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Going out on a Second Limb - An Analysis of the Deductibility of Interest by Recognising a Distinction between the Positive Limbs of s 51(1)

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Abstract
A Taxation Ruling and various cases have recently created debate on the topic of the deductibility of interest. It is submitted in this article that recognising a distinction between non business and business taxpayers as indicated by the two positive limbs of s 51(1) would clarify the determination of whether interest is deductible.

Keywords
tax, income tax, Australia

GOING OUT ON A SECOND LIMB - AN ANALYSIS OF THE DEDUCTIBILITY OF INTEREST BY RECOGNISING A DISTINCTION BETWEEN THE POSITIVE LIMBS OF S 51(1)

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A Taxation Ruling and various cases have recently created debate on the topic of the deductibility of interest. It is submitted in this article that recognising a distinction between non business and business taxpayers as indicated by the two positive limbs of s 51(1) would clarify the determination of whether interest is deductible.

1 Introduction

The deductibility of interest is a highly topical issue due to the Full Federal Court decisions of *FCT* v *Roberts* and *FCT v Smith*[1] and the long awaited final Taxation Ruling TR 95/25: "Deductions For Interest Under s 51(1) of the Income Tax Assessment Act 1936 Following *FCT v Roberts ; FCT v Smith*"[2]

Interest expenditure is deductible pursuant to the general provision s 51(1) of the Income Tax Assessment Act 1936 (Cth). Section 51(1) contains two positive limbs under which deductions are allowed. The first limb applies to all taxpayers whether in business or not, and the second applies only to business taxpayers. The majority of commentators[3] and the case law[4] have focused their analysis of the

1 92 ATC 4380. These decisions were heard together.

2 The ruling was previously released in draft form as Draft Taxation Ruling TR/D38 in August 1993.

3 See, eg: Evans and Scholtz, "Corporate Borrowings: The Limits of Interest Deductibility" (1994) 2 *Taxation In Australia* 222; Gauld, "Interest Deductibility: Principles for Practices" (1992) 27 *Taxation in*

issue of interest deductibility pursuant to s 51(1) on the use test developed in the early High Court decision of *FCT v Munro*,[5] which concerned a non business taxpayer. The use test has been adopted by the courts and commentators for both business and non business taxpayers. In difficult cases the courts have also developed further tests such as the maintenance of income producing assets test to determine the deductibility of interest.[6]

The issue of interest deductibility has been complicated by the question of the relevance of the subjective purpose or motive of the taxpayer. As with the use test, subjective purpose was originally considered in decisions concerning non business taxpayers under the first limb.[7] However, the Commissioner has disallowed interest deductions for business taxpayers based on subjective purpose considerations.

The Courts and commentators have been reluctant to recognise that there is a distinction between the two positive limbs of s 51(1). It is submitted in this article that there is an important distinction between the two limbs of s 51(1), whereby the scope of deductibility under the second limb is broader than that implied by both the use test and the maintenance of income producing assets test developed in cases decided under the first limb. Furthermore, it is submitted that subjective purpose has limited relevance to the interpretation of the second limb. There is support in recent decisions that the Courts are beginning to recognise a distinction between the two limbs with regard to the relevance of the use test and subjective purpose.[8] This distinction has also been recognised in Taxation Ruling TR 95/25.

Australia 12; Knight, "Interest Deductibility: Unsettled Issues" (1994) 2 *Taxation In Australia* 230; Russell, "Sub-section 51(1): Disquieting Trends in the Courts" (1994) 2 *Taxation In Australia Red Edition* 161; Slater, "Some Tax Aspects of Business Financing" (1993) *Taxation Institute of Australia Queensland Annual Convention*; Upfold, "Deductibility of the Cost of Funds" (1993) *NSW Intensive Seminar Taxation Institute of Australia* 48 and Wallschutzky and Richardson, "The Deductibility of Interest" (1995) 24 *Australian Tax Review* 5 and "The Deductibility of Interest: Current State of Play" (1995) 7 *The CCH Journal of Australian Taxation* 29.

4 *Ure v FCT* 81 ATC 4100, *FCT v Ilbery* 81 ATC 4661, *Fletcher v FCT* 91 ATC 4950, *FCT v Roberts & Smith* 92 ATC 4380 and *Case 33/95* 95 ATC 313.

5 (1926) 38 CLR 153.

6 *Begg v DFCT* (1937) 4 ATD 257 and *Yeung v FCT* 88 ATC 4193.

7 *FCT v Ilbery* 81 ATC 4661.

8 *Fletcher v FCT* 91 ATC 4950, *Kidston Goldmines Ltd v FCT* 91 ATC 4538 and *FCT v Roberts & Smith* 92 ATC 4380.

This article suggests that the use test and subjective purpose may be of assistance in determining the deductibility of interest for non business taxpayers pursuant to the first limb of s 51(1). The deductibility of interest for business taxpayers should be considered pursuant to the second limb, without reference to the use test or maintenance of income producing assets test. Business taxpayers should rely on second limb principles established in the Full Federal Court decision of *Magna Alloys Research Pty Ltd v FCT*,[9] to focus on the objective purpose for incurring the interest. In this regard subjective purpose is only of evidentiary relevance to determine the scope of the taxpayer's business or if the business person saw the expenditure as necessary.

The article considers the existence of a distinction between the two limbs of s 51(1). This will be followed by a discussion of the case law on interest deductibility to determine support for a two limb approach to interest deductibility.

2 Distinction between first and second limbs

Section 51(1) contains two positive limbs and a negative component:

> 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 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.

Principles established by the courts to interpret the first limb state that there must be a connection or nexus between the loss or outgoing and the activities undertaken to gain or produce assessable income, such that, the expenditure must be "incidental and relevant"[10] to the gaining of assessable income. This is determined by reference to the nature and "essential character"[11] of the loss or outgoing.[12] It is a question of fact whether a loss or outgoing is incurred in gaining or producing assessable income.[13] Accordingly, factors such as the

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9 80 ATC 4542.

10 *Ronpibon Tin NL & Tongkah Compound v FCT* (1949) 8 ATD 431 at 435.

11 *Lunney v FCT; Hayley v FCT* (1958) 11 ATD 404 at 413.

12 *Charles Moore & Co (WA) Pty Ltd* (1956) 11 ATD 147 at 149

13 *Ronpibon Tin NL & Tongkah Compound v FCT* (1949) 8 ATD 431 at 437.

objective or subjective purpose for incurring the expenditure can be relevant to characterise an outgoing.[14]

These principles may also be regarded as being relevant to interpret the second limb, as early cases dealing with s 51(1) commented that there was little distinction between the first and second limbs.[15] However, the High Court noted, in *Ronpibon Tin NL & Tongkah Compound NL v FCT*,[16] that the second limb may have been included in the present section to overcome an inadequacy said to exist in its predecessor.[17] This is a reference to the findings of the Third Report of the Royal Commission on Taxation 1934 (Ferguson Commission), which noted that the previous section applied only to losses and outgoings actually incurred in gaining or producing the assessable income. Further,

> it may be difficult, or even impossible, to prove that the expenditure was incurred for the purpose of "gaining or producing" assessable income though it may be clear that it was incurred for the purposes of the business, **or** that it will reduce losses and outgoings in future years thereby resulting in the increase in the taxable or net income.[18] (Emphasis supplied)

The Ferguson Commission found two reasons for the introduction of the second limb. The first was that the expenditure should be for the purposes of the business generally, and the second was that the expenditure should reduce future expenditure. Examples of the circumstances envisaged by the Commission may be found in the case law. These include: the retrenchment package in *W Neville & Co Ltd v FCT*[19] incurred to reduce expenditure in future years; the legal fees in *Magna Alloys*[20] to protect the names of the taxpayer's directors; and the interest free loan in *Total Holdings (Australia) Pty Ltd v FCT*[21] to increase the profits of the company's subsidiary.

