TR 95/25 - Income tax: deductions for interest under section 8-1 of the Income Tax Assessment Act 1997 following FC of T v. Roberts; FC of T v. Smith

Taxation Ruling
Income tax: deductions for interest under section 8-1 of the *Income Tax Assessment Act 1997* following *FC of T v. Roberts; FC of T v. Smith*

other Rulings on this topic

IT 2582

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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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

What this Ruling is about

Class of person/arrangement

1. This Ruling outlines the implications flowing from the decision of the Full Federal Court in *FC of T v. Roberts; FC of T v. Smith* 92 ATC 4380; (1992) 23 ATR 494 (*Roberts and Smith*) for individuals, general law partnerships, partnership for tax purposes only and companies.

Ruling

General principles governing deductibility of interest

2. The deductibility of a loss or outgoing comprising interest under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) (formerly subsection 51(1) of the *Income Tax Assessment Act 1936*) depends upon satisfying the words of the section, that is, being able to show that the loss or outgoing (or the part of the loss or outgoing in an appropriate case of apportionment) is:

(a) incurred by the taxpayer in gaining or producing assessable income of the taxpayer and the loss or outgoing is not capital, or of a capital, private or domestic nature ('first limb'); or

(b) necessarily incurred by the taxpayer in carrying on a business for the purpose of gaining or producing assessable income of the taxpayer and the loss or outgoing is not capital, or of a capital, private or domestic nature ('second limb').

3. The cases clearly indicate that whether or not a loss or outgoing incurred by a taxpayer satisfies the requirements of section 8-1 is dependent on all the facts and matters relating to the loss or outgoing incurred by the taxpayer in question. However, the following general principles are relevant to the question whether interest is deductible under section 8-1:

(a) The interest expense must have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income and not be of a capital, private or domestic nature. The test is one of characterisation and the essential character of an expense is a question fact to be determined by reference to all the circumstances.

(b) The character of interest on money borrowed is generally ascertained by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower. However, regard must be had to all the circumstances, including the character of the taxpayer's undertaking or business, the objective purpose of the borrowing, and the nature of the transaction or series of transactions of which the borrowing of funds is an element. In some cases, the taxpayer's subjective purpose, intention or motive may be relevant in deciding the deductibility of interest.

(c) A tracing of the borrowed money which establishes that it has been applied to an income producing use may demonstrate the relevant connection between the interest and the income producing activity. Normally this would be the case for non-business taxpayers. It might also be the case where a business makes a specific borrowing which goes to the structure of the business - for example, where a business makes a large borrowing to fund an offshore acquisition.

(d) A rigid tracing of the borrowed money will not always be necessary or appropriate (e.g., where the borrowing finances the replacement of funds withdrawn from the business by a person entitled to be paid those funds). In such cases the relevant question is whether borrowed funds are being used to replace another source of funding for business purposes.

(e) Interest on borrowed funds will not be deductible simply because it can be said to preserve assessable income producing assets.

(f) Interest on borrowings will not continue to be deductible if the borrowed funds cease to be employed in the borrower's business or income producing activity.

(g) The interest will not be deductible, to the extent to which it is private or domestic in nature, or is incurred in relation to the gaining or production of exempt income.

General law partnerships

The 'refinancing principle' in* Roberts and Smith *in relation to common law partnerships

4. In *Roberts and Smith*, Hill J said that interest on 'a borrowing [by a common law partnership] to fund repayment of moneys originally advanced by a partner and used as partnership capital' will be deductible under subsection 51(1) to the extent the partnership capital was employed in a business of the partnership which was carried on for the purpose of producing or gaining assessable income (ATC at 4389; ATR at 505).

5. 'In principle [he said] such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another' (ATC at 4388; ATR at 504). The same principle could apply to discharging a liability to a supplier of goods or services who extends trade credit to the partnership.

6. Hill J said that interest on borrowings to refinance funds employed in the partnership business will be deductible if the funds represent 'partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by the partners or other funds which have actually been invested in the partnership and which the partners were entitled to withdraw' (ATC at 4390; ATR at 506).

7. However, Hill J made it clear that interest on a borrowing by the partnership is not deductible to the extent that the borrowing is used to make payments to the partners which do not comprise a 'refund of moneys previously invested in the partnership business' (see ATC at 4390; ATR at 505-506). On this basis, interest on borrowings to replace partnership capital which is represented by internally generated goodwill or an unrealised revaluation of assets (which are simply book entries) will not be deductible to the partnership (see ATC at 4389 and 4390; ATR at 505-506).

