Hart-Ache: Hart’s Case & its Impact on Debt Advice

Commissioner of Taxation v. Hart [2004] HCA 26 (Hart’s Case) concerned the application of the general anti-tax avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 to a “split loan facility”. The Commissioner of Taxation won the high profile case in the High Court. The case centred on the deductibility of certain interest payments made by the taxpayers under the facility. The High Court concluded that, when viewed objectively, the Harts’ use of the product in question was for the dominant purpose of obtaining a tax benefit. The High Court’s decision drew attention to the deductibility of interest payments on income generating assets and the validity of the structures used by investors to maintain debt efficiency.

This paper summarises the case and clarifies the impact of the decision on debt advice and the use of debt wrap platforms. It provides general guidance only and cannot be relied upon as tax advice.

The Case

The taxpayers, Richard and Trudy Hart (a husband and wife), owned an investment property and their own place of residence. They used a “split” loan arrangement to refinance both properties by borrowing a single amount of $298,000, which was notionally divided up between two accounts – an investment loan account of $95,112 and a home loan account of $202,888. The loan was secured by the two properties and had a 25 year term. The facility agreement specifically provided for the borrowers to direct the application of the whole of the periodical payments required under the facility to the satisfaction of that part of the facility used for private purposes, while interest on the remaining balance of the loan (used for income producing purposes) was allowed to accrue and be capitalised and compounded. The Harts took advantage of this “Wealth Optimiser” feature of the product. Thus, repayments of $2,533 per month were calculated on the entire outstanding amount, but were made directly against the home loan component. No allocation was made to repay principal or interest on the investment component. The effect of this strategy was that the home loan was paid off quicker while interest was left to capitalise on the investment account. The Harts claimed a tax deduction for the interest accruing on the investment account as well as the compound interest that accrued on unpaid interest.

The ATO’s Position

The ATO disallowed the deductions claimed by the Harts on the basis that:

1. Interest on interest was not an expense incurred in the earning of income; and
2. Interest deductions were artificially inflated by directing all of the repayments to the home loan account, and this constituted a contravention of the general anti-avoidance provisions in Part IVA of the Tax Act.

Court Decisions

The case had a colourful history. The Harts appealed the Commissioner’s decision to the Federal Court where Justice Gyles upheld the ATO’s view that the arrangement was in breach of Part IVA. The Harts then appealed to the full bench of the Federal Court, which overturned the original decision, finding in favour of the taxpayer. Fearing an escalation in the marketing of “split loan” style arrangements, the ATO appealed the case to the High Court, which found the scheme to be in breach of Part IVA and found in favour of the ATO.

The key to understanding why the Hart’s loan arrangements were called into question lies in an understanding of how the High Court judges viewed the Hart’s motivations for entering into the scheme. Part IVA can only be applied when certain factors are met, including primarily “that a person who entered the scheme did so for the sole, or dominant, purpose of obtaining a tax benefit” (when viewed objectively). When considering the “objective purpose” of the taxpayers in Hart’s Case, the judges took into account the following aspects of the scheme:

1. Tax savings were aggressively marketed by the promoter of the scheme.
2. Repayments under the facility were fixed, thus providing no cash flow benefit to the Harts.
3. The interest rate paid under the facility was higher than the industry average at the time.

Given the individual circumstances of the case, taking into account how the scheme was marketed, the packaging of the repayments and the interest rate premium that the Harts were prepared to pay, the judges could find no other objective motivation than the additional tax deductions that would accrue to the Harts as a result of entering into this particular scheme (with its “wealth optimiser” structure), compared to the tax deductions that would have been available to the taxpayers if they had entered into a “standard financing arrangement”. Also of relevance was the fact that the investment account balance compounded to an amount in excess of the value of the investment property. The High Court’s order required principal repayments to be applied in a pro-rata manner to both the home loan component and the investment component of the facility.
Deductibility of Compound Interest

One of the criticisms of the outcome of the High Court’s decision in Hart’s Case is that it raised more questions than it answered. The application of Part IVA in Hart’s Case seemed to throw into doubt the circumstances in which taxpayers could claim tax deductions for interest expense on income producing assets without any breach of Part IVA. Business in particular pressured the ATO for greater certainty regarding the deductibility of such interest expenses.

As the application of Part IVA can only be determined in the context of individual circumstances, the ATO cannot provide any general advice on whether certain loan structures can be caught by Part IVA. Nevertheless, the ATO has sought to provide some level of clarification by issuing Taxation Determination TD 2008/27, which generally allows compound interest to be claimed as a tax deduction on the basis that it takes the same character as the primary interest to which it relates. However, it is important to note that this determination does not negate the principles in Hart’s case and should only be relied upon to claim a tax deduction for incidental compound interest expenses where there is a genuine commercial reason for the compounding, and not for unexplained continuous compounding over long periods of time. Investors who pay their interest regularly and limit the effects of compounding to situations such as temporary cash flow management issues should be able to protect themselves from potential tax avoidance allegations.

Tax Ruling Protection for Sub Account Use

Debt facilities with multiple credit lines do not contravene Part IVA per se. Taxation Ruling TR 2000/2 provides protection for investors using sub accounts under line of credit facilities with legitimate commercial objectives. Similarly, in the recent determination TD 2012/1 the ATO reiterated that where all payments are directed at the non-deductible private loan then Part IVA may apply to the arrangement. Specifically, the Tax Ruling allows the legitimate use of sub accounts drawn down from a single facility for the following purposes:

1. To keep borrowings applying to private or non-income generating assets SEPARATE from income generating (ie, investment) assets.
2. To determine TAX DEDUCTIBLE INTEREST PAYMENTS pertaining to income generating assets.

Generally speaking, sub accounts which deliver flexibility and control for investors are accepted by the Tax Office. However, arrangements that require fixed repayments and which link those repayments to an overall level of indebtedness should be avoided.

Implications for CALIA+

Like all cases where Part IVA is contravened, the High Court found tax avoidance to be the dominant or sole (objective) purpose of the taxpayers’ contrived arrangements in Hart’s Case. For investors with commercial motives, however, tax deductions for interest expense should generally continue to be available.

In fact, High Court Judges Gleeson and McHugh provided even greater guidance for investors seeking to optimise their tax position. They referred to an investor who uses an arrangement with an interest-only loan for the investment debt and a loan that can be paid down with surplus funds for the non-income generating debt as “acting rationally”, and they described such an arrangement as making “commercial sense”. The use of interest-only accounts for investment purposes would thus seem to be a best case position in practice for debt management structures. Access to interest deductions through the proper use of debt platforms, such as CALIA+, and their sub accounts, is thus supported by these comments from the High Court as well as the ATO’s comments in Taxation Ruling TR 2000/2.

Hart’s Case involved a structure which was contrived and lacked transparency and commercial intent and provided a result that most commentators considered ‘too good to be true’. Investors with commercial oriented motives and properly segregated assets with no compounding of interest, but using interest-only investment accounts or sub accounts under line of credit facilities to maximise investment debt, should, in practice, not be concerned by the outcome of Hart’s Case.