Interest
What is it and when is it deductible?

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September 2002
# Deductibility of Interest

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1. Introduction

The topic of this paper - *Interest Expenditure; What is it and when is it deductible?* – has become increasingly topical over the last three years or so as a result of the following high profile cases:

- **Steele**
  - pre-commencement interest and the general principles of interest deductibility
- **BHP**
  - what is interest?
- **Anovoy**
  - pre-commencement interest
- **Jones**
  - post cessation interest
- **Firth**
  - apportionment of interest deduction and capital prohibition
- **Rocca**
  - nexus to business activities
- **Hart**
  - compound interest and split interest loans

In addition to the substantial work done by the Courts in interpreting the legislation, the legislation itself has changed dramatically with the introduction of the debt/equity rules.

The question posed in the title is dealt with by looking first at what constitutes interest, then outlining briefly the general rules that apply to the deductibility of interest, before looking at a number of specific issues that arise out of those rules. Finally, specific provisions other than the general deduction provision are considered briefly.

In this paper, for ease of reading and for the good of the trees, the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* will be referred to as the 36 Act and 97 Act respectively.

2. What is Interest?

2.1 Features of interest

Interest is given an extended definition for limited purposes in the tax legislation (eg withholding tax). However, no general definition is given and neither section 8-1 of the 97 Act or section 51 of the 36 Act provide a separate test for the deductibility of interest. However, the fact that a payment is interest can be relevant as the courts have tended to accept that interest is a revenue expense.

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1 Many thanks to Jeff Tyler and Grant Howden of Allens Arthur Robinson for their invaluable assistance in researching and writing this paper.

2 Steele *v* DCT (1999) 197 CLR 459

3 *FCT v BHP Ltd* [2000] FCA 1431

4 *FCT v Anovoy* [2001] FCA 447

5 *FCT v Jones* [2002] FCA 204

6 *FCT v Firth* [2002] FCA 413

7 *P & G Rocca Pty Ltd v FCT* [2002] FCA 732

8 Hart *v* FCT [2002] FCA 904
The features that are relevant to determining whether a payment is interest are:

- Whether the payment is recurrent or periodic – although lump sum payments in advance or arrears may still be interest.
- Whether the payment secures a non-enduring advantage
- Is the payment in respect of moneys lent or credit extended.

These factors were considered in the BHP case.

2.2 Facts in BHP

Negotiations between BHP and General Electric Company (GE) for BHP to buy 100% of the shares in Utah International Inc and Utah-Marcona Corporation started in August 1982. Initial discussions were on the basis that GE would retain the profits of the companies up to completion.

A non-binding memorandum was signed on 27 January 1983. It provided for a purchase price of US$2.33 billion plus the consolidated net income of the companies up to 31 December 1982. BHP was to pay interest at 13% for the period from 1 January 1983 until completion. The interest was not to exceed the net profits of the companies for that period.

On 15 April 1983 the parties entered into a binding agreement. The purchase price of $2.4 billion was based on a valuation of the companies' assets at 1 January 1983. The binding agreement provided that that 12% 'interest' would be paid on the purchase price from 31 December 1982 to completion. However, the interest paid was not to exceed the combined net income of the companies for that period. The agreement also provided that no dividends were to be paid during that period.

Completion date was set as 31 October 1983 or as otherwise agreed. The sale completed on 2 April 1984. The 'interest' payment for the period 1 January 1983 to 2 April 1984 was US$185.539 million. BHP claimed the interest as a deduction for the 1984-year which resulted in a tax loss which BHP carried forward to offset against its income for the 1985 year.

The Commissioner denied the deduction on the grounds that it was an outgoing of a capital nature and issues amended assessments for both the 1984 and 1985 years.

2.3 Federal Court

The Federal Court did not accept that the deal between GE and BHP was for a sale price of $2.4 billion plus the net profits of the companies. In her Honour’s view the interest payment was to compensate GE for the loss of the benefit of the ownership of the shares from, at least, when the agreement was signed until completion. Accordingly, the payment was interest and deductible.

2.4 Full Federal Court

The issues on appeal in the Full Federal Court were whether the 'interest' was a deductible expense and, if it was not, whether the Commissioner was precluded from making an amended assessment in respect of the 1985-year because BHP had made full and true disclosure.

9 Broken Hill Pty Co Ltd v Commissioner of Taxation [1999] FCA 1628
Hill J dealt with both points in his judgment. Heerey and Merkel JJ agreed, without further comment, with Hill J’s reasoning in relation to the interest point. They delivered a joint judgment in relation to full and true disclosure.

Hill J noted that the real question was whether or not the expense met the deductibility test in section 51(1), not whether it was interest. However, its potential characterisation as interest was relevant because generally at least, interest, like other recurrent expenses, such as rent, is on revenue account.

His Honour noted that the label the parties use is not determinative, although it may be of some relevance:

… the Courts will always consider the substance of a transaction in characterising the character of an advantage which is sought to be obtained in determining whether an outgoing is on revenue account or whether, as here, on capital account and thus excluded from deductibility.

He then went on to consider what is required for an amount to be interest noting that often, but not always, interest will be consideration for a loan of money. However, a payment may also be interest is if it is made in respect of credit given otherwise than by way of loan. For example, allowing a purchaser time to pay the purchaser price is not the giving of a loan but it is the extension of credit. Hill J also commented that an amount payable in respect of a credit facility ‘whether or not it is used’ may be called interest. He went on to say that:

There can be no doubt that if, on the date scheduled for completion of a contract of sale, the vendor agreed to extend the time in which the purchaser is to pay the purchase price for a period, conditionally on the purchaser paying interest, that the amount could be called interests.

At the next paragraph he said:

Likewise, where under a contract of sale a purchaser is allowed into possession as at the date of the contract and becomes entitled to receive the benefits and bear the burdens of the property as at that date, it is not unusual for there to be an undertaking to pay money on the outstanding purchase price, or for that obligation to speak in terms of the purchaser paying interest.

Hill J said that, on the facts, no loan was made from GE to BHP – an unpaid purchase price is not a loan. In addition, BHP had not entered into ‘possession’ of the shares. He noted that there was no suggestion that the parties had agreed to defer completion of the contract. Although this is somewhat at odds with the fact that the original completion date of 31 October 1983 was extend to 2 April 1984.

Hill J considered the following factors in determining the correct characterisation of the payment, ignoring the label the parties used:

• It was ‘not at all obvious, indeed the indications are to the contrary, that the so called interest payment was for some extended credit that was given to BHP.’

