

# NEWSFLASH BOOKLET

## CLAIMABLE LOANS

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## **Important**

**This booklet is simply a collection of Newsflash articles relevant to claimable loans. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.**

## **What the Borrowed Money was Used for Determines Deductibility**

Traditionally, the interest is only claimable on a loan where the actual money borrowed is used directly to produce income i.e. buy the income producing property. The Roberts and Smith case of July 1992 has changed this. In this case a firm of solicitors borrowed money to pay the partners back some of the original capital they had invested in the firm. The Commissioner argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners, the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of property because technically they cannot owe money to themselves. The ruling goes on to say: “The refinancing principle” in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships. The joint owners of an investment property who comprise a sec 6(1) tax law partnership in relation to the property cannot withdraw partnership capital and have no right to the repayment of capital invested in the sense in which those concepts are used in Roberts and Smith. Accordingly, it is inappropriate to describe a business, as a “refinancing of funds employed in a business.”

IT2423 states that people who own less than three rental properties are not in business and therefore not in partnership under general law. This means that couples wealthy enough to be purchasing their third rental property can rent out their home then borrow the money to build themselves a new home and maybe claim the interest on the loan as a tax deduction against the rent earned on their old home. Note there have been a few cases where taxpayers have unsuccessfully tried to argue they are in business. In Cripps V Federal Commissioner of Taxation 1999 AATA 937 the taxpayers owned 14 town houses and other properties at various times. The ATO was successful in arguing they were not in business but the foundation of the ATO’s argument was that they had an agent managing the properties. So it is crucial that you run the properties as a business i.e. fully manage them yourself.

Regarding linked and split loan facilities. These loans link a loan for the rental home and a loan for the private home together so the bank will permit repayments from both rental and wages income to be paid off the private home loan with the interest on the rental home loan compounding. Accordingly, in a short period of time the mortgage can be shifted from the private home to the rental home. As the rental loan was used to purchase the income producing property and pay interest on that property, technically all the interest on that loan will be deductible. The Commissioner says in TR98/22 this is a scheme with the dominant purpose of reducing tax and he will apply Part IVA to deny a deduction for the interest on the interest. The High Court found in Harts’ Case 27-5-2004 that it was an arrangement with the dominant purpose of avoiding tax and caught by Part IVA but the court did not rule that interest on capitalized interest was not deductible. More details of the High Court’s decision in Hart’s Case and ways of capitalizing interest appear later in this booklet.

## **Line of Credit Facilities Dangerous**

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A \$100,000 loan used solely to purchase a rental property is financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of \$2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be \$98,000 owing on the rental property. In say 45

days when the borrower withdraws \$1,000 to pay off his or her credit card the loan will be for \$99,000. However, as the extra \$1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

The next time the borrower puts his or her 2,000 pay packet into the account the Commissioner deems it to be paying only 1/99 off the non-deductible portion i.e. at this point there is \$96,020 owing on the house and \$980 owing for non-deductible purposes. When, 45 days later, the borrower takes another \$1,000 out to pay the credit card, there will \$96,000 owing on the house and \$1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

In addition to the loss of deductibility, the accounting fees for calculating the percentage deductible could be high if there are frequent transaction to the account. The ATO has released TR2000/2 which confirms this and as it is just a confirmation of the law is retrospective.

To ensure deductibility and maximise the benefits provided by a line credit you will need an offset account that provides you with \$ for \$ credit. These are two separate accounts – one a loan and the other a cheque or savings account. Whenever the bank charges you interest on the amount outstanding on your loan they look at the whole amount you owe the bank i.e. your loan less any funds in the savings or cheque account.

## **Continuing to Claim Interest on a Loan After Business or Investment Sold**

A reader has sold an investment property for less than the amount he borrowed. He wants to know if he can still continue to claim the interest on the balance of the loan. The ATO has lost a few cases in this regard lately so there is a good chance that the reader will qualify for a tax deduction. FC of T v Jones, 2002 ATC 4135 and FC of T v Brown, 1999 ATC 4600 and TR 2004/4 are the references. TD 95/27 has been amended as the ATO recognizes that an employee using a car for work purposes that sells for less than the outstanding loan can continue to claim the interest.

Everything you can do to bring yourself into line with the positive points of the cases mentioned above should be done. Some of the relevant facts that you may be in a position to do something about are:

- 1) All the proceeds of the sale should be used to repay as much of the loan as possible.
- 2) Endeavor to appear to be unable to repay the loan from other assets other than the family home. This may mean as a couple if only one member owned the property sold at a loss the other member should hold any further investments.
- 3) Don't refinance the loan to extend its term or increase the interest rate. You must appear to be doing all that is possible to eliminate the loan. So refinancing to reduce the interest rate is ok. On the other hand if you have to change the loan from principle and interest to interest only because that is the only way you can afford the repayments you may be able to justify changing the loan.
- 4) If the loan is already fixed at the time the investment is sold, then you have an argument that you could not pay it out. This is a factor to consider if you are refinancing before the sale.

The above also applies if the investment was shares or if a business was sold for less than what is owing on it. In the case of a business the ATO has issued a statement that division 35 cannot work to quarantine the interest in these circumstances as the taxpayer is no longer in business. Division 35 is discussed in Non Commercial Businesses booklet. But all you really need to know is that Division 35 will not stop you claiming the interest

## **Losing Interest Deduction**

Imagine how you would feel if you borrowed \$100,000 to invest in shares. Then when it came time to do your tax return your Accountant told you the interest is not tax deductible because the money went from your loan to your cheque account so you could write a cheque to your broker. A recent AAT case decided that if loan funds are intermingled with other funds before being used for income producing purposes they are no longer considered to have their source in the loan.

Interest is not deductible on a loan unless the proceeds of the loan have been used to purchase or in relation to an income producing investment. The link can be simply lost by paying some spare cash off the loan and drawing it back later, or not being able to trace the flow of the funds to the investment. The ATO's own ruling states "a rigid tracing of funds will not always be necessary as appropriate." Yet in Domjan and

Commissioner of Taxation [2004] AATA 815 the ATO successfully argued that the placing of borrowed money into a savings/cheque account with other personal funds broke the link necessary to prove the funds were borrowed for tax deductible purposes.

The AAT is not the highest court in the land but relevant nevertheless. The sitting AAT member stated: “I accept the Commissioner's submissions. Where the funds have been intermingled it is impossible to determine the use to which they have been put. In other words the purpose of the borrowing cannot be ascertained. It cannot be said that the expenditure – that is the payment of interest – has been incurred in the course of gaining or producing assessable income”

Mrs Domjan also tried to argue that when she deposited private funds into her loan account they were quarantined from the loan so when she drew money from the loan for private purposes it was simply a redraw of those funds, not a separate loan for private purposes. She also contended that any private funds put back into the loan after the redraw should go only towards reducing the loan for private redraws. Further she should not be penalised for using her private funds to temporarily reduce the interest on the loan and as a result reduce her tax deduction. The AAT found that the funds could not be divided so all repayments were to be spread equally over the loan and she could not choose the character of the funds she was redrawing from.

Mrs Domjan was in for a penny in for a pound. She even claimed that as the bank required her to insure her home because it was security on the loan, the insurance should be tax deductible. No luck here either.

The AAT also found that when Mr Domjan used a lump sum he personally received to pay off his half of the loan, the amount had to still be split equally between them as they were co debtors on the loan. Therefore even though he had paid his share back he was still entitled to claim half the interest that related to Mrs Domjan's share. As a result of this it would now be prudent, when only one member of a couple is borrowing to buy their share of an income producing jointly owned investment, the loan should only be in his or her name, not both. Trying to get a bank to agree to this may be a problem. If the bank will accept the non borrowing partner only giving a guarantee and his or her name does not actually appear on the loan, the problem may be avoided.

What was alarming was the fact that Mrs Domjan, who prepared her own tax return received, a 25% penalty on the basis she had been careless in claiming the interest in relation to the redraws. The ATO's argument being she had been careless in relying on a draft ruling after the final ruling had been issued. In the ATO's world taxpayers preparing their own tax returns should have knowledge of the thousands of ATO rulings available and check regularly for updates. The AAT agreed with the ATO! I have quiet a problem with this conclusion because unlike the draft ruling the final ruling did not cover redraws. So the ATO's argument is really that Mrs Domjan should have followed up the draft to read the final ruling and then realise that by omitting parts of the draft but not issuing a counter view the ATO was really saying they no longer held the view expressed in the draft. The issue of redraws was eventually addressed in another ruling 2 years after Mrs Domjan had lodged the returns in questions.

