BAN TACS
National Accountants Group

NEWSFLASH
BOOKLET

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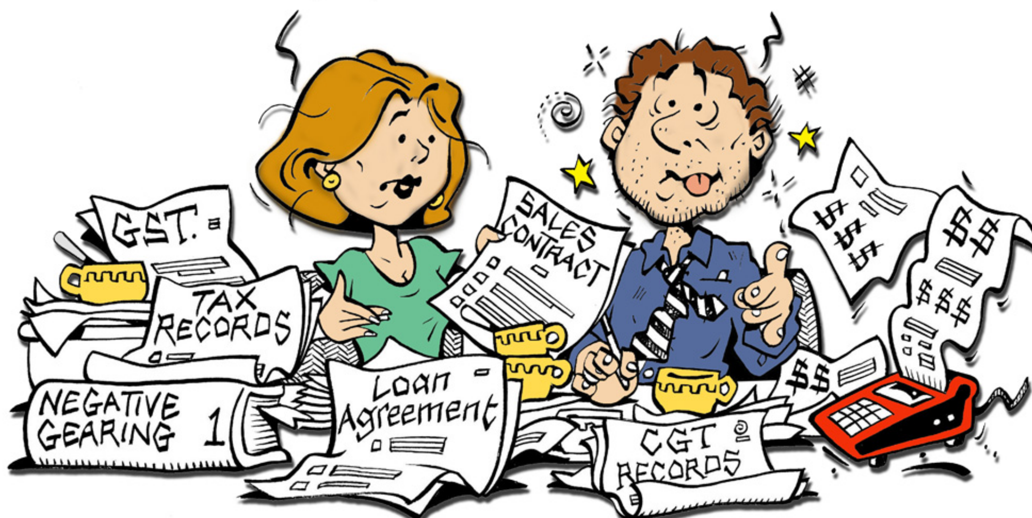

Important

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 were 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 daft 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.

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

On Friday 27th 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.

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 1/3rd tax deductible.

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

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.

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.

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 onto 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.

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 replace with the 1997 ITAA and even the 1997 Act was amended on 6th 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 6th 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 93/7states 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.

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.

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.

Interest on Mixed Purpose Loans

What the borrowed money is used to buy determines the deductibility of interest on a loan. So what do you do if it has been used for a few different purposes? This is a messy business you have to track the changes in the percentage used for deductible purposes and non deductible purposes. There is a calculator on our shopping page for only $9.99 that will help you do this https://www.bantacs.com.au/shop-2/apportionment-calculator/

Paragraph 18 of TR 2000/2 state that you can refinance a mixed purpose loan with two loans, one for the amount of deductible debt, and the other for the amount of the non deductible debt. Providing these two new loans pay out the old mixed loan at the same time the ATO will accept the split. Once they are separate loans you can concentrate on paying off the non deductible debt. Something that is not possible while ever the loans remain mixed because all repayments must be apportioned on a pro rata basis between the deductible and non deductible portions of the loan even though the payment may come from your wages.

I wonder how the ATO would feel about imposing these pro rata rules when a small amount of the borrowing was for a rental property expense, the rest was for private purposes and the rent was used to pay off the loan?

Expanding Part IVA Anti Tax Avoidance Provisions

The ATO are pushing to further increase their powers under Part IVA which is the anti tax avoidance provision of the Income Tax Assessment Act. Basically Part IVA examines a transaction and can disallow it if the dominant purpose of the transaction was a tax benefit.

Currently the ATO has to produce a counter argument that if it was not for the scheme the taxpayer would have had done something different which would have resulted in more tax being paid, note this has to be a plausible argument. The ATO cannot just say you should have made a choice that resulted in the highest tax payable, they can only argue that a reasonable person would have expected the taxpayer to have acted differently, if not for the tax benefit. This is a bit of a safety net to stop the ATO applying Part IVA to every deduction, there is a need to examine what a reasonable person would have done in those circumstances, and question if there is something artificial about the arrangement. As the law currently stands, Taxpayers can argue back that there is no way they would have handled their affairs in the way the ATO is suggesting they should have, because the tax consequences are too high so they would simply have done nothing.

Treasury has announced that the law will be changed to restrict the taxpayer's right to argue against what the ATO has decided they should have done. There is a real risk that the reasonable/plausible test will be removed.

The taxpayer's defence is already difficult because the law requires the taxpayer to argue that what a reasonable person would have done rather than why they made the choice they made. Further restrictions here could lead to the taxpayer having to accept whatever alternative action the ATO can dream up and this is on any arrangement not just marketed tax schemes. To quote the press release "this also includes steps within broader commercial arrangements".

It is time that everyday taxpayers brought this issue up with their local MP for the following reasons:

1) The new laws are intended to apply retrospectively from 1st March 2012 yet they have not even been written yet and are unlikely to pass through Parliament until the end of the year.
2) It is an abuse of power to create uncertainty for such a long period of time especially to such an already widely worded provision.
3) To allow the ATO to decide how a taxpayer should arrange their financial affairs will lead to further uncertainty even once the law is written and an unworkable taxation system as the ATO is not in a position to advise all taxpayers what it's opinion is of each transaction.
4) When evaluating the fairness of the law, parliament should consider that very few taxpayers can afford to fight the ATO in court as the ATO simply continues to appeal until the taxpayer runs out of money. Further the ATO has a history of using Part IVA on simple everyday mum and dad arrangements without sufficient testing in the court. If the ATO does not like something they simply say there is a tax benefit and they will apply Part IVA. The average taxpayer just has to accept this

whereas more wealthy taxpayers can fight it. Any discretion given to the ATO is a strike to tax more heavily those that can least afford it.

