in example four except Bob sells all the XYZ shares for $8,000 and pays that amount into the mixed purpose sub-account.

71. For a line of credit, the deductibility of interest depends upon the continued use of borrowed funds for income producing purposes. After the sale of the XYZ shares, there are no longer any outstanding funds then used for income producing purposes. Therefore, there would be no deduction allowed for interest accruing on the outstanding line of credit debt after the sale of the XYZ shares.

72. The $22,000 outstanding after the sale of the shares and repayment of the sale proceeds, comprises $20,000 of borrowed funds that continue to be applied to the purchase of a private vehicle and $2,000 of borrowed funds still outstanding that was lost on the sale of the income producing shares. After the sale of those shares, the outgoing of interest on that $2,000 ceases to be for the purpose of retaining the use of those funds for income producing purposes. The interest incurred after the sale relates to financing the capital loss made on the sale of those shares. The connection with the previous income producing use of the funds invested in the XYZ shares is broken on the sale of those shares. The 'occasion' of the incurring of that interest is no longer the obligation to pay interest under the terms and conditions applicable to the previous period of the borrowing arrangement.

73. No deduction would be allowable under s 8-1 ITAA 1997 in respect of interest on the borrowed funds lost on the sale of the income producing XYZ shares.

## Detailed contents list

74. Below is a detailed contents list for this draft Ruling:

**Commissioner of Taxation**
1 March 2000

*Previous draft:*
Previously issued in draft form as TR 1999/D3

*Related Rulings/Determinations:*
TR 93/6; TR 95/25; TR 98/22

*Subject references:*
- accrued interest
- home loan interest expenses
- interest expenses
- negative gearing
- rental property loan interest expenses

*Legislative references:*
- ITAA 36 51(1)
- ITAA 97 8-1

*Case references:*
- Steele v. DC of T 99 ATC 4242; (1999) 41 ATR 139
- Fletcher and Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- FC of T v. JD Roberts; FC of T v. Smith 92 ATC 4380; (1992) 23 ATR 494
- Kidston Goldmines Ltd v. FC of T 91 ATC 4538; (1991) 22 ATR 168
- FC of T v. Riverside Road Pty. Ltd. (in liq.) 90 ATC 4567; (1990) 21 ATR 499
- FC of T v. Brown 99 ATC 4600; (1999) 43 ATR 1
- Hallstroms Pty. Ltd. v. FC of T (1946) 72 CLR 634
- FC of T v. Carberry 88 ATC 5005; (1988) 20 ATR 151.

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