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14 *Magna Alloys Research Pty Ltd v FCT* 80 ATC 4542 and *Fletcher v FCT* 91 ATC 4950.

15 *Ronpibon Tin NL & Tongkah Compound v FCT* (1949) 8 ATD 431; *John Fairfax & Sons Pty Ltd v FCT* (1959) 101 CLR 30; *FCT v Finn* (1961) 12 ATD 348 at 350 and, more recently, in *FCT v Riverside Road Pty Ltd (in liq)* 90 ATC 4567.

16 (1949) 8 ATD 431.

17 Section 23(1) of the Income Tax Assessment Act 1922.

18 Third Report of the Royal Commission on Taxation (Ferguson Commission) (1934) 99.

19 (1937) 56 CLR 290, although this case was decided under the previous legislation, discussed below.

20 80 ATC 4542.

21 79 ATC 4279.

In these cases, the expenditure may not necessarily be regarded as "incidental and relevant" to the gaining or producing of assessable income as required by the first limb yet it is "dictated by the business ends to which it is directed".[22]

After noting the Commission's comments, the High Court in *Ronpibon Tin*[23] observed that the second limb,

> in actual working...can add but little to the operation of the leading words,...[the first limb]. No doubt the expression "in carrying on a business for the purpose of gaining or producing" lays down a test that is different from that implied by the words "in gaining or producing". But these latter words have a very wide operation and will cover almost all the ground occupied by the alternative.[24]

Clearly the High Court recognised a distinction between the two limbs and that the second limb is broader than the first limb. In so doing it accepted that the test for determining deductibility under the second limb is different from that under the first. Fullagar J in *John Fairfax & Sons Pty Ltd v FCT*[25] cited this passage and expressed the view that, "the categories of s 51(1) are clearly not mutually exclusive".[26] However, Fullagar J then recognised instances where a deduction would be allowable under the second limb but not under the first limb stating:

> it was not denied that there may be cases which fall outside the first category and within the second.[27]

His Honour then referred to the well known test laid down in *Amalgamated Zinc (De Bavay's) Ltd v FCT*,[28] *W Nevill & Co Ltd v FCT*[29] and *Ronpibon Tin*[30] for the interpretation of the first limb, namely that the expenditure be "incidental and relevant" to the end of gaining or producing assessable income, before he turned to the second limb and stated:

> The second may be thought to be concerned rather with cases where, in the carrying on of a business, some abnormal

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22 *FCT v Snowden & Willson Pty Ltd* (1958) 11 ATD 463 at 464.
23 (1949) 8 ATD 431 at 435.
24 Ibid.
25 (1959) 101 CLR 30.
26 Ibid at 40.
27 Ibid.
28 (1935) 54 CLR 295.
29 (1937) 56 CLR 290.
30 *Ronpibon Tin NL & Tongkah Compound v FCT* (1949) 8 ATD 431.

> event or situation leads to an expenditure which it is not desired to make, but which is made for the purposes of the business generally and is reasonably regarded as unavoidable.[31]

Fullagar J therefore also recognised a distinction between the first and second limbs. Whether the scope of the second limb is confined to abnormal events where the expenditure is reasonably unavoidable is questionable, although His Honour stated that this "may" be the case. Deane and Fisher JJ in *Magna Alloys* [32] stated that the second limb does not require that expenditure be "unavoidable" or "essentially necessary".[33]

Lehmann and Coleman[34] support an argument for recognising a distinction between the limbs on the grounds that the second limb is worded differently and is easier to satisfy. The second limb may be regarded as broader in its scope of deductibility by requiring that expenditure be dictated by the business ends to which it is directed. Those ends form part of, or are truly incidental to, the business carried on for the purpose of deriving assessable income,[35] although they need not produce specific assessable income.

A contrary position is taken by Pont,[36] who argues that the reasons for introducing the second limb postulated by the Ferguson Commission[37] have never occurred and that no case has ever been decided under the second limb alone. Whilst no cases have disallowed a deduction under the first limb on the basis that the expenditure reduces future expenditure, Pont appears to have overlooked *Magna Alloys*,[38] *Walker v FCT*[39] and *Kidston Goldmines Ltd v FCT*,[40] which were all clearly decided pursuant to the second limb on the basis that the expenditure was incurred for the purposes of the business. These decisions may be regarded as examples of the kind envisaged by the Ferguson Commission in giving their first reason for the introduction of the second limb.[41]

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31 (1959) 101 CLR 30 at 40.
32 80 ATC 4542.
33 Ibid at 4557.
34 *Taxation Law* (3rd edn 1994) at 394/395.
35 *FCT v Snowden & Willson Pty Ltd* (1958) 11 ATD 463 at 464.
36 "Section 51(1) Out On A Limb?" (1992) 1 *Taxation in Australia Red Edition* 18.
37 Above n 18.
38 80 ATC 4542.
39 83 ATC 4168.
40 91 ATC 4538.
41 Above n 18.

Gilders[42] denies that the two limbs allow taxpayers to be categorised into business and non business taxpayers. He regards the second limb as complementary to the first and submits that an item that fails the first limb cannot satisfy the second limb.[43] He does concede that the second limb may be easier to satisfy than the first, as the second limb does not require a direct link between the expenditure and assessable income but requires only that a business activity be carried on.

However, s 51(1) provides the two positive limbs as alternatives, and the discussion above indicates that the Ferguson Commission and the Courts envisaged that the second limb may have separate application to allow a deduction, whilst recognising that the first limb will generally allow a deduction in many but not all of the circumstances covered by the second limb.

If the second limb may be regarded as laying down a different test than the first limb, then many of the tests developed to interpret the first limb may be inappropriate for the second limb. In the context of interest deductibility, the commonly adopted test known as the use test was developed in cases decided under the first limb.

3 The early decisions and the development of the use test

Munro[44] is widely cited as the origin of the use test for determining the deductibility of interest pursuant to s 51(1). Under the test the use of the funds is evidentiary of the purpose for which the borrowing is made, determined by tracing the application of the funds so borrowed to an income producing use.

The case concerned the deductibility of interest on a mortgage over a rental property. The mortgage loan was used to acquire shares in a company, the majority of which were gifted to the taxpayer's sons, and also to provide an interest free loan to the same company.

The taxpayer argued that the interest payments related to a loan which was secured against a rent producing property, and were necessary to ensure retention of the rental property and, therefore, to maintain the income from the rental property. The relevant statutory provisions considered by the High Court in *Munro* were the

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42 "Section 51(1): The Facility and Felicity of the Limb Convention" (1993) 1 *Taxation In Australia Red Edition* 217.

43 Ibid at 221.

44 (1926) 38 CLR 153.

previous s 23(1)(a) and s 25(e) of the Income Tax Assessment Act 1926 (Cth).

Section 23(1)(a) stated that from the total assessable income of a taxpayer there shall be deducted all losses and outgoings and, among other things, interest actually incurred in gaining or producing the assessable income. This section was subject to s 25(e), which read that a deduction shall not in any case be made in respect of money not wholly and exclusively laid out or expended for the production of assessable income.

