

LAWS6841: Tax of Business and Investment Income B

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INTRODUCTION AND THE DEDUCTIBILITY OF INTEREST

Definition of interest

- Interest is not defined in the income tax legislation; the common law definition is often used for characterisation.
- At common law:
 - “interest” is a payment for using another person’s money (Lord Wright in *Riches v Westminster Bank* [1947] AC 390, 400).
 - “... interest is ... the return, consideration or compensation for the use or retention by one person of a sum of money belong to or owed to another, and that interest must be referable to a principal.”: Full Federal Court in *Century Yuasa Batteries* (1998) 38 ATR 442
 - In *Firth*:
 - “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 borrowed money during the term of the loan**. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and Associated 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.**”

Division 230 Basics: Key issues

- Treatment of financial arrangements: s 230-15
- Definition of financial arrangements: s 230-45(1)
 - Consider whether the financial benefit is ‘cash settlable’: s 230-45(2)
- Is it in relation to gains/losses arising from private arrangements? s 230-35
- Does it fall within any exceptions under subdivision H?
 - s 230-450: Short-term arrangements where non-money amount involved
 - s 230-455: Certain taxpayers where no significant deferral
 - s 230-460: Various rights and/or obligations
 - s 230-465: Ceasing to have a financial arrangement in certain circumstances
 - s 230-470.: Forgiveness of commercial debts
 - s 230-475: Clarifying exceptions
 - s 230-480: Treatment of gains in form of franked distribution etc.
 - s 230-481: Registered emissions units

Section 230-15 ITAA97: Gains are assessable and losses deductible

Gains

(1) Your assessable income includes a gain you make from a * financial arrangement.

Note: This Division does not apply to gains that are subject to exceptions under Subdivision 230-H.

Losses

(2) You can deduct a loss you make from a * financial arrangement, but only to the extent that:

- (a) you make it in gaining or producing your assessable income; or
- (b) you necessarily make it in carrying on a * business for the purpose of gaining or producing your assessable income.

Section 230-45 ITAA97: Financial arrangement – definition of financial arrangement

(1) You have a financial arrangement if you have, under an * arrangement:

- (a) a * cash settlable legal or equitable right to receive a * financial benefit; or
 - (b) a cash settlable legal or equitable obligation to provide a financial benefit; or
 - (c) a combination of one or more such rights and/or one or more such obligations;
- unless:

- (d) you also have under the arrangement one or more legal or equitable rights to receive something and/or one or more legal or equitable obligations to provide something; and
- (e) for one or more of the rights and/or obligations covered by paragraph (d):
 - (i) the thing that you have the right to receive, or the obligation to provide, is not a financial benefit; or

- (ii) the right or obligation is not cash settleable; and
 - (f) the one or more rights and/or obligations covered by paragraph (e) are not insignificant in comparison with the right, obligation or combination covered by paragraph (a), (b) or (c).
- The right, obligation or combination covered by paragraph (a), (b) or (c) constitutes the financial arrangement.

Section 230-45 ITAA97: Financial arrangement – definition of cash settleable

- (2) A right you have to receive, or an obligation you have to provide, a * financial benefit is cash settleable if, and only if:
- (a) the benefit is money or a * money equivalent; or
 - (b) in the case of a right--you intend to satisfy or settle it by receiving money or a money equivalent or by starting to have, or ceasing to have, another * financial arrangement; or
 - (c) in the case of an obligation--you intend to satisfy or settle it by providing money or a money equivalent or by starting to have, or ceasing to have, another financial arrangement; or
 - (d) you have a practice of satisfying or settling similar rights or obligations as mentioned in paragraph (b) or (c) (whether or not you intend to satisfy or settle the right or obligation in that way); or
 - (e) you deal with the right or obligation, or with similar rights or obligations, in order to generate a profit from short-term fluctuations in price, from a dealer's margin, or from both; or
 - (f) none of paragraphs (a) to (e) applies but you satisfy subsection (3); or
 - (g) you are able to settle the right or obligation as mentioned in paragraph (b) or (c) (whether or not you intend to satisfy or settle the right or obligation in that way) and you do not have, as your sole or dominant purpose for entering into the arrangement under which you are to receive or provide the financial benefit, the purpose of receiving or delivering the financial benefit as part of your expected purchase, sale or usage requirements.

Section 230-35 ITAA97: Treatment of gains and losses of private or domestic nature

Borrowings etc. used for private or domestic purpose

- (1) Subsections (2) and (3) apply if:
- (a) a * borrowing is made by you, or credit is provided to you, under a * financial arrangement; and
 - (b) you use some or all of the funds borrowed or the credit provided for a private or domestic purpose.
- (2) This Division does not apply to a gain you make from the arrangement to the extent that you use the funds raised or the credit provided for a private or domestic purpose.
- (3) A loss you make from the arrangement is not allowable as a deduction to you under any provision of this Act to the extent that you use the funds raised or the credit provided for a private or domestic purpose.

