


IT 2678 - Income tax: deductibility of interest on money borrowed to make superannuation contributions

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Taxation Ruling

Income tax: deductibility of interest on money borrowed to make superannuation contributions

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What this Ruling is about

1. The purpose of this Ruling is to explain whether interest expenditure incurred by :

- . an employer;
- . an employee; or
- . a self-employed person

on money borrowed to make superannuation contributions, is an allowable income tax deduction under subsection 51(1) of the *Income Tax Assessment Act 1936*.

Ruling

An employers' interest expenditure

2. Interest expenditure incurred by an employer on money borrowed for the purpose of, and applied in, making contributions to a superannuation fund to provide benefits to his or her employees or their dependants is an allowable deduction under subsection 51(1).

An employee's interest expenditure

3. Interest expenditure incurred by an employee on money borrowed for the purpose of, and applied in, making contributions to a superannuation fund to provide benefits to the employee and his or her dependants is an allowable deduction under subsection 51(1) (even though the superannuation contributions themselves are not allowable deductions under that subsection).

4. If money is borrowed by an employee for the purpose of, and applied in, making contributions to a superannuation fund to provide benefits solely for the employee's dependants, interest expenditure incurred on the borrowed money is not deductible under subsection 51(1).

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A self-employed person's interest expenditure

5. Interest expenditure incurred by a self-employed person on borrowings used to make superannuation contributions to provide benefits for that person and his or her dependants is an allowable deduction under subsection 51(1).

Date of effect

6. This Ruling applies (subject to limitations imposed by statute) to years of income commencing both before and after the date on which it is issued.

Explanations

An employer's interest expenditure

7. For interest expenditure to be deductible under subsection 51(1) in a situation where an employer carries on a business (which business is directed towards the gaining or producing of assessable income), the interest outgoing may be either:

- . incurred in (i.e. in the course of) gaining or producing the assessable income; or
- . necessarily incurred in carrying on business for the purpose of gaining or producing such income.

8. Interest outlaid in carrying on business by an employer on money borrowed and applied in making superannuation contributions to provide benefits for employees and their dependants is:

- (a) part of the cost of the employer's trading operations to produce income i.e., it has the character of a working expense (c.f. *John Fairfax and Sons Pty Ltd v. FC of T* (1959) 101 CLR 30 at 48); and
- (b) an outgoing, viewed objectively, that is reasonably capable of being seen, in the circumstances, as desirable or appropriate from the point of view of the pursuit of the business ends of the employer's business (c.f. *Magna Alloys and Research Pty Ltd v. FC of T* 80 ATC 4542 at 4559; (1980) 11 ATR 276 at 295).

9. For either of the two reasons in paragraph 8, the interest outlay therefore has the essential character of a working expense of the employer's business and it is deductible under subsection 51(1).

An employee's interest expenditure

10. For interest expenditure to be deductible under subsection 51(1), in a situation where a business is not being carried on, the expenditure must be incurred in gaining or producing the assessable income.

11. The relationship or connection between the interest expenditure and the assessable income must be such that the interest expenditure bears the character of an outgoing incurred in gaining or producing assessable income (*Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957; (1991) 22 ATR 613 at 621-2).

12. Interest expenditure will have the character of an income producing expense if it is incidental and relevant to the end of gaining or producing assessable income.

13. An interest outgoing is incidental and relevant to the end of gaining or producing assessable income if the funds are borrowed for the purpose of gaining that income and the borrowed funds are laid out (i.e. used or applied) for that purpose (*FC of T v. Munro* (1926) 38 CLR 153 and *Texas Co (Australasia) Ltd v. FC of T* (1940) 63 CLR 382).

14. The reference in subsection 51(1) to "*the* assessable income" is not to be read as confined to assessable income actually derived by a taxpayer in the particular income year in which an interest outgoing is incurred. It refers not only to assessable income derived in that or some other income year but also to assessable income of the taxpayer which the outgoing would be expected to produce (*Fletcher case* 91 ATC at 4957; 22 ATR at 621).

15. A contribution by an employee to a superannuation fund is an investment to secure rights under the fund. As relevant for present purposes, it is a payment made to secure at some future time either an annuity (assessable under section 25 or 27H) or a lump sum (assessable as to 5% under section 27C for pre-July 1983 service and assessable in full under section 27B for post-June 1983 service). The contributions, in effect, are periodical payments to acquire an income-producing asset, namely, an entitlement to an annuity or the assessable portion of a lump sum. If money is borrowed by an employee to make contributions, the borrowed funds (if so used) are paid on capital account. Interest outlays incurred in borrowing the funds are, however, on revenue account.