Probably Mrs Domjan greatest mistake was representing herself before the AAT. Though I have no answer as to how the average taxpayer can afford to be equally represented against the ATO and its unlimited, taxpayer funded, resources.

Footnote: This article was published in the Sunday Mail and some commentators criticised it claiming that surely if good records are kept of how the personal cheque account was used, transferring loan funds into it should not break the nexus. Don't be misled the AAT member residing over Domjan's case actually complimented her on her record keeping.

## **Hart's Case Decided for the ATO – Linked Split Loans**

On Friday 27<sup>th</sup> May, 2004 the High Court handed down its decision on Linked Split Loans in favour of the ATO.

I do not find it too surprising that they found that these types of loans were a scheme with the dominant purpose of a tax benefit therefore caught by Part IVA. This case was a clay pigeon for the ATO and yet it still needed to go all the way to the High Court. It was a clay pigeon because the banks marketed these arrangements on the basis of the tax savings. Therefore it was difficult for the taxpayer to argue a different motive.

It is important to remember this case does not change the deductible nature of interest or for that matter interest on interest. Gleeson & McHugh specifically stated that the question of the deductibility of interest

upon interest does not need to be addressed because the issue was already decided on the basis that there was a scheme to gain a tax benefit.

The moral of the story is not to get involved with mass marketed tax schemes unless they have an ATO ruling. This is because the ATO has no trouble proving your primary motive was a tax benefit as there is always an abundance of marketing propaganda to prove this. On the other hand don't lose sight of the fact that you are not obliged to pay more tax than necessary. In IT 2330 the ATO states:

*"Notwithstanding that an arrangement may not be capable of explanation by reference to ordinary business or family dealing and even though it may be entered into to avoid tax, it will not attract the operation of section 260 (now Part IVA) if its purpose is to take advantage of a specific or particular provision in the Income Tax Assessment Act and complies in every respect with the requirements of the specific or particular provision, i.e., the choice principle."*

This approach is supported in Harts case where the judges stated;

*"If such a taxpayer took out two separate loans, and the terms of the loan for the investment property were different from the terms of the loan for the residential property in that they provided for a higher ratio of debt to equity, and for payments of interest only, rather than interest and principal, during a lengthy term, then ordinarily that would give rise to no adverse conclusion under [Part IVA]. It may mean no more than that, in considering the terms of the borrowing for investment purposes, the taxpayer took into account the deductibility of the interest in negotiating the terms of the loan. How could a borrower, acting rationally, fail to take it into account?"*

Unfortunately the judges concluded that such a loan was not normally available so it was not reasonable to argue it was a normal arrangement apart from the tax benefit. Ultimately it was the linking of the loans that sunk them. This should not discourage investors seeking similar loans that stand on their own merits rather than being linked to a non deductible loan.

Fine tuning this theory in relation Part IVA we need to recognise that this test has two elements. Firstly there has to be a scheme and secondly it needs to have a dominant purpose of a tax benefit. In Hart's case it was recognised that a scheme as per 177A(1)(b) can basically include any .... course of conduct. So there is no point in poking around here for a gap other than to say the legislators could not have intended this section to be so wide or it would catch everything.

So now let's look at the dominant purpose of a tax benefit test. Which must also be present for Part IVA to apply. No this does not mean that if you walk into a newsagency to buy an invoice book your dominant purpose was to gain a tax deduction for the book and as it was a "course of conduct" that is it not tax deductible because this is a tax scheme. We have to be more realistic than that. Nevertheless the High Court found that Hely J was correct in stating:

*"A particular course of action may be both tax driven, and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine in favour of the taxpayer whether, within the meaning of Pt IVA, a person entered into or carried out a 'scheme' for the dominant purpose of enabling a taxpayer to obtain a tax benefit".*

So finding another reason to justify the arrangement is not enough. It is all about the dominant purpose. The simpler the arrangement the better, the more artificial it becomes the more it meets the definition of a scheme.

The court having disallowed the capitalised interest because it was part of a tax scheme did not have to rule on whether capitalised interest itself was tax deductible. I feel that the capitalised interest would normally be deductible providing it has not been created as part of a scheme with a dominant purpose to save tax.

Say for example you have a line of credit on your rental property and a separate loan on your home. Your tenant may pay you a couple of months rent in advance which you pay off your home loan as everything is up to date and cash flow looks good at the time. Over the next two months you have quiet a few personal expenses that take up all of your wages. Then the rates and some repairs are due on the rental property. You need to draw the funds to cover the rates and repairs from the line of credit on the rental

property and due to lack of funds the interest that month has to be capitalised. Luckily you just manage to make the P&I payment required on your home loan. This scenario is not a scheme. Events just happened that way and it is not for the ATO to tell you how to manage your affairs. Linking the two loans or a systematic approach to the increase in the loan on the rental property may point towards a scheme. Just watch out for spare funds to make extra repayments on your home and don't prop up the rental property with your spare cash if you can use the equity in your rental property instead.

This principle can also work with a business instead of a rental property.

## **Caution with Rental Property Interest**

You are only allowed to claim interest if the money borrowed was used to buy something that was income producing. Accordingly, if you use a line of credit to pay off your credit card that you have been living off then that amount was borrowed for non tax deductible purposes. This makes an awful mess of a normally tax deductible loan and can reduce it to 100% non tax deductible within 5 years because any repayments have to be pro rataed between the loan for the Rental Property and the loan for the Credit Card this of course means a larger portion of the repayments pay off the Rental Property and the portion of Credit Card debt increases each month.

We also now have Domjan's case to contend with. Unless there was a clear connection between the monies borrowed and the expense the interest is not deductible. In Domjan's case the placing of borrowed funds into a personal cheque account to pay Rental Property expenses broke the nexus and the interest on the borrowed funds was not deductible. The ATO is not enforcing Domjan yet but it does give them the precedent if they ever want to.

A substantial part of the ATO argument in Hart's case was the fact the bank marketed the arrangement as a tax minimisation scheme. If you can't afford the interest payment that month because of financial hardship and the bank lets you add it to your loan balance you will not be caught by the precedent in Hart's case.

So generally, what should you do? Note there may be better ways, looking at an individual circumstances:

1. Only use a Line Of Credit with a Credit Card used for private purposes, on a non deductible Loan
2. If other loans for Rental Properties are Lines of Credit, only draw on them for rental property expenses and make sure these expenses are paid direct not mixed with in a private cheque account or a credit card used for private purposes as well.
3. Compound interest only when financially necessary.
4. If you do not have a Main Residence or are considering buying a new one and renting out the one you are in, do not use funds in the offset account to pay rental property expenses. Draw them from the Line Of Credit on the rental property, keeping the offset amount as high as possible. The net result has no effect on interest but this will increase the amount of deposit you will have in the offset account for your Main Residence. When you draw this out, the original loan for the Rental Property or your old home once it is rented, is still fully tax deductible.
5. An offset arrangement is far better than a Line of Credit as it leaves the funds available for private purposes if needed.

## **Don't be Scared to Claim Capitalised Interest**

Interest on capitalised interest is deductible as long as it is not part of a scheme with dominant purpose of a tax benefit.