• BHP was not in possession of the shares from 1 January 1983 (when the ‘interest’ was calculated from) or from the date of the contract. As discussed below, this finding could be considered contentious given that BHP had the right to the profits of the companies being acquired.

10 Paragraph 42.
• The agreement was conditional and may have never completed. Interestingly, Hill J had earlier commented that an amount payable in respect of a credit facility 'whether or not it is used' may be called interest. The fact is that if the Agreement had not completed, no purchase price would have been payable and no interest. It would seem that the possibility of non-completion should not affect the character of the payment – a position adopted by Kenny J at first instance.

• The purchase price and ‘interest’ were both payable on completion. Interestingly, earlier in the judgment it was acknowledged that the fact that one physical payment is made does not preclude a payment from being interest, you look to the method of calculation and other factors.

• All that really happened is that the purchaser agreed to pay two sums of money on completion. One was called purchaser price. The other was called interest and calculated in a manner similar to interest. It is open to parties to a sale to fix a price, or part of a price, that is an agreed percentage of a figure that will become known at a future date (eg, receipts or earnings over a particular period).

Accordingly, in Hill J’s view, the payments under the contract were not interest but part of the total consideration paid for the shares and, as such, were a capital payment.

2.5 Comment

The Full Federal Court makes clear that for a payment to be ‘interest’ in respect of an uncompleted purchase contract there needs to be:

• a loan/extension of credit;
• a purchaser in possession; or
• an extension of settlement date

What is not clarified is what constitutes going into possession of shares? There is little law as to what constitutes possession in relation to shares. Clearly, Hill J took the view that the combination of the right to profits and reporting to BHP on events affecting the company together with restrictions on undertaking non-core business activities was not sufficient.

Must there be completion with handing over of completed share transfers? It would be more usual in such a case for the transfers to be retained by the vendor as security. Does the purchaser have to take over day to day control of the company for it to be in possession or would it be sufficient for the agreement to provide that the vendor will operate and manage the company as agent for the purchaser with provision for it to take instructions from the purchaser that were not inconsistent with protecting the vendor’s position as unpaid vendor of the shares?

Special leave to appeal to the High Court was denied on this point. The difficulty is, of course, that the High Court is reluctant to take on appeals dealing with the income/capital dichotomy. It was argued that special leave should be allowed if only to sort out when a purchaser of shares goes into possession of the shares. However, the transcript makes it clear that this argument was given little weight. One view is that this was because it was linked to a characterisation question relating to the income/capital dichotomy and therefore was not given much focus.
2.6 Full and True Disclosure

Another issue in the BHP case was whether the assessment for the 1985-year was out of time because BHP had made full and true disclosure of all relevant facts when it lodged an application for exemption from withholding tax on the interest payment.

As this issue is not directly relevant to this paper I will spend little time on it, but it is worth mentioning. Kenny J and Hill J held that full and true disclosure had been made as the ATO had the Purchase Agreement at the relevant time. Heerey and Merkel JJ found to the contrary on the basis that the withholding tax application had described the payment on which the interest was payable as a “loan”.

The High Court allowed special leave on this point. The day before the hearing of the High Court appeal the ATO effectively withdrew from the appeal and an order was subsequently made in favour of BHP. Accordingly, notwithstanding that the judgement of Heerey and Merkel JJ stands as the last detailed written reasons on this issue, it should not be accepted as representing the law.

3. When is Interest Deductible?

3.1 General deductibility provision

There is no specific interest deductibility provision. As Hill J said in BHP 11:

The question to be answered is rather whether the outgoing which BHP ultimately made on the completion of the agreement fell to be deducted under s 51(1) of the ITAA 1936.

Section 51(1) of the 36 Act, which applied to deductions until the end of 1997-income year, said:

51(1) 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 of a capital, private or domestic nature, or are incurred in relation to the gaining or producing of exempt income.

Section 8-1 of the 97 Act expressed the same idea but in a different form. That form clearly shows the two positive heads of deductibility and the denials that override those positive tests. It also includes an express acknowledgment that the provision is subject to specific deduction denying provisions elsewhere in the Act. The section reads as follows:

8-1(1) You can deduct from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

8-1(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature; or

(c) it is incurred in relation to gaining or producing you exempt income; or

11 At paragraph 15.
(d) a provision of this Act prevents you from deducting it.

Both section 51(1) and section 8-1 contemplate apportionment by the use of the ‘to the extent’ words. An amount of interest will only be deductible to the extent that is satisfies the positive deductibility test and to the extent that it does not fall within a prohibited head of deduction such as capital.

3.2 General principles

To satisfy the general test of deductibility there must be sufficient connection, or nexus, between the expenditure incurred and the income producing activity. As interest is the price paid for money borrowed or credit given, the Courts have generally looked at the purpose of the borrowing in order to determine whether the interest is deductible.

Where the borrowed money is used to fund business outgoings or to fund assets used to derive assessable income, the interest will satisfy the positive deductibility test. A rigid tracing of funds is not required.

To satisfy the positive test, the interest does not have to relate to income derived in the same year as the interest is incurred. As the cases discussed below, the test can be satisfied by establishing the necessary nexus with income derived in previous or future years.

3.3 Nexus

Roca v FCT\textsuperscript{12} is a recent case that illustrates the need for there to be a nexus between the expenditure by the taxpayer and the taxpayer’s own income producing activity.

Facts

The guiding shareholders of P & G Rocca Pty Ltd (the \textit{taxpayer}) were brothers who had been in business together for many years. Although they had a reasonably complex business structure, established for them by accountants, they thought of themselves as operating their businesses as ‘partners’.

On 5 April 1990 the taxpayer entered in a contract to purchase a property at Darlington in South Australia. On 10 May 1990 the Darlington Property Unit Trust was established. The trustee of the Trust was Accor Pty Ltd.

Settlement of the purchase of the Darlington property took place on 15 May 1990 with Accor having been nominated as the purchaser by the taxpayer. The purchase price was funded by the taxpayer by way of a bill facility with the Commonwealth Bank. The required funds were on lent to Accor under an informal interest free loan.

The taxpayer sold its business, including the right to operate the business at the Darlington property, to a third party by a contract dated 4 July 1995. The purchasers of the business agreed to lease the Darlington property from Accor. The proceeds of the sale allowed the repayment of the Commonwealth Bank debt.

The taxpayer paid the ‘interest’ and bank fees on that facility as well as the council rates, water rates and land tax in respect of the Darlington property. It was not reimbursed for these expenses by the Unit Trust or Accor.

