Pushing the Boundaries of Interest Deductibility — *Steele v Deputy Commissioner of Taxation*

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The decision of the High Court of Australia in *Steele v Deputy Commissioner of Taxation*[1] represents an extension of the traditional views on the characterisation of interest payments incurred in relation to the acquisition of a capital asset, under the *Income Tax Assessment Act* 1997 (Cth). The case has significant implications for Australian taxpayers seeking to make a deduction for interest expenses incurred on funds borrowed to acquire a capital asset for the purpose of producing or gaining assessable income.

I. Material facts and the statutory framework of the decision

In 1980, Mrs. Kathleen Steele (the taxpayer), purchased a property near the Perth airport, with the intention of building a motel on the site, following a favourable outcome to enquiries she had made to a public authority concerning rezoning. After executing a contract of sale of the land for $1million, Mrs Steele entered into negotiations with an architect and a construction company, as well as obtaining the relevant engineering, plumbing and council reports.

However, the project never eventuated and the property was sold some six years later. By that time, interest-related expenses incurred on loan monies used to purchase the property had accrued to more than $900 000, which she claimed as a deduction in respect of the time period in which she owned the property. The only business conducted on the property during her ownership was the agistment of horses which had produced a modest $28 943 between 1981 and 1987. The deduction for interest expenses was claimed under section 51(1) of the *Income Tax Assessment Act* 1936 (Cth):

> All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are the losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.[2]

II. Background to the appeal

The Administrative Appeals Tribunal accepted as accurate that it was the taxpayer's intention to build a motel on the property and operate it herself. She believed that this would be a profitable enterprise given the motel's close proximity to the airport. The tribunal thus made the finding of fact that the taxpayer's purpose in acquiring Tibradden was entirely commercial. It was further held that the interest expense incurred related to borrowings that were wholly used to purchase and hold a capital asset.

The Tribunal subsequently denied the deductibility of the majority of the loan interest payments on the ground that the purpose of the loan was to develop a future business enterprise, which was capital in nature.

The case was then appealed to the Federal Court, where Nicholson J substantially upheld the Tribunal's decision. The taxpayer then took the issue to the Full Court of the Federal Court, where the majority rejected her claim on the basis that the interest expenditure was an outgoing of a capital nature. Burchett and Ryan JJ constituted the

1 [1999] HCA 7.
2 The equivalent section in the *Income Tax Assessment Act* 1997 (Cth) is s 8(1).

majority in the Full Court. Their Honours noted that the purpose or advantage sought from the borrowing was the acquisition of a capital asset, which was not used in a business or income-earning activity at the relevant time. The dissenting judgment was delivered by Carr J, who came to a different conclusion on the facts while agreeing with the legal position of the majority.

III. Decision of the High Court

In the High Court of Australia, Gleeson CJ, Gaudron and Gummow JJ constituted the majority, which identified two main issues of the appeal. First, whether the interest payments were to be characterised as an outgoing of a capital nature and thus precluded from being deductible under the first negative limb of the section. Secondly, whether the first limb of s 51(1) was satisfied (which required that the interest expense be incurred in the gaining or producing of assessable income). Of the remaining two judges, Kirby J represented a dissenting view, while Callinan J stood with the majority on the legal issues.

As preliminary matters, the High Court noted that it is only necessary to consider the exceptions to s 51(1) where it is already concluded that one of the positive limbs applies. Whilst this appeal was argued on the basis that the first limb was relevant, the Commissioner argued, in the alternative, that it was not so satisfied. Also relevant to the appeal process was the characterisation of the question whether the interest incurred was capital in nature, as being a question of law. This point is significant to the validity of the initial appeal to the Full Federal Court under s 44 the *Administrative Appeals Tribunal Act* 1975 (Cth), which requires that it be on a 'question of law.'

1. The first issue — 'an outgoing of a capital nature'

This issue relates to the second limb of s 51(1),[3] forming part of the exception provided by the legislation, which disallows deductions for losses or outgoings which are incurred in the gaining or producing of assessable income, where such losses or outgoings are of 'a capital . . . nature.'

It was the view of the majority of the High Court that the Full Federal Court erred in deciding the case against the appellant on the ground that the interest was an outgoing of a capital nature. Subsequently, the majority held that the taxpayer should not be denied deductibility under the second limb exception of s 51(1).

