

## **Compound interest - tax deductibility**

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The ATO has just confirmed its view that deductions for compound interest are governed by the same principles as other interest expenses. Simply stated, compound interest is simply interest that accrues on interest that is unpaid.

The ATO's view is confirmed in the new *Draft Taxation Determination* TD 2008/D12, which also elaborates upon the general rules governing the deductibility of interest. In particular, the determination examines the application of the general rules concerning the deductibility of expenses, and, more particularly ordinary and compound interest.

The big catch, however, is that whilst governed by the same principles, it is possible that the general anti-avoidance provisions in Part IVA of the ITAA 1936 will apply to arrangements involving compound interest (particularly those involving split loan facilities) such as to deny the deductibility of compound interest in all, but the most exceptional circumstances. Unfortunately, this not at all stated in the new draft determination, but is instead found in statements made elsewhere by the ATO.

### **Deductibility generally**

Section 8-1 of the ITAA 1997 allows taxpayers to claim a deduction for any loss or outgoing that is incurred in gaining or producing assessable income to the extent that it is not of a private, capital or domestic nature.

It is section 8-1 that generally permits interest incurred on negatively geared rental properties to be claimed as a deduction (but possibly to all rental properties).

It is usually the “essential character” of an expense that determines whether it is tax deductible (*Lunney & Hayley v FC of T* (1958) 100 CLR 478).

### **Ordinary interest deductions**

Ordinarily, the character of interest expenses is determined by the purpose and/or use to which the borrowing is applied when the interest arises. Generally, the purpose of a borrowing can be determined from the use of borrowed funds and outgoings of interest ordinarily draw their character from that use (*Fletcher v FC v T* 91 ATC 4950; *Kidston Goldmines Ltd v FC of T (Kidston)* 91 ATC 4538).

This means that ordinary interest paid on a loan to acquire a rental property is usually tax deductible.

### **Compound interest deductions**

According to the ATO, in its new draft TD 2008/D12, the principles that govern the deductibility of compound interest are identical to those that govern the deductibility of ordinary interest. The ATO reaches this view by reference to the the Full Federal Court's decision in *Hart v FC of T* 2002 ATC 4608 (*Hart*).

While the *Hart* decision ultimately proceeded to the High Court, the High Court did not need to deal with the issue of the deductibility of compound interest.

### **Deductibility tests need to be continuously applied**

However, it should be noted that in all instances, including for both ordinary and compounding interest, the deductibility of interest is not determined only by the use or the initial use of the borrowings to which the interest relates.

Instead, the issue of deductibility of interest on a loan is essentially a question of fact in respect of the year or years of income for which it is to be determined. The relevant factual considerations can change over the term of the loan so that the facts relevant to the criteria for deductibility in one year may not necessarily be the same as those for another income year. In fact, it may be possible to make this statement about the purpose and use of a loan **within a given income year**.

## **General anti-avoidance provisions**

However, it should be noted, that the new draft TD is silent on the potential application of the general tax anti-avoidance provisions in Part IVA of the ITAA 1936 to arrangements involving compound interest. This leaves open the possibility of the provisions applying (without any discussion of the issue).

In fact, the anti-avoidance provisions may well apply in certain circumstances, including in particular those involving split loan facilities (as discussed in *Taxation Ruling TR 98/22* and *ATO Interpretative Decision ID 2006/297*).

This may mean that whilst the general principles governing the deductibility of interest apply to compound interest, compound interest may never be deductible by reason of the application of Part IVA of the ITAA 1936 to arrangements involving compound interest.