\textsuperscript{12} Roca v FCT [2002] FCA 732
For the financial years ending 30 June 1991, 1992, 1993 and 1994 the taxpayer claimed deductions for the interest, bank charges, rates and land tax it paid. The Commissioner issued amended assessments disallowing those deductions and disallowed the taxpayer’s objections to those amended assessments.

**Federal Court**

In the Federal Court Mansfield J said, a paragraph 49 of his judgment that:

> Where, as here, no assessable income was ultimately derived from the Darlington property until August 1995 when it was leased to [the Purchaser of the business] and no assessable income was ultimately derived from the Darlington property by the [taxpayer] as distinct from Accor, the characterisation of the outgoings may involve consideration of the objects and advantages which the [taxpayer] ought to achieve in making those outgoings: see eg Robert G Nail Ltd v Federal Commissioner of Taxation (1937) 57 CLR 695 at 708-709.

The Commissioner said that the interest expenditure was incurred preliminary to gaining or producing the assessable income. However, the Court rejected that submission as at all relevant times the taxpayer’s intention was to operate a retail business at the Darlington property and to produce assessable income by doing so. The fact that there were obstacles to obtaining this end such as planning and finance issues, did not change this.

The principal issue raised by the Commissioner was that there was not sufficient nexus between the payments of interest and other outgoings by the taxpayer and its gaining or producing assessable income. The Court held that in legal substance the Unit Trust and the taxpayer were independent. At paragraph 61 the Court concluded that:

> there is no sufficient nexus between the payments of interest by the [taxpayer] and the payments of other outgoings in respect of the Darlington property… and the gaining or producing assessable income of the [taxpayer].

This was because, while the taxpayer had intended always to derive income form operating a store on the Darlington property, it had intended to do as a tenant. It had not intended to derive income form the property as an investment.

The taxpayer argued that it could have paid rent for the Darlington property which would have been deductible and Accor may have been obliged to pay interest of a similar amount. The Court said that deductions could not be claimed on the basis of theoretical arrangements the parties may have entered into.

The case illustrates one of the problems that often arises when clients are “given” trust structures to hold their assets. It is not unusual in such cases for the clients to fail to understand that they no longer own the assets. That there is a difference between what they do and what their trust/corporate vehicles do. In this case the shareholders of the taxpayer did not understand that the property was not owned by the taxpayer. They viewed the entire arrangement as one under which the company owned the land and operated the business, not understanding that the property was owned by the Trust and, for tax reasons, if for no other, it was necessary to ensure that the holdings were treated accordingly. The lesson must be that we must make sure that our client’s understand their trust/corporate structures and that they are given the back-up necessary to make sure that all transactions are properly documented and fall within the right entity.
4. Pre-Commencement Interest

4.1 Steele

This decision has been with us for a number of years now. However, it is very important in the interest context as it gave the High Court the opportunity to consider the general principles in relation to interest deductibility.

Facts

In 1980 Mrs Steele purchased a 7.4-hectare block of land near the Perth airport from the proceeds of the sale of her business. Part of the purchase price was left outstanding at interest and later was refinanced. There were two houses, stables and other improvements associated with horse racing on the land. Prior to buying the land the taxpayer made inquiries about developing a motel on the site. While she owned the land she also made various attempts at obtaining consent to develop the site and entered into various negotiation and plans to develop the site. In January 1982 she sold a half interest in the land to a business associate with whom she had investigated development prospects. After a dispute with her co-owner she subsequently bought back her half interest. In 1987 she again sold a half interest in the property and sold the remaining interest 18 months later.

During the time the taxpayer owned it the only business activity carried out on the land was horse agistment from which the taxpayer earned a total of $28,943. Mrs Steele sought to deduct interest (on the unpaid purchase price and subsequent refinancing of the debt) and other outgoings of $909,649.

AAT

The Commissioner did not accept the claimed deductions and the matter went to the AAT which held that:

The [taxpayer] incurred interest on a loan to secure ‘Tibradden’ for a dual purpose, one to derive assessable income from the agistment activities – an affair of revenue – and the other to develop a profit-yielding structure of a future business enterprise – an affair of capital.

The AAT, therefore, apportioned the interest and outgoings allowing a deduction to the extent of the revenue purpose and denying a deduction in respect of the capital purpose.

Federal Court

The taxpayer appealed to the Federal Court which upheld the decision in the AAT.

Full Federal Court

The taxpayer appealed to the Full Federal Court where the majority (Burchett and Ryan JJ) held that the interest was a capital outgoing and not deductible. Their judgment quoted at some length from the Privy Council decision in Wharf Properties Ltd v Commissioner of Inland Revenue.

13 Steel v Deputy Commissioner of Taxation [1997] 167 FCA

14 [1997] AC 505, which held that interest incurred on money borrowed to acquire land to redevelop was on capital account and not deductible under Hong Kong law because the loan was applied for acquiring and creating a capital asset.
In a dissenting judgment, Carr J was of the view that Mrs Steele incurred the interest on the money borrowed to buy the property as part ‘of an adventure or undertaking whereby that property was turned to profitable account’ and this was sufficient to satisfy the first limb of section 51(1). As any profit from this undertaking would give rise to assessable income, the AAT was wrong in concluding that the interest was of a capital nature. Carr J considered that the matter should be referred back to the AAT for it to reconsider in light of Mrs Steele's business activities as a whole and not just the horse agistment activity.

High Court

The taxpayer then appealed to the High Court. In a joint judgment, Gleeson CJ, Gaudron and Gummow JJ confirmed that the reference to assessable income in section 51 was not to be read as limited to assessable income arising in the year the expenditure is incurred. Once it has been determined that the expense is incurred in gaining assessable income, the fact that little or no income is derived in the year the expense is incurred is not relevant.

Their Honours explained that the majority in the Full Federal Court were wrong in going straight to the question of whether the interest expenditure was of a capital nature. It is necessary to first determine whether the positive test as to the necessary nexus with assessable income is satisfied before the bar on capital deductions is considered.

The High Court majority considered the view of the majority in the Full Federal Court that the interest expenditure could be on capital account during the years prior to a motel being built and then switch to revenue account once the motel was constructed contained some problems. The money was borrowed to acquire and hold the land and there would have been no change to that purpose once a motel started operation.

Gleeson CJ, Gaudron and Gummow JJ accepted the proposition that under Australian tax law (unlike the UK) interest paid on money borrowed to acquire an income producing asset is generally deductible. There may be particular circumstances where it is proper to regard the purpose of the interest payments as something other than raising or borrowing the capital and, therefore, potentially of a capital nature but this case was not one of them. The interest paid by Mrs Steele was at ordinary commercial rates and terms and the issues that arise in relation to interest between parties not at arm’s length or not at commercial rates did not arise.

