TR 2019/2 - Income tax: whether penalty interest is deductible

Taxation Ruling

Income tax: whether penalty interest is deductible

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Relying on this Ruling

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

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

Further, if we think that the ruling disadvantages you, we may apply the law in a way that is more favourable to you.

Summary – what this Ruling is about

1. This Ruling explains when 'penalty interest' is deductible under section 8-1, section 25-25, section 25-30, section 25-90 or section 40-880 of the *Income Tax Assessment Act 1997* (ITAA 1997).[1]

2. The Ruling also considers whether penalty interest is included in:

- the cost base or reduced cost base of a capital gains tax (CGT) asset as an incidental cost under subsections 110-35(9) or 110-55(2)
- the cost of a depreciating asset under paragraph 40-190(2)(b).

Definitions

3. 'Penalty interest' is an amount payable by a borrower under a loan agreement in consideration for the lender agreeing to an early repayment of the loan. The amount payable is commonly calculated by reference to a number of months of interest payments that would have been received but for the early repayment.

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

Relevant provisions

4. The relevant provisions dealt with in this Ruling are:

- section 8-1 (general deductions)
- section 25-25 (borrowing expenses)
- section 25-30 (expenses of discharging a mortgage)
- section 25-90 (certain debt deductions relating to foreign non-assessable non-exempt income)
- subsections 110-35(9) and 110-55(2) (incidental costs for CGT asset)
- paragraph 40-190(2)(b) (element of cost of holding a depreciating asset)
- section 40-880 (business related costs).

Ruling

5. Penalty interest is generally deductible under section 8-1 where:

- the borrowings are used for gaining or producing assessable income or in a business carried on for that purpose, and
- it is incurred to rid the taxpayer of a recurring interest liability that would itself have been deductible if incurred.

6. However, penalty interest is not deductible under section 8-1 to the extent that it is a loss or outgoing of capital, or of a capital, private or domestic nature.

7. Penalty interest is not incurred *for* borrowing money so is not deductible under section 25-25.

8. Penalty interest incurred to discharge a mortgage is deductible under section 25-30 to the extent the loan moneys were used for producing assessable income. Unlike section 8-1, deductibility is not affected by whether the expenditure is capital or revenue in nature.

9. Penalty interest incurred in deriving foreign source income may be deductible under section 25-90 if, amongst other things, it satisfies the definition of debt deduction in paragraph 820-40(1)(a) because it is calculated by reference to the time value of money.

10. Penalty interest that is an incidental cost[2] incurred in relation to a CGT event or to acquire a CGT asset[3] is included in the cost base or reduced cost base.[4]

11. Penalty interest is not reasonably attributable to a balancing adjustment event occurring to a depreciating asset[5] so it is not included in the asset cost under paragraph 40-190(2)(b).

12. Penalty interest may be deductible under section 40-880 if the amount is not otherwise taken into account, or denied a deduction, under another provision. Section 40-880 is a provision of last resort.

Examples

Example 1

13. *John can refinance his rental property at a lower interest rate. In order to refinance, John pays out the first loan early. He incurs penalty interest calculated on the basis of one month's interest for each year of the loan period remaining.*

14. *The advantage sought in practical terms by repaying the first loan early and incurring penalty interest is future interest savings from a lower interest rate. Penalty interest is of a revenue character and deductible under section 8-1.*

15. *Alternatively, where refinancing affects the discharge of a mortgage securing the first loan, the penalty interest is deductible under section 25-30.*

Example 2

16. *Sally sells her rental property, repays the loan to discharge the mortgage over the property and incurs penalty interest.*

17. *The penalty interest is a necessary incident of the sale of the property. A payment so connected to the realisation of a capital asset will be on capital account and not deductible under section 8-1. As the penalty interest is not a cost of borrowing incurred in establishing the loan, it is not deductible under section 25-25. It is deductible under section 25-30 as an expense of discharging the mortgage.*

Example 3

18. *Alex obtained an unsecured loan to purchase a beach house to use solely as a holiday house for his family. Alex and his family*

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[2] Subsection 110-35(9). Incidental costs include borrowing expenses (such as loan application fees and mortgage discharge fees).
[3] A CGT asset is defined in section 108-5.
[4] Subsections 110-40(2), 110-45(1B), 110-55(4), 110-55(5), 110-55(9), 110-60(2), 110-60(3) and 110-60(7).
[5] A depreciating asset is defined in section 40-30.

move interstate for work. Alex sells the beach house, immediately repays the loan early and incurs penalty interest.

