TR 2000/D3 - Income tax: deductions for interest following the Steele and Brown decisions

This document has been finalised by TR 2000/17.
There is an Erratum notice for this document.

Draft Taxation Ruling
Income tax: deductions for interest following the *Steele* and *Brown* decisions

Preamble

This document does not rule on the application of a 'tax law'(as defined) and is, therefore, not a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. The document is, however, administratively binding on the Commissioner of Taxation. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling considers the implications of the decisions of the High Court in *Steele v. FC of T* 99 ATC 4242; (1999) 41 ATR 139, and of the Full Federal Court in *FC of T v. Brown* 99 ATC 4600; (1999) 43 ATR 1. The former concerns, amongst other things, the deductibility of interest on money borrowed to purchase land intended to be developed. The latter concerns the deductibility of certain interest incurred after the cessation of business. Both cases involve claims for interest incurred in periods during which no relevant assessable income was derived.

2. Although the cases deal with the issue in terms of subsection 51(1) of the *Income Tax Assessment Act 1936* ('the Act'), the decisions in the cases and the discussion in this Ruling have equal application to section 8-1 of the *Income Tax Assessment Act 1997*. All references to subsection 51(1) should therefore be taken as including a reference to section 8-1.

Ruling

Deductions for interest

3. The deductibility of interest is determined through an examination of the purpose of the borrowing and the use to which the borrowed funds are put (*Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613, *FC of T v. Energy Resources of Australia Limited* 96 ATC 4536; (1996) 33 ATR 52, and *Steele*).

4. Ordinarily '…the purpose of the borrowing will be ascertained from the use to which the borrowed funds were put…' (Hill J in *Kidston Goldmines Limited v. FC of T* 91 ATC 4538 at 4545; (1991) 22 ATR 168 at 176). However, as his honour later observed in *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380 at 4388; (1992) 23 ATR 494 at 504, '…a rigid tracing of funds will not always be necessary or appropriate…'.

Can interest be capital?

5. In *Australian National Hotels Limited v. FC of T* 88 ATC 4627; (1988) 19 ATR 1575 Bowen CJ and Burchett J said (at ATC 4633; ATR 1582):

> '... there is a special feature of loan capital, which flows from the ephemeral nature of a loan. The cost of securing and retaining the use of the capital sum for the business, that is to say, the interest payable in respect of the loan, will be a revenue item. It creates no enduring advantage, but on the contrary is a periodic outgoing related to the continuance of the use by the business of the borrowed capital during the term of the loan ...
>
> Rent ... and interest are both periodic payments for the use, but not the permanent acquisition, of a capital item. Therefore, a consideration of the often-cited three matters identified by Dixon J in *Sun Newspapers Limited v FC of T* (1938) 61 CLR 337 at p. 363 assigns interest and rent to revenue.'

6. However, when Mrs Steele's case came before the Full Federal Court in *Steele v. FC of T* 97 ATC 4239; (1997) 35 ATR 285, the majority (Burchett and Ryan JJ) said at ATC 4247; ATR 294 that in *The Texas Company (Australasia) Limited v. FC of T* (1940) 63 CLR 382, when Dixon J discussed the way the Australian system treats interest on money borrowed to secure capital, he was speaking in the context of current income-gathering activities. They said he regarded interest payments as part of the 'recurrent expenditure which must be incurred to obtain the use of the money'. They said that interest paid in relation to the acquisition or creation of a capital asset, which is later to be utilised in income-gaining activities, is paid so that, when the time comes, an enduring asset will be available for use in the intended activity. The implication is that in such circumstances the interest is a capital expense or is of a capital nature, and the fact that while the capital asset is being created the payments of interest are recurrent is not enough the change this conclusion.

7. On appeal, a majority of the High Court (Gleeson CJ, Gaudron and Gummow JJ) overturned the decision and rejected this reasoning of the Full Federal Court. The majority expressed the following view:

> 'As was explained in ANA, interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of the borrowed money during the term of the loan. According to the criteria noted by Dixon J in Sun Newspapers it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of the interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature. However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited time of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.' (at ATC 4248; ATR 148)

Interest incurred prior to assessable income

8. The rejection of the Full Federal Court's finding of capital did not dispose of the matter for the High Court. It revitalised the relevance of the earlier finding of the Administrative Appeals Tribunal that Mrs Steele should be denied a deduction in respect of the interest outgoings (in excess of agistment income) substantially on the ground that the first limb of sub section 51(1) was not satisfied.

