

# CLAIMABLE LOANS

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## **What the borrowed money was used for determines deductibility:**

Traditionally, the interest is only claimable on a loan where the actual money borrowed is used directly to produce income i.e. buy the income producing property. The Roberts and Smith case of July 1992 has changed this. In this case a firm of solicitors borrowed money to pay the partners back some of the original capital they had invested in the firm. The Commissioner argued, as has been accepted in the past, that the proceeds of the loan were not used to produce income but for the private use of the partners. The Federal Court ruled that such a simple connection is not appropriate – the partners have a right to withdraw their original investment and as a result the business needed to borrow funds to finance the working capital deficit. It was irrelevant that the loaned money was paid directly to the partners, the purpose of the loan was to allow the income producing activity to continue. The tax office issued a ruling on this matter TR95/25. The ruling states the Roberts and Smith case cannot apply to individuals i.e. sole owners of property because technically they cannot owe money to themselves. The ruling goes on to say:

“The refinancing principle” in Roberts and Smith has no application to joint owners of investment property, which are not common law partnerships. The joint owners of an investment property who comprise a sec 6(1) tax law partnership in relation to the property cannot withdraw partnership capital and have no right to the repayment of capital invested in the sense in which those concepts are used in Roberts and Smith. Accordingly, it is inappropriate to describe a business, as a “refinancing of funds employed in a business.”

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

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

## **Line of credit facilities dangerous**

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A \$100,000 loan used solely to purchase a rental property is financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of \$2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be \$98,000 owing on the rental property. In say 45 days when the borrower withdraws \$1,000 to pay off his or her credit card the loan will be for \$99,000. However, as the extra \$1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

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

pay the credit card, there will \$96,000 owing on the house and \$1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

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

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

## **Continuing to claim interest on a loan after business or investment sold**

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

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

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

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

## **Losing interest deduction**

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

Interest is not deductible on a loan unless the proceeds of the loan have been used to purchase or in relation to an income producing investment. The link can be simply lost by paying some spare cash off the loan and drawing it back later, or not being able to trace the flow of the funds to the investment. The ATO's own ruling states "a rigid tracing of funds will not always be necessary as appropriate." Yet in Domjan and Commissioner of Taxation [2004] AATA 815 the ATO successfully argued that the placing of borrowed money into a savings/cheque account with other personal funds broke the link necessary to prove the funds were borrowed for tax deductible purposes.

The AAT is not the highest court in the land but relevant nevertheless. The sitting AAT member stated: "I accept the Commissioner's submissions. Where the funds have been intermingled it is impossible to determine the use to which they have been put. In other words the purpose of the borrowing cannot be

ascertained. It cannot be said that the expenditure – that is the payment of interest – has been incurred in the course of gaining or producing assessable income”

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

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

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

What was alarming was the fact that Mrs Domjan, who prepared her own tax return received, a 25% penalty on the basis she had been careless in claiming the interest in relation to the redraws. The ATO’s argument being she had been careless in relying on a draft ruling after the final ruling had been issued. In the ATO’s world taxpayers preparing their own tax returns should have knowledge of the thousands of ATO rulings available and check regularly for updates. The AAT agreed with the ATO! I have quiet a problem with this conclusion because unlike the draft ruling the final ruling did not cover redraws. So the ATO’s argument is really that Mrs Domjan should have followed up the 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.

## **Hart’s case decided for the ATO – Linked split loans**

**Newsflash Issue: 82, By: Julia Hartman B.Bus CPA – Tax Accountant; Last Updated: 2004, June 15th**

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

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

It is important to remember this case does not change the deductible nature of interest or for that matter interest on interest. Gleeson & McHugh specifically stated that the question of the deductibility of interest upon interest does not need to be addressed because the issue was already decided on the basis that there was a scheme to gain a tax benefit.

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

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

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

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

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

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

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

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

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

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

Say for example you have a line of credit on your rental property and a separate loan on your home. Your tenant may pay you a couple of months rent in advance which you pay off your home loan as everything is up to date and cash flow looks good at the time. Over the next two months you have quiet a few personal expenses that take up all of your wages. Then the rates and some repairs are due on the rental property. You need to draw the funds to cover the rates and repairs from the line of credit on the rental property and due to lack of funds the interest that month has to be capitalised. Luckily you just manage to make the P&I payment required on your home loan. This scenario is not a scheme. Events just happened that way and it is not for the ATO to tell you how to manage your affairs. Linking the two loans or a systematic approach to the increase in the loan on the rental property may point towards a scheme. Just watch out for spare funds to make extra repayments on your home and don't prop up the rental property with your spare cash if you can use the equity in your rental property instead.

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

## **Caution with rental property interest**

You are only allowed to claim interest if the money borrowed was used to buy something that was income producing. Accordingly, if you use a line of credit to pay off your credit card that you have been living off then that amount was borrowed for non tax deductible purposes. This makes an awful mess of a normally tax

deductible loan and can reduce it to 100% non tax deductible within 5 years because any repayments have to be pro rataed between the loan for the Rental Property and the loan for the Credit Card this of course means a larger portion of the repayments pay off the Rental Property and the portion of Credit Card debt increases each month.

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

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

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

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

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

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

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

2004 Harts Case:

Gleeson CJ and McHugh J:

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

Note in the above Hart's are the respondents

2002 Harts Case:

Conti J:

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

# Capitalised Interest Update

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

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

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

## Capitalised Interest Is Deductible But Not If Your Avoiding Tax

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

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

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

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

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

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

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

# Progress On Capitalised Interest Ruling

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

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

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

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

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

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

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

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

## Capitalise Interest Doubters

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

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

## 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.

## **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.

## **Capitalised Interest Update**

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

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

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

## **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 maybe 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.

## 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.

## Redraws

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

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

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

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