


***IT 2661 - Income tax: apportionment of interest where money is borrowed to fund the purchase of an asset part of which is used for a business purpose and part for a non-business purpose***

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**ALLOWABLE DEDUCTIONS  
APPORTIONMENT OF  
INTEREST**

51(1)

OTHER RULINGS ON THIS TOPIC:

**TITLE: INCOME TAX: APPORTIONMENT OF INTEREST WHERE MONEY IS  
BORROWED TO FUND THE PURCHASE OF AN ASSET  
PART OF WHICH IS USED FOR A BUSINESS PURPOSE  
AND PART FOR A NON-BUSINESS PURPOSE**

NOTE: . Income Tax Rulings do not have the force of law.

- . Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

The purpose of this Ruling is to outline the special circumstances in which a taxpayer who borrows money to purchase an asset, part of which is to be used for a business purpose and part for a non-business purpose, may:

- (a) apply the whole of the borrowings to that part of the asset used for business purposes; and
- (b) deduct under subsection 51(1) of the Income Tax Assessment Act 1936 ("the Act") the whole of the interest paid on the borrowed sum.

The issue was considered by the Federal Court of Australia in F.C. of T. v. Carberry 88 ATC 5005;(1988) 20 ATR 151 where Davies J dismissed the Commissioner's appeal against the decision of the Administrative Appeals Tribunal reported as Case V30 88 ATC 276; AAT Case 4079 (1988) 19 ATR 3182. The Commissioner did not appeal from the decision of the Federal Court.

FACTS AND DECISION

2. The brief facts of the case were that the taxpayers (husband and wife) in order to increase their income, formed a partnership

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to acquire a kindergarten business. The partnership purchased a suitable property worth \$140,000 consisting of a residence and kindergarten in separate buildings. The purchase price included an amount of \$20,000 for goodwill, plant and equipment. To fund the purchase of the new property and additional equipment, the taxpayers used funds of \$80,000 from the sale of their previous residence and borrowed \$68,000 secured against the purchased property.

3. During the income years ended 30 June 1983 and 30 June 1984, the taxpayers claimed deductions in respect of the full amount of interest on the borrowings. The Commissioner allowed a deduction for one-half of the interest, treating the other half as relating to the residence and, therefore, private in nature and not deductible.

4. The Administrative Appeals Tribunal (Senior Member P.M. Roach) found that the partnership, as distinct from the individuals, borrowed the funds in order to purchase the business and that therefore the partnership "suffered the entire burden of interest on the borrowings and did so in such a way as to constitute the expenditure a loss or outgoing allowable pursuant to section 51(1) of the Act". The Tribunal went on to say that, even if it were to be considered that the individuals themselves incurred the liability for interest, in the circumstances the whole of the interest paid was "fairly and properly attributable to gaining the assessable income".

5. On appeal, Davies J (in the Federal Court), found that the Tribunal had not made any error of law and agreed that the taxpayers were entitled to a deduction in respect of the full amount of interest paid. Davies J pointed out that what had to be examined was the purpose for which the monies were borrowed and the use to which they were put.

6. His Honour accepted the finding of the Tribunal that the \$140,000 purchase price of the real estate and goodwill was to be apportioned as follows:

Residence	\$70,000
Kindergarten premises	\$50,000
Goodwill	\$20,000

Davies J also accepted that the partners' contribution of capital represented the difference between the \$80,000 which they had received from the sale of their previous residence and the \$70,000 required to purchase the new residence. Accordingly, his Honour agreed with the Tribunal that the borrowings of \$68,000 could be solely attributed to the \$70,000 required to purchase the kindergarten premises and the goodwill.

7. Davies J cited Chapman v. F.C. of T. (1968) 117 CLR 167 as authority for the proposition that a notional apportionment of

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land could be made in the circumstances. His Honour placed reliance on the passage at p.170 where Menzies J considered whether a notional apportionment of land could be made for the purposes of calculating a profit under paragraph 26(a) (now repealed) of the Act:

"The problem which has troubled me is ... whether it is possible to treat what was one acquisition as having been made with one purpose as to one part and another purpose as to the remainder. I have reached the conclusion that it is, and that to do so is in accord with common experience."

8. In Chapman, the taxpayer acquired 44 acres of rural land after being unable to obtain a smaller parcel of land. The taxpayer then subdivided 27 acres of the land into 18 allotments and sold the allotments at a profit. The remaining 17 acres were kept by the taxpayer for private purposes. Menzies J held that the profits from the sale of the 18 allotments were assessable under the first limb of paragraph 26(a) of the Act.

9. In reaching his conclusion, Menzies J observed that it often happens that the purchaser of an entirety proposes to break up the entirety and use one part in one way and another part in a different way. In such a case, Menzies J held that it would be "in vain" to search for a dominant purpose in respect of the entirety because there is a different purpose attached to parts of the entirety with neither purpose being subservient or dominant to the other.

10. Davies J adopted this reasoning in Carberry and was able to find that one part of the land had been purchased for the private purpose of providing a home for the taxpayers with the money acquired from the sale of their previous home. The borrowings on the other hand had been used solely to enable the partnership to acquire assets of the business and that therefore the Tribunal had not erred in law in finding that the total amount of interest paid by the partnership was an allowable deduction.

RULING

11. The approach adopted by the Federal Court is accepted in the special circumstances of the case. Essentially, the issue involved was whether it is possible, when a single asset is purchased using borrowings and there is a dual business and non-business purpose in the acquisition, to apply the whole of the borrowings to the business purpose and to allow a deduction for the interest paid on the whole of the borrowings.

12. In certain cases, such as Carberry, a single asset (such as land with a single title) may be capable of being properly regarded as having been notionally divided between a part acquired with a business purpose and a part acquired with a non-business purpose. In such a case, borrowings may be properly regarded as

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relating to the notional part of the asset acquired for a business purpose and a deduction will be allowed for the full amount of interest paid in respect of the borrowings.

13. However, for this method of apportionment to apply, it must be shown that the borrowings in fact relate solely to the notional part of the asset acquired for business purposes. In Carberry, for instance, the taxpayers were able to show that the part of the asset purchased for private purposes was paid for with the monies which the taxpayers had received from the sale of their previous residence. Accordingly, it was open to the Tribunal to find that part of the asset purchased for business purposes was in fact purchased with the borrowed funds.

14. Not all assets can be notionally divided into parts such that one purpose may be ascribed to one part and a different purpose to another part. For instance, most motor vehicles and machinery will be incapable of being notionally divided such that different purposes may be imputed to particular parts of the asset. A dual purpose may attend the borrowing of monies to purchase such an asset but the dual purpose is not divided between specific parts of the asset. In such a case, the principles of apportionment will apply to allow a deduction for the interest on the borrowings to the extent to which the asset is used for an income-producing or business purpose.

COMMISSIONER OF TAXATION

28 November 1991