9. At ATC 4251; ATR 150 the majority embraced the proposition that expenditure will be 'incurred in gaining or producing the assessable income' (that is, come within the first limb of sub section 51(1)) if it is 'incidental and relevant' to the gaining or producing of that income. In the case of Mrs Steele the relevant assessable income was not expected until well into the future, and the question arose as to whether, in all the circumstances, the interest expenditure was indeed both 'incidental and relevant'.

10. The majority found that the latter requirement was satisfied:

> 'Bearing in mind that the assessable income referred to is the assessable income of the taxpayer generally, it seems difficult to deny the relevance of the outgoing presently in question'.

11. Whether expenditure made prior to the derivation of expected assessable income is 'incidental' also falls for consideration. The majority explained the temporal relationship in the following way:

> 'there are cases where the necessary connection between the incurring of an outgoing and the gaining or producing of assessable income has been denied upon the ground that the outgoing was "entirely preliminary" to the gaining or producing of assessable income or was incurred "too soon" before the commencement of the business or income producing

activity. The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of facts relevant to a judgment as to whether the necessary connection might, in a given case, exist, but contemporaneity is not legally essential, and whether it is factually important may depend upon the circumstances of the particular case.

> As Lockhart J said in *FC of T v. Total Holdings (Australia) Pty Ltd*:
>
> "…[I]f a taxpayer incurs a recurrent liability for interest for the purpose of furthering his present or prospective income earning activities, whether those activities are properly characterised as the carrying on of a business or not, generally the payment by him of that interest will be an allowable deduction under s 51.
> …
> "I say 'generally' as some qualification may be necessary in appropriate cases, for instance, where interest is paid by a taxpayer as a prelude to his being in a position whereby he may commence to derive income. In such cases the requirement that the expenditure be incidental and relevant to the derivation of income may not be satisfied." '

12. It follows from *Steele* that interest incurred in a period prior to the derivation of relevant assessable income will be 'incurred in gaining or producing the assessable income' in the following circumstances:

- The interest is not incurred 'too soon', is not preliminary to the income earning activities and is not a prelude to those activities;
- the interest is not private or domestic;
- the period of interest outgoings prior to the derivation of relevant assessable income is not so long, taking into account the kind of income earning activities involved, that the necessary connection between outgoings and assessable income is lost;
- the interest is incurred with one end in view, the gaining or producing of assessable income; and
- continuing efforts are undertaken in pursuit of that end[1].

[1] This requirement is mentioned by Callinan J at ATC 4263; ATR 168. See further at paragraph 27 of this Ruling

Interest incurred after assessable income

13. *Brown's* case was one in which the facts presented a mirror image of those in *Steele*, to the extent that interest was incurred in a year subsequent to (*cf* 'prior to' in *Steele*) the year of derivation of the relevant assessable income. Even so, the process of determining whether such interest is deductible is only partially symmetrical and invokes some different considerations.

14. In *Brown's* case the interest in question was incurred at a time after the borrowed funds (or assets representing those funds, including goodwill) had been lost to the taxpayer. Had it been otherwise, deductibility would typically be determined through an examination of the use of the borrowed funds over the period during which the interest was incurred (see paragraphs 3 & 4 above).

15. Where interest has been incurred over a period after the relevant borrowings (or assets representing those borrowings) have been lost to the taxpayer, it is apparent that the interest is not incurred in gaining or producing the assessable income of that period or any future period. However, it will still have been incurred in gaining or producing 'the assessable income' if the occasion of the outgoing is to be found in whatever was productive of assessable income of an earlier period. This requirement will be satisfied if:

- the funds were borrowed for an income earning purpose and not used for any other purpose; and
- the taxpayer has no legal entitlement to repay the principal and as a result is saddled with an unavoidable stream of interest outgoings.

Date of effect

16. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 20 and 21 of Taxation Ruling TR 92/20).

Explanations

Deductions for interest

17. The majority in *Steele* did not dwell upon the general aspects of interest deductibility. Their comments were limited to the following:

> 'In deciding whether, in the present case, the interest was an outgoing "incurred *in* gaining or producing the assessable income", it is unnecessary to become involved in seeking to distinguish between the purpose of the taxpayer in borrowing the money and the use to which the borrowed funds were put' (at ATC 4251; ATR 150).

18. But this was not because the use and purpose were unimportant - it was because the use and purpose in this case were harmonious.