The High Court held unanimously that the interest was not deductible, essentially on the grounds that the nexus between the interest deduction and the earning of rents was too remote and the purpose of the borrowing was not connected with the production of assessable income. Knox CJ stated that the rent was not "referable" to the loan, the loan was not "instrumental in or conducive" to the rent income, and the rents were not received "in consequence" of the payment of interest.[45] Knox CJ and Isaacs J both made the point that the taxpayer was already entitled to the rents and, therefore, the interest payment was not incurred in gaining or producing the assessable income, despite the taxpayer securing the debt on the income producing property.[46]

The remaining Justices agreed with Knox CJ, although Starke J elaborated slightly to highlight that the interest "was not an outgoing by means of which the taxpayer procured the use of money whereby he made any income".[47] This comment appears to have been the basis for the headnote and was therefore highlighted in future decisions as the use test.

The exclusion provision in the earlier legislation was also decisive, according to Knox CJ[48] and Isaacs J.[49] Section 25(e) required the expenditure in question to be "wholly and exclusively laid out for the production of assessable income". (Emphasis supplied) This compares with the current provision, which allows apportionment.[50] A purpose of the borrowing was to fund a gift to

45 Ibid at 171.
46 Ibid at 171 and 197.
47 Ibid at 218.
48 Ibid at 170.
49 Ibid at 198.
50 Section 51(1) begins, "All losses and outgoings to the extent to which they are incurred".

the taxpayer's sons. This purpose was not to derive assessable income and therefore s 25(e) denied the deduction.[51]

Accordingly, it is submitted that *Munro* establishes the principle that, where money is borrowed by a non business taxpayer on the security of a rent-producing property, there is an insufficient nexus between the interest outgoing and the derivation of assessable income from the rental property. Subsequent case law[52] has built upon Starke J's comments to state that, in determining a nexus, the objective purpose of the borrowing may be evidenced from the use to which the funds have been put.

Munro involved a non business taxpayer and was decided pursuant to the predecessor to s 51(1), which basically contained only the first limb of the current provision. Accordingly, the use principle decided in *Munro* does not necessarily translate to correctly interpret the current provision, especially with regard to businesses, which may rely on the second limb. This was recognised in certain early court[53] and tribunal decisions which did not always adopt the use test for business taxpayers.[54]

The use test, however, was not immediately endorsed by the courts, as illustrated by *Begg v DFCT*.[55] Many commentators[56] have had difficulty reconciling *Begg* with *Munro*. This may merely illustrate that the words of the legislation need to be considered when determining the deductibility of interest, rather than relying entirely on tests.[57]

3.1 *Begg v DFCT*: anomaly or consistent with *Munro*?

The decision in *Begg* concerned the deductibility of interest incurred on a borrowing by the executors of a deceased estate to pay for estate duties. The decision applied the predecessor to s 51(1), as referred to above, containing only the first limb. Rather than liquidate the property and shares held by the estate at low prices due

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51 It is interesting to note that many of the extracts quoted from *Munro* to support the use test relate to the Judges' discussion of the exclusion provision: see (1926) 38 CLR 153 at 170 and 198.

52 Above n 4.

53 *Total Holdings (Australia) Pty Ltd v FCT* 79 ATC 4279.

54 *P23* (1963) 14 TBRD 114.

55 (1937) 4 ATD 257.

56 For example Knight, above n 3 at 235; Upfold, above n 3 at 51; Wallschutzky and Richardson, "The Deductibility of Interest", above n 3 at 7.

57 *Lunney v FCT*; *Hayley v FCT* (1958) 11 ATD at 412.

to the depression, the executors borrowed the funds required to pay the duties. The Commissioner assessed the beneficiary on the income from the estate without allowing a deduction for the interest. The Commissioner relied primarily on *Munro*, although not in terms of the use test. The Commissioner argued that interest incurred on a borrowing secured over an income producing property was not deductible, as the property was already income producing. However, the Court looked beyond the fact that the borrowing was secured on income producing assets and that the borrowed funds did not directly produce assessable income.[58] Reed J quoted at length from *Munro*, concluding that:

> The case does not establish that interest which is paid on a loan raised on property which is already rent producing is not, under any circumstances, properly the subject of deduction from the rents received.[59]

The Court in *Munro* had pointed out that a borrowing to effect repairs to the property would relate to the property and that interest incurred in relation thereto would be deductible.[60] Interest on a borrowing in these circumstances would be deductible, whether or not the loan was secured on the rent producing property. The comments of Reed J are, therefore, consistent with *Munro*, with respect to the need to look beyond the security of the borrowing to determine any nexus with the derivation of assessable income. Reed J pointed out that the borrowing preserved the assets in their income producing form and held that the interest was deductible.[61]

It is possible to distinguish *Begg* and *Munro* in a way which avoids conflict between the decisions.[62] *Begg* may be regarded as being decided on principles established to interpret the first limb, that is, the interest was incidental and relevant to the production of assessable income. This was evidenced by the objective purpose for incurring the interest which was to enable the executors to exercise their administrative powers and duties properly. These powers and duties included ensuring that the best price was obtained on the sale of trust property, and that the estate continued to earn assessable

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58 (1937) 4 ATD 257.

59 Ibid at 265.

60 (1926) 38 CLR 153 at 197.

61 This aspect of the decision was later followed in *Yeung v FCT* 88 ATC 4193, and was referred to as the maintenance of income producing assets test.

62 Note that in the recent decision of *Case 33/95* 95 ATC 313 at 318 it was concluded that the decisions were in conflict as *Begg* did not apply the use test.

income ensuring its existence. In these circumstances the actual use of the funds to pay estate duties, being a non income producing use of the borrowed funds, did not stamp the objective purpose of the borrowing as non income producing. Conversely, in *Munro* the borrowing was merely secured over income producing properties and this provided an insufficient connection between the rental income and a borrowing to purchase private assets.

3.2 Other early decisions

There were no major court decisions concerning interest deductibility until 1979.[63] However, numerous decisions were heard on the topic by the Taxation Board of Review. The use test gained prominence in a number of early Board decisions but primarily in decisions concerning similar facts to *Munro* rather than decisions involving business taxpayers.[64]

On the other hand, Board decisions did recognise the principle laid down in *Munro* with respect to the relevance of the security of a loan to the nexus between the interest on the loan and assessable income, rather than in terms of the use test.[65] For example, the Board in *Case P23*[66] recognised the use test as an evidentiary factor to be considered in the circumstances, stating:

> we do not think that *Munro's* Case is authority for the proposition that in applying s 51 of the present Act, one must fix attention only upon the direct or immediate use to which the borrowed money is put, regardless of other circumstances.[67]

The Board decision concerned a business taxpayer and provides support that the use test is not appropriate to business taxpayers. The taxpayer acquired a property from his aunt for the purpose of grazing. Part of the consideration included the requirement for him to buy a house for his aunt to reside in during her lifetime. The taxpayer borrowed the funds to purchase a house for his aunt.

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63 *Total Holdings (Australia) Pty Ltd v FCT* 79 ATC 4279. Note that *FCT v McCloy* 75 ATC 4079, which concerned home office expenses but included an interest claim, did not apply the use test and was mainly concerned with the private expenditure exclusion in s 51(1).

64 *Case N59* (1962) 13 TBRD 230; *Case B11* 70 ATC 46, *Case F72* 72 ATC 426 and *Case J57* 77 ATC 496.

65 *Case 5* (1950) 1 TBRD 9 at 10; *Case L71* (1960) 11 TBRD 433 at 434 and Case F34 74 ATC 192.

66 *Case P23* (1963) 14 TBRD 114.