Partnerships for tax purpose only

8. The 'refinancing principle' in *Roberts and Smith* has no application to joint owners of investment property which are not common law partnerships: *Case 12/95* 95 ATC 175; *AAT Case 10,079* (1995) 30 ATR 1169.

9. In *Yeung v. FC of T* 88 ATC 4193; (1988) 19 ATR 1006 (*Yeung*) the first issue was whether there was a partnership for tax purposes between the six family members. Davis J found that there was. He then proceeded on the basis that there was a 'partnership' and that from the partnership's point of view, what occurred was a change in the capital interests which each of the partners had in the partnership. However, the 'refinancing principle' in *Roberts and Smith* applies only where a partnership borrows to refund capital invested by partners (by way of a contribution to capital, a loan, or a share of any accumulated and undistributed realised profits which could be treated as having been distributed and lent back) or where one form of borrowing replaces another. Hill J makes it very clear (ATC at 4389-4390; ATR at 505-506) that reference to capital in this context is a reference to the capital of a partnership in the **partnership law sense**, that is, the 'original partnership capital in the Lord Lindley sense'.

10. The joint owners of an investment property who comprise a partnership for tax purposes only in relation to the property cannot 'withdraw' partnership capital and have no right to the 'repayment of capital invested' in the sense in which those concepts are used by Hill J in *Roberts and Smith*: see also *Case 12/95* (ATC at 181-182); AAT *Case 10,079* (ATR at 1169-1170). In *Case 12/95*; *AAT Case 10,079* the tribunal considered that the comments of Hill J (*Roberts and Smith* ATC at 4389; ATR at 504-505) cast considerable doubt on the application of the substitution of partnership capital principle to partnerships other than those that are partnerships at general law (see *Case 12/95* ATC at 182; *Case 10,079* ATR at 1175).

11. Accordingly, it is inappropriate to describe a borrowing by the joint owners of investment property, which does not constitute a business, as a refinancing of funds employed in a business.

Companies

12. In determining whether interest is deductible, regard must be given to the commercial context in which the company borrowed the relevant funds. For example, there will usually be a need for a business to maintain a pool of circulating capital from which to meet the expenses of that business. In these circumstances the deductibility of the interest expense cannot be determined by considering only the

immediate reason for making a payment and ignoring the overall purpose with which the liability was incurred: see Dixon J in *Herald and Weekly Times Ltd v. FC of T* (1932) 48 CLR 113 at 118.

13. Applying the reasoning of the Full Federal Court in *Roberts and Smith* to companies will mean that interest on a borrowing by a company may be deductible where the borrowing is used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income. Apportionment may be necessary where exempt income is also derived from the business activities.

14. The principle is the same as that which would apply to a replacement loan used to provide funds to meet a liability to a trade creditor or a lender of money where the relevant funds at the time of the replacement are being applied in the income producing business.

15. Similarly, interest on a borrowing by a company is likely to be deductible where the borrowing is used to fund the payment of a declared dividend (including a deemed unfrankable and unrebatable dividend paid from a "tainted share capital account" after 1 July 1998) to the shareholders in circumstances where the funds representing the dividend are employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income. In circumstances where the liability to pay the dividend reduces the amount to the credit of the unappropriated profits account and the reduction is replaced in the company's accounts by the loan, there will usually be a nexus between the interest expense and the carrying on of a business for the purpose of deriving assessable income.

16. As with partnerships, interest is not deductible if the borrowing finances payments to shareholders in reduction or extinguishment of share capital to the extent to which such capital represents bonus shares paid up out of an unrealised asset revaluation reserve or reduction of other equity accounts to the extent that they represent unrealised profit reserves (e.g., a reserve arising from the recognition of internally generated goodwill). Nor would interest be deductible where the borrowed moneys fund the payment of a dividend out of unrealised profit reserves. However, where the source from which bonus shares are issued and dividends are declared is a realised profit reserve, the interest on a borrowing used to repay the bonus shares or discharge the liability to pay a dividend would be deductible.

17. The reasoning in *Roberts and Smith* does not extend to interest on borrowing by a company to pay subvention payments (that is, payments to another company in a wholly owned group in exchange for a loss transferred under Subdivisions 170-A and 170-B of the

ITAA 1997). In these circumstances there is no withdrawal and replacement of capital in the sense spoken of by Hill J in *Roberts and Smith*.

