



69725

Edited version of private ruling

Authorisation Number 69725

This ruling is a private ruling for the purposes of Division 359 of Schedule 1 of the Taxation Administration Act 1953.

What this ruling is about:

1. Are you entitled to a deduction for the interest you incur on your line of credit?
2. Does Part IVA of the *Income Taxation Assessment Act 1936* (ITAA 1936) apply to interest incurred on your line of credit?

Ruling:

1. Are you entitled to a deduction for the interest you incur on your line of credit?

Yes.

2. Does Part IVA of the ITAA 1936 apply to interest incurred on your line of credit?

No.

Year(s) of income or period(s) to which this ruling applies:

Year ended 30 June 2007

Commencement date of scheme:

1 July 2006

The scheme that is the subject of the ruling:

You have an existing private home loan with a bank.

You will obtain a separate line of credit from the bank to use for investment purposes.

The private home loan and the line of credit are two distinct separate loan products from the bank. They are not sub accounts under single principal loan facility.

Sub accounts are not an available option under either loan facility.

Each loan has separate terms and conditions which refer to each respective loan solely. The loans are not linked in any way other than sharing the same security.

Your new line of credit will have the following features:

- ~ the loan will be a line of credit with a specified limit
- ~ the loan will be an on call facility with no specified term
- ~ the repayments will be on an interest only basis
- ~ there are no minimum repayments required to be paid to the loan while the loan debt is within the approved limit
- ~ interest is calculated on the outstanding debt of this loan only
- ~ the interest rate is based on the bank's standard rate for this facility. The interest rate may be discounted under a package, and
- ~ the interest applicable only to this line of credit will be added to this loan debt within the approved limit, capitalising this interest.

You will initially draw a portion of this line of credit to invest in managed funds. You will also make additional monthly contributions to your investments from this line of credit.

There will be no private use of this line of credit.

The line of credit will be obtained on a capitalised interest basis as you do not wish to use personal funds to service these investments.

Relevant provisions:

Income Tax Assessment Act 1997 Section 8-1.

Income Tax Assessment Act 1936 Section 177A.

Income Tax Assessment Act 1936 Section 177C.

Income Tax Assessment Act 1936 Section 177D.

Explanation: (This does not form part of the notice of private ruling)

Capitalised interest deduction

Section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) allows a deduction for all losses and outgoings to the extent to which they are incurred in gaining or producing assessable income except where the outgoings are of a capital, private 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, the interest on this borrowing is considered to be incurred in the course of producing assessable income.

In *Hart v. Federal Commissioner of Taxation* (2002) 121 FCR 206; 2002 ATC 4608; (2002) 50 ATR 369 (Hart's case) it was held, amongst other matters, that compound interest, as with ordinary interest, derives its character from the use of the original borrowings.

In your case, compound interest will be incurred on funds borrowed, under a line of credit facility, to acquire an income producing asset. As such, the compound interest will be incurred in earning assessable income and will be an allowable deduction.

Application of Part IVA

Part IVA of the ITAA 1936 is a general anti-avoidance provision that can apply in certain circumstances if you obtain a tax benefit 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 the taxpayer's 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).

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 an 'alternative postulate'. 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.

Objective purpose test

Section 177D of the ITAA 1936 provides that Part IVA applies to a scheme in connection with which the taxpayer has 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 the taxpayer 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 the taxpayer.

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 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 matters will be equally relevant in every case. Provided the eight matters 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. 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.

I. the manner in which the scheme was entered into or carried out

This first factor enables contrivance and artificiality to be identified by comparing the manner in which the scheme was entered into or carried out with the manner in which the alternative arrangement would have been implemented. If a scheme is entered into and carried out in the manner in which ordinary business or family dealings are conducted, the manner of the scheme will not indicate the purpose of obtaining the tax benefit.

II. the form and substance of the scheme

The second factor requires that substance, rather than form, be the subject of inquiry. Put simply the factor directs attention to whether there is a discrepancy between the form of the scheme and its substance, meaning its commercial and economic substance. A discrepancy between the business and practical effect of a scheme on the one hand, and its legal form on the other, may well indicate the scheme has been implemented in a particular form as the means to obtain a tax benefit if the substance of the scheme may be achieved or available by some other more straightforward or commercial transaction or dealing.

The presence of material steps in a scheme consistent with no other explanation than the purpose of obtaining a tax benefit will be critical in characterizing the purposes of the persons who entered into or carried out the scheme. It will be they which lend an air of artifice and contrivance to the manner in which the scheme is carried out, and usually it will be they which separate form from substance.