In reaching this conclusion, the majority first considered the general nature of interest payments, within a case-law context. Their Honours stated that:

> In the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.[4]

This view was supported by a number of case authorities which regarded interest as being a revenue item[5], which 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.'[6]

The High Court referred with approval to Dixon J's statement in *Texas Co (Australasia) Ltd v Federal Commissioner of Taxation*[7] that 'some kinds of recurrent expenditure made

3 Referred to as the first negative limb under the *Income Tax Assessment Act* (Cth).
4 [1999] HCA 7 at 29.
5 *Sun Newspapers v Federal Commissioner of Taxation* (1938) 61 CLR 337 at 359 per Dixon J.
6 *Australian National Hotels Ltd v Commissioner of Taxation* (1988) FCR 243 at 239–41 per Bowen CJ and Burchett J.
7 (1940) 63 CLR 382.

to secure capital or working capital are clearly deductible . . . interest on money borrowed for the purpose forms a deduction.'[8]

The High Court then went on further to state that the fact an asset has not yet become, and may never become, income-producing is no reason to conclude that interest is of a capital nature.[9] Whilst this may be relevant to a decision as to whether the case falls within the first limb of s 51(1), it does not exclude an outgoing from being deductible once it is established that it is incurred in the gaining or producing of assessable income.

This point was also supported by *Federal Commissioner of Taxation v Ilbery* by Toohey J, who, with Northrop and Sheppard JJ in agreement, accepted the proposition that:

> Interest on moneys which are borrowed for the purpose of acquiring an income-producing asset is deductible under s 51(1)[10]

but, subsequently, restated it as:

> so long as the . . . property was held for an income producing purpose, interest paid on a loan to acquire the property was deductible under s 51.[11]

The High Court, therefore, found error in the reasoning of the Full Federal Court, which had held that the character of the interest was determined by the advantage that was sought by the payments being the acquisition of a capital asset. The Full Federal Court stated a qualification to this statement that, had the motel been built and opened, the advantage would then have been achieved, and any advantage sought for further payments of interest would have been the continued availability of the sum borrowed to support the use of the capital asset in income-gaining activities.[12]

The High Court found fault in this argument of the Full Federal Court that the interest would have ceased to be capital in nature had the motel been built on the land and commenced to produce income. The majority noted that the immediate purpose of the borrowing, and the application of the borrowed funds, was and would have remained the acquisition of a capital asset. Had the motel begun to produce income it would not have altered the original purpose of borrowing, which was to acquire the capital asset for use in the gaining or production of assessable income. Therefore, the High Court was clear that the interest payments would have remained capital in nature, dismissing the qualification expressed by the Full Federal Court.

The High Court also distinguished *Wharf Properties Ltd v Commissioner of Inland Revenue*,[13] which was the main case supporting the Federal Court's reasoning on this matter. The unanimous decision of the Privy Council was distinguished on the basis that it was decided on legislation that was 'materially different from the Australian legislation,' where it was held that interest payments on a loan were being expended for a capital purpose. The High Court noted that the 'distinction between acquiring a capital asset and holding it as an income-producing investment, is not one upon which the Australian legislation turns.'[14]

The High Court favoured the contrasting authority of *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes*[15] where interest payments on borrowed funds made during construction of a hotel were held to be deductible under an equivalent section.

Subsequently, the High Court majority allowed the appeal on the ground that the Full

8 (1940) 63 CLR 382 at 468.
9 [1999] HCA 7 at 29.
10 (1981) 38 ALR 172 at 177.
11 (1981) 38 ALR 172 at 181.
12 (1997) 73 FCR 330 at 342.
13 [1997] AC 505.
14 [1999] HCA 7 at 33.
15 (1985) 16 ATR 867.

Federal Court had erred in finding that the interest payments were precluded from being deductible as being outgoings of a capital nature.

2. The second issue — 'incurred in the gaining or producing of assessable income'

The Commissioner then sought to deny deductibility of the interest payments on the basis that they did not satisfy the first limb of s 51(1), which requires the outgoing be incurred in the gaining or producing of assessable income.

The High Court referred to *Fletcher v Federal Commissioner of Taxation*[16] in its discussion of the meaning of 'assessable income' under the first limb of s 51(1), which is to be read as an abstract phrase. It is not confined to income actually derived in the particular tax year but, also, encompasses assessable income which the relevant outgoing would be expected to produce. Hence, the test of deductibility under the first limb involves consideration of whether the loss or outgoing can be found in whatever is productive of the assessable income or, if none is produced, what would be expected to produce assessable income. It is unnecessary to distinguish between the purpose of the taxpayer in borrowing the money and the use to which the borrowed funds were put.

The majority referred to with approval *Ronpibon Tin NL v Federal Commissioner of Taxation*,[17] in which the High Court had held that an outgoing may qualify as deduction provided it is shown to be incidental and relevant to the producing of assessable income, even though no such income is gained or produced in the year that the outgoing is incurred.

On the facts of the present case, the outgoing (interest payments) were found to be sufficiently relevant to the gaining or producing of assessable income. The important factor was that the taxpayer's purpose in incurring the interest payments was the gaining or producing of assessable income, and the mere fact that such purpose was not necessarily achieved did not preclude the outgoing from satisfying the first limb.