Individuals

18. Tests such as the purpose of the borrowing or the use and application of the borrowed funds, although only tools in assisting in determining what is essentially a question of fact, have a more obvious application in the context of individuals than they do in a large multi-faceted and widely owned businesses.

19. It is a well established principle of law that an individual cannot deal with and in particular cannot lend money to her/himself. It follows that where an individual carries on a business alone she/he cannot contribute capital to or lend money to such a business in such a way as to create a legal liability of the business to the individual in respect of the funds contributed or lent. The principles in *Roberts and Smith* cannot, therefore, apply to individuals.

Date of effect

20. 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 a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

General principles

21. Expenditure will be deductible under section 8-1 if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income, provided that the expenditure is not of a capital, private or domestic nature. As Hill J explained in *Roberts and Smith* (ATC at 4386; ATR at 501):

> 'In *FC of T v. Riverside Road Pty Ltd (in liq)* 90 ATC 4567 at 4573-4575 the full court of this court summarised the applicable principles governing deductibility under s. 51(1) of the Act. It is unnecessary to repeat them here. Suffice it to say that what is involved is a process of identifying the essential character of the expenditure to determine whether it is in truth an outgoing

> incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business having the purpose of gaining or producing assessable income: *Lunney & Anor v. FC of T* (1958) 11 ATD 404 at 413; (1957-1958) 100 CLR 478 at 499; *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957; (1991) 22 ATR 613. The expenditure must have the necessary connection with the operations or activities which more directly gain or produce assessable income so as to meet the statutory criterion that the outgoing be incurred in gaining or producing assessable income or in carrying on a business: *Charles Moore & Co (WA) Pty Ltd v FC of T* (1956) 11 ATD 147 at 149; (1956) 95 CLR 344 at 351; *FC of T v. DP Smith* (1981) 147 CLR 578 at 586; 81 ATC 4114 at 4117; (1981) 11 ATR 538. That is to say it must be "incidental and relevant" to that end: *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47 at 56.'

22. It has been said that the test of deductibility under the first limb of subsection 51(1) is that:

> 'it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income' (*Ronpibon Tin v FC of T* (1949) 78 CLR 47 at 57).

23. In determining the deductibility of a loss or outgoing regard should be had to all the objective circumstances surrounding the incurring of the loss or outgoing and in some circumstances the subjective purpose of the taxpayer may also be relevant. *Fletcher v. FC of T* 91 ATC 4950; (1991) 22 ATR 613. Tests such as the purpose of the borrowing or the use and application of the borrowed funds are tools to assist in what is essentially a question of fact (*Kidston Goldmines Ltd v. FC of T* 91 ATC 4538; (1991) 22 ATR 168).

24. Where the taxpayer carries on a business the second limb of section 8-1 requires there to be a relevant connection between the outgoing and the business. In deciding whether the interest is 'necessarily incurred' in the sense of 'clearly appropriate' to that business (*FC of T v. Snowden and Willson Pty Ltd* (1958) 99 CLR 431), regard must be had to the nature of the business activity (*Magna Alloys & Research Pty Ltd v. FC of T* 80 ATC 4542; 11 ATR 276), the business purpose for which the outgoing was incurred (*FC of T v. The Midland Railway of Western Australia Ltd* (1952) 85 CLR 306), the objective circumstances surrounding the incurring of the expenditure (*FC of T v. South Australia Battery Makers Pty Ltd* (1978) 140 CLR 645) and the character of the expense (*John Fairfax & Sons Pty Ltd v. FC of T* (1959) 101 CLR 30).

25. As was explained in *Magna Alloys & Research Pty Ltd v. FC of T* 80 ATC 4542 at 4545; 11 ATR 276 at 279:

> 'The purpose mentioned in the second limb is not a purpose imported by the phrase, incurred in carrying on; but the purpose of the business in the carrying on of which the deductible expenditure is incurred (*John Fairfax & Sons Pty Ltd v. FC of T* (1959) 101 CLR 30 at 49).'

Use test

26. As Hill J stated (*Roberts and Smith* ATC at 4388; ATR at 504):

> 'As the cases, including *Kidston*, all show, the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds are put. However, a rigid tracing of funds will not always be necessary as appropriate.'

