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Ruling

Subject: Rental expenses - interest - Part IVA

Question 1

Are you entitled to deduct the interest expense on your line of credit facility and rental loan?

Answer: Yes.

Question 2

Will the provisions of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) apply to deny the deductions for the interest incurred on your line of credit facility and the rental loan?

Answer: Yes, Part IVA will apply to deny deduction for the "Additional Interest" component of the deductible interest incurred on the loans mentioned at 1 above (as identified below).

This ruling applies for the following period

Income year ending 30 June 2010

Income year ending 30 June 2011

Income year ending 30 June 2012

Income year ending 30 June 2013

The scheme commenced on

1 July 2009

Relevant facts

You own a property jointly with your spouse, which you use as your primary residence (your home).

You own a property jointly with your spouse, which you use as a rental property (your rental property).

The structure of your borrowings in respect of these properties is summarised as follows:

Home loan

- borrowing used in respect of funding the purchase of your home
- total term 30 years
- principal and interest repayment basis
- loan in joint names with your spouse
- security provided for this loan is your home

Rental loan

- borrowing used solely in respect of funding the purchase of your rental property
- total term 30 years
- interest only repayment basis for 5 years, then principal and interest for the remaining term of 25 years
- loan in joint names with your spouse
- security provided for this loan is your rental property

Line of credit (LOC)

- borrowing used solely in respect of deductible expenses incurred for your rental property, including interest on your rental loan, rates, insurance and repairs
- current outstanding balance comprises 20% of the purchase price of your rental property, associated purchase costs of that property (including stamp duty and conveyancing costs), in addition to any deductible expenses for that property incurred as above
- line of credit
- loan in joint names with your spouse
- security provided for this loan is your home

While your home provides security for both the home loan and LOC, there is no priority of security between these facilities.

There is no personal use of the LOC or rental loan.

All of your and your spouse's income (including rent from your rental property) is credited to a transaction account, the balance of which is an acceptable offset arrangement reducing interest on the outstanding balance of your home loan (your offset account).

The following amounts are debited from your offset account:

- private expenses as you and your spouse determine
- home loan minimum monthly repayment (according to your home loan agreement)
- additional home loan repayments may be debited as you and your spouse determine

LOC interest

There is surplus income remaining each month after the above expenses are paid, thereby increasing the offset account's balance each month.

The effect of the offset account is that an increasingly larger proportion of the home loan repayment is a repayment of principal, reducing the home loan principal at a faster rate.

There is no requirement to make principal repayments to the LOC where the facility's outstanding balance debt remains under the approved limit.

The LOC will reach its limit every few years. At this time you will apply to reduce the limit on your home loan (having paid off a part of its outstanding balance, such as from the offset account) and apply to have the limit correspondingly increased on your LOC. You anticipate your home loan will have reduced sufficiently at the time each adjustment is required.

You have forecast that your home loan will be paid off during a future year. Any additional income, including any windfall gains and bonuses, will be used to repay your home loan faster and the corresponding limit of the LOC will be able to increase accordingly. Your forecast envisages that you will commence repaying the rental loan balance during the relevant year (having paid only interest up to that point) and your rental loan and LOC will be repaid in full during a future year.

The rental loan is initially interest only for 5 years, however you intend to renew or extend the interest only terms until when you commence principal repayments to this loan (according to your forecast as detailed above).

The LOC is for an undefined period and is subject to periodic review. However you and your spouse intend to maintain and utilise the facility until it is repaid in full (according to your forecast as above).

While the LOC is a sub account under a split loan facility, this LOC is the only sub account under this facility and you request this ruling on the basis that you and your spouse will not establish any other sub account under this facility.

The LOC is included in a loyalty package, which provides discounts including to interest on loan balances and to account keeping fees on transaction accounts. A transaction account is included in this package, however it is a separate account that cannot have an outstanding balance due from you and not a sub account for borrowing under the LOC.

Each loan has separate terms and conditions which refer to each respective loan.

You have stated that you purchased the rental property with a 'buy and hold strategy for retirement and an income stream' and that you are working with the dominant aim to pay your home off as soon as possible.

Relevant legislative provisions

Income Tax Assessment Act 1997 Section 8-1.

Income Tax Assessment Act 1936 Section 177D.

Income Tax Assessment Act 1936 Section 177A.

Income Tax Assessment Act 1936 Section 177C.

Reasons for decision

Interest deduction

Section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) allows a deduction for any loss or outgoing that is incurred in gaining or producing assessable income to the extent that it is not of a private, capital or domestic nature.