The fact that an asset has not or may never become income producing may be relevant under the positive deductibility test but it is not relevant to the question of whether the interest is on capital account. That is, the fact that the asset produces no income in a particular year does not make the interest on money borrowed to acquire that asset on capital account.

The decision in Travelodge Papua New Guinea Ltd v Chief Collector of Taxes is consistent with Australian authority. Wharf Properties does not represent the law in Australia.

Their Honours noted that there have been cases where it has been held that there was not sufficient connection between the outgoing and the assessable income on the grounds that the outgoing was ‘entirely preliminary’ to gaining or producing he assessable income. However, Mrs Steele’s interest expenditure was not too preliminary or too soon. She was committed to a profit

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15 (1985) 16 ATC 4432, which held that interest on money borrowed to build a new hotel was deductible during the construction phase.
making venture throughout. If she did nothing and eventually sold any profit would be assessable because of that.

Callinan J agreed with the reasoning of the majority except that he disagreed with the decision that the case should be remitted back to the AAT.

In his dissenting judgment, Kirby J emphasised that Mrs Steele’s ‘idea’ never came within range of reality of producing income. In his view, Mrs Steele’s case was bound to fail because of the prohibition against deductions of a capital nature and, therefore, it was not necessary to consider the positive nexus test.

Kirby J disagreed with any suggestion that the proposition that interest, by it very nature, is of an income nature was consistent with authority. Whether interest is of a capital nature depends on the facts of the particular case. In his view, the findings of the High Court in Federal Commissioner of Taxation v Energy Resources Australia Limited are relevant to the question. That case held that whether a deduction was available for a discount on the issue of promissory notes depended on how the funds raised are applied. If they are applied to strengthen the business entity or its income producing structure, the expense will generally be on capital account. He acknowledged that discounts are not the same in legal form as interest but they have the same commercial substance. In addition, he noted that wages, another recurrent expense, may be of a capital nature.

In his view, expenditure incurred in connection with a capital asset expected to produce income in the future, but not now doing so, may be characterised as on capital account. In addition, interest on money borrowed to finance the acquisition of an asset with a view to eventual conduct of a business may be incurred too early to be on revenue account. At that stage the hoped for income is too remote.

Kirby J considered that the provision under consideration in Wharf Properties was relevantly indistinguishable from the Australian provision and the reasoning in that case should be followed. The Wharf Properties test is to look at the purpose of the loan during the period in which the interest is paid. Once an asset has been acquired or created and is producing income, the interest is a cost of generating that income. Before that, it is a capital cost.

4.2 Anovoy

Facts

In July 1983 the taxpayer company bought a historical house in Perth which had been declared unfit for human habitation under the Health Act. The price was $100,000 of which $80,000 was borrowed from a financier. In July 1983 the taxpayer wrote to the Council stating that it intended to restore and renovate the premises. It also sought permission for the directors to live on the premises while this was done despite the designation as unfit for human habitation.

The intended purpose later changed to an intent to renovate the property as a gallery and café.

No work was carried out on the premises until 1988. This work was consistent with the premises being used as a single residence.

In May 1989 the property was valued by a local real estate agent at between $540,000 and $600,000 and up to $750,000 if the renovations were completed.

16 (1996) 185 CLR 66
The Commissioner allowed the taxpayer a deduction for interest on the money borrowed to acquire the property but not for the interest on money borrowed to fund the renovations.

**AAT**

The matter went to the AAT which found that the taxpayer always had the intention of making a profit out of the property (at that price it could not lose). However, the AAT held that:

...any necessary connection between the outgoings and future income earning activity is not satisfied merely on proof that [the taxpayer] is a company turning over every stone to see whether something may be hidden underneath which can, by one means or another, be turned to future profit...

The AAT allowed a deduction to the extent of the $1040 ‘rent’ income of the taxpayer paid by the directors who lived in the property.

**Federal Court**

The taxpayer appealed to the Federal Court by which time the decision in *Steele* in the High Court had overturned the decision in the Full Court. The Federal Court accepted that the AAT’s decision was heavily influenced by the overturned Full Federal Court decision in *Steele* and, therefore, remitted the case back to the AAT to be reconsidered.

**Full Federal Court**

Both the Commissioner and the taxpayer appealed that decision to the Full Federal Court. The majority, Lee and Lindgren JJ, found in favour of the Commissioner. They held the AAT was correct in looking at whether carrying out the renovations and additions formed part of an income generating activity and it was, therefore, relevant for the AAT to consider why the taxpayer acquired the property. The AAT found that the renovations were not effected in the course of any particular income producing activity. A proper analysis of the AAT’s finding is that, as required by the High Court decision in *Steele*, it applied the positive nexus test before considering the capital prohibition. The AAT found that there was not sufficient nexus between the interest on the money borrowed to carry out the renovations and the production of income in the future from an income producing activity in the property.

In a dissenting judgment, Carr J said that Federal Court had been right to refer the matter back to the AAT. The High Court decision in *Steele* required that a positive decision be made about the application of the nexus test. It was not clear that that the AAT had considered first whether the nexus test has been satisfied and then, if it had, whether a deduction was denied because of the capital prohibition. The question of whether there was sufficient nexus between the interest expenditure and the generation of income was a question of fact for the AAT. Carr J commented that, on the facts found by the AAT, the case was on all fours with *Steele*.

Interestingly, Carr J was the dissenting judge in *Steele* and the judgement of the majority in the High Court was on very similar terms to that of Carr J in the Full Federal Court. This is evidence of the fact that a tension still exists as to the appropriate test for deciding when pre-commencement interest will be deductible.

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17 Anovoy Pty Ltd v FCT 2000 ATC 4445

18 Whose dissent in the Full Federal Court in *Steele* found favour with the High Court.
4.3 Comment

Principles that can be taken from the above cases are:

- The nexus test must be applied before, and separately to, the capital prohibition test.
- The nexus test does not require income to be produced before related expenditure can be deducted. However, in some instances, the nexus test may be failed where the expenditure is incurred ‘too soon’.
- That interest is paid on money borrowed to acquire a capital asset does not mean that the interest is capital expenditure.
- Interest on money borrowed to acquire or create an income producing asset is not capital expenditure merely because the asset has not started to produce income (Travelodge confirmed, Wharf Properties not followed).
- It is possible for interest to satisfy the nexus test and fail the capital test. However, generally, that would be where there were factors such as a non-market interest rate that show that there is an additional, capital, purpose in paying the interest.