19. The Court in *Brown* followed the approach in *AGC (Advances) Ltd v. FC of T* 75 ATC 4057; (1975) 5 ATR 243 and *Placer Pacific Management Pty Limited v. FC of T* (1995) 95 ATC 4459; (1995) 31 ATR 253 when it drew upon the proposition that a taxpayer may still be entitled to a deduction after the business ceased in respect of a recurrent liability for interest:

> '… provided the **occasion** of a business outgoing is to be found in the business operations directed towards the gaining or production of assessable income generally …' (quoting from the majority judgment in *Steele*, emphasis added.)

It considered that it was:

> '… appropriate to approach the issue of the "occasion" of the loss or outgoing, being interest paid, by reference to the purpose of the taxpayer and his wife in borrowing the money and the use to which those borrowed funds were put.'

The Court went on, though, to indicate it may be possible that:

> '... as a result of the cessation [of the business], the occasion of the recurrent loss or outgoings in question was no longer to be found in the business operations ...' (at ATC 4520-4521; ATR 6-8)

20. The reasoning in *Brown*, then, is not a straight forward application of either 'use of funds' or 'purpose of borrowing', although these notions do have a part to play.

Interest and capital

21. Even though generally interest cannot be capital (see paragraph 7 above), the proposition does not extend to other types of recurrent expenditure. For example, if Mrs Steele had reached the stage of actual motel construction, weekly payments to bricklayers would be capital,[2] even though the recurrent interest expenditure in respect of the loan funds used to buy the land would not be so. And it might be noted that even though interest on borrowed funds is ordinarily on revenue account, the outlay of the relevant borrowed funds on other recurrent costs, such as the bricklayer payments, can still fail to give rise to a deduction for those costs owing to the operation of the capital exclusion.

Expenditure incurred prior to assessable income

22. It is well accepted that expenditure can satisfy the positive limbs of subsection 51(1) even though it is incurred in a period prior to any expected resultant income[3]. Even so, the majority in *Steele* acknowledged that those limbs will not be satisfied if that expenditure is 'too soon', 'preliminary' or a 'prelude' (see paragraph 11 above):

- An outgoing may be 'too soon' in the sense that a significant delay between the incurring of an outgoing and the actual or projected receipt of income may be relevant in determining whether expenditure is deductible; and
- An outgoing may be 'too soon' in the sense that the advantage conferred by the expenditure is necessary for, but not to be found 'in', the regular income earning activities ('functionally too soon'). Such a situation can arise even in the absence of the above mentioned 'significant delay'.

23. In relation to temporal delays:

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[2] 'Where a person is employed for the specific purpose of carrying out an affair of capital, the mere fact that that person is remunerated by a form of periodical outgoing would not make the salary or wages on revenue account' per Hill J in *Goodman Fielder Wattie Ltd v. FC of T* 91 ATC 4438 at 4453; 22 ATR 26 at 43.

[3] *Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (1949) 78 CLR 47 at 56 per Latham CJ, Rich, Dixon, McTiernan and Webb JJ 'The words "such income" [in subsection 51(1)] mean "income of that description or kind" and perhaps they should be understood to refer not to the assessable income of the accounting period but to assessable income generally. If they were so interpreted, they would cover a case where the business had not yet produced ... assessable income.'

> '… [s]tatements in the cases that a loss or outgoing was incurred "too soon" for it to satisfy the statute are not intended to lay down a further test …'.

Rather, it is merely that:

> '[t]he temporal hiatus may suggest the outgoing was incurred for some purpose other than the gaining or producing of assessable income' (both per Lee and Lindgren JJ in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR, 326 at 341).

Temelli v. FC of T 97 ATC 4716; (1997) 36 ATR 417 is a case in which it was found that the temporal hiatus left open the possibility of some purpose other than gaining or producing assessable income to such an extent that the required nexus did not exist.

24. There has been a number of instances in which Australian courts have held that an outgoing is not deductible because it falls into the second category (i.e., functionally too soon). For example:

- expenses relating to the establishing of a paper production industry were not deductible as they were held to be entirely preliminary and directed at deciding whether or not an undertaking would be established to produce assessable income - *Softwood Pulp and Paper Ltd v. FC of T* 76 ATC 4439; (1976) 7 ATR 101 .
- expenses incurred by a professional footballer in securing employment with a new club were incurred too soon to be properly regarded as gaining or producing assessable income – *FC of T v. Maddalena* 71 ATC 4161; (1971) 2 ATR 541.
- expenditure on research into the development and production of monoclonal antibodies was not deductible as the company was not conducting the research as a business or an activity of gaining or producing assessable income but rather as a collaborator in a research project - *Goodman Fielder Wattie*.