Whether interest has been incurred in the course of producing assessable income generally depends on the use to which the borrowed funds have been put. Where a borrowing is used to acquire an income producing asset, or relates to expenses of an income producing activity, the interest on this borrowing is considered to be incurred in the course of gaining or producing assessable income: Taxation Ruling TR 2000/2.

Accordingly, you and your spouse are entitled to a deduction for the interest expense incurred on your rental loan and LOC and the availability of that deduction is subject to the operation of Part IVA of the ITAA 1936 (as discussed below).

Application of Part IVA

Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) is a general anti-avoidance provision that can apply in certain circumstances if a tax benefit is obtained in connection with a scheme, and it can be concluded that the scheme, or any part of it, was entered into for the dominant purpose of enabling a tax benefit to be obtained. Part IVA is a provision of last resort.

The application of Part IVA depends on the facts of the particular case.

In order for Part IVA to apply, the following questions must be addressed:

- Is there a scheme as defined by section 177A of the ITAA 1936?
- Is there a tax benefit which was obtained in connection with the scheme as defined by section 177C of the ITAA 1936?
- Is the scheme a scheme to which Part IVA applies, as determined by section 177D of the ITAA 1936, where it would be concluded that your main or dominant purpose of entering into the scheme was to obtain the tax benefit

Scheme

For Part IVA to apply, the identified scheme must fall within the following wide definition of 'scheme'.

The definition applies to any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and any scheme, plan, proposal, action, course of action or course of conduct (subsection 177A(1) of the ITAA 1936).

In the present case, there is a 'scheme' as defined in section 177A of the ITAA 1936, being the following arrangement:

- The entering into the LOC which is drawn against to meet deductible expenses, incurred by you and your spouse in relation to your rental property;
- Your home being provided as security for your home loan and the LOC and the total limits of the outstanding amounts of these facilities based on the value of your home (so that, in the arrangement to which this ruling relates, the home loan balance outstanding and limit must be reduced to allow the intended increases in the LOC balance outstanding and limit);
- The absence of any requirement that principal payments be made the LOC provided its approved limit is not exceeded;
- Choosing to direct all income to your offset account, thereby effecting a reduction in interest on your home loan and enabling an accelerated repayment of the principal of your home loan, whilst allowing the outstanding balance of the LOC to increase;

- Periodic reallocation of the security value of your home from your home loan to the LOC, which is made possible by the accelerated reduction of your home loan and affected by a reduction of the home loan approved limit (the amount of approved limit in excess of the outstanding home loan balance) and increasing the LOC approved limit.

Tax benefit

The identification of a tax benefit necessarily requires consideration of the income tax consequences, but for the operation of Part IVA, of an 'alternative hypothesis' or a 'counterfactual'. This is what would have happened or might reasonably be expected to have happened if the particular scheme had not been entered into or carried out. This alternative arrangement also forms the background against which the objective ascertainment of the dominant purpose of a person occurs in accordance with section 177D of the ITAA 1936.

The alternative postulate would involve the taxpayers making repayments to a single facility drawn for several purposes, and making further drawings from that facility for several purposes, with each payment first allocated to overall interest due on the balance of the facility and then rateably to the outstanding principal as used for each purpose: *Commissioner of Taxation v. Hart* [2004] HCA 26; 217 CLR 216; 206 ALR 207; 78 ALJR 875; 2004 ATC 4603.

The alternative postulate applies to the extent that the LOC limit is to be extended corresponding to accelerated payment reducing the balance of the home loan. This must be distinguished from increases in the LOC limit that flow only from standard credit foncier payment under the home loan according to its 30 year term.

The alternative postulate has similar implications whether taking account of the three loans which include the separate rental loan or only taking account of the LOC and the home loan, as the LOC bears all the deductible expenses incurred in relation to the rental property financed through the rental loan. Additionally, similar implications occur regardless of the offset account, as payment into this account has essentially the same effect as repayments being credited directly and immediately to the home loan.

Consequently (as the LOC facility has an undefined credit period) the tax benefit is calculated as the difference between the aggregate deductible interest that will be incurred on the LOC, rental loan and home loan and the aggregate deductible interest that would be incurred on the LOC, rental loan and home loan if you made payments rateably between the LOC and home loan in proportion to their then outstanding balances so far as payments exceed the standard credit foncier payments on the home loan according to its 30 year term (including the home loan which incurs non-deductible interest) of the aggregate of the repayments that you make towards any one of them over those standard home loan payments until the LOC facility is terminated; *Hart*. The excess of deductible interest over that arising were you to make payments rateably against all outstanding amounts in this way under the LOC, rental loan and home loan is the identified tax benefit and is the 'Additional Interest' amount in discussing the operation of Part IVA in *Hart*.