67 Ibid at 118.

The loan was secured over the grazing property. The Board held that the interest on the loan to purchase the house was deductible. The Commissioner relied on *Munro* to argue that the interest was not deductible, since the money borrowed was used to acquire a house which was used for private purposes.

The Board considered that the purchase of the house was part of the purchase price for the grazing property. This established the nexus between the interest payments and the gaining of assessable income from the grazing property. The Board recognised that *Munro* should not be seen as laying down a broad principle to trace the use of the borrowed funds to an income producing asset.[68]

The first major Court decision concerning interest deductibility after *Munro* and *Begg*, also involved a business and did not apply the use test. *Total Holdings*[69] concerned the deductibility of interest on a borrowing onlent interest free to the taxpayer's subsidiary. The Commissioner argued that the borrowing was made for the purpose of enhancing the capital value of the subsidiary with the ultimate aim of disposing of the shares in the subsidiary at a non assessable capital profit and that the payment of interest could not be traced to any particular assessable income.[70] Lockhart J referred to both limbs of s 51(1) throughout his judgment, but stated in relation to business taxpayers:

> If a taxpayer with a continuing business incurs a liability for interest being incidental to or connected with the operations or activities regularly carried on or the production of income, the interest is an allowable deduction. The circumstance that each item of expenditure **cannot be traced to a particular item of income** does not prevent the deduction of the expenditure.[71] (Emphasis supplied)

This is a specific rejection of tracing the use of the funds, at least in relation to taxpayers entitled to rely on the second limb. The Court accepted the evidence of the taxpayer that the purpose of the interest free borrowing was to increase the profits of the subsidiary to hasten the possibility of a return to the parent in the form of dividends in the future. The Court considered the broad business

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68 Also see *M13* (1961) 12 TBRD 82 concerning a business using the nexus test.

69 79 ATC 4279.

70 Ibid at 4284.

71 Ibid at 4283. The judgment refers to *W Nevill & Co v* FCT (1936) 56 CLR 290, *Texas Co (Australasia) Ltd v FCT* (1940) 63 CLR 382 and Parsons, *Income Taxation in Australia* (1985) 351.

purpose of the borrowing, rather than trying to trace the use of the funds to the derivation of specific income.

Until the 1980s the use test was followed by some Board decisions[72] and rejected by others.[73] It is possible to conclude that the test was more readily accepted in decisions involving non business taxpayers in similar circumstances to *Munro*, where the borrowed funds were used for private purposes. In this regard, the use of the funds is evidentiary of the purpose of the borrowing, having an insufficient connection with producing assessable income.

In cases involving a business, neither the Boards[74] nor the Court in *Total Holdings*[75] applied the use test. This may be rationalised on the basis that the second limb does not require the use of the funds to produce assessable income, but that the funds are borrowed by a taxpayer in a business carried on for the purpose of producing assessable income.

From the early 1980s the courts began to adopt the use test more consistently as a starting point, religiously quoting *Munro* as the origin of the test.[76] In addition, as the commercial environment became more complex and tax avoidance more prevalent, the courts found the need to consider the relevance of subjective purpose to the interpretation of s 51(1). In the past the analysis was confined entirely to objective considerations.[77]

4. The use test and subjective purpose

A review of the cases which first looked beyond the use test and considered the subjective motive or purpose of the taxpayer as relevant shows that they were essentially concerned with non business taxpayers involved in avoidance transactions.[78] The application of the general anti-avoidance provision existing at the time[79] was considered ineffective. Accordingly, the subjective purpose of the taxpayer was considered to disallow the deductibility of interest in circumstances where the use of the funds was related to the derivation of assessable income, but a purpose for

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72 Above n 64.
73 Above n 65.
74 *Case P23* (1963) 14 TBRD 114 and *Case M13* (1961) 12 TBRD 82.
75 79 ATC 4279.
76 Above n 4.
77 *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430; *FCT v Phillips* 78 ATC 4361 and *FCT v South Australian Battery Makers Pty Ltd* 78 ATC 4412.
78 *Ure v FCT* 81 ATC 4100 and *FCT v Ilbery* 81 ATC 4661.
79 Section 260.

incurring the interest was also private or for tax minimisation. This has been endorsed by the High Court more recently in *Fletcher v FCT*,[80] despite the availability of the more potent general anti-avoidance regime contained in Part IVA. Whether the non-deductibility of interest in these circumstances would be more correctly dealt with under Part IVA is another question.[81] In any event, it is submitted that the consideration of subjective purpose has been taken out of context and used by the Commissioner to attack the deductibility of interest incurred in the course of genuine business transactions. This has created uncertainty as to the deductibility of a commonplace business expense. The relevance of the subjective purpose to a business taxpayer was considered in detail in *Magna Alloys*.[82]

4.1 *Magna alloys* and the relevance of subjective purpose

Magna Alloys did not concern the deductibility of interest but the deductibility of legal expenses associated with defending the company's directors against criminal charges. A single judge of the Federal Court had concluded that the dominant motive for incurring the expenditure was the relevant issue for consideration under the second limb of s 51(1). His Honour held that the directors' dominant motive in incurring the expenditure was to protect their own position, rather than to carry on a business, and therefore the expenditure was not deductible. The Full Federal Court was therefore called upon to consider whether the motive of the expenditure had any relevance to deductibility under the second limb.

Brennan J discussed in detail the relevance of subjective purpose to s 51(1) in terms of both the first and second limbs. His Honour stated that under the second limb subjective purpose was only relevant to determine the scope of the business being carried on by the taxpayer. Brennan J noted that:

> Though references to motive and purpose are to be found in cases arising under s 51, neither motive nor ... [subjective nor objective] purpose is a criterion of deductibility. The statutory criteria are expressed in the two limbs of s 51.[83]

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80 91 ATC 4950.

81 Pape, "Misleading Cases: Misnomers or Mistakes?" (1990) 25 *Taxation In Australia* 449; Myer, "Deductibility of Interest: In Search of Symmetry" (1990) 25 *Taxation In Australia* 196; Russell, above n 3 at 166-171.

82 80 ATC 4542.

83 Ibid at 4545.

He added that purpose is relevant to determine the essential character of the expenditure.[84] However, a careful reading of the judgment recognises that the purpose being referred to is the objective purpose for which the expenditure is being incurred.[85] That is, in cases concerning voluntary expenditure, to determine the essential character of the expenditure, the commercial reason or objective purpose for incurring the expenditure is a relevant factor to be considered.

In terms of the second limb, Brennan J said that the purpose to be considered is the "business purpose" of the expenditure, quoting from *FCT v The Midland Railway Co of Western Australia Ltd*[86] as follows:

> what governs the issue is **the business purposes** for which the outgoing was incurred from the point of view of the taxpayer company. The controlling factors are those which arise from the character of the business or undertaking and the relation which the expenditure or the liability to make it bore to the carrying on of the business or the gaining of assessable income.[87] (Emphasis supplied)

Although this quote covers both limbs, Brennan J concluded that, under the second limb, the "controlling factors" determine the business purposes and character of the business and connection of the expense to the business, and that "the taxpayer's state of mind had no part to play".[88] However, Brennan J does concede that the state of mind of the taxpayer may have evidentiary relevance to ascertain the controlling factors, such as to determine the scope of the taxpayer's business.[89]

His position may be summarised as follows:

> In cases to which a reference to purpose is required or appropriate, objective purpose will be found to be an element in determining whether expenditure is incurred **in** gaining or producing assessable income or **in** carrying on business. If the [objective] purpose of incurring expenditure is not the gaining or producing of assessable income or the carrying on of a business, the expenditure cannot be said to be "incidental and relevant" to gaining or producing

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84 Ibid at 4547.

