TR 93/7 - Income tax: whether penalty interest payments are deductible

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Australian Taxation Office

Taxation Ruling
Income tax: whether penalty interest payments are deductible

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling provides guidance in determining whether a "penalty interest payment" is deductible under either subsection 51(1), section 67 or section 67A of the *Income Tax Assessment Act 1936* ("ITAA"). In this Ruling the term "penalty interest payment" refers to an amount payable by a borrower under a loan agreement in consideration for a lender agreeing to accept an early repayment of a loan. The amount payable is commonly calculated by reference to a number of months of interest payments that would have been received had the premature repayment not been made.

2. The Ruling also considers the application of the capital gains and capital losses provisions (Part IIIA of the ITAA).

Ruling

3. A penalty interest payment is generally deductible under subsection 51(1) if:

(a) the loan moneys were borrowed for the purpose of gaining or producing assessable income or for use in a business carried on for that purpose; and

(b) the payment is made in order to rid the taxpayer of a recurring obligation to pay interest on the loan, where such interest would itself have been deductible if incurred.

4. Where the repayment of loan moneys borrowed for the purpose of producing assessable income is secured by mortgage, penalty interest payable on an early repayment which effects a discharge of the mortgage will generally be deductible under section 67A.

5. Penalty interest is not expenditure incurred in borrowing money so as to be deductible under section 67.

6. Where penalty interest is paid upon repayment of a loan incidental to the disposal of an asset, the payment is not taken into account under Part IIIA of the ITAA in calculating the amount of any capital gain or capital loss arising on the disposal.

Date of effect

7. This Ruling sets out the current practice of the Australian Taxation Office and is not concerned with a change in interpretation. Consequently, it applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Explanations

8. Subsection 51(1) provides that: "all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or are of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

9. Generally speaking, provided loan moneys were borrowed for the purpose of gaining or producing assessable income or for use in a business carried on for that purpose, penalty interest payable on early repayment of the loan will, unless it is of a capital nature, qualify for deductibility under subsection 51(1). This will commonly involve borrowings used to acquire an income-producing asset or to provide working capital to operate a business.

10. In the case of such borrowings, the central issue is whether penalty interest payments are "losses or outgoings of capital, or of a capital...nature". If so, then they will not be deductible under subsection 51(1), but may be deductible under sections 67 or 67A.

11. We do not consider that so-called penalty interest is, in fact, in the nature of interest. This is so even if the loan agreement uses the term "penalty interest". The description of an item used in any relevant agreement is not conclusive of its character (refer *FC of T v. Sth. Aust. Battery Makers Pty. Ltd.* (1978) 140 CLR 645 at 655; 78 ATC 4412 at 4417; 8 ATR 879 at 884 per Gibbs ACJ and *Cliffs International Inc.*

v. FC of T (1979) 142 CLR 140 at 148; 79 ATC 4059 at 4064; 9 ATR 507 at 512 per Barwick CJ). To call a payment "interest" does not conclusively determine that it in fact answers that description. Nor does it prevent the payment from being an outgoing of a capital nature.

12. Interest is considered to be "compensation to the lender for being kept out of the use and enjoyment of the principal sum": see *FC of T v. The Myer Emporium Ltd.* (1987) 163 CLR 199 at 218; 87 ATC 4363 at 4371; 18 ATR 693 at 702). Penalty interest is not paid for the use of the lender's money. It is paid in respect of a period when the borrower has repaid the loan and does not have the use of the money (refer R.W. Parsons, *Income Taxation in Australia* at para. 6.330)

13. The critical factor in determining the essential character of an outgoing is the character of the advantage sought by the making of the expenditure (*Sun Newspapers Ltd. v. FC of T* (1938) 61 CLR 337 at 363 per Dixon J). Whether an outgoing is capital or revenue in nature "depends on what the expenditure is calculated to effect from a practical and business point of view" (*Hallstroms Pty. Ltd. v. FC of T* (1946) 72 CLR 634 at 648 per Dixon J).

14. As a penalty interest payment is a cost directly attributable to obtaining early repayment of a loan, the question to be answered is effectively: "what, from a practical and business point of view, is the advantage sought from an early repayment of the loan?" This is a question of fact to be answered on a case by case basis.

15. Where the advantage sought is the release from the contractual obligation to incur a recurrent liability to pay interest on the loan, and such interest would itself have been deductible, then the penalty interest payment is on revenue account (*FC of T v. Marbray Nominees Pty. Ltd.* 85 ATC 4750; (1987) 17 ATR 93, *Metals Exploration Ltd. v. FC of T* 86 ATC 4505; (1987) 17 ATR 786). Such a payment does display certain capital indicia in terms of the tests enunciated by Dixon J. in the *Sun Newspapers case* (supra); i.e. it is a once-and-for-all type lump sum which eliminates a threatened disadvantage and thus produces a benefit of a lasting character for the taxpayer. Nevertheless, where the initiating cause for early repayment of the loan is a saving in future interest outlays, the payment is essentially revenue in character.

