

REPORT FROM THE GENERAL ANTI-AVOIDANCE RULES PANEL

2 November 2012

Room 127, 13th Floor
Sydney CBD Branch Office 'Latitude East'
52 Goulburn St, Sydney

- Attendees:**
- Panel Members:** Peter Walmsley (Chairperson), John Evans, George Hitti, Kevin Lindgren AM, QC, Tony Pane, David Williams
 - Secretariat:** (Acting): Mia Dang
 - ATO Officers:** Robert Puckridge (STC), Bruce Haine, Judy Hester
 - Taxpayer and Representatives:** [REDACTED], Ms Julia Hartman (BAN TACS Accountants)

The present matter concerns the possible application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) to an arrangement involving interest accruing on a loan, being a St. George Bank line of credit ('LOC'), which was used to pay the following:

- 20 per cent of the purchase price of an investment property;
- associated purchase costs of the property; and
- deductible expenses of the investment property including, interest on the taxpayer's investment property loan (RAMS investment loan).

Briefly, the taxpayer, [REDACTED], has a home loan, LOC and offset account with St. George Bank, and an investment property loan with RAMS.

This matter was not previously considered by the Panel.

Discussion

[REDACTED] and Ms Hartman were invited to address the Panel. [REDACTED] and Ms Hartman made the following points in their address and in response to questions from the Panel:

- The ATO's counterfactual is incorrect. The counterfactual uses an incorrect percentage differential, which results in the LOC being more expensive than the home loan. Had the correct differential been used, the LOC would actually be cheaper. Therefore, it makes sense to want to decrease the home loan first, as it is the more expensive loan, by maximising the principal repayments, which reduces the corresponding interest payments on the loan. This is a rational decision. [REDACTED] has adopted this approach

since purchasing the home in 2005 and continued with it after acquiring the Defence Housing Australia ('DHA') investment property.

- Arrangements similar to the present one whereby home loans are paid off quicker are common and are widely marketed by financial advisors, such as Noel Whittaker.
- The decision to pay off the home loan first probably came from the example set by [REDACTED] who paid off their home loan even though they were on a single income, and from the Australian cultural desire to own a home. That is why he has tried to deposit as much money as possible in his St. George Freedom offset account ('offset account'). For instance, from October 2005 to December 2009 he paid living expenses on his credit card to maximise the time that funds are left in the offset account.
- [REDACTED] finds the ATO's view that his decision was driven by tax avoidance both insulting and offensive.
- Another private ruling (with reference "94265") that was issued some 3 months prior to his private ruling application bore a striking resemblance to his case. However, in that other ruling it was noted that the investment would be positively geared in future and concluded that the interest was an allowable deduction; that there was no contrivance; and that it was commercially realistic as there was no other alternative. Although [REDACTED] understands that he cannot rely on other private rulings, there should be consistency applied in the ATO's private ruling system. He also referred to private ruling "69725". This ruling lead him to lodge his own private ruling application.
- Other than the abovementioned rulings and TD 2012/1, there was no other ATO guidance and the draft objection decision did not answer his questions.
- [REDACTED] requests clarification as to which of the factors that the ATO objects to, including the following:
 - (a) The negative gearing and the fact that he is running at a loss.
 - (b) The fact that he was not making repayments on the LOC.
 - (c) That no amount of his income (e.g. salary) is used to make repayments on the LOC.
 - (d) The fact that he keeps all of his funds in the offset account. If so, then what amounts is he allowed to keep in his offset account? He remarked that it seems like having an offset account and an investment loan will mean attracting Part IVA.
- In addition to the above question, [REDACTED] had approximately 19 other questions which were reduced to the below questions. These questions emphasise the uncertainty surrounding when the costs on a borrowing will be deductible.
 - Can he increase the LOC to make renovations to the rental property? Although there are no current plans to do so, it is an option that he might consider in the future. The draft objection decision appears to say that he cannot use the LOC for paying rates, insurance etc., and if he does then he cannot claim the interest expenditure as an allowable deduction.