The ATO is hesitant to clarify this in fear of opening the flood gates but on the other hand it cannot say that capitalised interest is not deductible because it would create chaos for businesses operating an overdraft. ID 2006/298 the LOC ruling that was withdrawn on 1-12-06 is a classic example of that. They withdrew it to stop the flood gates bursting but couldn't say it was incorrect. As for Hart's case they were not allowed to claim interest on interest because, due to all the bank's advertising material, the ATO had no trouble proving that the scheme was an arrangement with the dominant purpose of a tax benefit. When in the previous Hart's case the ATO tried to argue that capitalised interest was not deductible they lost. References:

2004 Harts Case:

Gleeson CJ and McHugh J:

*The issues in this appeal, and the relevant facts, are set out in the reasons of Gummow and Hayne JJ. We agree that the Commissioner's appeal on the Pt IVA issue should succeed, and that the question relating to the deductibility, in the circumstances, of interest upon interest (which was answered by all four members of the Federal Court in favour of the respondents) does not arise.*

Note in the above Hart's are the respondents

2002 Harts Case:

Conti J:

*90. I have had the advantage of reading the reasons for judgment of Hill and Hely JJ. As with Hely J, I am fully in accord with the reasons of Hill J for concluding that the compound interest incurred was deductible under subs 51(1) of the 1936 Act, being reasons which I consider to be essentially in line with those of Gyles J at first instance. The primary judge recorded, incidentally, that it may well be that by some future point in time, compound interest on Loan Account 2 will exceed the rental income for the time being to be derived from the Jerrabomberra property, being a circumstance which did not affect in principle his Honour's conclusion upon the subs 51(1) deductibility issue.*

## **Capitalised Interest Update**

The ATO has issued another ruling on capitalised interest. It is a Private Binding Ruling (PBR) so it will only protect the person who applied for it. Nevertheless PBR 69725 is well worth a read. In this example the taxpayer already has a home loan, they organise a line of credit to invest in shares. The line of credit was a distinctly separate account from the home loan but it was with the same bank. The taxpayer wrote to the ATO stating that he or she did not want to use personal funds to pay the interest on the line of credit. The limit of the line of credit would be used for further investments into shares and to cover the interest that would be capitalised. No mention was made as to how the dividends from the shares would be used. The taxpayer wanted to know if he or she was entitled to a tax deduction for the interest on the capitalised interest and the ATO said yes.

The PBR also concedes that the 2002 Harts case stands, in that if the interest is incurred on borrowings that are deductible then interest on that interest is deductible. As far as Part IVA goes the PBR concludes that "a reasonable person would conclude that you did not enter into the scheme for the dominant purpose of obtaining a tax benefit" and leaves it open to the Taxpayer to choose not to use personal funds to pay the interest. It seems a blatant omission that the use of any earnings from the investment is not addressed. I feel we can rest assured that if they thought they could argue that the earnings from the investment should be used to meet the interest then they would have repeated it several times over.

Those readers who are not afraid of a confrontation with the ATO may choose to redirect rental income towards their private mortgage. Why not get an ATO ruling first and let us know the result. In the meantime even the most conservative reader should not use income that is not directly from the investment to prop it up. Borrow the money necessary to meet the cash short fall and use all your personal income to pay off any personal debt.

## **Capitalised Interest is Deductible BUT Not if Your Avoiding Tax**

In November the ATO released ATO IDs 2006/297 and 2006/298, they state this fact despite at first reading appearing to contradict each other

ID 2006/297 gives the example of an investor that has a split loan with a bank, one loan for his or her home and the other for his or her rental property. But the agreement with the bank is that all repayments go towards the home loan allowing the interest to capitalise on the rental property. In these circumstances the ATO concedes that the interest on the capitalised interest is deductible. But they will use Part IVA to void the deduction

Interestingly, ID 2006/298 gives the example of a split loan for a home and rental property but the loans are lines of credit. It states that choosing not to make the interest repayment on the rental one will not provoke the ATO to use Part IVA to void the deduction.

The reasoning behind this is in the history of the Hart's cases. In the 2002 it was ruled that capitalise interest is deductible. In 2004 the ATO appealed and the Harts lost but not because capitalised interest is not deductible. The judges said they did not need to rule on the issue of capitalised interest because the arrangement was disallowed under Part IVA. Part IVA can override a deduction that is technically allowable if it has become so because of a scheme with the dominant purpose of a tax benefit. In Hart's case it was not difficult for the courts to conclude this, because of the abundance of bank propaganda material promoting the tax benefits.

So what are the sorts of things the ATO looks for to decide that there is a "Scheme with the dominant purpose of a tax benefit" TR 98/22 is a good source of reference here but make sure you get a current copy as it was amended considerably in 2004, as a result of Hart's case. Refer paragraphs 16 and 25 for some of the most relevant points being:

- A planned course of conduct designed to produce a tax benefit
- Facilities structured to provide additional interest deductions
- Facilities marketed on the basis of tax benefits
- A structure as to how the home is paid off quicker than the rental property
- Absence of another commercially justifiable reason for the arrangement
- Both loans with the one lender

The IDs are a common sense conclusion supported by case law. A stricter interpretation would be an administrative nightmare for businesses operating a bank overdraft.

## **Progress on Capitalised Interest Ruling**

On the 1<sup>st</sup> December, 2006 the ATO withdrew a ruling stating that interest on capitalised interest was deductible in a normal line of credit (ID 2006/298). They withdrew the ruling, can you believe, to prevent uncertainty! Anyone who is now more certain because they have less information on the subject could you please contact me and explain. It maybe different if they said it was wrong but they didn't. And I think it was right. Anything less and you would have businesses running an overdraft in big trouble. But nevertheless if it is predominantly a scheme to reduce tax it is caught by Part IVA.

We have been nagging the ATO to give us more information. All they could tell me was that their opinion is expressed in TR 98/22 and TD 99/42. The latter ruling specifically addresses line of credit arrangements and says they can be caught. Both rulings are still focused on loans where there is an understanding with the bank that a minimum repayment intended to cover both loans is required to be paid off the private loan.

In a true line of credit situation there is no repayment requirement providing the limit is not reached. This was the case in ID 2006/298 which stated in the facts but not in the decision reasoning "there were no fixed minimum principal and interest repayments required by the lender".

The bottom line is all these rulings accept that capitalised interest is tax deductible as long as it is not part of an arrangement to reduce tax. So you can't have a scheme or arrangement with the bank but if you have the available credit you can pay rental property expenses and capitalise the interest. It would also help if you don't use a systematic approach.

TR 98/22 lists the elements required for a loan to be an arrangement to reduce tax and be caught by Part IVA - summarised as follows:

- A planned course of conduct designed to produce a tax benefit
- Facilities structured to provide additional interest deductions
- Facilities marketed on the basis of tax benefits

- A structure as to how the home is paid off quicker than the rental property
- Absence of another commercially justifiable reason for the arrangement
- Both loans with the one lender

ID's like ID 2006/298 come from applications for private rulings by taxpayers. They are sterilised so that the taxpayer cannot be identified and made available to the public as a guide as to how the ATO is thinking. In sterilising the ruling the particular facts of the case were removed to the extent it made a blanket statement that a line of credit would allow you to claim capitalised interest. The situation cannot be that straight forward as the banks would simply start marketing a new product designed to give a tax advantage with a line of credit instead of the loans offered in Hart's case. But it is not the type of loan that is at issue it is the existence of an arrangement that has the dominant purpose of a tax benefit.

So tax scheme promoters are out but it is not up to the ATO to tell you how to manage your money. With a sound knowledge of the issues as discussed in our claimable loans booklet seize every legitimate opportunity to repay non deductible debt.

## **Capitalised Interest Doubters**

For readers who still worry that capitalised interest is not deductible here is another twist on the cases covering this issue. Part IVA, our anti tax avoidance scheme legislation operates on a premise that you have artificially created a tax deduction. You see Part IVA cannot apply unless a tax advantage has been achieved. So for the final Hart's case to be decided on the basis that Part IVA disallowed the deduction for capitalised interest means that if capitalised interest comes about in a way other than a scheme to reduce tax it will be deductible. That is exactly what they have to be saying for the court to have resorted to Part IVA.

This means you can still borrow to pay the rates, repairs, interest etc on your rental property and claim the interest on this new loan as a tax deduction as long as it is not a scheme to reduce tax.

## **ATO Claims Interest is NOT Deductible if Your Spouse Earns More Than You**

In PBR 61949 the ATO claims that the cost of a laptop, used to produce income, is tax deductible but the interest on the loan to buy it is not. The taxpayer's income was spasmodic and when he applied for a loan to purchase a computer to use in his business the finance company would only lend based on his wife's income and the loan had to be in her name. The loan repayments were made from their joint bank account. But the ATO decided, in its wisdom, that the interest was not deductible to the taxpayer because his income was irregular so at times it may have been his wife's income that made the interest repayments.

We do not give this ruling a snowball's chance in hell of standing up in the courts. But who wants to go there? Accordingly, you should make sure your name is also on any loan documents and it may be worthwhile arranging for the repayments on any equipment used in your business to come out of a bank account in your name only. Ideally income from the business should be used to make these repayments even if it means your spouse meets the private expenses of you both.

