IT 2606 - Income tax: deduction for interest on borrowings to fund share acquisitions

TAXATION RULING NO. IT 2606

INCOME TAX: DEDUCTION FOR INTEREST ON BORROWINGS TO FUND SHARE ACQUISITIONS

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I 1012270	INTEREST TOTAL HOLDINGS SHARE ACQUISITIONS	51(1)

OTHER RULINGS ON THIS TOPIC:

PREAMBLE The issue of the deductibility of interest incurred on funds borrowed for the purpose of share acquisitions has recently arisen in the course of this Office's large case audit program. This issue and a related issue involving the inter-company dividend rebate have arisen as a result of the takeover and other share acquisition activity during the 1980's. The dividend rebate issue, which involves the operation of the former subsection 46(7) of the Income Tax Assessment Act 1936, is the subject of a separate ruling (see Taxation Ruling IT 2605).

2. The purpose of this ruling is to set out the Office's views on the issue of interest deductibility in the context of share acquisitions in the 1980's. In particular, the Ruling sets out the views of this Office on the application of the decision of the Full Federal Court in FCT v. Total Holdings (Aust) Pty Ltd (1979) 79 ATC 4279,9 ATR 885 as guided by more recent judicial decisions.

3. As mentioned in the Court's judgment, Total Holdings (Aust) Pty Ltd (Total Holdings) was a member of the multinational Total group. The policy of that group was to establish local trading companies in various countries with the intention that those companies become profitable as soon as possible. Total Holdings acquired an Australian operating company, Total (Australia) Limited (TAL), in 1957. Total Holdings borrowed funds from its parent company at interest and over the period 1 January 1960 to 31 December 1968 on-lent part of those funds to TAL interest free as this was the best method of establishing TAL as a profit making entity and presenting its accounts in a favourable light. According to the uncontested evidence presented by Total Holdings it was essential that TAL's operating results should appear as good as possible.

4. The evidence also showed that it was intended that once TAL was profitable those profits would be remitted to Total Holdings

by way of dividends and interest. To this end the loans to TAL were repayable on demand so that there was nothing to prevent Total Holdings from calling in the loans and then relending at interest. In fact this was subsequently done after Total Holdings sold a half share in TAL to Boral Ltd in 1968. The Commissioner disallowed so much of the interest paid by Total Holdings as was referable to that part of the funds on-lent interest free to TAL. The Commissioner conceded a deduction for that part of the interest on the borrowed funds as used to acquire shares in TAL.

5. Lockhart J, with whom Northrop and Fisher JJ agreed, held at ATC p. 4283, ATR p. 890:

> "... if a taxpayer incurs a recurrent liability for interest for the purpose of furthering his present or prospective income producing activities, whether those activities are properly characterised as the carrying on of a business or not, generally the payment by him of that interest will be an allowable deduction under s.51".

6. The Court found that the on-lending of moneys interest free was designed to render TAL profitable as soon as commercially feasible and to promote the generation of income by TAL and its subsequent derivation, either as dividends or interest, by Total Holdings. Consequently, in light of the principle referred to in paragraph 5, Total Holdings was entitled to a deduction in respect of the interest paid by it on funds which were on-lent interest free to TAL.

7. Whether a deduction is allowable for interest relating to interest free on-lending and share acquisitions in particular cases will obviously depend on the facts of individual cases. This ruling attempts to provide some guidance as to how the principles which have emerged from Total Holdings and other case law should be applied in different factual circumstances.

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8. It is accepted that the principle stated by Lockhart J in Total Holdings is correct in law. This Office also accepts that where the facts of a case are substantially similar to those in Total Holdings a deduction for interest is allowable under subsection 51(1) of the Act.

9. As a general rule, interest on money borrowed to acquire shares will be deductible under the first limb of subsection 51(1) where it is expected that dividends or other assessable income will be derived from the investment. Such an expectation will usually exist as shares by their very nature are inherently capable of generating dividends, whether in the short or long term. However, such an expectation must be reasonable and not a mere theoretical possibility; there must be a prospect of dividends or other assessable income being received.

10. A deduction for interest will not be allowable where shares were acquired solely for the purpose of capital profit on their resale and the proceeds of sale are not assessable income under subsection 25(1) of the Act. Where a capital gain is assessable

under Part IIIA of the Act, i.e. post 19 September 1985 acquisitions, section 51AAA applies to make it clear that a deduction for interest is not allowable (see Taxation Ruling IT 2589). Where shares were acquired for the purpose of resale at a profit and the profit is assessable under either section 25A or 26AAA of the Act, interest would be taken into account in determining the profit or loss on disposal of the shares. A deduction for interest will of course be allowable where the proceeds of the resale are assessable under subsection 25(1) of the Act.