In reaching this conclusion, the High Court discussed and qualified statements made by Lockhart J in *Federal Commissioner of Taxation v Total Holdings (Aust) Pty Ltd*:

> If a taxpayer incurs a recurrent liability for interest for the purpose of furthering his present or prospective income-producing activities ... the payment by him of that interest will be an allowable deduction under s 51.[18]

However, Lockhart J qualified this:

> Interest is paid by a taxpayer as a prelude to his being in a position whereby he may commence to derive assessable income. In such cases the requirement that the expenditure be incidental and relevant to the derivation of income may not be satisfied.[19]

In response to this qualification, the High Court distinguished this case as not being one in which the taxpayer had in contemplation a variety of alternative possible uses of Tibradden, some of income-producing nature and others not. There was no suggestion that the taxpayer ever contemplated using the property for private or domestic purposes. While the taxpayer was not financially committed to the motel development, the court held that she did not appear to have envisaged any use of the property other than one which would produce assessable income. Consequently, the outgoing was found to be relevant in the sense that it furthered the taxpayer's purpose to acquire a capital asset in order to produce assessable income.

The High Court thus approved of the criticisms made by the Full Federal Court of the Tribunal's application of the first limb of s 51(1). The Tribunal had stated that there were too many contingencies to be able to say with certainty that income would ever be derived

16 (1991) 173 CLR 47.
17 (1949) 78 CLR 47 at 56.
18 (1979) 24 ALR 401 at 406.
19 (1979) 24 ALR 401 at 406.

from the project. The Full Federal Court and High Court disagreed with this statement, stating that there does not have to be certainty that an endeavour will be crowned with success in order to justify a deduction under s 51(1).

IV. The dissenting judgment

Kirby J delivered the dissenting judgment, approving the Full Federal Court's view that the outgoings in this case were of a capital nature and therefore not deductible under the second limb of s 51(1). His Honour stated that to find interest to be of an income rather than of a capital nature was totally inconsistent with foregoing authority. Underlying the main point of dissent was Kirby J's express approval of the Privy Council decision in *Wharf Properties Ltd v Commissioner of Inland Revenue*,[20] which the majority distinguished. Kirby J rejected the argument of the majority that the legislation on which that case was decided materially differed from s 51(1). His Honour quoted Lord Hoffman with approval that 'each payment of interest must be considered in relation to the purpose of the loan during the period for which the interest was paid.'[21] Kirby J further stated that the court must:

> look to the purpose for which the particular payment is made at that stage of the taxpayer's investment. While an exact correlation between the receipt of assessable income and the incurring of 'losses and outgoings' . . . is not required by the Act, the more distant, nebulous, uncertain or unpromising the prospect of assessable income, the more likely it will be that they will be assigned to the classification 'of a capital . . . nature'.[22]

On this basis, Kirby J held that the gaining or producing of assessable income was too remote from the incurring of the outgoings in this case:

> [I]nterest on a loan taken out to finance the acquisition of assets purchased with a view to the eventual conduct of a business may be incurred too early to be on revenue account.[23]

Therefore, Kirby J held that the outgoings should be characterised as being capital in nature, thus precluding them from deductibility under the second limb of s 51(1). This was in contrast with the majority of the High Court who held that the purpose for which the interest payments were made was to acquire a capital asset *for the use in the gaining or production of assessable income.*

V. Conclusion

The majority of the High Court therefore allowed the appeal and held that the interest payments were deductible under s 51(1) as being made with a view to gaining or producing assessable income, and were not characterised as being capital in nature. Their Honours agreed with Carr J in the Full Federal Court who proposed that the issue involved a judgment of fact. They thus remitted the matter to the Tribunal, as it was not a case in which only one conclusion would be available.[24]

The decision represents a significant development in the area of taxation law, particularly in relation to general allowable deductions under the equivalent s 8(1) of the *Income Tax Assessment Act* 1997 (Cth). Interest payments made with a view to producing or gaining assessable income will not be characterised as being capital in nature merely

20 [1997] AC 505.
21 [1997] AC 505 at 511.
22 [1999] HCA 7 at 88.
23 [1999] HCA 7 at 78.
24 Callinan J disagreed with the view that the matter should be remitted to the Tribunal. His Honour was of the view that this was a case that was not open to any other conclusion and would have allowed the High Court to substitute its judgment for that of the Tribunal, see Note 22 at 112.

because they are incurred on funds used to acquire a capital asset. Provided the purpose of the taxpayer in borrowing the money was to acquire a capital asset *in order to* produce assessable income, deductibility will not be denied merely because no such income may be derived in that year, or any subsequent years.