19. *Penalty interest is incurred in connection with selling a private-use asset; the expenditure is private in nature and not deductible under section 8-1. As the loan is unsecured, section 25-30 cannot apply.*

20. *The penalty interest is an incidental cost which relates to the sale of the beach house and can be included in the cost base under subsection 110-35(9) or the reduced cost base under subsection 110-55(2). However, if Alex did not repay the loan immediately it would be difficult to demonstrate that the penalty interest is an incidental cost.*

Date of effect

21. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
22 May 2019

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Deductibility under section 8-1 – general deductions

22. A deduction is not available under section 8-1 for a loss or outgoing that is capital or of a capital nature.

23. The critical factor in determining whether penalty interest is capital in nature is the advantage sought[6] by the early loan repayment. This is a question of fact to be considered on a case by case basis, from a practical and business point of view.[7]

24. Where the advantage sought is release from the recurrent liability to pay interest which would have been deductible, the penalty interest payable is revenue in character.[8] This is despite the payment displaying capital characteristics[9] such as being a once-and-for-all type lump sum which eliminates a threatened disadvantage and produces a benefit of a lasting character for the taxpayer.

25. Where penalty interest is payable to divest a capital asset or is incidental to the realisation of an asset, then it will generally be on capital account.

26. Penalty interest is not in the nature of interest. The description of an item in an agreement is not conclusive of its character.[10] To call an amount of penalty interest payable 'interest' does not determine that it is interest and does not prevent it from being of a capital nature.

27. Interest is considered to be 'compensation to the lender for being kept out of the use and enjoyment of the principal sum'.[11] Penalty interest is not paid for the use of the lender's money; it is paid in respect of a period when the borrower has repaid the loan and does not have the use of the money.[12]

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[6] *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73 (*Sun Newspapers*), per Dixon J.
[7] *Hallstroms Pty Ltd v Federal Commissioner of Taxation* [1946] HCA 34, per Dixon J.
[8] *Commissioner of Taxation v Marbray Nominees P/L (as trustee for the RP and NB Alberts Family Trust)* [1985] VicSC 629; *Metals Exploration Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1986] VicSC 300.
[9] Per Dixon J in Sun Newspapers.
[10] *Commissioner of Taxation (Cth) v South Australian Battery Makers Pty Ltd* [1978] HCA 32, per Gibbs ACJ and Cliffs International Inc v Commissioner of Taxation (Cth) [1979] HCA 8, per Barwick CJ.
[11] *Commissioner of Taxation v Myer Emporium Ltd* [1987] HCA 18.
[12] Parsons, RW, 2011, Income Taxation in Australia, Thomson Reuters, Sydney, p 6.330.

Deductibility under section 25-25 – borrowing expenses

28. Capital expenditure incurred for borrowing money may be deductible under section 25-25. Penalty interest is not a cost of borrowing incurred in establishing the loan[13]; it is incurred after money is borrowed. Therefore, it is not incurred *for* the borrowing and is not deductible under section 25-25.

Deductibility under section 25-30 – expenses of discharging a mortgage

29. Penalty interest incurred to discharge a mortgage is deductible under section 25-30 to the extent the loan moneys or property are used for producing assessable income. No deduction is available for payments of principal or interest.[14] Unlike section 8-1, deductibility is not affected by whether the expenditure is capital or revenue in nature.

Deductibility under section 25-90 – certain debt deductions relating to foreign non-assessable non-exempt income

30. Penalty interest may be deductible under section 25-90 if it is incurred in earning certain foreign source income. The amount of that deduction is limited by the thin capitalisation rules[15], and is limited by the requirements of section 25-90 itself, including that the penalty interest must be calculated by reference to the time value of money.[16]

Cost base or reduced cost base – incidental costs

31. Penalty interest incurred to either acquire a CGT asset[17] or that relate to a CGT event may be an incidental cost[18] that forms part of the cost base or reduced cost base of the asset.[19]

32. Penalty interest is not a penalty under section 26-5 so is not excluded from the cost base or reduced cost base on that basis.[20]

33. However, penalty interest is excluded from the cost base or reduced cost base to the extent it is deductible.[21]

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[13] *Ure, Richard Michael v The Commissioner of Taxation of the Commonwealth of Australia* [1981] FCA 9.
[14] Subsection 25-30(4).
[15] Division 820.
[16] *Commissioner of Taxation v Noza Holdings Pty Ltd* [2012] FCAFC 43.
[17] A CGT asset is defined in section 108-5. Incidental costs include borrowing expenses (such as loan application fees and mortgage discharge fees).
[18] Subsection 110-35(9). Incidental costs include borrowing expenses (such as loan application fees and mortgage discharge fees).
[19] Subsection110-55(2).
[20] Subsections 110-38(4) and 110-55(9D).

Cost of holding a depreciating asset

34. Expenditure incurred, after you start to hold a depreciating asset, that is reasonably attributable to a balancing adjustment event occurring for the asset is taken into account in calculating the cost of the asset.[22] Penalty interest is not expenditure that is reasonably attributable to the disposal of a depreciating asset; it is incurred because of an early repayment of a loan.