The ATO’s views on deductibility of interest, post the decision in Steele and Brown are set out in TR 2000/17. At paragraph 28 the ATO express the view that for the expenditure incurred before income has been produced to be deductible there must be continuing efforts undertaken in pursuit of assessable income. Later in the paragraph it is said that:

We have concluded that the concept of ‘continuing efforts’ should not be taken to require constant on-site development activity. 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 review the venture some time in the future.

5. Post-Cessation of Business

5.1 Steele

The majority in Steele noted that there are:

cases which have decided that a taxpayer may be entitled to a deduction after a business has ceased, provided the occasion of the business outgoing is to be found in the business operations directed towards the gaining or production of assessable income generally.

However, it was not necessary for the judges in that case to go on an elaborate on when such an occasion might exist.

5.2 Brown

Facts

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19 See also section 25-85 of the 97 Act.
20 FCT v Brown 99 ATC [1999] FCA 721 – see 5.2 below
21 For an example of the ATO’s application of this view see ATO ID 2001/307
In November 1988 Mr and Mrs Brown borrowed $105,000 to buy a delicatessen business. The loan required 120 monthly repayments of $1832 in principal and interest.

In or around March 1990 the Browns sold the business for $65,000 which left a balance outstanding on the loan of approximately $42,000. They continued to pay interest on this loan until it was repaid in full in July 1995. The terms of the loan did not allow for early repayment.

**Federal Court**

The Commissioner disallowed deductions for interest on the loan for the period after the business had been sold and the matter proceeded to the Federal Court. Carr J found that the loan was inextricably linked with the acquisition of the business. As a result there was sufficient nexus between the payment and the interest and the carrying on of the business for the purpose of producing assessable income. The interest was deductible.

**Full Federal Court**

The Commissioner appealed to the Full Court and argued that:

- Once the business had ceased, the reason for the payment of the interest was the voluntary decision of the taxpayers not to repay the loan. This broke the nexus between the carrying on of the business and the interest expense.

- If the above was not accepted, once the business ceased to be carried on, the interest could not relate to the operation of the business so it must relate to the acquisition of a capital asset – ie, the business that had ceased to exist.

- The time between the ending of the business and the incurring of the interest for the 1993 and 1994 tax years meant that the expenditure was no longer sufficiently proximate to the previously conducted business.

Lee RD, Nicholson and Merkel JJ held that it was appropriate, in determining the ‘occasion’ of the loss or outgoing (ie, the interest expense), to refer to the purpose of the Brown’s in borrowing the money and the use to which it was put. That is, the occasion for the interest expense was the bank loan the purpose of which was to allow the Brown’s to acquire and carry on the business. They agreed with the Federal Court’s findings and:

In particular his Honour, in determining that the occasion for the loss or outgoing in question was the payment of interest which the taxpayer was *obliged* to pay under the Bank loan contract, was applying the principles established in AGC, Placer and Riverside Road to the undisputed facts of the present case.

They agreed that there may be such a period of time between the cessation of the business and the payment of the interest that ‘the payment is no longer sufficiently proximate to the activities of the business to be deductible’. However, the evidence did not establish that time had come in the Browns’ case.

Their Honours noted that it was not relevant that the loan might, as a practical matter, be able to repaid early. Carr J was correct in holding that the relevant issue was whether the legal terms of the contract allowed early repayment.

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23 *Brown v Commissioner of Taxation* [1998] 746 FCA
At paragraph 28 of their judgment, their Honours said:

Had the loan agreement in question been a “roll over” business loan facility which entitled the taxpayer conducting the business, on the date of each monthly payment, to elect to repay the principal and thereby avoid incurring liability for interest or to “roll over” the loan and continue to be liable for interest, that may have been a different situation. In that circumstance there may be considerable force in a contention that the occasion of the liability was the election to "roll over" the loan on each monthly payment date, rather than any liability arising under the terms of the original loan agreement establishing the terms of the "roll over" facility. In such a case the cessation of the business or sale of the income-producing asset acquired with the borrowed funds might properly be regarded as breaking the nexus in much the same way as certain post cessation interest payments were not allowed as deductions in *Riverside Lodge*. However, as explained earlier, that is not the situation in the present case.

### 5.3 Jones

**Facts**

Mrs Jones carried on a partnership with her husband. In May 1990 they borrowed $70,000 from the ANZ for business purposes. The loan was secured over the family home. It had a nominal term of 10 years but was repayable at any time – although subject to a penalty if repaid in the first two years.

In September 1992, when Mr Jones was very ill, the partners started to sell the partnership assets so as to reduce their indebtedness. The business ceased operating during the tax year ending 30 June 1993.

Mr Jones died in December 1992 when the loan balance was $100,000. The debt was reduced to $80,000 with the proceeds from Mr Jones’ superannuation policy.

Mrs Jones continued to make payments under the loan and this took more than half of her income as a nurse. In May 1996, she borrowed $74,000 from RAMS (at a lower rate of interest) and used that to repay the ANZ loan.

The Commissioner disallowed Mrs Jones interest deductions for the period after the business ceased to operate. Mrs Jones’ objection was disallowed and she took the matter to the AAT.

**AAT**

The AAT held that the interest was deductible for the period up to 1996. It found that, as a matter of fact, the taxpayer did not make a voluntary decision not to repay the loan. She did not have the financial capacity to do so.

**Federal Court**

Dowsett J in the Federal Court held that the cessation of the business did not break the nexus between the interest expense and the income producing activity. He noted that passage of a substantial period of time might break the nexus on the basis that it indicated that the loan was kept on foot for ‘reasons unassociated with the former business’. Similarly, he noted that where a conscious decision is made to extend a loan (as discussed in *Brown*):

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24 Federal Commissioner of Taxation v Jones [2001] FCA 1153
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.

That was not the case for Mrs Brown. She was not in a position to repay the loan. The interest on the ANZ loan continued to be deductible after the business ended and the refinancing of the loan did not change that.

*Full Federal Court*

The Commissioner argued that, as the loan could be repaid at any time, the obligation to pay the interest came into existence when the taxpayer chose not repay the loan. The Commissioner argued that paying interest in that situation is no different to continuing to pay rent on a tenancy at will over premises formally used in a business.

Beaumont, Finn and Sundberg JJ held that a judgment was required as to whether there was a nexus between the interest and the business operations. There had to be ‘sufficient proximity’ between the interest expense and the business operations.

They rejected the Commissioner’s proposition that Mrs Jones chose not to pay principal each month. The loan was for a fixed term and unless the taxpayer defaulted it would continue for that term unless paid early. In any event, as found as a fact by the AAT, Mrs Jones did not have the financial capacity to repay the loan. She was paying a business loan on a non-business income.