25. Neither the majority, nor Callinan J, found that Mrs Steele's interest payments were incurred 'too soon' in either of the senses discussed in paragraph 22 above:

- Even though the interest was incurred well prior to anticipated resultant income:

  > 'The appellant's intentions were always entirely commercial ones for the purpose of gaining or producing assessable income. As the majority here has also said, there was no suggestion that

> the applicant ever contemplated using the property for private or domestic purposes …' (Callinan J at ATC 4261; ATR 165)

and

> '… the expenditures.....were made with one end in view, of gaining or producing assessable income ...' (Callinan J at ATC 4263; ATR 168)

and any suspicions that might have been entertained about the true intentions were allayed by the observation that the interest expenditure was:

> '… made over a period that may be viewed as a relatively short one in the relevant industry …' (Callinan J at ATC 4263; ATR 168)

- Even though the interest was incurred over a period during which it was intended to improve the asset secured by the borrowed funds, leaving open the possibility that the outgoing was not incurred 'in' the (future) income earning activities, there was no such finding. Significantly, while both the majority and Callinan J were very much alive to the possibility that expenditures can fail to be deductible for these kinds of reasons (majority at ATC 4251; ATR 151, and the cases there cited and Callinan J at ATC 4262; ATR 167), they did not countenance the notion that interest during a period of improvement might be seen as 'paid by a taxpayer as a prelude to his being in a position whereby he may commence to derive income' (see paragraph 11 above).

26. It follows that interest on borrowed funds which have been expended upon any aspect of the development of a property which is solely intended to be employed in income earning operations would satisfy the first of the conditions at paragraph 12 above.

27. The last of those conditions requires that continuing efforts are undertaken in pursuit of assessable income. It received no attention from the majority, and consideration of this matter is to be found in the reasons of Callinan J. We have concluded that the concept of 'continuing efforts' should not be taken to require constant on-site development activity. However, if a venture becomes truly dormant and the holding of the asset is passive, relevant interest will not be deductible even if there is an intention to revive that venture some time in the future. This is consistent with *Inglis v. FC of T* 80 ATC 4001; (1980) 10 ATR 493 (see Brennan J at ATC 4004; ATR 496, except for the comments about interest deductions being capital which must now be considered incorrect, and Davies J at ATC 4008; ATR

500). *Inglis* is a case cited with approval by the majority, although in a slightly different context (*Steele* at ATC 4251; ATR 151).

Expenditure incurred after assessable income

28. Since *AGC* and more recently *Placer Pacific*, it is clear that the statement of the Court in *Ronpibon Tin* that:

> '… it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of assessable income …' (at 57)

bears the implication that a loss or outgoing can be deductible even if it is incurred after the cessation of income earning activities. But in order to be deductible the occasion of the outgoing must be found in those income earning activities.

29. The cases do not make clear what the 'occasion' is, although it is obviously distinct from the event of 'incurrence', given that the outcomes in these cases turn upon the finding that the 'incurrence' of the outgoing was subsequent to its 'occasion'. Those cases do however provide examples of 'occasions':

- in *AGC* the occasion of a debt that turned bad after the cessation of business activities was found to be in the 'agreement by which the debt was created' (per Mason J at ATC 4072; ATR 260)
- in *Placer Pacific* the occasion of an outgoing to remedy a defective conveyor system at the taxpayer's previous business premises was found to be in the agreement for the supply of the conveyor belt which was alleged to be defective;

30. *Brown* demonstrates that the occasion of interest expenditure can sometimes be found in income earning activities even where those activities are now defunct and all the borrowed funds (or assets representing those funds) are lost. Mr Brown was successful in his claim for interest deductions because he had no legal entitlement to make early repayment of the loan, and as a result was unable to avoid incurring liability for interest - in other words, even though the income earning activities had ceased, the taxpayer was saddled with an unavoidable stream of future interest outgoings. That burden was an absolute legacy of the prior income earning activities. In view of these circumstances the interest deduction was allowable because:

> '… the cessation of business did **not** have the consequence that the "occasion" for the liability to pay interest no longer remained the original liability to pay that interest under the Bank loan.' (at ATC 4522; ATR 10, emphasis added).

31. However, Mr Brown would have failed in his claim if he had the power to avoid the future interest outgoings. Had the loan agreement been like a 'roll over' facility, which provided the borrower with the legal entitlement to elect to repay the principal and thereby avoid incurring liability for interest:

> '... that may have been a different situation. In that circumstance there may be considerable force in a contention that the **occasion** of the liability was the election to "roll over" the loan on each monthly date, rather than any liability arising under the terms of the original loan agreement ...' (at ATC 4522; ATR 10).