## **Loans in Joint Names**

Nothing seems to have come of Tabone's case. The one we warned you about where the court found that because the borrowings were in the name of both members of the couple and both contributed to the repayments then they were only entitled to claim half of the interest each. This was a big problem because the income producing property was only in the husband's name so the wife could not deduct her share of the interest. The case was decided on another angle so this is not a strong precedent just a comment from the courts. Nevertheless there is too much at stake with large property loans to get it wrong.

The very best option is to persuade the bank to have the loan documents in the name of the spouse who owns the investment with maybe the other spouse giving a guarantee. But if that is not possible at least organise a loan document between spouses where the non investor spouse lends their share of the loan the investor spouse at the same rate of interest that the bank is charging.

## Simple Rule for Borrowing

Interest is only deductible on a loan where the money borrowed was used to purchase an income producing asset. The people that this rule bothers the most are the ones that have paid off their home, want to buy a new one to live in and rent out the old one. Trouble is they get no tax deduction for interest because there is no loan where the money was used to buy the income producing property.

You may never think this will happen to you but times change job transfers happen and a bargain presents itself. The only way to make sure you are not caught is to never ever pay off any loan on any property. That is right, keep them all interest only and put the money you would have used to pay off principle into an offset account. Attach the offset account to the loan for whichever property you are living in at the time.

The only disadvantage of this strategy is that banks do not see the amount sitting in the offset account as equity which you can borrow against. This means that, in extreme cases of this strategy, the only equity you will have is the increase in the value of the properties. One of the advantages of investing in houses is the high lending ratio allows you to borrow the maximum and so have the maximum amount of money working for you. If you are interested in maximising your equity there will be a trade off in utilising the flexibility of an offset account.

## Business Owners Reducing Non Deductible Debt

Here is an interesting titbit for business owners that realise that with careful planning they could use some of their business liquidity to reduce the non deductible debt on their home. As discussed in earlier edition as long as it is not a scheme to reduce tax you can capitalise interest on borrowings for deductible purposes. This means if you have some spare cash in your business account you can use it to reduce your home loan. If at a later date the business needs the cash back you can draw it back off your home loan but as that draw is used for business purposes the future interest on that portion of the loan is tax deductible. The interesting titbit is a very old case Case F17 6 TBRD 1955 where the board held that even though the need for the business overdraft arose from the extravagant lifestyle of the business owner he was entitled to a deduction for the interest on the overdraft where it related to cheques drawn to pay business expenses.

Now remember if what you do is a scheme to avoid tax you cannot capitalise interest. I am not suggesting a particular course of conduct. I am just saying not to waste good cash sitting in the business bank account and don't forget if you draw money on your home loan to put into the business bank account for business expenses the interest on that portion of the loan will be deductible.

Note this gets a lot more complicated if the business is a trust or company as the money is not your money so you need to speak to your accountant about safe methods of withdrawing the money from the business and replacing it. Generally the arrangement won't work as well in companies or trusts.

## Redraws

A tax deduction is only allowable on the interest on a loan if the original borrowings were used to purchase an income producing asset or refinance the remaining balance of a loan that was originally used to purchase an income producing asset. As you pay off the original borrowings you reduce the interest you can claim. Redrawing on the loan will not increase the interest you can claim unless the funds redrawn are also used in relation to an income producing asset.

For example, assume you borrowed \$300,000 to buy a rental property. You sell your own home (which you did not owe anything on) and rent while building a new one. This means you have \$200,000 in spare cash while the building of your new home is in progress. To save a bit of interest on the \$300,000 rental property loan, which has a redraw facility, you pop the \$200,000 in there until you need it. Trouble is when you redraw the \$200,000 to make the progress payments on your home you are borrowing for private purposes. You have paid \$200,000 off the rental property loan and now only have \$100,000 of the original loan left. In the future the interest on that loan will only be 1/3<sup>rd</sup> tax deductible.

This problem is overcome by putting the spare funds in a separate account but offsetting that for against the rental property loan.

## How to Pay Your Home Off Sooner

Here is an example of just how knowing the latest tax laws can help you build your wealth through decreasing non deductible debt. Bare with the story it has some very exciting numbers in it. This is based on a recent ATO ruling PBR 69725.

Firstly you need to understand the difference between good debt and bad debt. At its worse bad debt is that wide screen TV or expensive to run car that is not generating you any income. The debt on your home, while being part of a very worthwhile investment is also bad debt because it is not tax deductible. For example if you are earning over \$75,000 a year you will have to earn at least \$1.71 to pay your tax and then have \$1 left to pay the interest on your home mortgage. On the other hand if the interest you are paying relates to a loan for investments you receive a tax deduction for it so you only have to earn \$1 to pay \$1 in interest. I think you can already see the benefits of getting rid of non deductible debt.

Here is my dream situation.

Mum and Dad own a home worth \$560,000 on which they still owe \$150,000. Even at an 80% lend, so mortgage insurance does not apply, they have another \$250,000 available that they can borrow. So they go to the bank and arrange a line of credit for \$250,000 that is completely separate from their home loan but secured by the same property. They decide to invest \$200,000 into a managed fund from which they expect a return of 4% in fully franked dividends and conservatively estimate capital growth to be 5%.

Mum and Dad have a good income of over \$80,000 a year each but they have a lifestyle to match. This is why they chose to only invest \$200,000, it gives them further available credit of \$50,000 should they not be able to afford the interest repayments on the investment loan.

Having read Noel's book Making Money Made Simple they can see the advantage of compounding their investment return so they advise their financial planner to organise for the dividends to be reinvested. Further, in accordance with Noel's advice they arrange with the bank that the term of the loan, originally used to purchase their home be paid off over 10 years. Now if they paid their home off over 30 years at 7.5% it would cost them \$1,049 per month. Over 10 years the repayments are \$1,781 per month so they need to find another \$732 per month. But let's see what this \$200,000 investment can do for them.

Now to the affect the \$200,000 borrowing has on their tax refund. If the first year they will have a deduction for \$15,000 in interest with \$8,000 in dividends and \$3,429 in franking credits this gives them a tax loss of  $\$3,571 \times 41.5\% = \$1,482$  refund but wait there is more they also get the franking credits back  $\$1,482 \text{ plus } \$3,429 = \$4,911 / 12 = \$409$  per month. By applying to the ATO to have the tax instalments in their wages reduced to give them the tax benefit of their refund cheque during the year they already have an extra \$409 per month towards their \$732.

Now the trick here is they do not pay any interest off the \$200,000 investment loan. There is nothing wrong with this PBR 69725 says you don't have to use your private funds to pay for an investment loan and the dividends are being reinvested so there are no investment funds available to pay the interest. The interest is then capitalised and, assuming, for simplicity, they pay their interest annually next year they will be charged interest on \$215,000 all of which will be tax deductible. So in year two their tax return will include interest of \$16,125. Now as the dividend has been reinvested and we are expecting 5% capital growth the dividend received in year two is \$8,720 with franking credits of \$3,737. This will give them a refund of \$5,259 or \$438.25 per month. By year 10 the tax refund is exceeding the \$732 per month in extra repayments but even at the start they only had to take an extra \$323 per month out of their household budget. The tax office is contributing more than they are.

So what have they got at the end of the 10 years. They have paid off all their non deductible debt ie paid off their house in  $1/3^{\text{rd}}$  of the time, 10 years rather than 30 years for only a small increase in the repayments. They now have an investment portfolio worth \$434,379 yet the investment line of credit has only increased to \$390,279 so they could sell off the portfolio and have \$44,100 which would cover the capital gains tax if they want to take that road. But a much better path would be to continue with the investment and salary sacrifice the money they had been paying off their house into superannuation so they could pay out the debt when they retire. By saving to repay the loan in superannuation they are saving at a tax rate of 15% while still getting a deduction on the loan at 41.5%.

I must point out at this stage that PBR 69725 is a private ruling so you cannot technically enforce it against the ATO. It is only published to give taxpayers an idea of what the ATO is currently thinking. If you want to be confident you should apply for a ruling of your own quoting PBR 69725.

It is important that these loans are independent of each other, no linked or split facility and that they are not organised through a lender who promotes the tax benefits of such loans.