The Commissioner’s comparison with a tenant under a tenancy at will was inapposite. The tenant has a free choice whether to retain the premises (Mrs Jones had no free choice whether to continue with the loan). In addition, the use of the premises would change from a business to private. There was no such change in Mrs Jones’ case.

In the judges’ view, contrary to the Commissioners’ contention, *Riverside Road* did not establish that a taxpayer who has a legal right to repay a business loan can never deduct the interest on that loan once the business ceases. In their view, the obiter comments in *Brown* in relation to rollovers applied to cases where the taxpayer had a true choice. That is, where the borrower has the resources to pay the loan. In any event, they held that Mrs Jones’ loan was not a rollover but merely one that was to run for an agreed term unless terminated early.

The Full Court agreed with Dowsett J’s view that the refinancing of the loan in May 1996 did not break the nexus. They commented that:

> It is well-established that when an original borrowing is refinanced, the new financing takes on the same character as the original borrowing.

### 5.4 Comment

The principles coming out of these cases in relation to interest paid on business loans after the cessation of the business are:

- There is no automatic bar to a taxpayer deducting interest on the loan after the business has ceased.
- The period of time between the cessation of the business and the incurring of the interest expense may be such that the ‘payment is no longer sufficiently proximate to the activities of the business to be deductible.’
• An ability to rollover a loan may not necessarily break the nexus.
• A refinanced loan takes on the same character as the original borrowing.
• Where the taxpayer is legally and practically able to repay the loan the nexus with the former business’s income producing activities will be broken.

TR 2001/17 at paragraph 36, in relation to the decision in Brown, states:

The practical effect of this analysis is that any taxpayer who has borrowed for income earning activities and had:

• lost the borrowed funds (and any assets representing those funds); and
• ceased the relevant income earning activities

will be entitled to deductions for the interest incurred subsequent to the cessation of those activities, but only up to the amount of interest that the taxpayer was legally powerless to prevent accruing from the time of cessation.

This statement is inconsistent with the view expressed by the Full Federal Court in Jones.

6. Capital/Apportionment

6.1 Firth

Facts

The taxpayer entered into 37 protected equity investment loans (PEILs). The loans were for one year with interest paid in advance. The loans were used to buy shares in listed companies and were secured over those shares. The taxpayer could elect to repay the loans himself or have them repaid out of the proceeds of the sale of the shares. In the later case, and except in the case of bankruptcy or certain other defaults by the taxpayer, the lender’s right of recourse was limited to the proceeds of the shares.

The interest rates charged varied between 17.3% and 19.3% and the rate varied depending on the time of advance and the shares purchased.

The taxpayer claimed interest deductions of $1,268,277.60 for the tax year ending 30 June 1999. The Commissioner disallowed $353,021 of the deduction on the basis that a portion of the ‘interest’ was paid to obtain the non-recourse feature of the loan and payment for that advantage was a capital payment. The amount of interest disallowed was the difference between the interest paid at the PEIL rate and the Commissioner’s published ‘Benchmark Rate’ based on the Reserve Bank’s Bulletin Indicator Lending rates for personal unsecured loans.

Federal Court

In the Federal Court the parties agreed that if the interest was to be apportioned between a deductible and non-deductible amount, the Commissioner’s basis for apportionment was acceptable.

25 Arguably that comment in Jones was dicta as the judges stressed that Mrs Jones loan was not a rollover loan. However, it would be strange if a refinanced loan takes on the character of the loan it replaces but a rolled over loan does not.
The Federal Court said that the fact that a loan on non-recourse terms might entail greater risk to
the lender meant that, ordinarily, a higher interest rate would be charged. However, that did not
mean the loan transaction can be artificially broken down into ‘one involving a multiplicity of
purposes when, as a matter of commercial substance, there was but one purpose.’ The Court held
that the taxpayer had only one purpose in paying the interest and that was to obtain the borrowed
funds to invest in shares.

The Judge went on to comment that if he was wrong on the above point, and part of the interest
was paid for the non-recourse feature, that amount was still deductible. The non-recourse feature
related to the repayment of loans with terms of one year and, therefore, did not create any
continuing advantage or benefit beyond the term of the loan. The cost of such an ephemeral
advantage is a revenue cost.

**Full Federal Court**

The Court unanimously dismissed the Commissioner’s appeal. In their judgment Sackville and
Finn JJ considered only whether apportionment was required. They said that the starting point in
resolving the issue was the principle recognised in *Steele* that ‘interest payments on moneys
borrowed to secure capital or working capital are generally on revenue account.’ The fact that the
interest was paid in an advance in a lump sum does not, of itself, indicate that the interest is not on
revenue account.

Their Honours acknowledged that, as recognised in *Steele*, there may be cases where a purpose
of paying interest may be something other than to raise or maintain the borrowing (eg, *Ure v
FCT*²⁶).

The Commissioner claimed that the non-recourse feature was inconsistent with the basic feature of
a loan – that it be repaid. Their Honours said that it was well established that it is possible to have
loans with limited recourse. Where this is the case, this factor will usually be taken into account in
setting the interest rate. However, that does not alter the arrangements characterisation as a loan.

The relatively high interest rate for the PEILs no doubt reflected their non-recourse nature.
However, that was the basis on which the lender lent and the taxpayer’s purpose in paying the
interest was to acquire the funds to invest in the shares. There is nothing in the agreement that
suggests that the taxpayer had any other purpose in incurring the liability to interest.

In his separate judgment, Hill J discussed the basis for apportionment of expenses. He said that it
was not necessary in this case to go outside the contractual arrangements actually entered into by
the parties to determine what the interest payments were made for.

Hill J said that whether or not interest is deductible is normally determined by looking at the
purpose of the borrowing and that will ordinarily require regard to be had to the use the borrowed
funds are put to. In particular:

> …the terms upon which the loan is made will have little significance in determining whether the
> interest payable under the loan is deductible. This is because it is the use of the money once
> borrowed that will normally chart the connect between the interest and the assessable income or
> business.

²⁶ *Ure v FCT* (1981) 11 ATC 4100
Hill J commented that it would ‘be strange’ if it was necessary to determine all the various benefits and burdens under a loan agreement in order to determine whether the interest was deductible. The parties could have agreed that the non-recourse feature would be provided for a separate consideration. However, they did not do that and:

whether the contract is severable or indivisible and thus whether apportionment is required or not will depend upon the terms of the contract and the nature of the advantage sought to be gained under it.

