TR 2004/4 - Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities

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Taxation Ruling

Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities

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If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

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What this Ruling is about

Class of person/arrangement

1. This Ruling considers the deductibility of interest expenses incurred prior to the commencement of income earning activities, or after income earning activities have ceased.

2. This Ruling does not consider the deductibility of interest expenditure incurred where the relevant assessable income comprises a net profit rather than income in accordance with ordinary concepts.

3. The decisions discussed in this Ruling deal with the issue of the deductibility of interest in terms of subsection 51(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). The decisions in these cases and the discussion in this Ruling have equal application to section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). All references to subsection 51(1) should therefore be taken as including a reference to section 8-1.

Date of effect

4. This Ruling applies to income years commencing both before and after its date of issue. However, this Ruling will 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 this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

5. [Omitted.]

Ruling

Deductions for interest

6. The deductibility of interest is typically 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 v. FC of T* 99 ATC 4242; (1999) 41 ATR 139 (*Steele*)).

7. 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?

8. Outgoings of interest are a recurrent expense. The fact that borrowed funds may be used to purchase a capital asset does not mean the interest outgoings are therefore on capital account (see *Steele* 99 ATC 4242 at 4249; (1999) 41 ATR 139 at 148).

Interest incurred prior to assessable income

9. 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]

Interest incurred after assessable income

10. Where interest has been incurred over a period after the relevant borrowings (or assets representing those borrowings) have been lost to the taxpayer and relevant income earning activities (whether business or non-business) have ceased, it is apparent that the interest is not incurred in gaining or producing the assessable income of that period or any future period. However, the outgoing 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.

11. Whether or not the occasion of the outgoing of interest is to be found in what was productive of assessable income of an earlier period requires a judgment about the nexus between the outgoing and the income earning activities.

12. An outgoing of interest in such circumstances will not fail to be deductible merely because:

- the loan is not for a fixed term;
- the taxpayer has a legal entitlement to repay the principal before maturity, with or without penalty; or
- the original loan is refinanced, whether once or more than once.

13. However, if the taxpayer:

- keeps the loan on foot for reasons unassociated with the former income earning activities; or
- makes a conscious decision to extend the loan in such a way that there is an ongoing commercial advantage to be derived from the extension which is unrelated to the attempts to earn assessable income in connection with which the debt was originally incurred,

the nexus between the outgoings of interest and the relevant income earning activities will be broken.

14. A legal[2] or economic[3] inability to repay is suggestive of the loan not having been kept on foot for purposes other than the former income earning activities.

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[1] This requirement is mentioned in *Steele* by Callinan J at 99 ATC 4242 at 4263; (1999) 41 ATR 139 at 168. See further at paragraph 36 of this Ruling.
[2] cf *Brown*.
[3] cf *Jones*.

Interest expense associated with holding vacant land

14A. Where the interest expense is associated with holding vacant land (for example, interest on a loan to purchase vacant land) and is otherwise deductible in accordance with this Ruling, section 26-102 of the ITAA 1997 may operate to deny that deduction. More generally, section 26-102 is discussed in draft Taxation Ruling TR 2021/D5 *Income tax: expenses associated with holding vacant land*.

Penalty 'interest' payments

15. 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 whether or not it can truly be characterised as interest.

Explanation

Deductions for interest

16. In the course of his judgment in *Kidston Goldmines Ltd v. Federal Commissioner of Taxation*, Hill J explained that the concepts of the use to which funds are put and of subjective purpose were useful in determining the deductibility of interest as 'tools to assist in the resolution of what is essentially a question of fact'.[4] Justice Hill warned, however, that there is a danger of substituting for the words of subsection 51(1) of the ITAA 1936 (now section 8-1 of the ITAA 1997) language which does not appear in it: '[t]he statutory issue is whether the interest outgoing was incurred in (i.e. in the course of) the income producing activity, or in the case of the second limb of the subsection, whether the interest outgoing was incurred in (i.e. in the course of) the business activity which is directed towards the gaining or producing of assessable income'[5] (see also *FC of T v. JD Roberts*).

[4] 91 ATC 4538 at 4545; (1991) 22 ATR 168 at 176.
[5] 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177.

17. An examination of the use to which funds are put and of subjective purpose will in the normal case lead to the same conclusion. As Justice Hill noted in *Kidston Goldmines*, 'there is much to be said for the view that the tests of purpose and application of funds are but two sides of the one matter'.[6] The Courts have noted, however, that difficulties can arise where either test is adopted to the exclusion of the other.[7] Further, difficult issues will arise in cases when the purpose of the borrowing and the use to which the borrowed funds are put may be seen to differ (see *FC of T v. Firth* 2002 ATC 4346 at 4349; (2002) 50 ATR 1 at 5 per Hill J).