## Capitalised Interest

The ATO have been very busy lately in issuing rulings on capitalised interest. Usually when the ATO issue a ruling they will not be drawn into the question of whether the arrangement will be caught by Part IVA, the section designed to catch schemes with a dominant purpose of a tax benefit. Fortunately, these rulings specifically ask the Part IVA question so it was, in some cases, answered. This point is very relevant for capitalised interest questions because the only time the ATO has been successful in stopping a taxpayer claiming capitalised interest was when the ATO argued the dominant purpose was a tax benefit (Hart's case 2004).

A Brief Summary of the Rulings:

**PBR 80938** – the big issue here is that the ATO said Part IVA applied to deny the deduction for capitalised interest when there was an arrangement with a separate bank from those providing the loans for the investments. This bank “b” provided three lines of credit with a floating cap. One to buy the family home and one to cover interest on interest on the investment loans, that was payable because the investment income was less than the interest and associated expenses. The trap here was that the ATO argued that because of the floating cap the borrowing had an arrangement similar to that in Hart's case so Part IVA applied. That is there was an agreement with the bank that providing the home loan was reduced the loan for the investments could be increased. Really the only point to take from this PBR is don't use a floating cap when personal debt is involved. And I would dearly love a person in business to write in for a ruling on the fact that their business overdraft is secured by their home on a floating cap arrangement. If the ATO tried to apply the same principles to that loan then most small businesses with an overdraft have a record keeping nightmare on their hands.

The ATO's argument could be summarised that the split loan with the floating cap has to be looked at as one loan and the repayments made have to be apportioned, on the basis of the balance outstanding, over all the splits. “The fact that the aggregate of the outstanding balances in the sub-accounts of the LOC facility cannot exceed the credit limit in substance reinforces the argument that there is, in reality only one loan”.

**PBR 79493** – The ruling is about one of those loans that do not require the borrower to make the full interest repayment in the first 5 years. Only a percentage of the interest is payable, the balance being capitalised into the loan. Each year the percentage of the interest, that is not payable, decreases until at the end of 5 years the full rate of interest is payable. The important point in the ruling is “Your investment loan is a distinct separate loan product. It has separate terms and conditions which refer to it solely. Your investment loan is not linked in any way to another loan”. Also the taxpayers had the argument that the arrangement was entered into so that they had more cash flow available to enter into other property investments. The ATO concluded that the dominant purpose of the arrangement was cash flow not a tax benefit, so was not caught by Part IVA.

**PBR 76986 and 76985** – Accepts that interest on money borrowed to pay rental property expenses such as rates, repairs and insurance is deductible. The alarming bit here is that the ATO refused to give a ruling on whether Part IVA applied. The two PBRs appear to have been submitted by the same person with two different scenarios to work out just how far they could push the issue. The ATO asked for more information before they would answer re Part IVA but there was no practical way the taxpayer could answer the questions the ATO asked so they then used this as an excuse not to rule! It is this sort of behaviour by the ATO that plays right into tax scheme promoters hands as they come up with reasons why they have not got an ATO ruling on their arrangement.

**PBR 69725** – Don't get too bogged down by the negatives in these rulings we still have PBR 69725 where the ATO allowed a claim for capitalised interest because the taxpayer did not want to use personal wages to prop up the investment. In this ruling they also agreed that Part IVA did not apply.

Remember that PBRs are only binding on the ATO by the person who applied for the ruling.

## Shifting Non Deductible Debt to Business Debt

PBR 79002 is about borrowing to pay business expenses including the purchase of trading stock and using the income of the business to pay off non deductible debt. Seems a bit cheeky but it is perfectly

legitimate. Mind you a PBR is only binding on the ATO for the benefit of the person who applied for the ruling so if you are at all concerned you should apply for your own.

The key is being able to cover the arrangement as not being a scheme with the dominant purposes of a tax benefit. Nevertheless, it is not for the ATO to tell you how to run your business.

In the situation described in the ruling the taxpayer opened a separate bank account into which the business income was deposited. From this account the private home loan was repaid, some business expenses were paid and the interest on the line of credit used to pay the balance of the business expenses was paid. The ruling found that as the taxpayer was a sole trader he or she was not precluded from using the business income to repay private debt.

The ruling found that there was not a dominant purpose of a tax benefit in the arrangement because there was no tax benefit! In fact it was simply a finance option available to business. This finding was further supported by the fact the taxpayer intended paying off the home loan in 3 to 4 months and then working towards persuading the bank to accept the business as security on the loan for the business expenses, arguing that the dominant purpose of the arrangement was asset protection ie the family home. An argument the ATO accepted.

## Capitalising Interest

**PBR 79460 and PBR 79803** – In these rulings the taxpayer had a principle and interest loan with an offset account for their home and two loans for their investment property, one interest only and the other was a line of credit. The interest only investment loan was secured by the rental property. The line of credit was secured by the taxpayer's home but all three loans were distinctly different loans with the same bank. The line of credit was used to pay the interest on the interest only investment loan and all rental property expenses such as rates and insurance. The rent was deposited into this line of credit.

This simple and tidy arrangement was accepted by the ATO as capitalising interest without the dominant purpose of a tax benefit. The taxpayer proposed that they redirect the rent into the offset account which offset their home loan. Though the taxpayer intended to make the interest payments on the line of credit so it was only the interest on the other investment loan that was compounding. To quote the ruling:

“In summary, you wish to deduct the compounding interest on the investment LOC against the income the rental property has produced. You will not pay anything toward the investment LOC (over and above the monthly interest) until after the loan relating to your home is repaid in full”.

The ATO in both rulings said that technically the interest was deductible but would not rule on whether Part IVA would prevent the taxpayer claiming the deduction because the dominant purpose of the arrangement was a tax benefit.

The ATO quoted the 2001 Hart's case.

”The incurring of compound interest depends upon a decision not to pay simple interest as it falls due. Sometimes such a decision will be compelled by impecuniosity. That case can be left aside. Take a case where a private individual has the means to pay simple interest as it falls due on an investment loan, but chooses to purchase an object of art instead. It is not clear beyond argument that interest upon interest would be deductible as being incurred for the purpose of gaining or producing assessable income in those circumstances.”

My dictionary describes impecunious as poor, penniless. So it would seem that when Gyles, in Hart's 2001 case said it can be left aside I assume he was saying if you can't afford the repayment then capitalised interest will be deductible. So what if you arrange for the loan on your own home to be principle and interest over 10 years or less and the only way you can afford the repayments is to use the rental income as well? Then is the arrangement not caught by Part IVA as having the dominant purpose of a tax benefit?

## Draft ATO Ruling on Capitalising Interest

The ATO has issued a draft ruling TD 2008/D12 on the compounding of interest on a deductible loan. In short the draft ruling tries to argue that relying on Hill J's and Hely J's exact words in their summing up statements in the 2002 Harts case (which by the way were identical) – “The compound interest like the ordinary interest will take its character from the use to which the original funds borrowed are put” – is incorrect and that more attention should be given to discussions earlier in the case about the purpose and use

of the expenditure. Despite the fact that in this discussion Hill J states that “it is unnecessary in the normal case to distinguish between the two tests”.

It seems to us that the ATO is unnecessarily complicating the issue to create uncertainty so that more conservative taxpayers will be too scared to claim capitalised interest. The summing up statement by the judges seems to be intended to simplify the application of the purpose and use test when applying it to capitalised interest and should be treated as such. For the ATO to claim that a literal reading of this judgement is incorrect is in my opinion an attempt by the ATO to change the words clearly spoken by three judges of the Full Federal Court and they have no right to do this.

We have expressed this opinion together with a plea to not over complicate the issue when the government claims to be concerned with tax simplification. Readers interested in this topic might also like to voice their objection. The deadline is the 3<sup>rd</sup> October, 2008. Comments on this ruling can be sent to [briony.andrew@ato.gov.au](mailto:briony.andrew@ato.gov.au)

Please note you cannot claim capitalised (compounded) interest as a tax deduction if the dominant purpose in doing so was a tax benefit.

## **Claiming Interest on an Unrelated Loan**

PBR 84855 puts a new angle on when interest on a particular loan is deductible PBRs come from ruling applications so can only be enforced on the ATO by the person who applied for the ruling. The taxpayer sold Property X which was purchased with Loan A and used the sale proceeds to pay off Loan B which was used to purchase Property Y. The ATO accepted that the interest on Loan A was now deductible against the rent earned on Property Y. The reasoning in the ruling was - “It is accepted that the ‘use’ or objective purpose of loan A will then be attributed to property Y. Property Y is an income earning rental property and accordingly, you are entitled to a deduction for the interest expense on loan A.”