Hill J agreed with the other judges that no apportionment was required as the taxpayer had one purpose only in paying the interest. However, he went on to comment that if apportionment was required, the amount payable for the non-recourse feature would still be on revenue account. He agreed that, if the taxpayer was considered to be a share trader, there was an analogy between an amount paid to obtain a non-recourse feature and a premium paid to secure against a foreign exchange loss, which had been held to be on revenue account\(^\text{27}\). He also considered the short term nature of the loans relevant. However, he went on to say that the real reason why an amount attributable to the non-recourse feature would be on revenue account was:

the real character of the payment was no different from the real character of the balance of the interest paid. It lay in the securing of funds to permit the acquisition by the taxpayer of income producing assets. it was on revenue and not on capital account for the same reason as the balance of the interest paid by the taxpayer was.

An application seeking special leave to appeal to the High Court has been lodged.

6.2 Hart\(^\text{28}\)

Facts

Mr and Mrs Hart wished to buy a new residence, move into it, and rent out their existing residence (the investment property). They needed to borrow to refinance the loan on the investment property and to pay for the new residence. They did this by entering into a ‘Wealth Optimiser’ loan from Austral Mortgage.

Under the Wealth Optimiser, the loan was split into two accounts. One account related to the investment property and the other related to the new residence. The monthly payments under the loan were to be credited to the account that related to the new residence until that account was fully repaid. Interest accruing on the investment property account was capitalised and added to the amount owing under that account. If payments continued at the set monthly rate the account for the new residence would be paid off in somewhat over seven years. The balance of the investment property account would have substantially increased over that time.

The Hart’s sought to deduct the interest accruing on the investment account. This included compound interest (ie, interest charged on unpaid interest that had been capitalised to the account).

The Commissioner applied Part IVA of the ITAA 36 and allowed deductions on the basis that all payments had been applied proportionately against both loan accounts

\(^{27}\) Australian National Hotels Ltd v FCT 88 ATC 4627

\(^{28}\) Hart v Commissioner of Taxation [2002] FCAFC 222
Federal Court

The Federal Court held that the compound interest on the investment property account was deductible as it bore the same character as the simple interest that accrued on the account. Both lots of interest were incurred in gaining or producing the Hart’s assessable income.

However, the Federal Court went on to hold that the Commissioner had correctly applied Part IVA to the arrangement.

Full Federal Court

In the full Federal Court each of the three judges gave a separate judgment. However, only Hill J discussed the question of the deductibility of the interest apart from Part IVA. Heely and Conti JJ noted that they agreed with Hill J on that point and then went on to consider Part IVA.

The Commissioner had submitted that compound interest was different to simple interest as it was not ‘the price of money used to purchase anything.’ Rather it is interest on money that has not been paid. The Commissioner argued that as the compound interest was not paid on money borrowed to hold the investment property it was expenditure of a private nature. Alternatively, he argued that the compound interest was incurred so that the home loan could be repaid faster and that also gave it a private character.

Hill J dismissed the submission that compound interest has no relationship with the income produced from the investment property. He held that there is no reason why compound interest should be treated any differently to simple interest. Both are the cost of borrowing money.

The Commissioner also argued that the compound interest was paid by the taxpayers in order to obtain a tax deduction\(^\text{29}\). Hill J quoted the test of deductibility proposed by Deane and Fisher JJ in Magna Alloys\(^\text{30}\) of:

\[
\text{whether the outgoing was reasonably capable of being seen as desirable or appropriate from the point of view of the business ends of that business and, if so, whether those responsible for carrying on the business so saw it.}
\]

Hill J then said that:

\[
The fact that a taxpayer had even a dominant purpose of obtaining a tax benefit would not, in my mind, preclude a deduction, so long as the combined test was satisfied. On the other hand, a finding that there was no other purpose of incurring a loss or outgoing than obtaining a tax deduction would.
\]

The primary focus of the decision in Hart is on Part IVA. It was held that Part IVA did not apply as the dominant purpose of the Harts was to finance and refinance the two properties. I will not comment further on this aspect of the decision given the topic under discussion but to say that the decision has further added to the “mystique” of the subjective versus objective tests for determining intention for Part IVA purposes. It is an issue that might be cleared up if special leave to appeal to the High Court is granted.

\(^{29}\) The Commissioner argued in the *BHP v Commissioner of Taxation* [1999] FCA 1228 that the ‘interest’ was paid to obtain a tax deduction but did not submit that Part IVA applied as a result.

\(^{30}\) *Magna Alloys and Research Pty Ltd v Commissioner of Taxation* (1980) 49 FLR 183 at 210

7.1 Debt/equity rules

Division 974 of the 97 Act contains rules that deny deductibility where ‘interest’ is paid on an interest in a company that is in substance equity rather than debt. The new debt/equity rules contained in Division 974 distinguish between debt and equity interests based on the economic substance of the arrangement rather than its legal form. In general, the new rules operate to all instruments issued on or after 1 July 2001. They apply from 1 July 2004 to instruments issued before 1 July 2001 unless the issuer has made an election to apply the new rules earlier.

To be treated as debt, an arrangement must have the following characteristics:

- the arrangement is intended to raise finance for the issuer or a connected entity;
- the issuer receives financial benefits under the financing arrangement;
- the issuer has an effectively non-contingent obligation to provide financial benefits to another entity; and
- it is more likely than not that the value provided will exceed the value received and both values are not nil.

If an interest falls within both the debt and equity classifications (e.g., a hybrid security), it will be treated as debt.

Under the old rules, only shares were treated as equity interests. Under Division 974, it is possible to have shares that are deemed to be debt interests and for loan arrangements to be deemed to be equity interests. The distinction is relevant because returns on debt interests are deductible but not frankable while returns on equity interests are not deductible but are frankable. Thus, dividends on shares which are classified as debt are deductible on the same basis as interest. However, in relation to dividends and contingent interest, the amount of any interest deduction is capped at an amount equal to 150 basis points over the interest rate on the issuer's ordinary debt.

Also, returns on debt instruments will be subject to interest withholding tax rather than dividend withholding tax and the debt characterisation rules apply for the purposes of the thin capitalisation rules. Returns on debt instruments cannot be franked even if the returns are in the form of dividends on shares.

Some examples of the characterisation of instruments under the debt/equity rules follow:

- Convertible preference shares - Usually dividends can only be paid if there is sufficient profit. Therefore, not treated as a debt interest. The conversion of the preference shares, would not be taken into account as a financial benefit to be provided by the issuer.

- Redeemable preference shares - Assuming that dividends are payable at a fixed rate and are redeemable on a fixed date within 10 years of issue for their issue price – a debt interest.