Derivative financial arrangement held for private or domestic purpose

- (4) Subsections (5) and (6) apply if:
- (a) you are an individual; and
 - (b) you make a gain or loss from a * derivative financial arrangement; and
 - (c) the arrangement is held, wholly or in part, for a private or domestic purpose.
- (5) This Division does not apply to a gain you make from the arrangement to the extent that the arrangement is held or used for a private or domestic purpose.
- (6) A loss you make from the arrangement is not allowable as a deduction to you under any provision of this Act to the extent that the arrangement is held or used for a private or domestic purpose.

Debt/Equity Rules: Basic concepts

- Characterisation of return based on economic substance rather than form (Div 974)
- Non-equity shares (debt interests):
 - Deduction for dividend/return; link to s 8-1
 - deductibility of interest (s 25-85)
- Non-share equity interests: no deduction for return (s 26-26)

Interest & tracing/use of borrowed funds

Munro

Facts: Used funds to acquire shares to provide an interest-free loan to company. Security (for the loan) was a rent producing property. Used building as an asset to take additional fund to purchase shares which was on-lent to a company on an interest-free loan. The taxpayer had control of that company.

Taxpayer argued: Amount as deductible. They were not earning income directly but there was an indirect derivation as a result of the company being profitable.

Held: Relevance was determined on the use of the funds and not the security given.

- Must show borrowed money, although you don't have to rigidly trace the actual amount of money.
- Acknowledged that money accounts can be difficult to trace

Ure

Facts: Employee solicitor borrowed funds at commercial interest rate between 7.5% to 12.5%. The whole of the funds were on-lend to the wife and to a company at 1%. The taxpayer reported income on the 1% and sought to claim a deduction on the remaining 7.5-12.5% deduction

Held:

- Deductible to the extent that the taxpayer himself derived assessable income from the fund. In this case, he was entitled to a deduction equal to 1% of the borrowed funds.
- The remaining was found to be lend for private purposes.

Carberry → case on strict tracing

Facts: Husband and wife formed a partnership to acquire kindy business. Partnership purchased a property consisting of a residence and kindy in a separate building. To fund the purchase, taxpayer used funds from the sale of their previous residence and borrowed the remaining against their new property. Taxpayer claimed deduction on full amount borrowed.

Commissioner: Only allowed deduction on half of the interest (representing the kindy).

AAT found:

- the partnership, as distinct from the individuals, borrowed the funds in order to purchase the business and that therefore the partnership "suffered the entire burden of interest on the borrowings and did so in such a way as to constitute the expenditure a loss or outgoing"

On appeal:

- Agreed that partnership was entitled to full amount of interest paid
- **Held:**
 - Referred to the case of Chapman:
 - Menzies J observed that it often happens that the purchaser of an entirety proposes to break up the entirety and use one part in one way and another part in a different way.
 - Menzies J held that it would be "in vain" to search for a dominant purpose in respect of the entirety because there is a different purpose attached to parts of the entirety with neither purpose being subservient or dominant to the other.
- The taxpayer was able to show which 'bits' of the borrowing went to the business and not their private home. Found that the entire borrowings had been allocated for the purpose of acquiring a partnership business.

ATO issued IT2661:

- For the method of apportionment to apply, it must be shown that the borrowings in fact relate solely to the notional part of the asset acquired for business purposes.
- In Carberry, for instance, the taxpayers were able to show that the part of the asset purchased for private purposes was paid for with the monies which the taxpayers had received from the sale of their previous residence.

Change of purpose or use

- Look at how the money was used OR the intention at the time it was borrowed: Munro
- Common sense would say that if the purpose change, your ability to deduct could also change.
- Obiter by Toohey J in Ilbery.
- Although the funds were used for that purpose initially, the purpose has changed at the time when you seek to claim a deduction.
- Look at the asset in the current period to see whether it is used to produce assessable income.

- TD 2008/27: “The character of interest is determined by the reason it arises, which is usually determined by the purpose to which the borrowing is being applied when the interest arises”: with reference to Spassked [2007] FCAFC 205 (emphasis added)
- In **TD2008/27**:
 - The character of interest is determined by the reason it arises, which is usually determined by the purpose to which the borrowing is being applied when the interest arises.
 - It is also possible that even within a given income year the purpose or use of a loan can change from non-income producing to income producing or vice versa.

Ilbery

Facts: Pre-payment of rent. Someone had prepaid the amount upfront, and then changed the purpose of what they were doing.

Held: Toohey:

- Necessary to distinguish between repayment of interest in the present case and the characterise of the payment it would have had over the years on money borrowed.
- Character of one determines the other
- You can't have a different outcome just because you paid up front.