27. Generally, the starting point for determining the essential character of an interest expense is to determine the 'use' to which the borrowed funds have been put, i.e., you trace the borrowed funds (*Roberts and Smith* ATC at 4388; ATR at 504; *Kidston Goldmines Ltd v. FC of T* 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177, *Hayden v. FC of T* 96 ATC 4797 at 4801; (1996) 33 ATR 352 at 356). However, such a tracing will not necessarily be determinative (*Roberts and Smith* ATC at 4388; ATR at 504). This will be particularly so in a multi-faceted and widely owned business. As Hill J warned in *Roberts and Smith* (ATC at 4388; ATR at 503-504), there is a danger in substituting for the words in subsection 51(1) language which does not appear in it.

Preservation of assets test

28. It has been argued that interest is deductible provided the borrowed funds can be said to preserve the taxpayer's income producing assets. The preservation of assets test can take different forms. Often, the proposition is put in circumstances where a taxpayer has income producing assets which could be sold to generate funds to satisfy non-income producing needs. An alternative to selling the assets would be to retain them and, instead, borrow money to satisfy the non-income producing needs. When a borrowing is made, it is argued that the interest expense is incurred in producing assessable income because, without the borrowing, the income producing assets would have been sold. It follows, according to the argument, that the borrowing enables the preservation of the income producing assets and, therefore, the interest expense is sufficiently

connected with the income derived from those assets to satisfy section 8-1.

29. In *FC of T v. Munro* (1926) 38 CLR 153 (*Munro*) the High Court considered whether interest incurred on a borrowing which was not used to produce assessable income, but was secured by an income producing asset, was deductible. The taxpayer argued that if the interest obligations were not discharged, the income producing asset that secured the borrowing would be in jeopardy. Thus, the discharge of the obligation to pay interest was incurred in producing assessable income. The High Court rejected this proposition.

30. In *Roberts and Smith* Hill J commented on the two cases usually cited as authority for the preservation of assets argument; *Begg v. FC of T* (1937) 4 ATD 257 or *Yeung*. In respect of *Begg* Hill J said (*Roberts and Smith* ATC at 4389; ATR at 505) that:

> 'The case has stood for a long time and the present is not the appropriate occasion to consider its correctness. There may, however, be thought to be some difficulties in reconciling what was there said with the decision of the High Court in *Munro*.'

31. In respect of *Yeung* Hill J said (*Roberts and Smith* ATC at 4389; ATR at 505) that:

> 'For present purposes it is sufficient to note that the result reached in *Yeung* seems clearly correct if the case is viewed simply as one involving a borrowing to fund the repayment of moneys originally advanced by a partner and used as a partnership capital, particularly given that the original funds were used to purchase the rental property.'

32. Hill J has clearly indicated his difficulties with the principle which has been extracted from *Begg*. At the same time Hill J also explained the decision in *Yeung* on the basis of the principle which he was applying in *Roberts and Smith*. The principle is that, if there is a partnership at general law, the business of that partnership could be funded by moneys originally advanced by a partner as partnership capital and interest on a borrowing to repay that capital would be deductible. The comment by Hill J on *Yeung* has little, if anything, to do with the preservation of assets proposition and certainly does not support it.

33. A similar conclusion was reached by Mr K Beddoe in an unreported AAT decision given on 30 May 1995 (AAT reference QT 94/116).

33A. In *Hayden* the Federal Court considered whether interest incurred by an Executor on borrowings that were used to discharge an obligation of the deceased estate was deductible under subsection 51(1). The fact that the borrowing of funds permitted income producing assets to remain as part of the estate so that the income stream to the estate was not diminished, did not bring the interest of the borrowings within a loss or outgoing under subsection 51(1).

The decision in *Roberts and Smith*

34. As Hill J stated (*Roberts and Smith* ATC at 4388; ATR at 504):

> 'The issue continues to be whether the interest outgoing was incurred in the income producing activity or, in a case falling to be tested under the second limb, in the business activity which is directed towards the gaining or producing of assessable income'; and
>
> 'The funds to be withdrawn in such a case [where a partner calls up an amount owing to him as undrawn partnership distributions] were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of assessable income.'
>
> 'In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. Both these cases would equally satisfy the second limb of s. 51(1). In no sense could the interest outgoing in either case be characterised as private or domestic. Similarly, where moneys are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible, irrespective of the use which the partner repaid makes of the funds' (*Roberts and Smith* ATC at 4388; ATR at 504); and
>
> 'The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership or, in other words, the partnership business. Likewise, the interest incurred on the borrowings will not be incidental and relevant to the partnership business' (*Roberts and Smith* ATC at 4390; ATR at 506).

