TR 1999/D3 - Income tax: deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities

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This document has been finalised by TR 2001/2.

Draft Taxation Ruling

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

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Preamble

Draft Taxation Rulings (DTRs) present the preliminary, though considered views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling considers the deductibility of interest incurred 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 7 below and redraw facilities as described in paragraphs 8 to 10 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 extra payments 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 extra payments.

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 both income producing and non-income producing purposes.

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. Generally, the lender requires the borrower to make a minimum monthly payment equal to the interest, fees and charges that have accrued on the facility. Every payment into that facility, to the extent it is in excess of the interest, fees and charges, is a repayment of principal. Under these facilities, the borrower is able to make repayments to reduce the amount owing under the line of credit account or sub-account at any time. Any extra repayments over and above the required minimum payments 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 repayment over and above the required minimum payment, the taxpayer can direct this repayment be allocated to a particular sub-account.

Redraw facilities

8. 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 repayment.

9. The redraw facility allows the borrower to make extra repayments over and above the minimum repayments required under the loan agreement, and then permits the borrower to redraw an amount equivalent to those extra repayments at a later time. The extra repayments reduce the borrower's outstanding loan debt and money redrawn increases the outstanding loan debt.

10. 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

11. 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 applied exclusively to an income producing purpose. Interest is not deductible where funds drawn down on a private sub-account are applied to a non-income producing purpose.

12. Where a taxpayer has a mixed purpose sub-account, or the line of credit facility comprises only one account that is used for both income producing and non-income producing purposes, the interest needs to be apportioned between those 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 this approach to apportionment is not the only approach that is fair and reasonable.

13. Where interest accrues daily under a mixed purpose 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 must be 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.

14. Where interest on borrowed money accrues daily, we accept it would be unnecessarily onerous to require a manual daily

apportionment calculation. We accept the interest accrued in a month is deductible under section 8-1 to the extent it is related to the average outstanding principal used that month for income producing purposes. The deductible portion of interest accruing in each month is calculated as follows:

$$\text{total interest accrued for the month} \times \text{deductible interest percentage figure}$$

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

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

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.

16. Where a taxpayer makes repayments over and above the required minimum payment and the line of credit facility comprises one mixed purpose account only, these repayments must be apportioned across the total debt. The taxpayer cannot notionally allocate the repayments to a particular portion of the total debt, e.g., the non-income producing portion.

Redraw facilities

17. 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. Where the original borrowing is for non-income producing purposes and the taxpayer uses the redrawn funds exclusively for income producing purposes, that part of the accrued interest attributable to the redrawn funds is deductible.

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

19. Where a taxpayer uses redrawn funds partly for income producing purposes and partly for non-income producing purposes, the taxpayer must apportion the interest that has accrued on the redrawn funds.

Date of effect

20. 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

21. For an expense or outgoing to be deductible under section 8-1 of the ITAA 1997 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).

22. 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.

23. 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 ...'

24. It is not possible to prescribe exhaustively all the factors that 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 where his Honour says:

> 'The purposes for which money is laid out is an issue of fact, turning upon the objective circumstances which human experience would judge to be relevant to the issue ...'

Line of credit facilities and redraw facilities

25. 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. Similarly, a draw down on a line of credit that has not been fully drawn is a new borrowing of funds.

26. In our view, it is not correct to characterise the reduced loan balance as comprising the previous loan balance plus the extra repayments or available credit as if those extra repayments or available credit were standing to the credit of the borrower in the books of the lender. The extra repayments or available credit 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.

27. 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.

28. 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.

29. 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.

30. A mixed purpose line of credit sub-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 loan 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.

Alternative views

31. It has been suggested that funds withdrawn from a loan account or a line of credit account can be attributed to the extra repayments made and they 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.

Examples

Example one

32. 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

33. 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.

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

35. 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.

36. 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.

37. 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.

38. 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.

39. 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

40. 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.

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

42. 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.

43. 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

44. Kathy has a home loan that is linked to an interest offset savings account into which her wages are paid and from which she makes private drawings for living expenses. The credit balance of the interest offset savings account reduces the interest payable on her home loan. Kathy also has a separate home equity line of credit that comprises two sub-accounts. One sub-account is used to borrow money that is used solely for investments in income producing shares. Another sub-account is used to borrow money that is used solely for holidays. Kathy moves to another city on work for six months and rents out her home.

45. In the period in which Kathy's home is available for rent, the interest accrued on the outstanding balance of her home loan will be fully deductible. The deductibility of that interest will not be affected by private drawings from the interest offset savings account. The interest accrued on the line of credit sub-account used solely for investments in income producing shares will be fully deductible. The interest accrued on the sub-account used solely for holidays will not be deductible.

Detailed contents list

46. Below is a detailed contents list for this Ruling:

Your comments

47. If you wish to comment on this Draft Ruling, please send your comments by: 26 March 1999

to:

Contact Officer: Bob Barkley

Telephone: (07) 4753 7252

Facsimile: (07) 4753 7275

Address: Australian Taxation Office
PO Box 9990
Townsville QLD 4810.

Commissioner of Taxation

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No draft issued

Related Rulings/Determinations:

TR 93/6; TR 95/25; TR 95/33; TR 98/22

Subject references:

- accrued interest
- home loan interest expenses
- interest expenses
- negative gearing
- rental property loan interest expenses

Legislative references:

- ITAA36 51(1)
- ITAA97 8-1

Case references:

- Fletcher and Ors v. FC of T (1991) 173 CLR 1; 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
- FC of T v. South Australian Battery Makers Pty Ltd (1978) 140 CLR 645; 78 ATC 4412; (1978) 8 ATR 879
- Ure v. FC of T 81 ATC 4100; (1981) 11 ATR 484

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