85 Brennan J uses the word "motive" to distinguish objective and subjective purpose, ibid at 4544 and 4546/4549.

86 (1952) 85 CLR 306.

87 Ibid at 313.

88 80 ATC 4542 at 4549.

89 Ibid at 4549/4550.

> assessable income or carrying on business; or to be incurred "in the course of gaining or producing" assessable income or of carrying on a business; nor can the undertaking or business be seen to be "the occasion of" the expenditure.[90]

Deane and Fisher JJ considered the case in terms of the second limb only and concluded that the expenditure must be seen objectively as desirable or appropriate for the ends of the business. Subjective purpose is only relevant, in their view, in determining if the objective purpose of the expenditure was also the actual business purpose of the taxpayer.[91] They stated:

> The controlling factor is that, 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. Provided it comes within that wide ambit it will for the purpose of s 51(1), be necessarily incurred in carrying on that business if those responsible for carrying on the business so saw it.[92]

They then continue to distinguish between voluntary expenditure which achieves its intended purpose and which is obviously relevant to the business, and that which does not achieve its intended purpose. They conclude that:

> Cases where the outgoing does not achieve its intended purpose or where the connection with the business is indirect and remote demonstrate, however, the need to distinguish between the character of an outgoing determined merely by reference to objective factors and its character determined in the light of subjective purpose in any precise formulation of the ingredients of the second limb of s 51(1).[93]

Their judgment does not differ significantly from that of Brennan J and the decision may be summarised as stating that in the case of an involuntary outgoing, such as for a trading stock purchase, that subjective purpose has no part to play in the analysis.

In the case of a voluntary outgoing, in determining whether the expenditure meets the legislative criteria, such as being "incidental and relevant" to carrying on a business, a factor to consider is the objective purpose of the expense. This purpose will determine

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90 Ibid at 4551/4552.
91 Ibid at 4560/4561.
92 Ibid at 4559.
93 Ibid.

whether the essential character of the expenditure is desirable or appropriate to meet the ends of the business. Deane and Fisher JJ added that one may need to consider also whether this was the subjective purpose of those responsible for the business, whereas Brennan J confined any subjective analysis to a determination of the character of the taxpayer's business.[94] These views may be reconciled, as Deane and Fisher JJ's inquiry of whether the business person saw the expenditure as necessary could be answered by Brennan J's consideration of the scope and character of the taxpayer's business. The judges' comments on purpose are referred to below as the *Magna Alloys* principle. Other commentators have similarly concluded that the interpretation of the second limb of s 51(1) is primarily a consideration of objective purpose.[95]

Magna Alloys has been used as authority to consider the subjective purpose of the taxpayer for incurring expenditure in later cases concerning the deductibility of interest by non business taxpayers,[96] despite the majority judgment confining their analysis to the second limb.

4.2 Application of the *Magna Alloys* principle to interest deductibility decisions

Ure[97] concerned a non business taxpayer who borrowed money at interest rates of up to 12.5% and onlent the money at 1% to a family company and the taxpayer's spouse. Brennan J applied the first limb, referred to the test laid down in *Munro*[98] and determined that the monies were used for the purpose of gaining assessable income. In previous decisions concerning the deductibility of expenditure, the inquiry generally went no further.[99] However, His Honour considered whether incurring interest at rates of up to 12.5%, whilst in receipt of interest income of only 1%, could truly be said to be incurred in the earning of that income.[100] Brennan J referred to his comments in *Magna Alloys* that objective purpose is a factor in characterising the expenditure, stating:

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94 Leibler, "The Changing Interpretation of Section 51: The Need to Show Purpose in Obtaining Deductions" (1983-4) 17 *Taxation in Australia* 490.

95 Parsons, *Income Taxation in Australia* (1985) 322; Waincymer, *Australian Income Tax Principles and Policy* (1991) 221; Grbich, Bradbrook and Pose, *Revenue Law Cases and Materials* (1990) 340-1.

96 Note that in Brennan J's quotes (above n 83, n 87 and n 90) the two limbs were generally discussed together.

97 81 ATC 4100.

98 (1926) 38 CLR 153.

99 Above n 77.

100 *Ure v FCT* 81 ATC 4100 at 4104.

> Those purposes do not depend upon the state of the taxpayer's mind but upon what the taxpayer in the circumstances of the case is ascertained to have done in using and arranging for the use of the borrowed moneys.[101]

His Honour found that tracing the use of the funds confirmed the existence of other purposes for incurring the interest, namely to provide income for the taxpayer's wife and to provide a family home, amongst other purposes.[102] As these other purposes did not relate to the derivation of assessable income, the interest deduction was apportioned. Therefore, tracing the use of the funds was determinative in characterising the purpose for incurring the expenditure.

Deane and Sheppard JJ referred to the relevant case law including *Munro* and described the use test as determining the objects or advantages which the application and use of the borrowed money were intended to gain.[103] They concluded that the predominant but indirect objects of the borrowing, namely the provision of accommodation for the family and financial benefits to the taxpayer's wife and family trust, were not incidental and relevant to the earning of assessable income, but were of a private and domestic nature and therefore excluded by the negative part of s 51(1).

The decision illustrates that, even in the case of the first limb, the use test has its limitations where the amount of the expenditure does not objectively wholly relate to the derivation of assessable income. *Ure* may be seen, nonetheless, as endorsing the use test and the process of tracing, as the Court traced the monies from the borrowing, past the earning of interest income, to its ultimate use by the taxpayer's family. In any event, the references of Deane and Sheppard JJ to indirect objects or motives of a personal or domestic character[104] paved the way for the argument in *Ilbery*[105] that the subjective motive of the taxpayer was crucial to the inquiry, at least in terms of the first limb.

Ilbery concerned a taxpayer who prepaid five years of interest relating to a borrowing to acquire an income producing property. The

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101 Ibid.
102 Ibid.
103 Ibid at 4109/4110.
104 Ibid at 4109.
105 81 ATC 4661.

decision developed the use of subjective purpose in interpreting the first limb. The Court quoted the discussion of Brennan J in *Magna Alloys* as to the relevance of purpose when considering a voluntary payment under the first limb, although it failed to note his distinction between objective and subjective purpose.[106] Toohey J added that the subjective purpose may stamp an outgoing as not having any connection with the gaining or production of assessable income. Accordingly, His Honour concluded that, as the taxpayer's subjective purpose in incurring the interest prepayment was to gain a tax advantage, the connection with the gaining of assessable income was not apparent. This subjective purpose was thought to override any commercial advantage from the prepayment of interest, namely, the reduction in interest rate for the term of the loan.[107] This is a departure from the approach of Brennan J in *Magna Alloys* and *Ure*, which referred primarily to objective purposes, as Toohey J referred to the subjective purpose of tax minimisation.

The decision is anomalous[108] with respect to the emphasis placed on subjective purpose and may be regarded as a response to the inadequacies of the anti-avoidance provisions in force at that time.[109] In any event, *Ilbery* concerned the first limb of s 51(1) and therefore may be regarded as the precedent for taxpayers subject to the first limb, as evidenced by comments by Lusher J in the later case of *Walker v FCT*[110] and the approach taken by the High Court in *Fletcher*.[111]

Walker concerned a partnership in the business of breeding cattle involving substantial upfront fees which ensured that the investment would not produce positive returns for many years. The case dealt with the second limb of s 51(1) and, based on the comments in *Magna Alloys*, Lusher J rejected any suggestion that the subjective purpose of obtaining a tax deduction had a part to

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106 80 ATC 4542 at 4667.