18. 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.[8]

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

20. A full court of the Federal Court in *FC of T v. Brown* 99 ATC 4600; (1999) 43 ATR 1 (*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 …[9]

This approach was implicitly endorsed by a differently constituted full court of the Federal Court in *FC of T v. Jones* 2002 ATC 4135; (2002) 49 ATR 188 (*Jones*).

21. The Court in *Brown* 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.[10]

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[6] 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177.
[7] On this point para 3(b) of Taxation Ruling TR 95/25 states that while 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, 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.
[8] *Steele* 99 ATC 4242 at 4251; (1999) 41 ATR 139 at 150-151.
[9] *Brown* 99 ATC 4600 at 4606; (1999) 43 ATR 1 at 7 quoting from the majority judgment in *Steele*.
[10] *Brown* 99 ATC 4600 at 4606; (1999) 43 ATR 1 at 8.

22. Determining the 'occasion' of the loss or outgoing, then, does not involve a straightforward consideration of either the 'use of funds' or the 'purpose of borrowing', although both of these notions do have a part to play.

Interest and capital

23. 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.

24. 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 to change this conclusion.

25. 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 *Australian National Hotels Ltd v. FC of T*, 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 Ltd v. FC of T* 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 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 term 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.[11]

26. Even though generally interest cannot be capital (see paragraph 8), 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,[12] 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

27. 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 subsection 51(1) was not satisfied.

28. In *Steele's* case (99 ATC 4242 at 4251; (1999) 41 ATR 139 at 151), 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 subsection 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'.

29. 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.[13]

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[11] *Steele* 99 ATC 4242 at 4248-4249; (1999) 41 ATR 139 at 148.

[12] '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.

[13] *Steele* 99 ATC 4242 at 4251; (1999) 41 ATR 139 at 151.

30. 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.[14]

31. 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.[15] 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 30):

- 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'.

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[14] *Steele* 99 ATC 4242 at 4251; (1999) 41 ATR 139 at 151.

[15] *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.'

32. In relation to temporal delays:

> … [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 …[16]

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.[17]

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.

33. In the following examples, the outgoing incurred would not be deductible because the outgoing is incurred 'too soon', 'preliminary' or a 'prelude':

- 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*;
- expenditure on research into the development of products made from tea tree oil was not deductible as the expenditure was not capable of being identified with the derivation of any assessable income – *Howland Rose & Ors v. FC of T* 2002 ATC 4200; 49 ATR 206; and
- interest incurred on a loan used to purchase options to acquire shares as the options do not give rise to an entitlement to dividends. Although the options may be converted into shares at a later date, from which

[16] per Lee and Lindgren JJ in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326 at 341.
[17] per Lee and Lindgren JJ in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326 at 341.

dividends may be expected, the interest expense is considered to be both preliminary to and remote from any possible derivation of assessable income.

34. 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 31:

- 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 …[18]

  and

  … the expenditures … were made with one end in view, of gaining or producing assessable income …[19]

  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 which may be viewed as a relatively short one in the relevant industry …[20]

- 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 99 ATC 4242 at 4251; (1999 41 ATR 139 at 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'.

35. 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 9.

36. The last of those conditions requires that continuing efforts are undertaken in pursuit of assessable income. This condition 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

[18] *Steele* per Callinan J at 99 ATC 4242 at 4261; (1999) 41 ATR 139 at 165.
[19] *Steele* per Callinan J at 99 ATC 4242 at 4263; (1999) 41 ATR 139 at 168.
[20] *Steele* per Callinan J at 99 ATC 4242 at 4263; (1999) 41 ATR 139 at 168.

concept of 'continuing efforts' should not be taken to require constant on-site development activity. The comments of Callinan J indicate that a test of 'continuing efforts' would need to be set within the context of the normal time frames of the relevant industry. 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; (1979) 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* 99 ATC 4242 at 4251; (1999) 41 ATR 139 at 151).

37. Two recent decisions of the Federal Court concerning the deductibility of interest prior to the derivation of assessable income are *Anovoy Pty Ltd v. FC of T* 2001 ATC 4197; (2001) 47 ATR 51 (Lee, Carr, Lindgren JJ) and *P & G Rocca Pty Ltd v. FC of T* 2002 ATC 4543; (2002) 50 ATR 184 (Mansfield J).