35. Hill J makes it clear in his discussion at ATC at 4389-4390; ATR at 504-506 that in his view a partnership cannot claim to be replacing funds contributed as partnership capital when it borrows to make a payment to a partner to the extent that the equity or capital

account being reduced by the payment is represented by internally generated goodwill. Interest on borrowings used to make such a payment would not be deductible. In our view, this limitation on a partnership's entitlement to a deduction applies also where the account being reduced, represents an unrealised capital profits.

36. The explanation for this limitation on deductibility of interest is that partnership capital must be contributed and can never exceed the amount contributed. A partnership is not entitled to describe what is, in effect, a revaluation reserve as partnership capital. Similarly, if a partnership dissipates contributed partnership capital as a result of making operating or capital losses, only the remaining part of the original partnership capital can be returned to partners as partnership capital. It is not possible to reinstate the balance of that capital by revaluing assets.

Statutory partnerships

37. In *Case 12/95* (ATC at 181); *AAT Case 10,079* (ATR at 1175) the AAT was of the view that:

> '...the purpose of the definition of "partnership" as it appears in section 6(1) of the Act is the application to arrangements answering that description of Division 5 of Part III of the Act and, in the circumstances of this reference, particularly sections 90, 91 and 92. Against that background, and here the words of Fisher J are repeated, the deeming provisions are required by their nature to be construed strictly and only for the purpose for which they are resorted to and it is improper to extend by implication the express application of such a statutory fiction. This fiction does not, in our opinion, cloak an arrangement of the kind now being contemplated with the additional refinements of partnership assets and liabilities and partners capital accounts. On that basis the Tribunal finds that there are no partnership assets or liabilities nor are there capital accounts capable of being accessed by the applicant or his spouse. What remains is a relationship of co-ownership as joint tenants which is more accurately described as an investment rather than as partners in a business operation. For these reasons the Tribunal concludes that the argument of the bank loan being used to replace portion of the capital accounts of the partners is not available to the applicant.'

Companies

38. In principle, the approach adopted by Hill J in *Roberts and Smith* is not limited to partnerships and could apply to companies. For

example, in *Kidston Gold Mines Limited v. FC of T* 91 ATC 4538; (1991) 22 ATR 168, Hill J said (ATC at 4545; ATR at 176):

> 'Where the funds are employed in a business devoted to assessable income, it may be said that monies borrowed to secure capital or working capital will be clearly deductible: *The Texas Company (Australasia) Limited v. FC of T* (1940) 63 CLR 382 at 468 per Dixon J.'

39. However, the limitation on interest deductibility referred to in paragraph 35 above would also apply to a company that sought to use borrowings to make payments to shareholders in reduction of an account that was represented by revaluations of assets. If the account was represented by realised capital gains, however, interest on the borrowings would not be denied on this basis.

Apportionment

40. Under the reasoning in *Roberts and Smith*, interest on borrowed funds will be fully deductible provided the amount of 'capital' attributable to the borrower at the time of the borrowing is equal to or greater than the amount borrowed. If the amount of capital attributable to the borrower is less than the amount borrowed it will be necessary to apportion the interest expense. Generally the proportion of interest deductible will be equal to the proportion of capital that had been used to derive assessable income.

Asset revaluation reserve

41. In relation to paragraph 16 of this Ruling, it is noted that under *Australian Accounting Standards AASB 1010* on 'Accounting for the revaluation of non-current assets', a revaluation reserve may represent both realised (by sale of the assets) and unrealised increases in the value of assets. In determining the deductibility of interest we will assume that in this situation the borrowings are first used to replace the part of the reserve that represents realised revaluations. However, the taxpayer must demonstrate how much of that reserve represents realised revaluations. In the absence of such evidence a deduction will not be allowed. This approach is particularly appropriate given that we understand that there is nothing in the standard which prevents the revaluation increment in respect of an asset that has been sold from being transferred to a realised capital profits reserve.

Borrowing used to repay an existing loan

42. Interest on a new loan will be deductible if the new loan is used to repay an existing loan which, at the time of the second borrowing,

was being used in an assessable income producing activity or used in a business activity which is directed to the production of assessable income (*Roberts and Smith* ATC at 4388; ATR at 504).

Examples

Example 1: Statutory partnership

43. A and B are husband and wife. They own the family home and, using $50,000 of their own funds and initial borrowings of $100,000, they jointly purchase a rental property. A and B are deemed to be partners in respect of the rental property within the extended definition of partnership in subsection 995-1(1) of the ITAA 1997 as they are in receipt of income jointly, but do not in any way carry on a business so as to make them general law partners.