107 Furthermore, Toohey J (at 4668/4669) also referred to the fact that at the time of the prepayment no income producing property had been acquired and therefore the outgoing was not incidental and relevant to the derivation of assessable income. However, this should not be fatal to the deductibility of an outgoing, which may be incurred prior to income being derived (*Ronpibon Tin NL & Tongkah Compound v FCT* (1949) 8 ATD 431 and *Vallambrosa Rubber Co Ltd v Farmer* (1910) 5 Tax Cas 529).

108 Also see Parsons comments, above n 71 at 358-363.

109 Section 260.

110 83 ATC 4168.

111 91 ATC 4950.

play in the inquiry.[112] Lusher J distinguished clearly between the two limbs[113] and with regard to business outgoings he noted, consistently with *Magna Alloys*, that:

> where the business is for the purpose of gaining or producing such income, the nature or ambit of the business having been determined, it is a question of fact whether there is a match of the expenditure with an acceptable business purpose within that ambit. This is an objective examination and has nothing to do with the taxpayer's state of mind, motivation or purpose other than it may be relevant as an evidentiary matter to the determination of the parameters of the business or its nature.[114]

Ilbery was distinguished, perhaps too hastily, on the basis that the expenses were incurred preliminary to the income earning activity.[115] In *Ilbery* this issue was treated as secondary to the primary reason for disallowing the expenditure, that the subjective purpose was to obtain a tax deduction.[116] *Ure* was distinguished on the basis of the private and domestic nature of the expenses.[117] Lusher J's decision was confirmed on appeal,[118] and his conclusion on *Magna Alloys* supports the analysis that a distinction between the positive limbs is relevant. In any event, the decision is an illustration of the approach taken by the Commissioner since *Ure* and especially since *Ilbery*. That approach is to disallow a deduction, particularly for interest, where there is a negative return on the investment, although only in the initial years, on the presumption that a subjective purpose of the expenditure was to obtain a tax deduction. The Commissioner raised similar arguments in *FCT v Janmor Nominees Pty Ltd*[119] and *FCT v Gwynvill Properties Pty Ltd*.[120] The Commissioner was successful in the latter decision.

Gwynvill Properties was decided pursuant to the second limb and concerned the deductibility of a prepayment of interest. Following *Ilbery*, Jackson J held that the amount was not deductible, as the subjective purpose of making the payment was to obtain a large tax

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112 It will be noted that the facts are similar to *Fletcher v FCT* 91 ATC 4950, except that a business was at issue.

113 83 ATC 4168 at 4195. Note the reference to *FCT v Munro* (1926) 38 CLR 153, specifically with regard to the first limb.

114 83 ATC 4168 at 4195.

115 Ibid at 4196.

116 81 ATC 4661 at 4668/4669.

117 83 ATC 4168 at 4199.

118 84 ATC 4553.

119 87 ATC 4813.

120 86 ATC 4512.

deduction.[121] Interestingly, at first instance in *Gwynvill Properties*,[122] Hunt J distinguished *Ilbery* on the basis that the case at hand concerned the second limb, whereas the taxpayer in *Ilbery* was not carrying on a business.

Neaves J did not refer to subjective purpose specifically, but based his decision on the judgment of Deane and Fisher JJ in *Magna Alloys*. His Honour considered whether objectively the transaction achieved the injection of additional funds from outside the company group. In his view, the prepayment of interest was not "explicable as being appropriate to achieve the espoused business end",[123] as he believed the transaction did not provide additional funds to the company group.

The comments by Fisher J in dissent were also based on the *Magna Alloys* principle. However, he allowed the deduction, stating that:

> the obtaining of a tax deduction was not the only purpose of the taxpayer. The taxpayer's purpose was...viewed objectively, capable of being seen as "desirable or appropriate" in the pursuit of the taxpayer's business ends...The fact that it was also a major concern of the taxpayer that it achieve a deduction of the amount of interest paid and that it sought thereby a tax benefit or advantage does not deny the taxpayer a deduction under s 51(1).[124]

Accordingly, Fisher and Neaves JJ, although applying the same principle from *Magna Alloys*, took a different view of the facts in determining whether, objectively, the transaction achieved the business ends. In any event, the case presents an unclear precedent. The two majority judgments were based on different principles,[125] as Jackson J may be seen as endorsing the relevance of subjective purpose as a primary factor in interpreting the second limb.

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121 Ibid at 4527.

122 85 ATC 4046 at 4053.

123 86 ATC 4512 at 4523.

124 Ibid at 4516.

125 The Government's response to the decision was the introduction of specific provisions prohibiting the type of transaction (ss 82KH and 82KL). The courts may have disallowed the deduction under s 51(1), fearing the inadequacy of Pt IVA when faced with possible tax avoidance. See Pape, above n 81 at 453, although his reference to *Ure* suggests a direct tracing approach, rather than a consideration of whether the expenditure is relevant to the business as a whole.

Difficulties in reconciling the authorities led the Court in *Yeung v FCT*[126] to resolve the issue by establishing the maintenance of income producing asset test to allow a deduction for interest, based on comments in *Begg*.[127]

4.3 Maintenance of income producing asset test

In *Yeung*[128] the taxpayer was a partnership which borrowed funds to repay capital contributions to certain partners who had financed the purchase of partnership assets. The borrowing was not directly for the purpose of deriving assessable income. Furthermore, the use of the funds could be traced to the repayment of partnership capital that was used for private purposes.

Counsel for the taxpayer argued that a partnership existed pursuant to the extended definition in s 6(1), as the partners were in receipt of income jointly. Whether a legal partnership existed was not argued. The Court allowed the interest deduction, but had difficulty doing so because of the precedents of *Munro*,[129] *Ure*[130] and *Ilbery*.[131] The Court finally interpreted *Begg*[132] to mean that interest on a borrowing that ensures the maintenance of the income producing assets is incurred in the course of deriving assessable income.

It is not clear under which limb of s 51(1) the case was decided. Nor is it clear whether the Court considered that the partnership was carrying on a business or not, although the use of the term "income earning enterprise"[133] to describe the activities of the partnership tends to indicate a business was being considered.[134] This is further supported by the fact that it appears that the partnership held a number of rental properties and substantial funds had been invested. If the partnership was carrying on a business, then the case could have been decided based on *Magna Alloys* [135] principles. To finance the withdrawal of partners' funds to which they were entitled, the business borrowed rather than disposing of its income producing

126 88 ATC 4193.
127 (1937) 4 ATD 257.
128 88 ATC 4193.
129 (1926) 38 CLR 153.
130 81 ATC 4100.
131 81 ATC 4661.
132 (1937) 4 ATD 257.
133 88 ATC 4193 at 4204.
134 This conclusion is confirmed by comments in a recent decision *Case 12/95* 95 ATC 175 at 182.
135 80 ATC 4542.

assets. As the partners were entitled to their partnership funds, borrowing rather than disposing of assets may be regarded as objectively desirable or appropriate to meet the ends of the business. On this analysis, a reference to *Begg*, a first limb decision, and the use of the maintenance of income producing asset test, has further complicated the area.[136]

Parsons reconciles *Begg* and *Yeung* with his function test[137] stating that:

> the issue would be whether the function of the borrowing is to support the process of income derivation - the conduct of a business or the holding of property whence income is derived - and whether it continues to have this function.[138]

Parsons argues that the function of the borrowing sustained the continued holding of income producing property against a realisation of that property which would otherwise have occurred.[139] This is distinguishable from counsel's argument for the taxpayer in *Munro*, that the income producing property provided security for the borrowing and that the interest payments sustained the income producing asset from foreclosure by the lender.[140]

Parsons appears to agree with Forsyth[141] that an argument that the borrowing allowed the taxpayer to retain the income producing asset would have been successful in *Munro*.[142] However, this argument has not been accepted in numerous Board and Tribunal decisions based on the use test.[143]

It is submitted that *Yeung* and *Begg* are better reconciled by ignoring the maintenance of income producing asset test and by recognising instead the distinction between the two limbs. *Begg* may be considered as an application of the nexus requirement, and *Yeung* as a product of the confusion in the area of interest deductibility when

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136 Discussed below.