- If deductible expenditure is paid out of the LOC and no amount of rental income, etc., is used to make payments on the LOC, will any interest in respect of that expenditure not be deductible?
- Is he allowed to have any amounts sitting in the offset account? Reference was made to a private ruling (reference number '94265') which suggested that repayments were required, and to TD 2012/1. If the ATO imposed a limit on how much can be kept in an offset account, it would be a record-keeping nightmare to track every amount. Why is it that he cannot put all of his and his wife's income into their home loan? Consider the hypothetical scenario where [REDACTED] and his wife do not have enough money to cover the payments in respect of the rental property. For instance, if he and his wife lost their jobs, can they choose the order in which to make payments on the non-deductible and deductible borrowing?
- If the ATO's points on Part IVA revolve around the home loan being more expensive than the LOC, and if this point were removed, how will the arrangement cross over the line? Is it not [REDACTED] choice whether or not to use his wages to pay off the rental expenditure? Does the reference in TD 2012/1 to what is reasonably expected to be paid towards the LOC restrict his choice?
- Is the choice to keep wages creating a scheme to which Part IVA applies?
- The following references and statements were made:
 - Every relevant account that [REDACTED] holds with St. George Bank and RAMS is an account that a bank normally makes available to its customers, which allows the efficient management of his affairs.
 - The application of Part IVA in *Hart's case* was as a result of the special circumstances in that case, which included a pamphlet that clearly said that certain conduct would lead to a tax deduction. However, there is no such pamphlet in [REDACTED] case, and all of the accounts are standard accounts that are made available by a bank to its customers.
 - TR 2000/2 involved a mixed purpose loan such that amounts used to pay off the LOC could not be identified. To track each amount to the LOC would be difficult and would be a record-keeping nightmare. This would be a ridiculous result.
 - The arrangement is analogous to an arrangement involving business loan deductions.
- The following statements were made in respect of the facts:
 - The bank allows a cap on the interest until a certain limit is reached. There is no requirement for the interest to be due on any given day so there is no need for [REDACTED] to worry about payment. At the moment, [REDACTED] has not paid any interest on the LOC.
 - The offset account offsets only the home loan. All income that was transferred to the offset account would assist in paying off the home loan quicker. This would mean that the LOC would increase owing to the interest that accumulates on interest. The LOC was secured by a mortgage over the home.

- The advantage of paying off the home loan is that [REDACTED] will be able to pay off both the LOC and the home loan 4 years quicker.
- The home loan is slightly more expensive even though the interest is 0.1% less than the LOC rate owing to the monthly fees of \$15 per month. It was agreed that the home loan may be more or less expensive than the LOC depending on the assumptions that are made, particularly concerning the outstanding balance of the LOC. However, the difference in rates is not a deal breaker; the decision to use the LOC is so that [REDACTED] does not have to keep track of everything, which makes it easier to keep tax records.
- By using the offset strategy [REDACTED] would accelerate repayments, because he could pay off the loans sooner (in approximately 12 years).
- [REDACTED] pays off his credit card, because the interest rate is 19%, however, he does not pay the LOC because there is no gain in terms of interest rates.
- [REDACTED] had made this decision 4 years ago. His strategy was the same before and after the purchase of the investment property. The motives, before and after, were not dominated by tax. All of his income goes into the home loan as it did before purchasing the investment property.
- If it was as simple as changing the asset that secures the LOC then [REDACTED] could change the security such that the bank holds security over the rental property instead of the home. The security for the LOC is over the home, because at the time he did not own the rental property. He can now 'flip it' so that the home is unencumbered if that makes all the difference.
- [REDACTED] made the following concluding statements:
 - He and his wife do not understand the question about dominant purpose. They have been doing this consistently for 7-8 years. It makes sense to pay off first the loan that is more expensive. He should be able to choose how to use his income.
 - The DHA property that he bought in Queensland is currently performing poorly, but if the market improves then it may become a positively geared investment.
 - He wanted to raise the points referred to in the TD, which gave rise to a lot of confusion. The TD is not specific enough and he needs better guidance.
 - He and his wife have not done anything aggressive in terms of tax and have been compliant in respect of their tax obligations.
 - He noted the 7 months that it took the ATO to complete his private ruling and the extensions of time following the lodgement of his objection. He commented that it has been a disillusioning process.


Discussion and advice

The Panel:

- advised that the function of the GAAR Panel is to deal only with [REDACTED] specific circumstances. It is not there to prescribe rules about [REDACTED] conduct, nor is it

there to consider hypothetical scenarios or to provide advice as to what arrangements will attract Part IVA;

- advised that the purpose of the discussions is to give [REDACTED] an opportunity to address what the ATO, in its draft objection decision, considers to be the basis for the application of Part IVA;
- advised that the draft objection decision concerns the interest that accrues on the LOC which is attributable to the use of the LOC to pay deductible expenditure;
- noted that [REDACTED] strategy is not simply one of paying off a home loan using an offset account, but one of paying off the non-deductible loan and incurring deductible expenditure on the deductible loan;
- noted that if [REDACTED] had paid the deductible expenditure from another source, for instance from the offset account or another account, the offset account will have a lower balance, which will result in the total combined loans taking longer to pay off. The difference between the projections is only explicable by the use of the LOC;
- advised that the issues concerning record-keeping are not relevant to the operation of section 177F;
- noted that the size of the tax benefit may not be significant in the first year, but will increase over the term of the loans;
- noted that the present arrangement appears to be a variant of the arrangement in *Hart*, although [REDACTED] case is much closer to the line;
- advised that the Panel members were, in many ways, sympathetic to [REDACTED] and his representative, however, it is difficult to identify a purpose that is served by the arrangement that is not attributable to a tax benefit. An alternative purpose based on administrative convenience is not persuasive;
- advised that having regard to the available evidence before the Panel, prima facie, it was not unreasonable for the Commissioner to apply Part IVA;



Mia Dang
Secretary

November 2012

4/12/2012



Peter Walmsley
Chairperson

November 2012

4/12/2012