III. the time at which the scheme was entered into and the length of the period during which the scheme was carried out

The third factor draws attention to particular 'timing' aspects of the manner in which a scheme is entered into or carried out. It will include consideration of the time the scheme, or any part of it, was entered into or carried out, and the length of the period during which it was carried out. This factor will enable consideration of the extent to which the timing and duration of the scheme go towards delivering the relevant tax benefit or are related to commercial opportunities or requirements.

It may also be relevant to note that the time at which a scheme is entered into is not proximate to any commercial occasion; that is, the timing of the scheme does not seem to be associated with an opportunity or need that might point to a non-tax purpose. In other circumstances timing and duration is more likely to be neutral or point to a non-tax purpose.

IV. the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme

The fourth factor expressly focuses on the tax benefit and any other tax consequence resulting from the scheme.

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

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 that has resulted, will result, or may reasonably be expected to result, from the scheme

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

The fifth, sixth and seventh factors involve identifying changes in financial position or any other consequences that may be reasonably expected to result from the scheme, not just changes that have resulted or will result.

These factors focus on the non-tax effects of the scheme, not only for the relevant taxpayer, but also for all connected parties. These factors look to the practical financial, legal, economic and any other outcomes achieved by the scheme for the taxpayer and connected parties. For example, the change in the position of a taxpayer may mean little if there is an inverse change in the position of another person as a result of the scheme, and that other person is an associate or alter ego of the taxpayer such as a spouse or a wholly-owned company. These factors will often require consideration in conjunction with the second factor.

The absence of any practical change in the overall financial, legal or economic position of a taxpayer and connected parties that are affected by the scheme is likely to add weight to the dominance of the tax purpose when all the paragraph 177D(b) of the ITAA 1936 factors are weighed together.

VIII the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in (VI)

The eighth factor inquires into the nature of the connection between the taxpayer and any other person whose financial position is reasonably expected to change as a result of the scheme or for whom there are any other consequences from the scheme. The existence of any connection between the taxpayer and these other persons is relevant to the identification of the other factors, such as the manner of the scheme, the form and substance of the scheme, and the tax, financial and other consequences of the scheme.

This factor requires attention to be paid to the existence of any family relationship between the taxpayer and the persons who are affected in any way by the scheme. This could assist a taxpayer in some cases. Many dealings which would be decidedly odd between strangers may be entirely explicable between family members.

In your case

Scheme

The scheme consists of the following steps:

- ~ You will obtain a line of credit loan which you will use to invest in income producing managed funds.
- ~ You are considering capitalising the interest on this loan.
- ~ You will then claim interest on the capitalised interest as a deduction.

The alternative arrangement

You obtain the line of credit on an interest only basis and do not capitalise the interest.

Tax benefit

The tax benefit from this scheme is the deductibility of interest on capitalised interest.

Objective purpose test

- I. You have stated that your reason for entering into the scheme is to negatively gear the loan, but avoid using your personal funds to repay the interest on these loans.
- II. There is no contrivance or artificiality in the manner in which the scheme was carried out. You will simply not have to pay interest as it is incurred. The decision to capitalise interest is allowable by the bank due to the level of your security. In fact, generally for floating line of credit loans, no monthly payments of principal or interest are required until the credit limit is reached.
- III. The substance of the scheme is the deductibility of interest incurred on capitalised interest on your loan. The form or method adopted is by obtaining the line of credit on this basis. This is a commercially realistic arrangement and there is no other more straightforward method of achieving this.
- IV. The length of the period during which the scheme will operate is uncertain. It is considered that this factor is not determinative in the final conclusion.
- V. This factor requires an examination of the result that would have been achieved by the scheme from the normal operation of the ITAA1997 or the ITAA 1936, excluding the operation of Part IVA. You would obtain a tax benefit of the deductibility of interest incurred on capitalised interest. This has been reflected in the first section of this ruling.
- VI. There is no overall financial advantage obtained despite the tax benefit as the availability of interest deductions on capitalised interest has only arisen as a result of you incurring additional interest expense in relation to your borrowings.
- VII. There is also no overall financial advantage of any other person as a result of you entering into the scheme.
- VIII. The benefit to you is the deductibility of interest incurred on capitalised interest. The other consequence for you as a result of entering into the scheme is the incurring of additional interest.

Conclusion

Based on the above, the arrangement that is the capitalisation of interest on your line of credit is a scheme. You will obtain a tax benefit from entering into the scheme in the form of the deductibility of interest incurred on capitalised interest.

However a reasonable person would conclude that you did not enter into the scheme for the dominant purpose of obtaining a tax benefit. You wish to negatively gear this loan and you do not wish to make repayments using personal funds. While the fact that a particular scheme may have a sound commercial basis does not preclude the operation of Part IVA, the Commissioner considers that the obtaining of the tax benefit identified was not the dominant purpose of entering into the scheme.

Therefore the scheme is not one to which Part IVA applies.

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