5) It is extremely difficult to get a private ruling from the ATO on how Part IVA will be interpreted by them and certainly not possible within sufficient time to make a timely decision on "steps within broader commercial arrangements".
6) Part IVA is already confusing and being abused as a scare tactic by the ATO, they do not need any more powers. Taxpayers must have some rights to certainty.

If you think I am exaggerating, consider that the ATO has already used Part IVA to prevent taxpayers offsetting a capital gain they have made during the year by, before 30th June, selling off shares that have a capital loss and later buying those shares back. This simple choice is now already considered a tax scheme, what next? The first thought that comes to mind is choosing an interest only loan rather than principle and interest on your rental property.

If we allow the ATO to decide what your action should be without at least requiring them to consider what a reasonable person would do, we may as well throw out the rest of the tax law and just let them decide each year just how much they would like of your hard earned dollars.

The bottom line is that if the ATO cannot meet the requirement that a reasonable person would not consider the transaction to have been entered into for the dominant purpose of a tax benefit, then that should be the end of the matter and the ATO should not be given any powers to go beyond that to choose what other course of action the taxpayer should have taken so that they would have paid more tax. Considering the harsh penalties the ATO has in its arsenal, taxpayers should not be forced to examine everyday transactions (or "steps within broader commercial arrangements") for the possibility of a more tax expensive way of doing business. After all it would still be better to pay the extra tax then suffer an ATO audit and penalties. This is what will happen when clear guidelines at law are replaced by ATO discretion.

Getting Your Loan Right

As discussed in detail in our claimable loans booklet there are many ways a loan can lose its deductibility. Quite often it is the bank's administration practices that will slip you up. For example the bank may require you to draw down immediately the loan you have arranged in readiness to pay a deposit when you find the right house. They may even just step in and put the money into your everyday banking account. This simple transfer by the bank will ensure that the interest will never be deductible on that loan. Another trap is the bank instructing you to use your savings to pay the deposit quickly while they organise the loan for the deposit, then reimburse yourself. That loan will also not be deductible. Or at the eleventh hour the bank does not provide you with the terms original you agreed to.

This is why I prefer clients to use brokers. They are acting for you not the bank. They know what each bank has available and the games they play. In the case of the brokers we recommend, they also know how to make sure the deductibility of your loan is not compromised. On top of all that they do the shopping around for the best loan for you.

Please read our claimable loans booklet so you know the traps, but do yourself a favour and make sure your broker is aware of these too. On the booklets page of the web site https://www.bantacs.com.au/media-library/booklets/ and on the cover of the claimable loans booklet we have listed brokers, covering the east coast, who understand the traps and what the banks have to offer.

Borrowing To Pay Rental Property Expenses

Recently I was invited to appear before the General Anti Avoidance Rules Panel regarding a client's ruling application to capitalise interest. This panel consists mainly of ATO officers with a few independent members of the legal profession. We do not have a full answer regarding capitalizing interest yet but I would like to inform readers of what the ATO is thinking.

The ATO officer presenting the ATO's argument was called Robert. He gave very little away but one point he made perfectly clear was that it is not just capitalizing interest they are chasing but any interest on borrowings incurred for rental property expenses. He would not be drawn into borrowings for repairs or renovations but he clearly stated that if you borrow to pay the rates or insurance on your rental property and have other non deductible debt with an offset account attached (or for that matter a redraw facility or LOC) then it may be considered a scheme with the dominant purpose of a tax benefit to not use your savings or income including wages to pay the rental property expenses. This is the case even if the rental property

expenses exceed the rent received. Robert also point blank refused to be drawn on where the money was to come from considering the amount of the rates may well exceed the person's wages and whether other personal expenses such as food or money set aside for an emergency are required to be used to make this payment.

It appears that the ability or inability to make the rates payment is not relevant it is simply the action of choosing to borrow to pay expenses that is a scheme with a dominant purpose of a tax benefit. What the ATO are saying is that interest incurred on borrowings for rental property expenses (if you have non deductible debt) is no longer deductible by virtue of threats to apply Part IVA, not by any legal precedent or legislation. But it is still ok to capitalise the interest on a margin loan for shares or run or claim interest on an overdraft for a small business.

Rules To Keep Your Borrowing Tax Deductible

1) What the borrowed money is used to buy determines deductibility, not where it is secured.
2) Interest on a loan is deductible if the borrowed funds were used in relation to a property that is now income producing.
3) You need to have a clear nexus between the borrowed funds and the expenditure, no detours via personal accounts, once mixed with private funds the link is lost.
4) Reimbursing yourself from borrowings will not create the necessary nexus because the money actually borrowed is not used in relation to the property it is used for whatever purpose you put the reimbursed funds to i.e. buy groceries, so not deductible. This is important to remember when funding the deposit for an investment. Don't let the bank talk you into using your own funds while they get the loan organised.
5) If you borrow money to pay expenses for the renovation that you have paid for on credit card that is ok, as long as the borrowed funds are paid directly to the credit card. This is simply refinancing a debt.
6) If the credit card also has non property related expenses on it you will need to pay them at exactly the same time. For example you have a balance of $1,000 on your credit card, $600 for the renovation and $400 for private purposes. On the same day take $400 from your personal account to pay off the card and $600 from the loan for the renovations and pay it off the card.

If you think this is over the top, have a read of what the ATO did to Wilma Domjan in her 2004 AAT Case

Ask BAN TACS

For $79.95 at Ask BAN TACS, https://taxquestions.com.au/ 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. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

More Information

Please make sure you continue to keep your knowledge up to date by subscribe to our Newsflash reminder. There are many other booklets available on our web site https://www.bantacs.com.au/media-library/booklets/ in fact the whole web site is full of useful information so also have a look around under topics.

How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?

- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

......and the list goes on!
To ensure you don’t make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

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