Temporal nexus/contemporaneity

- Look at the timing of when a deduction can occur.
- Softwood Pulp – expense was not incurred to derive assessable income. The feasibility report was obtained too early.
- Commissioner sought to limit the effect of Steele in TR 2004/4
- **TR2004/4**: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities
 - **Interest incurred prior to assessable income:** 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.

Steele v DFCT [1999] HCA 7

Facts:

- Steele bought a 7 hectare racehorse training & agistment centre in 1980 for \$1m to redevelop as a motel & townhouse complex to be run personally.
- In late 1981 a development application was refused but after selling half of her interest to a business associate, a 2nd development application was approved in early 1982. In 1986, following litigation, the Steele acquired the associate's half-interest. In 1987, she again sold half of her interest & in 1988 she sold her remaining interest.
- While she held the property, it was only used for agisting horses from which she derived \$29,000

Issue: Whether the \$909k interest incurred by the taxpayer on the unpaid purchase price, on borrowings from a finance company and later a bank on the security of the property was deductible.

HC Held: Allowed the interest deduction

- *'Having regard to the original purpose for which she acquired the land, Carr J said, any profit on a resale would have constituted assessable income. He considered that from the time the appellant acquired the land she had embarked on a profit-making undertaking or scheme. In those circumstances, the appellant's operations, were, in his view, sufficiently linked to the derivation of assessable income.'*

Expenses associated with holding vacant land

- Denial of deductions for vacant land holding costs
 - s 26-102(1), from 1.7.19, denies a deduction for expenses associated with holding land (e.g., interest costs relating to its acquisition), if there is no substantial and permanent structure (in use or available for use) on the land having a purpose independent of any other structure or proposed structure, unless the land is in use (or available for use) in carrying on a business (ss (2)) at the time specified in ss (3).
 - The section is aimed at addressing concerns that deductions are being improperly claimed and is also intended to reduce tax incentives for land banking. It appears that s 26-102 is aimed at cases like Steele, where interest was incurred in a period prior to the derivation of relevant assessable income.
- Extension to residential premises
 - s 26-102(4) extends the denial of holdings costs to residential premises constructed, or substantially renovated. Deductions will only be allowed a property has been constructed on the land, it has received approval to be occupied and is available for, or is currently leased, hired or licensed.
 - s 195-1 of the GST Act defines "residential premises"
 - There is no provision to allow denied deductions to be carried forward for use in later income years. However, as the expenses are not deductible would be included in the cost base of the asset under s 110-25 (e.g., borrowing expenses and council rates)
- Express exceptions:
 - For certain entities (corporate tax entities, etc)
 - Where structures affected by natural disasters or other exceptional circumstances
 - Primary production business
 - Land lease, etc under an arm's length dealing which used, or available for use, by lessee in COB
- Other impacts
 - 'Carrying on a business' test will generally exclude land held for commercial development
 - Costs associated with non-PP land used for agistment the expense will be denied
 - Costs for land acquired as part of a 'profit making scheme or undertaking'? if not a business in itself the expenses are denied.

Temporal nexus: post-cessation interest

Placer Pacific

Facts: supplied fault conveyor belt system to taxpayer. It led to them incurring costs and a loss. Resulted in the business coming to an end. Because they still had things outstanding, the issue was whether they would get a deduction from those ongoing expenses given that the business has ceased.

Held: Deductible.

- Was entitled to deduction sought
- i.e., when you borrowed the money it was borrowed for the business in deriving assessable income.
- There is no relevant distinction to be drawn between losses and outgoings. Provided the occasion for the loss or outgoing is to be found in the business operations directed to gaining or producing assessable income, that loss or outgoing will be deductible unless it is capital or of a capital nature.

Brown:

Facts: Deli business. The taxpayer was unable to pay the loan. The business ceased. Taxpayer continued to pay interest on this loan.

Issue: Whether interest was deductible

Held: The cessation of the business does not stop the amount incurred to derive assessable income in another period from being deductible.

- Entitled to get deduction on interest. Applied judgement in *Placer Pacific*

Jones

Facts: Trucking business ceased with an existing loan. The taxpayer refinanced the loan to get a better rate.

Issue: Whether the re-finance sever the link from the original loan and the current one, therefore affecting deductibility of the interest.

Held: No, it did not. Still deductible.

- Financing did not break the nexus between the loan. Merely replacing one loan with another.
- Intention flowed through to the new loan.
- Does not matter if the taxpayer was in the position to repay the loan

Guest

Facts: Business ceased. Had the option to repay the loan but they didn't take it up. Interest continued to grow

Issue: Whether interest was still deductible

Held: Yes

- Ability to repay the loan should not be the test
- Look at the real connection between the interest and the income earning business
- Applied test from *Placer Pacific*

Is there mischief? **TR2004/4** – at paragraph 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).”
- **AKA** □ ATO's view is that the longer the loan, the more tenuous the loan and its harder to draw it back to the business.
- **Not the courts view!!!!**