Notwithstanding the fact that the loan balances in the LOC and rental property loan relate to an income producing investment, there is an inextricable link between those loans and the home loan by virtue of the approved limits for the home loan and LOC as a whole and the home being provided as security for the home loan and LOC as a whole.

By allowing the borrowings in the LOC to increase with the payment of deductible rental property expenses while making extra payments reducing the balance in the home loan, you will be claiming gradually larger deductions each time interest is charged on the LOC, relatively increasing this deductible interest and will be recording a decreasing amount outstanding under the home loan and reducing the non-deductible interest due under that loan.

The approved limits of the home loan and LOC as a whole are determined by the security value of your home, with drawings and any payments being able to be allocated between these individual facilities at your convenience, providing the outstanding debt balance of the LOC does not exceed its approved limit. Your arrangement anticipates that the approved limit of the LOC may rise as the outstanding balance of the home loan is reduced by extra payments.

By reducing the outstanding debt in one loan, that is your home loan, this allows for the surplus security value attributed to your home loan to be reallocated to your LOC. This is effected by reducing the approved limit of the home loan and increasing the limit of your LOC, allowing the LOC to be available to be further drawn without any overall greater obligation under the home loan and LOC facilities as a whole and allows interest on the LOC to increase relative to interest on the home loan. In substance, the home loan and LOC facilities as a whole are operating as one account drawn for multiple or mixed purposes, so far as payments exceed those required by the standard credit foncier payments on the home loan according to its 30 year term.

Objective purpose test

Section 177D of the ITAA 1936 provides that Part IVA applies to a scheme in connection with which you have obtained a tax benefit if, after having regard to eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling you to obtain the tax benefit.

Section 177D of the ITAA 1936 refers to 'the purpose' of the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme. The person need not be you.

The objective test in paragraph 177D(b) of the ITAA 1936 is the core of Part IVA and has been described by the High Court as the 'pivot' or 'fulcrum' on which Part IVA turns. It is frequently referred to as the 'statutory predication test'.

The consideration of purpose or dominant purpose under paragraph 177D(b) of the ITAA 1936 requires an objective conclusion to be drawn. The conclusion required by section 177D of the ITAA 1936 is not about a person's actual, i.e., subjective, dominant purpose or motive. It is possible for Part IVA to apply notwithstanding that the dominant objective purpose of obtaining the tax benefit was consistent with the pursuit of commercial gain.

A conclusion about a relevant person's purpose for section 177D of the ITAA 1936 is the conclusion of a reasonable person based on all the facts and evidence that are relevant to considering the eight factors for the scheme. However, not all of the factors will be equally relevant in every case. Provided the eight factors are each taken into account, it is possible to arrive at the conclusion as to purpose by making a global assessment of purpose.

Consideration of the eight factors involves comparison of the scheme with the alternative arrangement (counterfactual). In other words, the conclusion about the dominant purpose of a person entering into or carrying out the scheme, or any part of it, necessarily requires consideration of what may otherwise have occurred.

Broadly, the tax benefit identified by the counterfactual is worked out on the basis counterfactually that payments made to any part of the home loan, rental loan and LOC facilities are applied proportionately to each purpose. These eight factors are as follows:

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

The manner in which the scheme is being carried out strongly suggests a tax purpose. The linking of the home loan and LOC in determining their respective approved limits, paying all deductible rental property expenses from the LOC while directing all income to the home loan and the security provided by the home are really what makes the LOC in its current form possible. By organising the LOC facility such that it is drawn down to meet the rental expenses, whilst the home loan borrowed for home loan purposes is being paid down on an accelerated basis supporting increase in the LOC limit and with all your income strongly indicates the structure of the loan arrangements were for tax purposes.

Similar to *Hart*, the tax benefit is not the entire deduction claimed for the interest incurred on the LOC. Rather, it is the Additional Interest amount in relation to the LOC facility.

In addition, the fact that payments on the LOC are only payable at the end of the revolving credit period or on demand (reasonably understood to arise only so far as the approved limit for the LOC from time to time is exceeded or the LOC facility is cancelled) is beyond what is available outside an arrangement such as the one proposed. The fiscal efficacy of the arrangement from the lender's point of view is the acceleration of increasing equity in the home as a result of the increased repayments of the balance relating to the home loan while debt increases relative to what would otherwise have been the case in the LOC.