This is excellent news if you don’t want to pay off a loan fixed at a low interest rate or if you paid the wrong loan off by mistake. But make sure you apply for your own ruling before relying on this.

Readers who have purchased a new home and are renting out their new home may want to know why they can’t claim the interest on their new home because, after all, the loan enabled them to keep their old home as a rental property. All I can say is fair question but I’m sure the ATO will say no way.

## **Using the Rent to Pay Off Your Home**

For those of you that think Accountants lead a boring life let me dispel this myth once and for all. I have spent a couple of days amusing myself immensely by asking the ATO a very pertinent question. Gives you the same sort of thrill as rattling a dog’s chain, standing back and watching them try to sound like they know what the hell is going on.

My question seemed simple enough. If you use the rent from your investment property to pay off your own home, in the meantime capitalising interest on the rental property, will the ATO consider your dominant purpose to be a tax benefit? The counter argument being that the dominant purpose was simply to pay off your own home sooner which is the logical approach for any home owner. One of the main goals in your working life is to get your home paid off. Why should the ATO attack such an action?

I started by sending them an article I wrote for Australian Property Investor magazine’s February edition and asked them for a comment. The response was that they don’t provide comments on hypothetical’s or opinions. So I then submitted a reader’s question on the issue. The response this time was that they don’t answer questions about specific situations and I should apply for a ruling. No I don’t know what type of questions they do answer, but they certainly didn’t want to answer mine. When I said the ruling process would take too long and that my experience was that rulings always took much longer than the 28 days specified in legislation, they suggested I ring the tax agent advisers section of the ATO. I did and spoke to Brian. He told me he couldn’t answer and that I needed to apply for a ruling. I asked would I be entitled to as the reader would not want to be identified. He said that should not be a problem. Well it was and my ruling application was rejected for that very reason.

Needless to say they don’t want to come out and say it, if they thought they could give a negative answer they would have been right back. I don’t give up that easy, that was just the fun bit, now I’ll get serious stay tuned.

## **Capitalising Interest – Comment**

Just by way of a comment PBR 84855 further verified capitalised interest is deductible by stating: 'Further, interest on a new loan used to repay an existing loan, or pay the interest expense incurred on an existing loan of this type will generally also be deductible as the character of the new loan is derived from the original borrowing.

### **Draft Ruling on Capitalised Interest Finalised**

TD 2008/D12 has been finalised as TD 2008/27. The ruling can be summed up as saying “the principles governing the deductibility of compound interest are the same as those governing the deductibility of ordinary interest”. That is about all the ruling says the real areas of interest are in the Appendix and Compendium of Comments on submissions made about the draft.

The Appendix, in paragraphs 11 and 12, states that the test to be applied is the question of the purpose of the borrowing and the use to which the funds are put. It can be summed up as saying, in the normal case, the use to which the borrowed funds are put is enough, no need to look at the purpose of the borrowing and that in the normal case of compound interest the new interest takes on the same use as that applying to the original borrowings. It then goes on to say that the ruling does not include a consideration as to how the anti avoidance provisions of Part IVA could be applied.

Of particular reassurance to my concerns is item 8 in the Compendium which states that the objective of the ruling is to clarify that the principles of deductibility apply in the same way whether the interest be ordinary interest or compounded interest and to reject a view that was forming that as a result of the 2002 Hart’s case compounded interest was in some way more deductible than ordinary interest. Considering these comments I will now get off my soap box, refer Newsflash 175. Looks like its business as usual.

### **Borrowing Costs When Loan Not Approved**

TD 93/48 states that the costs you may incur in trying to obtain finance for a rental property are not tax deductible as borrowing costs if the loan is not approved, because they are not a cost of incurring income. Though there is ample argument in the CGT section of the 1997 ITAA to include them in your cost base under section 110-25(4) ownership costs or 110-35(9) borrowing costs or 110-35(2) if they are for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser. Maybe even under 110-25(2) regarding money paid in respect or acquiring the property. Of course they can’t be included in the cost base if you don’t end up buying the property.

### **Using Rent Income to Pay Off Your Home Sooner**

We have recently received a ruling from the ATO confirming that, in appropriate circumstances it is ok to use the rent you receive to pay off your non deductible debt while capitalising interest on the rental property loan and interest on that capitalised interest will also be tax deductible. In the particular circumstances of our ruling it reduced term of the clients private home loan to less than 7 years.

Now if the dominant purpose of your arrangement is to gain a tax benefit then the ATO can apply Part IVA to deny you a deduction for the capitalised interest. This approach stems from Hart’s case in 2004 where the ATO proved that the taxpayers’ dominant purpose in capitalising their interest was a tax benefit because they used a linked loan that was promoted by the banks for its tax benefits.

In our ruling we were successful in arguing that the dominant purpose was to pay off their home loan sooner and the tax benefit was incidental. We also showed that the property would eventually become positively geared.

Our approach was that the client was going to use the rent and other income to pay down the mortgage on her own home capitalising the interest payments on the rental properties in another line of credit. Our question was, as she was going to do this anyway it was just a matter of whether the ATO required her to apportion the interest between deductible and non deductible on the new line of credit and if so on what basis. Of course it is well settled that capitalised interest takes on the nature of the original interest so they could not say it had to be apportioned and they could not say that endeavouring to pay down your home as soon as possible had a dominant purpose of a tax benefit because every home owner tries to pay their home off as quickly as possible.

If you have been using rent to pay off your own home, possibly due to financial difficulties or any other reason that is not solely or dominantly to gain a tax benefit you might also like to apply for a ruling to make sure that the ATO can't come along later and apply Part IVA. The ruling response we received was a private binding ruling so can only be relied upon by the person who applied for it.

On the property investors page of our web site is a checklist and more information on this issue. If you have been using the rent to pay off private borrowings and are concerned we can prepare your own private ruling application for \$350.

## **Interest Not Deductible On Loan To Purchase Options**

ID 2009/71 goes to the heart of many employee share ownership incentives. In ID 2009/71 the ATO ruled that the interest on money borrowed by an employee to purchase options for shares in his employer was not deductible.

An option typically only entitles you to purchase shares. Interest is only deductible if the borrowed money was put to some income producing use. The options themselves will not produce income. Income is only likely to come into the arrangement if the options are exercised and the shares acquired as a result, produce dividends. This is too far removed from the purpose of the borrowings.

If the option is exercised then the interest expense, and for that matter to price of the option can be included in the cost base of the share. But note the interest expense cannot go so far as to create a capital loss.

## **Interest Apportionment Calculator**

If you have both undeductible and deductible components combined in the one loan it can be a massive job to work out what portion of the interest is tax deductible if there have been draw downs during the year. To speed up this process we have created a calculator that helps you estimate the portion of interest you can claim. It is a simple excel worksheet which you can download for \$9.95.

## **Tax Schemes and Part IVA**

The following puts the ATO's scare tactics back in perspective. In nearly every PBR they issue they refuse to consider whether Part IVA could apply and whenever they don't like an arrangement they threaten Part IVA. Yet, in the explanatory memorandum to the introduction of Part IVA Callian J stated, that the provisions of Part IVA are directed against tax avoidance arrangements that are blatant, artificial or contrived.

## **Deducting Penalty Interest**

There has been quite a bit of confusion as to whether the penalty interest that a bank charges you for breaking a fixed interest loan is deductible or not. To add to this confusion the ATO ruling on the topic is outdated yet the ATO is still treating it as current. If you find the following tough going don't feel embarrassed, it is tough going. Don't give up, at the end I give three examples that should cover most scenarios so hang in there you will get a clear answer to your situation.

The offending ruling is TR93/7, it was released in 1993 and discusses sections of the Income Tax Assessment Act (ITAA) which were replaced with the 1997 ITAA and even the 1997 Act was amended on 6<sup>th</sup> April, 2006. This means that the section numbers referred to throughout the ruling are no longer correct but for the most part still mean the same thing. Except when it comes to the discussion on what can be included in the Capital Gains Tax (CGT) cost base of an asset, this part is so out of date it is now incorrect.