32. That is, in a case where a borrower does not have an obligation to keep the loan going, but merely an opportunity to do so, that person is not saddled with an ongoing interest burden and so:

> '… the cessation of the business or sale of the income producing asset acquired with the borrowed funds might properly be regarded as breaking the nexus [required to satisfy subsection 51(1)]' (at ATC 4522; ATR 10).

33. Whilst it is true that Mr Brown did indeed make early repayment because of an indulgence extended by the bank, the Court explicitly found that there was **no legal entitlement** to do so (at ATC 4519 & 4522; ATR 5 & 10). And such a finding was necessary in order that the taxpayer succeeded in his claim. In illustrating this critical point of distinction, the Court used the case of a 'roll over' facility as an example of a case in which early repayment is possible, and so exemplify cases in which a taxpayer could 'avoid incurring liability for interest' (at ATC 4522; ATR 10).

34. The practical effect of this analysis is that any taxpayer who has borrowed for income earning activities and has:

- lost the borrowed funds (and any assets representing those funds); and
- ceased the relevant income earning activities

will be entitled to deductions for the interest incurred subsequent to the cessation of those activities, but only up to the amount of interest that the taxpayer was legally powerless to prevent accruing from the time of cessation. Take, for example, the case of such a taxpayer who, under the terms of the loan agreement, was required to give six months notice to repay the principal. If the borrower did not give notice at the time of the cessation of the business, the first six months interest would be deductible (just as it would be to the person who gave the notice) but the interest that accrued after six months would not.

35. Even if a premature repayment of capital gives rise to a penalty, the taxpayer will still be considered as being entitled to make early repayment. The approach to penalties described below will ensure that whether, on the one hand, the taxpayer cannot make early repayment and is saddled with interest or, on the other hand, suffers penalties upon early repayment, equivalent tax relief will be available in respect of unavoidable outgoings.

Penalty 'interest' payments

36. In a case where borrowed funds are lost and there is a penalty imposed upon early repayment of the borrowing, that penalty will be deductible as if it were interest that could not be avoided (see second dot point in paragraph 15) whether or not it can truly be characterised as interest. More generally, penalty 'interest' is discussed in Taxation Ruling TR 93/7.

Detailed contents list

37. Below is a detailed contents list for this Ruling:

Your comments

38. We invite you to comment on this draft Taxation Ruling. We are allowing 6 weeks for comments before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

Comments by Date: **5 May 2000**
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Commissioner of Taxation
22 March 2000

Previous draft:

Not previously issued in draft form, but follows from TR 97/D18

Related Rulings/Determinations:

- IT 196
- IT 209
- TR 92/3
- TR 93/7
- TR 95/33
- TR 98/22
- TD 95/27

Subject references:

- interest expenses
- deductions and expenses

Legislative references:

- ITAA 36 51(1)
- ITAA 97 8-1

Case references:

- AGC (Advances) Ltd v. FC of T 75 ATC 4057; (1975) 5 ATR 243
- Australian National Hotels Limited v. FC of T 88 ATC 4627; (1988) 19 ATR 1575
- FC of T v. Brand 95 ATC 4633; (1995) 31 ATR 341

FC of T v. Brown 99 ATC 4600; (1999) 43 ATR 1

- FC of T v. Energy Resources of Australia Limited 96 ATC 4536; (1996) 33 ATR 52
- FC of T v. JD Roberts; FC of T v. Smith 92 ATC 4380; (1992) 23 ATR 494
- FC of T v. Maddalena 71 ATC 4161; (1971) 2 ATR 541
- FC of T v. Total Holdings (Australia) Pty Ltd 79 ATC 4279; (1979) 9 ATR 885
- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- Goodman Fielder Wattie Ltd v. FC of T 91 ATC 4438; 22 ATR 26
- Inglis v. FC of T 80 ATC 4001; (1980) 10 ATR 493
- Kidson Goldmines Limited v. FC of T 91 ATC 4538; (1991) 22 ATR 168
- Placer Pacific Management Pty Limited v. FC of T (1995) 95 ATC 4459; (1995) 31 ATR 253
- Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47
- Softwood Pulp and Paper Ltd v. FC of T 76 ATC 4439; (1976) 7 ATR 101
- Steel v. FC of T 97 ATC 4239; (1997) 35 ATR 285
- Steele v. FC of T 99 ATC 4242; (1999) 41 ATR 139

- Sun Newspapers Limited v. FC of T (1938) 61 CLR 337
- Temelli v. FC of T 97 ATC 4716; (1997) 36 ATR 417
- The Texas Company (Australasia) Limited v. FC of T (1940) 63 CLR 382

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