44. Two years later A and B borrow $50,000 to renovate the family home, and claim that the borrowing replaces a notional withdrawal of partnership capital.

45. There is no capital account capable of being withdrawn by A and B, and having regard to the use of the borrowed funds, the interest incurred is not deductible being of a private or domestic nature (see *Case 12/95*; *AAT Case 10,079*).

Example 2: General law partnership

46. D borrows $25,000 which is contributed as capital to a partnership.

47. Two years later, the partnership borrows $25,000 to return D's initial capital contribution. The use of the repaid funds in D's hands will not be determinative of the deductibility of the interest to the partnership. At the time of the borrowing by the partnership, the $25,000 previously contributed by D was being employed in the partnership's assessable income producing business. On these facts the interest expense will be deductible to the partnership as the borrowed funds can be seen to replace the partnership capital (see *Roberts and Smith*).

48. The funds borrowed by D are no longer invested in the partnership (an income producing asset). Whether or not D will continue to get a deduction for the interest expense on the original borrowings will depend on the use to which the funds returned to him by the partnership are put. If D uses those funds for a private purpose, then no further interest will be allowed.

49. If the amount borrowed by the partnership exceeds the partnership capital (e.g., if at the time of the second borrowing the partnership had repaid most of the capital) interest would only be deductible to the extent of the partnership capital attributable to the taxpayer.

Example 3: Individual

50. If a rental property (as in Example 1) was owned solely by an individual C, then the interest on the second borrowing would not be deductible. This would be the case even if the rental property was used as security for the second borrowing (e.g., a second mortgage) (see *Munro*).

Example 4: Sole trader

51. F is a sole trader who has built up his business over many years. His balance sheet shows his proprietorship/capital in the business as $200,000. This amount is represented by the income producing assets of the business, and there is no goodwill or revaluation of assets shown in the accounts.

52. F decides to restructure his business. He purports to withdraw $50,000 of his capital from the business and replace it with borrowed funds. He uses the money to purchase a yacht for his family's personal use. On a strict tracing approach, the use of the funds is private and clearly the interest expense is not deductible.

53. Despite accounting entries which show that the borrowed funds were placed into the business, it cannot be shown that the borrowings replaced F's equity in this income producing assets. An individual cannot withdraw equity from his/her own assets. Therefore, the interest expense is not deductible.

Example 5: Company

54. A company runs a business to produce assessable income and it wants to reduce the entitlement of its shareholders to the real assets of the company (either by way of an agreement to buy back shares or otherwise reduce paid up capital, or by way of dividends from profits that arose from the company's income producing activities). It is short of liquid assets so it borrows funds which are intended to take the place of funds to be paid to the shareholders. In these circumstances the company has in effect replaced capital with debt. On the basis of the principles in *Roberts and Smith* the interest on the borrowing would be deductible to the extent that it replaced capital or realised gains which were used in the business to produce assessable income.

Cross reference of provisions

55. Section 8-1, Subdivisions 170-A and 170-B and the definition of 'partnership' in subsection 995-1(1) of the *Income Tax Assessment Act 1997,* to which this Ruling refers, express the same ideas as subsections 51(1), sections 80G and 160ZP and the definition of 'partnership' in subsection 6(1), respectively, of the *Income Tax Assessment Act 1936.*

Note- The Addendum to this Ruling that issued on 26 May 1999 applies to the 1997-98 or a later income year.

Commissioner of Taxation

29 June 1995

ISSN 1039 - 0731

ATO references
NO 95/4339-2
BO

Previously released in draft form as TR 93/D38

Price $1.60

FOI index detail
reference number
I 1016586

subject references
- allowable deductions
- deductions for interest

legislative references
- ITAA 1936 6(1)
- ITAA 1936 51(1)
- ITAA 1936 80G
- ITAA 1936 160ZP
- ITAA 1997 8-1
- ITAA 1997 Subdiv 170-A
- ITAA 1997 Subdiv 170-B
- ITAA 1997 995-1(1)

case references
- Begg v. FC of T (1937) 4 ATD 257
- Charles Moore and Co (WA) Pty Ltd v. FC of T (1956) 11 ATD 147; (1956) 95 CLR 344
- FC of T v DP Smith (1981) 147 CLR 578; 81 ATC 4114; (1981) 11 ATR 538
- FC of T v. Munro (1926) 38 CLR 153
- FC of T v. Riverside Road Pty Ltd (in liq) formerly Fremantle Motor Lodge Pty Ltd 90 ATC 4567; (1990) 21 ATR 499
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