38. We consider that the reasons for judgment in *Anovoy* are not inconsistent with the principles expressed in this Ruling. By contrast to the facts of *Steele*, the taxpayer's commitment in *Anovoy* to income producing activity was 'so vague as to be dismissed out of hand'.[21]

39. In *P & G Rocca*, outgoings by way of interest were paid by the taxpayer to access funds which were onlent to a separate but associated corporate entity so that the second entity could purchase a property to be used in the expansion of the taxpayer's business. The taxpayer did not, however, have any right to occupy the property during the income years in question. Ultimately the taxpayer sold its business before building a new store on the purchased property. Mansfield J noted that there were significant similarities between the facts of the case and the facts in *Steele*. In particular, at no time did the taxpayer contemplate any alternative use of the property which would not involve it being a location at which assessable income would be derived.[22] Nonetheless, Mansfield J held the interest payments were not deductible concluding that there was no sufficient nexus between the payments of interest and the gaining or producing of assessable income *of the taxpayer*. In reaching this conclusion, Mansfield J noted that:

> Whilst the intention of the applicant was that a Rocca Bros store would be built at the Darlington property and it would then operate that store to generate income, it intended that it would do so only ultimately as a tenant of the applicant. It intended to generate

[21] See para 66 of the Tribunal's reasons for decision as extracted in para 49 of the majority judgment of the Federal Court in *Anovoy* at 2001 ATC 4197 at 4206; (2001) 47 ATR 51 at 61.
[22] *P & G Rocca* 2002 ATC 4543 at 4555; (2002) 50 ATR 184 at 197-198 para 52.

> income at the property, but not from the use of the property as an investment.[23]

Expenditure incurred after assessable income

40. 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 …[24]

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.

41. As was stated by a full court of the Federal Court in *Placer Pacific* (Davies, Hill, Sackville JJ):

> … 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, the fact that that outgoing was incurred in a year later than the year in which the income was incurred [sic] and the fact that in the meantime business in the ordinary sense may have ceased will not determine the issue of deductibility.[25]

42. The cases do not make clear what the 'occasion' of an outgoing is, although it is obviously distinct from the notion of 'incurrence', given that the outcomes in these cases turn upon the finding that the 'incurrence' of the outgoing was subsequent to its 'occasion'. The 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 was found to be in the agreement for the supply of the conveyor belt which was alleged to be defective.

43. The facts in *Brown* and *Jones* 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:

- in *Brown*, the taxpayer partners borrowed to acquire a delicatessen. After a number of years of trading the business was sold at a loss. The proceeds of the

[23] *P & G Rocca* 2002 ATC 4543 at 4557; (2002) 50 ATR 184 at 199 para 61.
[24] *Ronpibon Tin* (1949) 78 CLR 47 at 57.
[25] *Placer Pacific* 95 ATC 4459 at 4464; (1995) 31 ATR 253 at 259.

disposal were made over to the bank but were insufficient to satisfy the liability fully; and

- in *Jones*, the taxpayer, together with her husband, borrowed money to fund a trucking and equipment hire business. After her husband's death, Mrs Jones sold the assets of the business but, as with the Browns, the proceeds (plus other amounts on hand) were insufficient and she was unable to fully repay the loan. Subsequently Mrs Jones refinanced the loan because she was able to obtain a lower rate of interest through an alternative lender.

44. In both *Brown* and *Jones*, the interest in question was incurred at a time after the relevant income earning activities had ceased and 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 6 & 7.) Even so, the Court had no difficulty in holding, in both instances, that interest incurred on the loans continued to be deductible despite the cessation of the relevant income earning activities.

45. *Brown* and *Jones* accordingly demonstrate that the occasion of interest expenditure can be found in the relevant income earning activities even where those activities are now defunct and all the borrowed funds (or assets representing those funds) are lost. Although these cases involved taxpayers who carried on a business, we accept that there is no reason why the same principle should not apply to income earning activities that do not constitute a business, such as passive investments.

46. In determining whether a particular outgoing of interest incurred after the cessation of the relevant income earning activities is deductible, it is useful to contrast cases in which the continuing liability to interest is seen to be merely a burdensome legacy of the past (suggestive of a continuing nexus with prior assessable income) with cases in which that liability is seen to be associated with present or future advantages (suggestive of a broken nexus). Dowsett J's reasoning in *Jones* in the first instance illustrates this approach:

> …the passage of a substantial period of time after the cessation of business may be relevant to the question but not necessarily conclusive. In such cases **passage of time may lead to the inference that the taxpayer has kept the loan on foot for reasons unassociated with the former business**. Similarly, where a conscious decision is made to extend the loan in the way contemplated in *Brown*, it will often be clear that there is an ongoing commercial advantage to be derived from such extension which should be seen as unrelated to the attempts to earn assessable income in connection with which the debt was originally incurred. These are not the circumstances of the present case. It is clear … that the respondent has not been in a position to repay the loan, although she has been attempting to do so as best she can from the

> resources available to her. This demonstrates that **the failure to repay the loan over the quite lengthy period since her husband's death is attributable to her financial position and not to any decision to keep the loan on foot for other reasons**.[26]

