

## A warning on tax deductions for borrowings

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**Claiming a tax deduction for the interest paid on funds borrowed is one of the most basic tax deductions on offer. It's a "bread and butter" tax law issue. But it's not always as simple as it sounds.**

In the very simplest of terms, a deduction is available where the funds borrowed are used for an income-producing purpose. More precisely, the tax law says that interest is tax deductible to the extent it is incurred in gaining or producing assessable income, or in carrying on a business for that purpose, and is not of a capital, private or domestic nature. This invariably (but not always) means that assessable income for tax purposes needs to be produced.

The words of the tax law may seem straightforward enough, but when applied to factual situations, the seemingly obvious outcome is not always so obvious.

A recent case before the Administrative Appeals Tribunal (AAT) illustrated the issues involved and also served as a timely reminder and warning of the tests for tax deductibility.

In the case, a taxpayer (Mr Tanti) sought a tax deduction of just over \$18,000 in his 2006-07 tax return in respect of interest paid or payable on funds he borrowed from his mother and on-lent interest-free to a telephone sales franchise company in which he was the sole shareholder and director.

The company had a \$195,000 line of credit with a bank and Mr Tanti also borrowed \$250,000 from his mother at varying rates of interest under several loan agreements. The loan funds of \$250,000 were on-lent by Mr Tanti interest-free to the company which, in turn, used the funds to reduce or extinguish its line of credit with the bank.

The business line of credit was used in the franchise business and was secured by registered mortgages over rental properties belonging to Mr Tanti and his mother. The business was paying interest on the line of credit and correctly claimed the interest as a deduction in its income tax returns.

Tanti also withdrew funds from the line of credit to purchase shares in a private company. The Tax Office allowed the interest on the line of credit as a deduction.

The telephone franchise business had made losses in 2004-05, 2005-06 and 2006-07 and Tanti eventually sold the business in May 2006. The AAT said that in his 2006-07 tax return, Tanti disclosed income from salary and wages totalling \$72,475 he received from two unrelated sources but did not disclose any income from his franchise company. This was an important finding by the AAT.

The AAT said the Tax Office accepted that interest of \$3,610 on the funds used to purchase the shares in the private company was deductible, so no problem there. However, the AAT considered that the balance of the interest (\$14,489) was not deductible. In its view, the interest could only be said to be incurred in gaining or producing Tanti's assessable income if the interest had "a sufficiently close connection with the activities by which the assessable income is produced".

Tanti claimed the interest was incurred in the course of the business activity which was directed towards the gaining or producing of assessable income. But, which business activity? The AAT said it had a problem with this contention because it was unclear which entity's business activity was intended. It was, in the AAT's view, also

unclear "which entity's assessable income was involved and how the interest incurred was directed towards the gaining or production of that assessable income".

The AAT said that, according to the evidence, Tanti had been an employee of his company from the date the company was established and commenced its business. According to the AAT, there was no evidence that, since 30 September 2004, Tanti himself had been engaged in any business or business activity. He did not receive any income by way of salary, director's fees, dividends or interest from his company in respect of the 2005-06 and 2006-07 tax years.

The AAT considered there was no connection between the interest and Tanti's activities as an employee of his company, nor any connection between the interest and any director's fees, dividends or interest he might have received from the company. It said the only entity that could have been entitled to a deduction for the interest of \$14,489 was Tanti's company itself, but that company did not incur the interest as a business expense.

Although the funds borrowed from Tanti's mother were on-lent interest free to his company, the AAT considered there was no prospect of him deriving an income from the company, whether as dividends or interest, in the future. This was fatal to his claim for the deduction and is the single most important point to take away from the AAT's decision. The company was not a profitable entity and Tanti sold the business of the company in May 2006, prior to the year of income in which a deduction was sought for the interest paid to his mother.

In making its decision, the AAT distinguished a prominent Federal Court case – *FCT v Total Holdings (Aust) Pty Ltd* (1979) 9 ATR 885 – where, in allowing a tax deduction for interest, the court held that the purpose of lending by a company to its subsidiary was to make the subsidiary profitable as soon as possible. In anti's case, the AAT could see no prospect of him deriving an income from his company in the future.

Another significant point to note is that the situation in Tanti's case is not uncommon. There are numerous AAT decisions involving claims for tax deductions for interest incurred in circumstances similar to Tanti and, in those cases, no deduction was allowable for the interest that had been incurred.

Borrowing money for use in a business will generally see the interest properly claimable as a tax deduction, but it does also depend on the circumstances in question.

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