The manner in which the home loan and LOC operate and are linked by the way the scheme is entered into and carried out suggests that the tax benefit is the purpose or at least the dominant purpose of the scheme.

(ii) the form and substance of the scheme

In substance, only one loan facility is being made to make accelerated payments on the home and to pay the deductible rental property expenses including interest on the rental loan, while the form would indicate that there were three separate loans with independent borrowings. The fact that the aggregate of the outstanding balances in the home loan and the LOC cannot exceed their combined approved limits, and that increasing limits on the LOC depend on accelerated payment of the home loan (as determined by the security value of the home) in substance reinforces the argument that there is in reality only one loan in this respect with all payments in excess of the standard credit foncier payments on the home loan according to its 30 year term being in substance payments which would be expected to be directed indifferently towards the outstanding balances.

The use of common security allows the existence in form of three loans with the non-tax features of a single loan used for the purposes recorded in drawings against each loan. The growing equity in the home by reason of accelerated payments (towards the home loan, including into the offset account which reduces interest on the home loan) allows the debt owed under the LOC to increase.

The additional tax benefit produced only by the form of the scheme and not its substance suggest that the tax benefit is the purpose or dominant purpose of the scheme.

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out

The length of time over which the scheme is proposed to operate does indicate a tax avoidance purpose. The overall credit limit on the LOC facility will be in place for an undefined period but subject to periodic reviews and otherwise repayments are payable on demand or to the extent of any excess balance over the overall credit limit. Apart from the tax effect, allowing the debt in the LOC to increase without principal reduction over such a period as described in the arrangement to which this ruling relates while making interest and principal payments on your home loan does not make commercial sense. The length of the period during which the scheme is carried out appears to be such as to maximise the tax benefit from the additional interest incurred on the LOC, corresponding to increasing (absolutely or relatively) deductible rental property expenses, while correspondingly more interest and principal are paid on the home loan, the private component of the arrangement.

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by this scheme

Allowing the borrowing on the LOC to increase without repayment and using the funds released by such action to pay the interest on and reduce the amount of the home loan would result in an increasingly larger tax deduction for interest each time the interest is charged on the increasing debt in the LOC in comparison to the interest deduction obtained under the counterfactual.

This increasingly larger deduction would have the effect of reducing the amount of tax payable on your income and may eliminate in total the tax payable on your income for some periods of the arrangement. This result suggests that the tax benefit is the purpose or dominant purpose of the scheme.

(v) any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme

The tax benefit would have the effect of improving your financial position by:

- increasing cash flows as a result of a greater proportion of the interest incurred being an allowable deduction against your assessable income;
- by increasing the equity in the private residence as a result of the increased repayment ability; and
- by reducing the interest component of the home loan which is non deductible.

These improvements to the financial position of you and your spouse are solely a result of the tax benefit identified above to you and your spouse entering the scheme and are consistent with concluding that the purpose or dominant purpose is deriving that tax benefit.

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result, or may reasonably be expected to result, from the scheme

You and your spouse jointly own both the home and rental properties and are joint borrowers of the home loan, rental loan and LOC. It is considered your spouse's financial position mirrors yours and the changes to your spouse's tax position are the same as those to yours.

This factor is considered neutral in determining whether one of the purposes for entering the scheme is tax avoidance.

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out

As detailed above, you and your spouse jointly own both the home and rental properties and are joint borrowers of the home loan, rental loan and LOC. It is considered your spouse's financial position mirrors yours.

Consequently, this factor is considered neutral in determining whether one of the purposes for you entering the scheme is tax avoidance.

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi).

The LOC facility and the rental loan are jointly held with your spouse and you are joint owners of the home and rental properties. For reasons mentioned at (vi) and (vii) above, this factor is considered neutral in determining whether one of the purposes for you entering the scheme is tax avoidance.

CONCLUSION:

The scheme entered into is considered to be dependant on the inextricable linkage between the home loan and LOC in the calculation of their approved limits and the allocation of those limits as a whole following any acceleration of home loan payments, and any offset account benefits, to allow the home loan limit to fall and the LOC limit to rise and in the provision of the home as security. The Commissioner is satisfied after considering all of the factors in section 177D that the proposed scheme is one to which Part IVA would apply.

Therefore, the Commissioner would exercise his discretion under section 177F to determine that the 'Additional Interest' incurred under the scheme and referable to you shall not be an allowable deduction to you for the year of income.

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