- Perpetual subordinated debt - If interest can only be paid if there is sufficient profit - not treated as a debt interest. If interest is cumulative, will be debt if the rate of return means that the amount paid on the debt will at least equal the amount received on issuing the debt.
7.2 Thin capitalisation

Division 820 of the 97 Act introduced a new thin capitalisation regime that restricts the amount of tax-deductible debt that a multinational can allocate to its Australian operations. Division 820 applies to debt deductions relating to debt interests (using the debt/equity rules discussed above).

The new rules:

• extend the thin capitalisation rules to the Australian operations of both inbound investors (foreign entities investing in Australia) and outbound investors (Australian entities with controlled foreign investments); and

• limit tax deductions relating to total debt of the Australian operations, not just related-party foreign debt.

There is a safe harbour level of total debt of 75% of certain Australian assets. The alternative arm’s-length test requires the taxpayer to demonstrate that the level of debt could have been sustained by an independent entity. A further test allows Australian multinationals to gear their Australian operations to 120% of their worldwide gearing levels.

Modified rules apply to financial institutions, Australian banks and Australian branches of foreign banks.

7.3 Prepayments

Sections 82KZL to KZMF contain special rules affect the timing of otherwise allowable deductions for prepaid interest.

The general rule is that deductions for prepaid expenses are apportioned over the period to which the expenditure relates (the ‘eligible service period’). Certain taxpayers can claim an immediate deduction for expenditure where the eligible service period is 12 months or less and ends in the next income year (the 12-month rule).

Taxpayers must use the general rule unless the 12-month rule is available. Deductibility under the 12-month rule is available to:

• individuals incurring non-business expenditure;

• STS taxpayers incurring business and non-business expenditure; and

• certain prepaid expenditure relating to a plantation forestry managed agreement.

Transitional rules apply to the general rule for expenditure incurred in 2002 and 2003 where the eligible service period ends no more than 13 months after the date of the expenditure.

Prepaid expenditure under ‘tax shelter’ arrangements (managed investments where expenditure exceeds assessable income in an income year) are not eligible for the 12-month rule and must apportion expenditure under the general rule.

Sections 82KJ, 82KK and 82KL contain specific anti-avoidance measures for ‘pre-payment’ schemes (section 82KJ), tax deferral arrangements between associated parties (section 82KK) and ‘expenditure recoupment’ schemes (section 82KL).
7.4 Non-commercial loans

Under Division 7A of the 36 Act, amounts paid by a private company to an associated person (eg, a shareholder) are treated as dividends. There are specific exclusions from the general rule: eg, payment of a genuine debt is not treated as a dividend. Under Division 7, amounts paid may be treated as dividends where the Commissioner forms the view that the payments were in substance a distribution of profit. Division 7 has a residual application: it does not apply where Division 7A applies.

Division 13 of Part III of the 36 Act allows the Commissioner to adjust deductions claimed by substituting an ‘arm’s-length’ consideration for the consideration agreed by the parties under certain international transactions. Division 13 applies to transactions between Australian residents and non-residents that alter the level of income derived in each jurisdiction from the level that would be derived if the transaction was conducted at arm’s length.

7.5 Leveraged funding

The anti-avoidance measures in section 51AD deny otherwise allowable tax deductions attributable to the ownership of plant in certain leveraged lease transactions. Section 51AD disallows deductions attributable to ownership of property where:

- the acquisition or construction of the property was financed by ‘non-recourse’ debt;
- the property is leased to an end-user, or is used to provide goods or services and an end-user has effective control over that use; and
- the end-user:
  - is a non-resident which uses the property wholly or principally outside Australia;
  - uses the property other than solely for the purpose of producing assessable income (eg is a tax-exempt body); or
  - was the owner of the property before it was acquired by the new owner under a sale and lease-back arrangement.

In such cases, the owner will be deemed not to have used or held the property for the purpose of producing assessable income or in carrying on business for that purpose. In effect, tax deductions will be disallowed but income derived remains assessable.

The Government has recently announced proposed changes to section 51AD. Draft legislation is expected in early 2003.

Division 243 of the 97 Act includes an amount in a taxpayer’s assessable income on the termination of a limited recourse debt arrangement in certain circumstances. Division 243 is intended to ensure that a taxpayer cannot obtain deductions that are in excess of amounts actually paid under the arrangement.

7.6 Division 16E – discounts and deferred interest

A common technique to increase the return to a lender is the use of loan discounts and premiums. In certain circumstances, the discount or premium is considered to be a substitute for interest and is assessable as income (eg, where the interest rate charged on the loan is less than the arm’s-length commercial rate).
Division 16E of the 36 Act contains rules that require accrual recognition of gains and losses relating to discounted and deferred interest securities over the term of the security (effectively treating the discount as if it were compound interest). A security falls within Division 16E where:

- the term of the security will or is likely to exceed one year; and
- the payments under the security other than periodic interest exceed the issue price by a specified amount. The excess of payments over issue price is called the ‘eligible return’.

Division 16E merely adjusts the timing of income and deductions; Division 16E applies only where the discount or deferred interest is considered to be ordinary income.

### 7.7 Convertible notes

Interest paid on convertible notes is deductible where the specific requirements of section 82SA of the 36 Act are met.

### 7.8 Withholding tax

Section 26-25 of the 97 Act prohibits a taxpayer from deducting a payment of interest unless the taxpayer has complied with the requirements of the PAYG withholding system (where required).

Specifically, a taxpayer cannot deduct a payment of interest if the taxpayer is required to withhold an amount from the payment and fails to do so, or fails to pay any amount so withheld to the Commissioner.

If a taxpayer has an interest-bearing investment with an investment body and fails to supply its tax file number, the investment body is required to withhold 48.5% of the interest paid to the taxpayer.

### 7.9 ATO general interest charge

Section 25-5(1) of the 97 Act allows a taxpayer to claim a deduction for any general interest charge incurred by the taxpayer.

### 7.10 Exempt income

Under section 8-1(2) of the 97 Act, interest on borrowings relating to the production of exempt income is not deductible.

### 7.11 Otherwise non-deductible interest and the CGT cost base

Under Subdivision 110-A, interest that is not otherwise deductible is taken into account when calculating the GST cost base of a capital assets acquired after 21 August 1991. In effect, the non-deductible interest reduces the CGT liability on the ultimate sale of the asset.

The types of interest that can be taken into account are interest on money borrowed to:

- acquire the asset;
- refinance money that was borrowed to acquire the asset; and
- finance capital expenditure incurred to increase the asset’s value.

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