16. We are satisfied in the present circumstances that the laying out by an employee of borrowed funds for the purposes of gaining *the* assessable income - in other words assessable income generally of the employee, including assessable income in future income years - furnishes the required relationship or connection between an interest outlay on the borrowed funds and the assessable income the employee expects to derive on his or her cessation of employment. The interest

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outlay therefore has the character of an income-producing expense, i.e., an outgoing incurred in gaining or producing assessable income, and is deductible under subsection 51(1).

17. These circumstances are different from borrowing money to pay premiums on a life assurance policy. In Taxation Ruling IT 2504 we concluded that (except for key man insurance and split dollar insurance) interest incurred in borrowing funds to pay life assurance premiums is not deductible under subsection 51(1) for 2 reasons:

- (i) the interest is not incurred in gaining or producing assessable income because any connection between the payment of the interest and the possibility of gaining assessable income by way of bonuses on the life assurance policy is too remote; and
- (ii) expenditure related to a life assurance policy on the policy holder's own life is of a private nature.

18. The first reason given in IT 2504 does not apply to interest incurred by employees on funds borrowed to pay superannuation contributions. Long term life policies are not designed to produce assessable income (although they may do so if the policy is terminated in the first 10 years) whereas the nature of a superannuation scheme is that it provides annuities (assessable in full) and/or lump sums (assessable in part or in full) to contributors. Even though the contributor may not derive assessable income from the fund for many years and that derivation is dependent on certain contingencies, there is a sufficient connection between the interest expenses and the derivation of assessable income to satisfy the first limb of subsection 51(1) (*FC of T v. DP Smith* 81 ATC 4114; (1981) 11 ATR 538).

19. Secondly, unlike interest on money borrowed to pay life assurance premiums, interest on money borrowed to pay superannuation contributions is not private in nature. A policy of insurance on a taxpayer's own life is essentially a private matter (*Case Y20 91 ATC 243 and IT 2504*). It is a method by which a person can provide benefits for dependants or others on that person's death. Superannuation contributions are an investment to secure rights which are expected to produce assessable income of the contributor (*FC of T v. Markey* 89 ATC 4600 at 4605; (1989) 20 ATR 948 at 953). Superannuation schemes often provide for benefits to be paid to a contributor's dependants or estate on the contributor's death but that does not affect the essential character of contributions to funds or of interest on money borrowed to pay contributions.

20. If an employee borrows money for the purpose of, and lays it out in, making contributions to a superannuation fund to provide benefits solely for his or her dependants, there is no connection between any interest outlay on the borrowed money and the assessable

income of the employee. No part of the interest outlay in these circumstances is therefore deductible under subsection 51(1).

21. Even though interest expenditure incurred by an employee on money borrowed to make superannuation contributions, in the circumstances stated in paragraph 3 above, is deductible under subsection 51(1), this does not mean that the contributions themselves are an allowable deduction under subsection 51(1). These contributions are outgoings of capital or of a capital nature : Case J23, 77 ATC 220; 21 CTBR (NS) Case 46; Case K52, 78 ATC 510; 22 CTBR (NS) Case 72; Case P130, 82 ATC 651; 26 CTBR (NS) Case 58; Case Q18, 83 ATC 63; 26 CTBR (NS) Case 79 and *Markey* ATC at 4605; ATR at 953.

A self-employed person's interest expenditure

22. For the same reasons in paragraph 10 to 16 above, interest expenditure incurred by a self-employed person is deductible under subsection 51(1) to the extent that the interest is laid out on borrowed money applied to make superannuation contributions to provide benefits for the self-employed person and his or her dependants.

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- ITAA 25; ITAA 27B; ITAA 27C
- ITAA 27H; ITAA 51(1)

case references

- Fletcher & Ors v. FC of T 91 ATC 4950; (1992) ATR 613
- John Fairfax and Sons Pty Ltd v. FC of T (1959) 101 CLR 30

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- Magna Alloys and Research Pty Ltd v. FC of T 80 ATC 4542;(1980) 11 ATR 276
- FC of T v. Markey 89 ATC 4600;(1989) 20 ATR 948
- FC of T v. Munro (1926) 38 CLR 153
- FC of T v. DP Smith 81 ATC 4114; 11 ATR 538
- Texas Co (Australasia) Ltd v. FC of T (1940) 63 CLR 382
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- Case Q18 83 ATC 63; 26 CTBR (NS) 538 Case 79