[¶504] Interest deductibility — the saga continues, 31 July 1998

Click to open document in a browser

Contributed by Dr Justin Dabner, James Cook University of North Queensland.

The rules relating to the deductibility of interest in Australia have long been contentious and unclear. The problem is that the underlying tests, namely the use to which the borrowed funds are put, the occasion or purpose of the borrowing and sometimes the motive for the borrowing, often tend to march in different directions depending upon the facts.

Particularly difficult have been cases concerning the deductibility of interest incurred before a business commences or after its cessation.

The decisions last year in *Steele v FC of T* 97 ATC 4247 (now on appeal to the High Court) and *Wharf Properties Ltd v Commr of Inland Revenue of Hong Kong* 97 ATC 4225 served to raise further doubt as to deductibility in the pre-business scenario. Since these decisions, it is unclear whether there is a new principle that there is no deduction available until income is derived, or whether they were simply decisions on the facts which suggested that the connection between the interest incurred and the subsequent income-generating activities was too remote.

As regards the post-business scenario, this was traditionally problematic due to the perceived conflict in the High Court decisions in *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295 and *AGC (Advances) Ltd v FC of T* 75 ATC 4057; (1975) 132 CLR 175. However, the recent decision in *Placer Pacific Management Pty Ltd v FC of T* 95 ATC 4459 was thought to have clarified this issue. Namely, if it could be concluded that the occasion of the outgoing could be found in the prior carrying on of the business, then the amount was deductible notwithstanding that it was incurred after the business had ceased. The recent decision in *Brown v FC of T* 98 ATC 4695 (see *Tax Week* ¶470 (1998)) illustrates that the waters are still muddy even in relation to post- business interest deductions. Notably, the Commissioner appears to have been buoyed by the decision in *Steele* and arguments raised in that case find currency in the Commissioner's submissions in *Brown*.

The facts of Brown

The facts of Brown are not remarkable. A partnership of the taxpayer and his wife had borrowed $105,000 to fund the purchase of a delicatessen. The loan was repayable in monthly instalments over 10 years, although it could be repaid earlier without penalty. After three years the delicatessen was sold for $65,000 and the net proceeds of the sale were applied in reduction of the loan. However, a balance of $42,000 remained outstanding on which the partners continued to make repayments. At issue was the deductibility of the interest for the four years following the cessation of the business until the loan was fully repaid.

The Commissioner argued that:

once the business had ceased, the loan moneys were used to fund the ownership of private assets;
the occasion of the outgoing was either the loan transaction which pre-dated business operations or the monthly payments which post-dated the business; and
the time period which had elapsed between the cessation of the business and the incurring of the interest was such as to break the connection between the interest payments and the business activities.

Carr J rejected all three submissions. It is appropriate to examine each one, and the way it was dealt with by his Honour, to glean some insight into the Commissioner's current thinking on interest deductibility.

Use of the loan

It was argued that, because the loan could be repaid at any time without penalty, the object of the borrowing was the retention of private assets.

Carr J rejected this argument on the basis that his Honour did not consider that there had been any change in the use of the borrowed monies. The fact that the borrowers could have repaid the loan out of their private resources did not assist in characterising the use of the borrowed funds. He emphasised that the tax position of the partnership was to be determined on the basis of the facts, not on what might or might not have been done. To accept the Commissioner's arguments would, in his Honour's view, amount to a notional transmogrification of the bank loan from being a source of business funds into a fund applied for private purposes. However, in reality, there was no such change in the application of the borrowed funds as they had simply been lost in the delicatessen venture.

Two observations can be made about this analysis.

Firstly, the Commissioner is trying to do a "negative *Begg*". *Begg v DFC of T (SA)* (1937) SASR 97 is often cited as authority for the proposition that, if funds are borrowed to fund a private venture when the alternative would have been to dispose of an income-producing asset, then the purpose of the borrowings is to preserve an income stream and therefore the interest ought be deductible. This "preservation of assets" argument does not appear to have gained much favour (certainly with the Commissioner), and the case is probably best viewed as restricted to its facts or stating a principle, the application of which is reserved to factual situations where the application of the primary use test is ambivalent.

The Commissioner's argument could be characterised as a "negative *Begg*" because he is, in fact, arguing that because the taxpayer could have used its private funds to pay off the business loan, then the purpose of the loan was to preserve private assets.

This leads to the second observation, namely that *Carr* J's criticism of the Commissioner's attempt to assess the taxpayer on the basis of what he ought to have done, rather than on the basis of what was actually done, is consistent with sentiments of the High Court in the recent decision in *FC of T v Orica* 98 ATC 4494 (see *Tax Week* ¶284 (1998)). That decision involved the assessability of the "gain" from a debt defeasance transaction. The Commissioner had argued that the transaction was akin to the investment of funds which would derive interest and therefore the "gain" was assessable. The High Court emphasised that it was not for the Commissioner to re-characterise the taxpayer's actual transaction into a less tax effective form.

These sentiments are welcome. Whilst this argument of the Commissioner has been very successful in the context of Pt IVA, it is most improper to attempt to re-characterise normal commercial transactions which have no tax avoidance element.

Occasion of the outgoing

Carr J rejected as being too narrow the Commissioner's argument that the occasion of the outgoing was the original loan transaction. Rather, the occasion of the outgoing was the loan transaction *plus* the outlaying of the proceeds in the purchase of a business.

It is difficult to comprehend the Commissioner's argument. Had it been accepted, then none of the interest would have been deductible, even during the currency of the business. The argument seems to arise on some overly enthusiastic application of *Steele*. That is, as no business had commenced until the delicatessen was purchased, then the immediately preceding loan transaction was too early in time to have its occasion in the business.

An alternative argument was that the occasion of the outgoing was each monthly payment. In *Carr* J's view, this was unrealistic.

Whilst no issue can be taken with his Honour's conclusion, this is where he ventures into a grey area where the deductibility principles have a strained application. What would have been his Honour's conclusion had the delicatessen been converted to private use rather than sold? Presumably then, the use principle would override the occasion principle. Contrast this to where a family home has begun to be rented out.

Presumably again, the use principal will override the occasion test. Alternatively, the occasion test is to have a different application depending upon the exact facts.

Interval between business cessation and interest expense

Carr J concluded that the time interval was not such as to break the connection between the business activities and the outgoing. His Honour referred to *AGC (Advances)* and *Placer Pacific* for the proposition that, provided the occasion of the outgoing was to be found in the business operations, then it would be deductible. He also applied *FC of T v Riverside Road Pty Ltd (in liq)* 90 ATC 4567.

Conclusion

It is hoped, and indeed expected, that the Commissioner will not appeal against the decision in *Brown*. The arguments raised by the Commissioner are commercially unacceptable and, if adopted by the courts, would only serve to compound existing deficiencies in the law. Clearly, the Commissioner, excited by his win in *Steele*, was hoping to further push the boundaries of the interest deductibility principles in the Revenue's favour.

Particular concerns include:

the decision is an attempt to rework the "preservation of assets" argument in the Commissioner's favour, notwithstanding that the Commissioner has continually rejected the application of this principle in the taxpayer's favour;
the Commissioner is attempting to dictate to taxpayers as to how they ought to arrange their affairs (so as to maximise the tax payable); and
the Commissioner would appear to refuse to concede that an outgoing related to a business can be deductible either before the derivation of assessable income or after the cessation of the derivation of assessable income.