137 Above n 71 and Parsons, "*Roberts and Smith*: Principles of Interest Deductibility" (1993) 1 *Taxation in Australia Red Edition* 261 discussed below.

138 Parsons, above n 71 at 349.

139 Above n 137 at 267.

140 Ibid.

141 "Some Simple Problems Concerning Interest and Like Payments" (1986) 15 *Australian Tax Review* 4 at 10.

142 Above n 71 at 349 and above n 136 at 269, although rejected in many subsequent Board and Tribunal decisions: see *Case N59* (1962) 13 TBRD 230; *Case 5* (1950) 1 TBRD 9; and *Case L71* (1960) 11 TBRD 433.

143 Above n 64.

the two limbs were not distinguished. On the one hand Hill J in *Roberts & Smith*[144] confirmed that the maintenance of income producing asset test is difficult to reconcile with the authorities and he cast doubt on the correctness of *Begg*.[145] On the other hand he stated that the decision in *Yeung* was correct if regarded as:

> involving a borrowing to fund the repayment of moneys originally advanced by a partner and used as partnership capital, particularly given that the original funds were used to purchase the rental property.[146]

It may be that the function test is better confined to interpreting the second limb, rather than attempting to use it as a single test to encompass both limbs. This will be developed further.

5 Recent decisions: a move towards a distinction between the limbs

Ure[147] and *Ilbery*[148] generally applied the use test developed in *Munro*[149] for non business taxpayers. *Ilbery* introduced the relevance of subjective purpose, whereas *Yeung*[150] applied the maintenance of income producing asset test said to have been established in *Begg*.[151] Whilst the Commissioner continued to argue the use test and the relevance of subjective purpose for all taxpayers, the Courts became reluctant to apply these concepts to business taxpayers, despite the reference to subjective purpose for a business taxpayer in *Gwynvill Properties*.[152] Furthermore, the maintenance of income producing asset test has not resurfaced again.

In *FCT v Carberry*[153] the Commissioner unsuccessfully argued that borrowed monies were used for non-income producing purposes based on *Munro*. A couple sold their home and used the proceeds, plus additional borrowings, to acquire a kindergarten with a private residence attached. The taxpayers sought to deduct the entire interest expenditure in relation to the borrowing. The taxpayers

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144 92 ATC 4380.
145 The maintenance of income producing asset test was ignored in *Case 33/95* 95 ATC 313.
146 92 ATC 4380 at 4389.
147 81 ATC 4100.
148 81 ATC 4661.
149 (1926) 38 CLR 153.
150 88 ATC 4193.
151 (1937) 4 ATD 257.
152 86 ATC 4512.
153 88 ATC 5005.

argued that the portion of the purchase price referable to the private residence was paid out of the proceeds from the sale of their original home and that, therefore, the entire borrowing related to the purchase of the kindergarten.

There was no question of tax avoidance in the handling of the taxpayers' affairs, nevertheless the Commissioner sought to argue that the purpose of the borrowing was partly private and partly for the earning of assessable income, using a strict tracing of the use of the borrowed monies which could not be traced specifically to either purchase.

The Court held that the borrowing wholly related to purchasing the kindergarten and that the interest was fully deductible. The previous home was of greater value than the current one attaching to the kindergarten and the additional borrowed funds were required to purchase the kindergarten business. There was no evidence from the banking documents to show that the loan was related to the whole or part of the property, but the accounts were prepared on the basis that the loan related to the business. The Court did not refer to either limb specifically, but it did apply the first limb decisions in *Ure* and *Ilbery*, restating the test as follows:

> what is relevant is the purpose for which the money was borrowed or applied...was that purpose directed to the earning of assessable income or was it directed to some other purpose?[154]

The Court also held that one must look to the "use to which those borrowed moneys were put."[155] This analysis was adopted despite the fact that the case concerned a business and, therefore, the deductibility question could have been considered under the second limb using *Magna Alloys* principles.

Based on the Commissioner's argument, tracing the use of the funds could have resulted in a conclusion that the borrowing was for two purposes, being the purchase of a home and the purchase of a business, resulting in the non deductibility of a portion of the interest. However, clearly the taxpayers had the funds to purchase a private residence from the proceeds of their previous home, and it was their decision to apply the borrowing to the acquisition of a business. Such a borrowing was clearly desirable and appropriate to the ends of the business, ignoring any tracing of actual funds. If

154 Ibid at 5007.
155 Ibid at 5009.

Munro, Ure and *Ilbery* were not seen as the primary authorities on the interpretation of s 51(1) for the deductibility of interest, and the distinction between the limbs was given more consideration - such that the use test was not applied to business taxpayers - the deductibility of interest in the circumstances of this case would have been clearer.

FCT v Riverside Road Pty Ltd (in liq)[156] also concerned a business taxpayer. The Full Federal Court, after reviewing the authorities on the differences between the two limbs, concluded that the different wording under the limbs would not affect the outcome of the case. The facts of the case were complex. The taxpayer company was a hotel operator. The original property and fittings were financed by way of equity, shareholder loans and a secured loan. The company subsequently entered into a contract to dispose of the land and buildings to a related company. The secured loan was repaid from funds loaned from another source, the loan also being increased to provide further working capital. The purchase price and legal title to the land did not change hands until the property and the business was later sold to outside interests. In the meantime, the land and buildings were leased back to the taxpayer company to use in its hotel operating business.

The Commissioner disallowed deductions for interest payments relating to the period after the sale and leaseback on the basis that the motive of the taxpayer in entering into the arrangement was tax minimisation. The Commissioner argued the application of the anti-avoidance provisions in the alternative to non-deductibility under s 51(1).

The Court determined that the case could be decided under either limb, referring to *Munro* and *Magna Alloys*.[157] A strict tracing of the use to which the funds were put indicates that the interest was deductible, as the funds were originally used to buy an income producing property. The use test does not work when the circumstances change[158] and, as in this case, the property which was the subject of the original loan is sold. The Court had to consider whether the interest on a loan secured over the land and buildings, which were sold to a related party with an interest free loan, was deductible. The reason for the interest free loan was not apparent from the decision but, given the arguments on the anti-avoidance provisions, the whole transaction may be seen as a way of obtaining

156 90 ATC 4567.
157 80 ATC 4542.
158 *Kidston Goldmines Ltd v FCT* 91 ATC 4538 at 4545, discussed below.

a tax deduction for the interest and the lease payments without any actual flow of funds on the disposal of the property.[159]

It seems that the purpose of the borrowing changed after the money had been borrowed, from that of acquiring an income producing property, to one of providing working capital to the business and an interest free loan to a related party. The part of the loan relating to the provision of extra working capital to the business was necessarily incurred in the business of hotel management and the interest on this part was held to be deductible.[160] The part of the interest which related to the interest free loan was held to be non deductible.