TR 93/7 states that penalty interest costs are not interest for the purposes of income tax. It is not a payment for the use of someone else's money it is a payment to break a contract possibly to avoid future interest charges but certainly not itself in the form of interest. If the penalty interest is incurred to reduce future interest such as refinancing at a lower rate or paying the loan off early, if the interest was deductible then the cost of the penalty interest will also be a deductible expense in the financial year incurred. Note even if you need to borrow the penalty interest it is still fully deductible in the year incurred and you will be entitled to a deduction for the interest on the money borrowed to pay the penalty interest, providing the property is still used for income producing purposes.

The above would not apply if you are paying out the loan early as a result of selling the property. In this case it would be a capital cost but the penalty interest would still be fully deductible under section 25-30 of the 1997 ITAA (section 67A of the 1936 ITAA) as a mortgage discharge cost to the extent that the borrowed money has been used to produce income. Loan discharge fees and deferred settlement fees can also be fully deducted in the year incurred, under section 25-30 again providing the borrowed money had an income producing purpose.

Most circumstances will be covered by the two scenarios above. But neither of these can apply when the borrowed money has not been used to produce income, for example a holiday home or a house you are living in but don't want to use your CGT main residence exemption on. In these circumstances you are looking to include the penalty interest in the cost base when calculating the CGT.

Now back in the days when TR 93/7 was written the cost base for CGT purposes could only be made up of capital items specifically listed in the legislation. These items included borrowing costs (not otherwise deducted) listed in section 135 of the 1997 ITAA. But the ATO argues in TR 93/7 that borrowing costs can only include costs to bring a loan into existence not to bring it to an end.

In TR 93/7 the ATO claimed that none of the other elements of a cost base fitted the description of penalty interest. The way the CGT cost base legislation is structured it would have to be specifically described in the act to be included unless it falls within section 110-25(4), the third element of the cost base. The list in this section is simply by way of example so does not limited that section to just the items listed. Back when TR 93/7 was written the third element of the cost base could only include the non capital costs of ownership. Accordingly TR 93/7 argues that the penalty interest is capital in nature so cannot be included in this section. On 6<sup>th</sup> April, 2006 changes were made to the third element of the cost base, the words "non capital costs of ownership" were replaced with "costs of ownership". The list of non capital costs such as interest, rates, insurance etc continued in the section but are only examples of non capital costs. It is now recognized that ownership costs go wider than this, to obviously include capital costs. TR 93/7 states that "the payment would not be included in the cost base of the asset .... as it ....is not a non-capital cost". So the change in the legislation from the use of the words non-capital costs to costs of ownership should, in my opinion, open the gates to include the penalty interest in your cost base for CGT purposes, if it does not qualify elsewhere as an expense.

Nevertheless, due to the 50% CGT discount, in most cases, a CGT cost is only worth half of a normal expense. So if your intention is to sell a property and you are facing large break costs it maybe worth refinancing to a variable loan before you sell. Then you can be sure the costs will be fully deductible because the property is rented at the time. If you tenants move out before you sell then the deduction for mortgage discharge costs under section 25-30 will be reduced because the loan was not fully used to produce income ie towards the end the loan maintained a property held only to be sold rather than re let.

## **Examples**

Breaking the loan to sell the property but it has not been income producing:

The penalty interest is included in the cost base under the third element but note this element can only reduce a capital gain not increase a capital loss.

Breaking the loan to sell a rental property:

This is a capital cost but section 25-30 of the 1997 ITAA allows mortgage discharge costs such as penalty interest to be claimed as an outright deduction in the year incurred providing the money borrowed has been used to produce income.

Breaking the loan for a rental property to refinance at a lower interest rate or pay off:

As this action will reduce future interest payments the penalty interest costs are simply a cost of reducing future interest expenses which means it will be a fully deductible expense in the year incurred.

## **How Capitalising Interest Sees the Year Out**

The ATO has requested another 3 months to consider how they will treat arrangements where borrowings are made from a line of credit to make the interest payments on investment property loans while

the rent is used to pay off private debt. The ATO's last objection was not with the rent being used to pay off private debt but the fact that the line of credit and the private debt were secured by the same property, ie the family home. They argued that the loans were linked because they share the same security. There seems very little point in trying to speed up the process at this time of year so we will wait the 3 months hoping to get a conclusion early in the new year. Though, if they ask for a further extension, after that, it maybe quicker to just push the matter into the courts. An option the ATO may want to avoid because it will draw more publicity to the issue, so stay tuned!

In the meantime if you are buying a rental property and want to leave your options open to borrow the interest payments on the rental property loan you should bear this in mind when you set up the loans at the time of purchase. Of course you can't enter into the arrangement with the dominant purpose of a tax benefit. But if you may one day enter into a budgeting strategy that maximises keeping every cent possible offset against your home loan for as long as possible, to reduce interest, then you need to make sure that the line of credit from which you will borrow the interest on the rental property can be secured elsewhere other than your home. This is where it is important to keep your options open at the time of purchasing a rental property, to maximise the equity available in it to secure the line of credit. For example you would use up all the equity in your own home as security on a loan for the deposit for the rental property. This will be such a large deposit that the rest of the borrowings for that purchase can be secured against the rental property and still leave equity in the rental property available to secure the line of credit if and when necessary.

## **Arrangements to Increase Debt on a Property**

The idea is that the ratio of ownership on a rental property changes between spouses with one spouse borrowing to buy more of the property off the other spouse. If there is equity in the property then the selling spouse only needs to pay down the portion of the debt that represents the portion of the house sold which leaves some of the proceeds to reduce non deductible debt. The buying spouse borrows a portion of the current market value so effectively some of the equity gained in the property is released. We are not saying this arrangement is not acceptable to the ATO, to the contrary in ID 2001/79 they accepted such an arrangement but this ID is not enough to protect you as discussed below. If you want to be sure that this arrangement will work for you, you should get an ATO ruling. The primary argument of your ruling request is that you did not enter into the arrangement with the dominant purpose of a tax benefit. Fundamental to your argument is a valid alternative dominant purpose. If you don't have this then the ATO can use Part IVA to ignore the new loan and revert to the situation had the transaction not been entered into. Considering the stamp duty and refinancing cost it is worth making sure the ATO will allow the interest as a deduction first, by getting a ruling on your dominant purpose for the arrangement.

In Hart's case 2004 the ATO won their argument that Part IVA applied by simply producing the bank advertising material promoting the tax benefits of the arrangement. So if your financier offers you a product to achieve this don't touch it because it shows you were motivated by the tax benefit.

In ID 2001/79 a taxpayer was allowed a deduction for money borrowed to buy out his or her spouse's share of a rental property. The trouble is this is only an ID so at best only protects anyone who relies on it in good faith from penalty interest, the ATO will still amend the tax returns and charge the tax. The second problem with this ID is it does not address the issue of whether the ATO would apply Part IVA. In short this ID should only be used as a reference in a ruling application rather than relying on it.

If you go ahead with this arrangement make sure that there truly is a transfer of ownership and that the borrowed funds go directly from this new loan into the individual bank account of the selling spouse, upon settlement. It is important that there is a clear audit trail showing the money being used to purchase an income producing asset and that this is not mixed with private funds.

## **Capitalising Interest in a SMSF**

Generally a SMSF can only borrow against an asset once. This means a SMSF lacks leverage because it is very difficult to borrow against the increased value of the asset.

The recent changes to the SMSF borrowing laws has left a small window of opportunity here. Section 67A(1) of the SIS Act allows for the original borrowings on the property to be refinanced but then in an attempt to limit exploitation of this provision it states:

(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section [67B](#)) in relation to the single acquirable asset (and no other acquirable asset); and

This means that you could stop paying the interest on the loan, if the bank would let you, and save the cash for a deposit on another property, then refinance the original loan and the unpaid interest.

## Capitalised Interest Update – A Draft Ruling Issued

On the 29<sup>th</sup> June the ATO issued a draft ruling, TD 2011/D8 on arrangements where interest is capitalised on a rental property loan while the rent is used to reduce the principle on the non deductible debt on the private home.

This ruling may come as a shock for some investors who have paid many thousands of dollars to finance brokers and property spruikers for such an arrangement. It certainly makes us feel a lot better about our conservative, get a private ruling approach.