47. Cases in which the taxpayer does not have the legal power to repay the loan early and hence is unable to avoid incurring ongoing interest liabilities belong to the first category (ie a burdensome legacy of the past). In these cases, a nexus will continue to exist between the interest outgoings and the relevant income earning activities at least until the end of the period during which the interest cannot be avoided. *Brown* is an example of such a case. In *Brown*, there was no entitlement under the relevant loan agreement to repay the loan prior to its term without prior agreement of the bank.[27]

48. By contrast, where the taxpayer does have the legal power to repay the loan and hence avoid incurring ongoing interest liabilities, the reasoning of Dowsett J in *Jones* in the first instance suggests the nexus will continue until a time at which it can be inferred that:

- the taxpayer 'has kept the loan on foot for reasons unassociated with the former business'; or
- the taxpayer has made a conscious decision to extend the loan in such a way that there is an ongoing commercial advantage to be derived from the extension which is unrelated to the attempts to earn assessable income in connection with which the debt was originally incurred.

49. In deciding in any particular case whether such inferences can be drawn, it is necessary to undertake a commonsense or practical weighing of all the factors of the case. As was recognised by the Court in *Brown*:

> …there may come a period of time between cessation of business and the payment of interest which is such that, in all the circumstances of the case, the payment is no longer sufficiently proximate to the activities of the business to be deductible under s 51(1) with the consequence that those activities no longer provide the occasion for the outgoing … **Answers to such questions depend upon a 'commonsense' or 'practical' weighing of all the factors**: see *Fletcher* at ATC 4958; CLR 18.[28]

50. In weighing the factors of a case, regard should be had to the following general observations:

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[26] *FC of T v. Jones* 2001 ATC 4607 at 4613 – 4614; (2001) 47 ATR 638 at 645 (emphasis added). See also para 4 of the decision of the Full Federal Court at 2002 ATC 4135 at 4137; (2002) 49 ATR 188 at 190.

[27] *Brown* 99 ATC 4600 at 4603; (1999) 43 ATR 1 at 5 para 12. This was so even though the bank, as a matter of practicality rather than legal obligation, was prepared to allow early repayment without penalty.

[28] *Brown* 99 ATC 4600 at 4608; (1999) 43 ATR 1 at 9 para 25 (emphasis added). In *Jones* the Court drew attention to these remarks, apparently with approval (2002 ATC 4135 at 4140, (2002) 49 ATR 188 at 194 para 15).

- The less the financial resources of the taxpayer, the more likely it is that an inference could be drawn that the existence of a continuing obligation to pay interest is a burdensome legacy of the past rather than a result of the taxpayer choosing to keep the loan on foot for reasons unassociated with the former income earning activities. *Jones* is an example of a case in which the limited financial capacity of the taxpayer was given considerable weight by the Court in determining whether interest incurred by the taxpayer after the cessation of the relevant income earning activities continued to be deductible;
- The more liquid the resources of the taxpayer, the more likely the inference could be drawn that the loan is being kept on foot for reasons unassociated with the former income earning activities. For example, where there are sufficient funds held in cash or on deposit in a bank account that could relatively easily be applied in repayment of the principal, the refusal to make such repayment would suggest that the loan is being kept on foot for other reasons. However, the inference is unlikely to be drawn if it would be unreasonable in the circumstances to expect the taxpayer to apply their liquid resources against the loan;
- The realisation or exchange of assets without a diversion of these resources in repayment of the principal will tend to indicate a breaking of any nexus that might previously have been maintained even after the cessation of the income earning activities. For example, the decision to realise shares and use the proceeds to purchase a leisure yacht rather than make a repayment would be highly suggestive of a break of any previously existing nexus. On the other hand, though, the sale of a taxpayer's residence and the use of the proceeds to purchase another closer to a new place of employment would typically not have that effect;
- The greater the time since the cessation of the income earning activities, the more likely it is that an inference could be drawn that the continuing obligation to pay interest is a result of the taxpayer choosing to keep the loan on foot for reasons unassociated with the former income earning activities; and
- Refinancing of a loan does not of itself break the nexus between outgoings of interest under the loan and the prior income earning activities. However the decision to refinance may, in all the circumstances, lead to the inference being drawn that the taxpayer has made a conscious decision to extend the loan, and has done

this in order to derive an ongoing commercial advantage.

Penalty 'interest' payments

51. 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 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

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Previous draft:

Previously released as TR 2003/D8

Related Rulings/Determinations:

TR 92/1; TR 93/7; TR 95/25; TR 97/16; TR 2006/10 ; TR 2021/D5

Legislative references:

- ITAA 1936 51
- ITAA 1936 51(1)
- ITAA 1997 8-1
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- Anovoy Pty Ltd v. FC of T 2001 ATC 4197; (2001) 47 ATR 51
- 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 326
- 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
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- FC of T v. Jones 2001 ATC 4607; (2001) 47 ATR 638 (Federal Court)
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