16. On the other hand, where the penalty interest payment is paid effectively as a price to rid the taxpayer of a burdensome capital asset or is otherwise incidental to the realisation of an asset, then it will generally be on capital account.

17. Where repayment of a loan is secured by mortgage, penalty interest payable on early repayment may be deductible under section 67A. Section 67A provides a deduction for expenditure (excluding principal or interest payments) incurred in connection with the

discharge of a mortgage securing repayment of moneys borrowed for the purpose of producing assessable income. Unlike subsection 51(1), deductibility is not affected by whether the expenditure is capital or revenue in nature. As previously discussed, so-called penalty interest is not, in fact, in the nature of interest, and is therefore not excluded on this basis from deductibility under section 67A.

18. Borrowing expenses which are on capital account and for that reason not deductible under subsection 51(1) may qualify for deduction under section 67. However, penalty interest is not "expenditure incurred... in borrowing money" for section 67 purposes. These words, in the context of section 67(1), refer to a "cost" of borrowing; i.e. expenditure incurred in relation to the actual establishment of the relevant loan. The liability to pay penalty interest is first incurred after the money is borrowed, and is therefore not incurred in borrowing the money. The payment is not made pursuant to a contractual obligation which was incurred at the time of borrowing as an incident of establishing the loan (refer *Ure v. FC of T* 81 ATC 4100; (1981) 11 ATR 484).

19. Where penalty interest is paid upon repayment of a loan incidental to the disposal of an asset, the payment is not taken into account for Part IIIA purposes in calculating the amount of any capital gain or capital loss arising on the disposal. The payment would not be included in the cost base of the asset under section 160ZH. In particular, it is not within the categories of "incidental costs" of acquisition or disposal in subsections 160ZH(5) or 160ZH(7), and, as it is not in the nature of "interest" (see paragraphs 11 and 12 above), is not a "non-capital cost" under subsection 160ZH(6A).

Examples

Example 1

20. Two years ago, Peter obtained a loan from a financial institution to purchase a rental property. The loan is for a period of five years, with interest payable at a fixed rate of 15 per cent per annum. Because of falls in prevailing interest rates, Peter can now refinance the property with a loan at a lower rate of interest, say 11 per cent. In order to refinance, Peter pays out the first loan early. Under the loan agreement, he incurs a penalty interest payment calculated on the basis of one month's interest for each year of the loan period remaining.

21. The advantage sought in practical terms by making the penalty payment and repaying the first loan is the future interest savings obtainable from the differential in rates charged on the two loans. The payment is therefore of a revenue character and deductible under

subsection 51(1). Were the refinancing to involve the discharging of a mortgage securing repayment of the first loan, the payment would also have been deductible under section 67A.

Example 2

22. Anne obtains a loan from a financial institution to purchase a rental property. Within the term of the loan Anne decides to sell the property. This requires her to repay the loan in order to discharge a mortgage over the property which secures the loan. In paying out the loan early Anne incurs a penalty interest payment.

23. The repayment of the loan, and the associated incurrence of the penalty payment, is a necessary incident of the sale of the property. A payment so connected to the realisation of a capital asset will be on capital account. The payment is therefore not deductible under subsection 51(1). The payment will, however, qualify for deductibility under section 67A as expenditure incurred in discharging a mortgage.

Example 3

24. Croydon Road Pty. Ltd. obtained an unsecured loan for a period of five years. It used the loan moneys to purchase plant and equipment with which to operate a new landscape gardening business in conjunction with its existing plant nursery business. After 12 months the new business had proven unprofitable. It was closed down so as to avoid further trading losses being incurred and the plant and equipment were sold. The loan was then repaid and a penalty interest payment incurred.

25. The penalty payment is made in connection with ridding the company of burdensome or unprofitable assets or parts of its business operations. It is therefore of a capital nature and not deductible under subsection 51(1). As the loan is unsecured, section 67A has no possible application.

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- deductions
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- ITAA 51(1); ITAA 67
- ITAA 67A ; ITAA Part IIIA

case references

- Cliffs International Inc. v. FC of T (1979) 142 CLR 140; 79 ATC 4059; (1979) 9 ATR 507
- Hallstroms Pty. Ltd. v. FC of T (1946) 72 CLR 634
- FC of T v. Marbray Nominees Pty. Ltd. 85 ATC 4750; (1986) 17 ATR 93
- Metals Exploration Ltd. v. FC of T 86 ATC 4505; (1986) 17 ATR 786
- FC of T v. Sth. Aust. Battery Makers Pty. Ltd. (1978) 140 CLR 645; 78 ATC 4412; (1978) 8 ATR 879
- Sun Newspapers Ltd. v. FC of T (1938) 61 CLR 337
- FC of T v. The Myer Emporium Ltd. (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693
- Ure v. FC of T 81 ATC 4100; (1981) 11 ATR 484