11. In order to obtain a deduction for interest a company must show that the expense was incurred for the purpose of furthering its present or future assessable income producing activities, whether or not those activities constitute the carrying on of a business. It is not enough simply that another company within the same group and not the taxpayer will derive assessable income as a result of the incurring of the interest expense (Hooker Rex Pty Limited v. FCT (1988) 88 ATC 4392 at 4404 and 4411, 19 ATR 1241 at 1253 and 1262).

12. In deciding whether interest was incurred "for the purpose of furthering (his) present or prospective income producing activities" it is necessary to determine the essential character of the interest expenditure (F.C. of T. v. Riverside Road Pty Ltd (in liq.) (1990) 90 ATC 4567 at 4574; Fletcher & Ors v. F.C. of T. (1990) 90 ATC 4559 at 4563). In determining the essential character of an interest outgoing, regard must be had to its connection (if any) with the income producing activities of the taxpayer (F.C. of T. v. D.P. Smith (1981) 147 CLR 578 at 586; 81 ATC 4114 at 4117; 11 ATR 538 at 542).

13. In Magna Alloys & Research Pty Ltd v. FCT (1980) 80 ATC 4542, 11 ATR 276, Brennan J. said:

> "The phrases 'in the course of', 'incidental and relevant', and 'the occasion of' ... import a connection between the incurring of expenditure on the one hand and the gaining or production of assessable income or the carrying on of a business on the other" (at ATC 4546, ATR 280);
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> "The relationship between what the expenditure is for and the taxpayer's undertaking or business determines objectively the purpose of the expenditure" (at ATC 4551, ATR 287).

14. In the context of share acquisitions under consideration in this Ruling, the interest expense will generally be incurred by a company which is carrying on a business. It will therefore be appropriate to consider whether the expense incurred is connected with the carrying on of a business which has as its purpose the production of assessable income. In the Magna Alloys case, Deane and Fisher JJ said at ATC 4559, ATR 295: "Viewed objectively, the outgoing must, in the circumstances, be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income".

> "Business outgoings may be properly and necessarily incurred in pursuit of indirect and remote, as well as direct and immediate, advantages. The fact that the business advantage sought is indirect or remote will not of itself preclude the pursuit of that advantage from characterising the outgoing as an outgoing necessarily incurred in carrying on the relevant business".

15. The taxpayer's purpose in incurring expenditure may be relevant in some situations in determining the characterisation of the expenditure. The question of purpose has been considered in a number of cases (see Magna Alloys per Brennan J at ATC 4544 - 4552, ATR 279-287; John v. FCT (1989) 166 CLR 417 at 426, 89 ATC 4101 at 4105, 20 ATR 1 at 6; Fletcher at ATC 4564-4566.

16. After referring at length to John's case, the Full Federal Court in Fletcher said at ATC 4565:

> "In our opinion in determining the essential character of an expenditure purpose is not necessarily the criterion or test of deductibility. But in cases of voluntary expenditure, the purpose for which the expenditure was incurred may be relevant. The extent of the relevance and the weight placed upon the evidence with respect to it will vary according to the circumstances of each case. In some cases, (for example Ilbery) it may be critical; but at the other end of the spectrum, where the connection between expenditure and the gaining or producing of assessable income is clear by reference to the objective facts, it may be superfluous to consider the purpose for which the expenditure was incurred".

17. It is a question of fact in each case whether an activity such as the acquisition of shares or interest free loans to subsidiaries forms part of a business carried on for income producing purposes. Two apparently contrasting cases are relevant to this question. In Reliance Finance Corporation Pty Ltd v. FCT (1987) 87 ATC 4146, 18 ATR 224 the Supreme Court of NSW implicitly held that the "business ends" of a money-lender were defined by the earning of interest on moneys lent and accordingly held (again without saying so explicitly) that an interest outgoing on borrowed moneys which were on-lent interest free was not relevant to, or connected with, or dictated by, those business ends. The interest was therefore not deductible. In FCT v. E.A. Marr and Sons (Sales) Ltd (1984) 84 ATC 4580, 15 ATR 879 the taxpayer, a holding company, carried on a business which comprised the income-earning activities of leasing land, buildings and plant and providing management and administration services to subsidiaries. Additionally, the taxpayer leased plant to its subsidiaries at cost to itself but with no present or future expectation of payment from the subsidiaries. The Full Federal Court held that this activity, though not income earning, was part of the same business, and further that the occasion for the making of the lease payments by the taxpayer was the carrying on of that business. The Marr case can be distinguished from Reliance Finance and other cases where there is no expectation of

assessable income on the basis that in Marr there was potential for future dividend income (see ATC 4585, ATR 884).