This ruling is only a draft and there will be many submissions by the profession because it goes way too far and ignores established case law. Nevertheless, it makes some very reasonable points.

Firstly a bit of background information. Capitalised interest is only deductible if it is not part of a scheme with the dominant purpose of a tax benefit (Part IVA). There have been a few private rulings allowed by the ATO where taxpayers were successful in arguing their dominant purpose was simply to pay their home off sooner or that they should not be required to use private funds to prop up an investment.

The draft ruling specifically and exclusively covers the argument that the dominant purpose was simply to pay their home off sooner. Of particular interest is a point that surprisingly has not been used before by the ATO. That, if the overall debt of the taxpayer remains the same then they are not really achieving their desired result. Of course the overall debt doesn't remain the same, it should reduce by that nice fat tax refund cheque but we are not too sure whether that is a good line to argue, considering we are saying the dominant purpose is not a tax benefit.

The ruling does go too far in implying that you must use your wages etc to prop up your investment possibly leading to borrowing for private expenses instead. It also claims to apply retrospectively which is unreasonable considering the number of rulings and case law it contradicts. Accordingly, we do not expect to see the final ruling taking this form and are aware of many submissions that will be made against it. In the seminar section of our web site there is an area for follow up material. Our submission against the draft will, once completed be posted there. If you would also like to make a submission against this draft you can find the arguments we consider relevant by visiting our site shortly. Submissions will need to be made by the 29<sup>th</sup> July, 2011 to [ruth.geary@ato.gov.au](mailto:ruth.geary@ato.gov.au)

So where to now? Don't let this prevent you from applying for a ruling if you feel you have another suitable argument that is not based on paying your home off sooner. Examples may be that you have high home loan repayments (the term of your home loan maybe 10 years) and didn't get the pay increase you expected or spouse has to take time off work etc. So cannot afford to meet all your commitments and need to use the rent for private purposes just to get by. There are many precedents that mean the ATO would loath to try to tell you how you should manage your money.

Here are the basics on when capitalised interest is allowed that we learned from the Harts cases.

- 1) Capitalised interest takes on the nature or the original borrowings – if the interest on the original loan is deductible then you can claim interest on borrowings to pay the original interest
- 2) If you can't afford to make an interest repayment and have to borrow it (ie allow the loan balance to increase because you have available credit) then interest on that borrowing is tax deductible
- 3) If you enter into an arrangement to capitalize interest with the dominant purpose of achieving a tax benefit then the interest on the interest is not tax deductible because it is caught by Part IVA a scheme with the dominant purpose of a tax benefit. In Harts case the ATO simply had to produce bank advertising material saying there was a tax benefit in the loan.

Note PBRs are private binding rulings so cannot be enforced upon the ATO by anyone other than the rulee, nevertheless here are some interesting ATO responses:

PBR 69725 – An investment in shares where the taxpayer said he or she did not want to use other wages income to prop up the cash shortfall in the investment. They ATO said they could borrow the shortfall instead and that interest on interest would be deductible. No mention was made of the use to which the

dividends were put. If the ATO thought they could require the taxpayer to use the dividend to pay off the loan or interest then it certainly would have. There are many case precedents where the ATO has not been allowed to tell a person how they should manage their affairs.

PBR 81797 – Accepted dominant purpose was not a tax benefit but simply quarantining a rental property expenses, so Part IVA did not apply.

PBR 94265 - ATO accepted that the dominant purpose was to own their home sooner, not a tax benefit, so Part IVA did not apply

PBR 1011345133229 – ATO considers the arrangement is caught by Part IVA because just like Hart’s case the loans are linked. The ATO claims the loans are linked because they share the same security.

Based on the above if you do have another dominant reason other than the tax benefit or owning your own home sooner you should apply for a ruling and take care that you LOC where the interest is capitalized is not secured, against the private home. This can be achieved by using all the equity in the home as a deposit for a rental property and then having spare equity in the rental property to secure the LOC where interest is capitalized and rental expenses are paid. It is best to keep this LOC separate from the loan to actually buy the rental property just in case everything goes pear shaped, at least you have not tarnished the loan where interest is clearly deductible. Also make sure you don’t enter into your arrangement with a lender that is promoting the tax benefits or that it is a way to own your home sooner.

## **Capitalising Interest – Our Submission**

Our submission to TD 2011/D8 is now on the web site in the seminars section where notes and follow up material is sometimes posted from our seminars. If you have any interest in this topic at all please have a read and consider making your own submission on any points that may apply to you.

## **Reverse Mortgages**

These can be a great retirement tool if you live too long. The idea is that the bank lends you money secured by your home. You do not have to make any repayments on the loan and the bank cannot take your house until you die. Of course the power of compounding interest is working in reverse getting you more rapidly in debt each year. But if the banks can’t sell the house out from under you, what does it matter. For reason that I can’t quite comprehend people seem to worry about leaving something to their children. If you use this strategy as a backup, in case you live longer than you anticipated, then your children will already have retired and have accumulated enough assets in their working life. If they haven’t by then, they are probably only going to waste yours.

. Terms vary from bank to bank but you are unlikely to ever be able to borrow more than 45% of the valuation and then probably not until you are 85 years old. At 65 years of age you are only likely to be able to borrow 20% to 25% of the valuation depending on your lender.

## **Capitalising Interest Rulings**

We still encourage you to apply for a ruling if you are going to systematically capitalise interest while making more than the required repayments on your own home. Though if you can wait until the ATO finalise TD 2011/D8 we might have a clearer view of what is acceptable with the ATO.

It maybe that a ruling application made by an individual has a greater chance of success than one lodged by a professional. The ATO may be less worried about the floodgates opening.

We have set up a page on our web site to provide you with the guidance you need to make your own application. Our offices are more than happy to review your application or provide advice.

The web page can be accessed from the menu on the property investors’ page.

What you need to argue is that your dominant purpose for capitalising the interest on your rental property is not a tax benefit. The main point in TD 2011/D8 was that it may not necessarily be a good enough excuse that you were motivated by wanting to pay off your home sooner. Other reasons you may have are financial necessity or the accounts are set up that way for ease of record keeping. Even laziness, you don’t want to go checking your account balance all the time.

# Saving Tax on Your Investment Property – The Book

“Every investment property tax-related question you’ve ever wondered about is answered here and – perhaps more importantly – the ones you didn’t think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion.” Eynas Brodie, Editor, Australian Property Investor magazine.

Combining Noel Whittaker’s easy reading style with Julia Hartman’s mind numbing attention to detail was a major challenge but made it to the book stores. You can also purchase it online by going to: [bantacs.com.au/book\\_savingTax.php](http://bantacs.com.au/book_savingTax.php). The cost is \$29.95 plus \$5.95 postage – tax deductible of course!

## Ask BAN TACS

For \$59.95 at [Ask BAN TACS](http://bantacs.com.au/askban_tacs) you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion.

## Back Issues & Booklets

To obtain free back issues of the fortnightly BAN TACS Newsflash or any of the following booklets visit our web site at [www.bantacs.com.au/freebies.php](http://www.bantacs.com.au/freebies.php). You can also [subscribe to our Newsflash reminder](#).

*Alienation of Personal Services Income*

*Claim Your Trip Around Australia*

*Defence Forces [Military]*

*How Not To Be A Developer*

*Fringe Benefits Tax*

*Goods and Services Tax*

*Key Performance Indicators*

*Overseas Backpacker Fruit Pickers*

*Secret Plans and Clever Tricks*

*Self Managed Superannuation Funds*

*Buying a Business*

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*Death and Taxes*

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*Investors*

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*Real Estate Agent*

*Selling a Business*

*Subcontractors*

*Wage Earners*

*Capital Gains Tax*

*Claiming a Motor Vehicle*

*Division 35*

*FBT for PBIs*

*Miners*

*Professional Practices*

*Rental Properties*

*Small Business*

*Teachers*

*Year End Tax Strategies*

**Disclaimer:** Please note in many cases the legislation referred to above has only just passed through parliament. The full effect is not clear yet but it is already necessary to make you aware of the ramifications despite the limited commentary available. On the other side of the coin by the time you read this information it may be out of date. The information is presented in summary form and intended only to draw your attention to issues you should further discuss with your accountant. Please do not act on this information without further consultation. We disclaim any responsibility for actions taken on the above without further advice as to your particular circumstances.