Deductibility under section 40-880 – business related costs

35. Expenditure may be deductible under section 40-880 where the expenditure is capital expenditure, business-related and the business is carried on for a 'taxable purpose'.

36. Section 40-880 can apply only where no other provision allows or denies a deduction, or includes the cost in a CGT cost base or depreciating asset cost. Section 40-880 is a provision of last resort.

37. Eligibility for deduction under section 40-880 is determined at the time the expenditure is incurred. If eligible under section 40-880, generally the expenditure may be deducted over five years in equal proportions.[23]

38. It would be very unusual for penalty interest to be deductible under section 40-880, especially given the broad definition of 'CGT asset'. Taxation Ruling TR 2011/6 *Income tax: business related capital expenditure – section 40-880 of the Income Tax Assessment Act 1997 core issues* sets out the ATO view of business-related capital expenditure.

39. The non-commercial loss rules[24] may defer any deduction for penalty interest otherwise deductible under section 40-880.

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[21] Subsections 110-40(2), 110-45(1B), 110-55(4), 110-55(5) 110-55(9), 110-60(2), 110-60(3) and 110-60(7).
[22] Paragraph 40-190(2)(b).
[23] Subsection 40-880(2).
[24] Division 35.

Appendix 2 – Detailed contents list

40. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Previous Rulings/Determinations:

TR 93/7

Related Rulings/Determinations:

TR 2004/4; TR 2006/10;
TR 2011/6

Legislative references:

- ITAA 1997
- ITAA 1997 8-1
- ITAA 1997 25-25
- ITAA 1997 25-30
- ITAA 1997 25-30(4)
- ITAA 1997 25-90
- ITAA 1997 26-5
- ITAA 1997 Div 35
- ITAA 1997 40-30
- ITAA 1997 40-190(2)(b)
- ITAA 1997 40-215
- ITAA 1997 40-285
- ITAA 1997 40-880
- ITAA 1997 40-880(2)
- ITAA 1997 108-5
- ITAA 1997 110-35(9)
- ITAA 1997 110-38(4)
- ITAA 1997 110-35(9)
- ITAA 1997 110-40(2)
- ITAA 1997 110-45(1B)
- ITAA 1997 110-55(2)
- ITAA 1997 110-55(4)
- ITAA 1997 110-55(5)
- ITAA 1997 110-55(9)
- ITAA 1997 110-55(9D)
- ITAA 1997 110-60(2)
- ITAA 1997 110-60(3)
- ITAA 1997 110-60(7)
- ITAA 1997 118-24
- TAA 1953

Cases relied on:

- Cliffs International Inc v Federal Commissioner of Taxation (Cth) [1979] HCA 8; (1979) 142 CLR 140; 79 ATC 4059; (1979) 9 ATR 507
- Commissioner of Taxation v Noza Holdings Pty Ltd [2012] FCAFC 43; (2012) 201 FCR 445; 2012 ATC 20-313; (2012) 82 ATR 5
- Commissioner of Taxation (Cth) v South Australian Battery Makers Pty Ltd [1978] HCA 32; (1978) 140 CLR 645; 78 ATC 4412; (1978) 8 ATR 879
- Commissioner of Taxation v Myer Emporium Ltd [1987] HCA 18; (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693
- Commissioner of Taxation v Marbray Nominees P/L (as trustee for the RP and NB Alberts Family Trust) VicSC 629; (1985) 81 FLR 280; 85 ATC 4750; (1985) 17 ATR 93
- Hallstroms Pty Ltd v Federal Commissioner of Taxation [1946] HCA 34; (1946) 72 CLR 634
- Metals Exploration Ltd v Commissioner of Taxation of the Commonwealth of Australia VicSC 300; (1986) 85 FLR 381; 86 ATC 4505; (1986) 17 ATR 786
- Sun Newspapers Limited v Federal Commissioner of Taxation [1938] HCA 73; (1938) 61 CLR 337; (1938) 5 ATD 87; (1938) 1 AITR 403
- Ure, Richard Michael v The Commissioner of Taxation of the Commonwealth of Australia [1981] FCA 9; (1981) 50 FLR 219; 81 ATC 4100; 11 ATR 484 (1981)

Other references:

- Parsons, RW 2011, Income Taxation in Australia, Thomson Reuters, Sydney, p 6.330

ATO references

NO:	1-BB3GXVC
ISSN:	2205-6122
BSL:	TCN
ATOlaw topic:	Income tax ~~ Capital allowances ~~ Business related costs Income tax ~~ Capital gains tax ~~ cost base and reduced cost base Income tax ~~ Deductions ~~ Other