18. It is clear from the decision in Marr that the the inquiry as to what is encompassed within a business is not to be narrow in scope and should include an examination of practical matters relating to the conduct of the business. For example, if the acquisition of shares by a company secures a source of supply or demand for the company's business the interest on borrowed funds used to acquire the shares would be deductible. Interest would also be deductible where a company's business was that of a holding company, i.e., holding shares in subsidiaries from which it expects to receive dividends (see Esquire Nominees Ltd v. F.C. of T. (1973) 129 CLR 177 at 221 and 229, 73 ATC 4114 at 4123 and 4128, 4 ATR 75 at 85 and 91). In such circumstances the interest outgoing could "be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income" (Magna Alloys - see paragraph 14 above). It is also appropriate to have regard to the operations of the company group in determining the extent of the taxpayer's business.

19. While the facts of individual cases will be critical in determining whether the acquisition of shares (either directly or through an existing subsidiary) is connected to a company's business, it is important to always bear in mind the commercial reality of the transaction. Borrowings by large public companies to fund takeovers and other share acquisitions of the kind considered in this Ruling involve real loans with real liabilities and real money. In those circumstances it would be expected that a relevant connection with a company's business would be found in most cases.

20. Cases may arise, however, where the borrowing company is either not carrying on a business for the purpose of gaining or producing assessable income or, alternatively, the acquisition of shares or the interest free on-lending to a subsidiary is not considered to be part of the company's business. In such cases it is necessary to consider whether the interest expense was incurred in gaining or producing assessable income and therefore deductible under the first limb of subsection 51(1). As pointed out at paragraph 9, interest will generally be deductible where borrowed funds are used to acquire shares because shares are inherently capable of generating dividend income. In the case of an interest-free loan to a subsidiary a deduction for interest on the borrowed funds would also be generally allowable on the authority of the decision in Total Holdings. In Total Holdings the evidence before the Court showed that the loans were made in order to make the subsidiary profitable as soon as possible and to increase its standing with local banks. The parent had a policy of requiring dividends to be remitted and it had sufficient control over the subsidiary to ensure that this policy was followed. This was sufficient evidence to show an expectation of income by the parent at some time in the future. The Court held that a deduction was allowable under either limb of subsection 51(1).

21. In some cases there may be evidence of a policy or plan that the borrower company not receive dividend income at least until its loan had been discharged. Such a policy may have been designed to overcome the operation of the former subsection 46(7) of the Act and thereby achieve the full tax benefit of both the interest deduction and the inter-company dividend rebate by ensuring the interest deduction was not set off against dividend income (see Taxation Ruling IT 2605). Despite the deferral of the receipt of income a deduction would still be allowable under the first limb of subsection 51(1) provided there was always an expectation and intention as well as the potential for dividends to be paid to the borrower company, albeit in the long term (Ronpibon Tin N.L. v. FCT 78 CLR 47 at 57, Total Holdings). Whether such intention and potential exists is a question of fact to be decided having regard to all the objective circumstances in each particular case. In this regard evidence as to purpose may be relevant. For the reasons outlined earlier in this Ruling, a deduction may in any event be allowable under the second limb of subsection 51(1) in such cases.

Summary

22. As indicated earlier in this Ruling, the facts of particular cases will be critical in deciding whether a deduction for interest is allowable. In looking at each case, the relevant principles to be followed are summarised below:

(a) Before there can be a deduction, it must be shown that there is a connection between the incurring of the interest and either -

(i) the activities of the company which do, or are expected to, produce assessable income; or

(ii) the business of the company, being a business carried on for the purpose of earning assessable income.

(b) Where the connection between the interest expense and the production of assessable income is clear by reference to the objective facts, the expense will be deductible without any need to have regard to the company's purpose (Fletcher at ATC 4565).

(c) If, however, no income is derived by the company from the transaction to which the interest expense relates, and there is no obvious connection with the carrying on of a business to gain or produce assessable income, then the company's purpose, though not determinative of deductibility, may be relevant to the characterisation of the expenditure i.e. to the determination of whether it has the requisite connection to the company's income-producing or business activities (John's case; Fletcher's case).

(d) In the process of characterisation all the relevant circumstances must be weighed, and where purpose becomes relevant this will encompass the direct and indirect objects and advantages which the company sought in making the outgoing.

(e) Factors to be considered in determining the essential character of the interest expense include the actual use to which the borrowed moneys were put and the connection between that use and the activities by which the company usually produces assessable income.

23. Where purpose is relevant to the characterisation of the interest expense, matters which should be considered include statements made by the company and other statements, e.g., in company minutes and memoranda, as to -

(i) the dividend policy of the company or group;

(ii) the reasons for the borrowing;

(iii) the use to which the borrowed moneys were to be put;

(iv) the connection between that use and the income-producing activities of the company.

COMMISSIONER OF TAXATION
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