After discussing *Munro*, the Court in *Riverside Road*, in a joint judgment, said:

> So too, here, it is no argument for the deductibility of the interest that, unless paid, the income by way of profits on the running of the motel would cease. Rather, the case must be resolved by determining whether the essential character of the interest outgoings after the sale and leaseback was such that it can be said that those outgoings were incurred by the respondent in the course of the gaining or production of assessable income or, having regard to the business then carried on by it, they were necessarily incurred by the respondent in carrying on that business.[161]

Brennan J, in *Magna Alloys*,[162] referred to the "essential character" of the expenditure and to the fact that the objective purpose of the expenditure may stamp it as of a business or income-earning kind. Based on these principles, the Court concluded that there was no connection between the interest and operating a rented hotel.[163]

Although the Court did not see the need to distinguish between the limbs, the analysis adopted was in accordance with the principles of *Magna Alloys*. This indicates a change from the application to businesses of the first limb cases, that were decided on the use test, in order to determine the deductibility of interest.[164] In a case concerning a business, the refusal of the Court to be drawn into

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159 90 ATC 4567 at 4571.
160 Ibid at 4576/4577.
161 Ibid at 4576.
162 80 ATC 4542 at 4547.
163 90 ATC 4567 at 4576.
164 An argument based on *Total Holdings (Australia) Pty Ltd v FCT* 79 ATC 4279, that an interest free loan to a related party is not fatal to the deductibility of interest, was not canvassed.

arguments based on a subjective purpose of the taxpayer being tax minimisation[165] is in contrast to *Fletcher*.[166] It indicates a shift towards a distinction between the limbs with regard to the relevance of subjective purpose.

Fletcher was argued purely on first limb analysis.[167] What is interesting to note about this decision is the clear analysis of the relevance of the use test and motive or subjective purpose to the interpretation of the first limb. The Court implied that the use test is only relevant to interpret the first limb and said that:

> To the extent that the outgoings of interest incurred in the borrowing can properly be characterised as of a kind referred to in the **first limb** of s 51(1), they must draw their character from the use of the borrowed funds.[168] (Emphasis supplied)

The Court referred to *Munro* and *Ure* to support this statement, thus emphasising the first limb status of those decisions. Specific reference to the first limb is also made in other parts of the judgment.[169]

The Court stated that subjective purpose may be relevant under the first limb when considering voluntary outgoings, such as a prepayment, or where a lesser or nil receipt of income was associated with the outgoing.[170] Where an outgoing results in the receipt of a larger amount of assessable income, then "ordinarily" a reference to the taxpayer's subjective purpose is not required, as the nexus with derivation of assessable income is obvious.[171] The Court determined that

> the disproportion between the detriment of the outgoing and the benefit of the income may give rise to a need to resolve the problem of characterisation of the outgoing for the purposes of the sub-section by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing...[and if it appears that] the whole outgoing is properly to be characterised as genuinely

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165 90 ATC 4567 at 4577.
166 91 ATC 4950.
167 Ibid at 4957.
168 Ibid at 4958.
169 Ibid at 4957 and 4958.
170 Ibid.
171 Hill J applied these principles in *Crawford v FCT* 93 ATC 5234 to allow a deduction for interest where no income had been derived, as the taxpayer subjectively envisaged that income would ultimately be derived.

> and not colourably incurred in gaining or producing assessable income, the entire outgoing will fall within the first limb of s. 51(1).[172]

The arrangement in *Fletcher* involved partners entering into a complex, 15 year annuity scheme. The Court found that, if the partners did not intend to remain in the scheme for the full 15 years, then the excess of outgoings over assessable income in the early years could only be explained by the substantial personal income tax advantages to be derived in those early years. They held that this would be fatal to the obtaining of a tax deduction for the interest.[173]

A further point to note about the decision is the tax avoidance nature of the arrangement being considered. Again it appears that the Court was reluctant to pursue the disallowance of the deduction under the anti-avoidance provisions, despite the fact the new Part IVA was then in force.[174]

Cases such as *Ilbery* and *Gwynvill Properties* raised the issue of the relevance of subjective purpose. However, comments in cases such as *Riverside Road*[175] and *Fletcher* have toned down the relevance of subjective purpose to cases decided under the first limb. More specifically, *Fletcher* indicates that the two limbs may be distinguished with regard to the relevance of the use test and subjective purpose. Nonetheless, the Commissioner has continued to base his arguments around the use test and tracing for business taxpayers, even though the courts have been reluctant to consider subjective purpose in the case of businesses.[176]

Kidston Goldmines Ltd v FCT[177] involved a business and was decided under the second limb. Hill J recognised the inadequacy of

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172 91 ATC 4950 at 4958.

173 The matter was remitted to the AAT for determinations of fact.

174 Refer comment in *Crawford*, above n 171 at 5241, that Pt IVA would probably have applied in *Fletcher*.

175 90 ATC 4567 and see *John v FCT* 89 ATC 4101 at 4105. Also see comments by Myer, "Deductibility of Interest: In Search of Symmetry" (1990) 25 *Taxation in Australia* 196 at 203.

176 *Metropolitan Oil Distributors (Sydney) Pty Ltd v FCT* 90 ATC 4624 concerned a business, although decided under both limbs. The Commissioner argued the interest outgoing was made to obtain a tax deduction. Davies J noted that s 51(1) "is not primarily directed to purpose or motive" and allowed the interest as a deduction, as it was incurred in carrying on the business for the purpose of producing assessable income, despite tax planning motives being evident (see 4634).

177 91 ATC 4538.

using tests developed under the first limb for businesses. The Commissioner argued that, as the monies borrowed could be traced directly to the purchase of an income tax exempt mine, the interest was not deductible on an apportionment basis against income earned on the short term money market. Against this argument Hill J said:

> In determining deductibility under s 51(1), reliance on the tests both of purpose of the borrowing and of application of the funds present difficulty. If the true test were confined to purpose of the borrowing, a taxpayer who borrowed funds for an income producing purpose would continue to receive a deduction, notwithstanding that the income producing activity had ceased.... A test of application of funds borrowed also presents difficulties. Where funds are borrowed with the intention that they be used to purchase, for example, a property for letting, and the proceeds of the borrowing are paid into a bank account from which funds are drawn both for the purchase and to satisfy non-income producing outlays, a tracing of funds approach would require an apportionment of interest, yet it would generally be accepted that the taxpayer would be entitled to a deduction for the whole of the interest, at least provided that the equivalent to the amount borrowed found its way into the purchase of the income producing asset.[178]

His Honour then restated his view that such tests are but "tools to assist in the resolution of what is essentially a question of fact"[179] and should not be seen to replace the words of the legislation.[180] He pointed out that, as the case related to a business taxpayer, the second limb was applicable and the question then became whether the:

> interest expense is "necessarily incurred", in the sense of "clearly appropriate" to or "adapted for" that activity...then provided there is a relevant connection between the outgoing and the business, the outgoing will be apportionable.[181]

Hill J concluded that, as the interest "constitute[d] working expenses of the business of the taxpayer",[182] the interest could be apportioned between the exempt and the income earning uses of the working funds. He thereby rejected the notion of tracing in relation to the funds of a business.

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178 Ibid at 4545.
179 Ibid.
180 Ibid.
181 Ibid at 4546.
182 Ibid.

Nevertheless, he did conclude that in the "normal" or the "usual"[183] case the purpose of the borrowing and the application of funds will demonstrate the relevant connection with the income producing activities. His Honour did not specify the particular circumstances of the normal or usual case, although he did cite *Munro* in saying that the purpose of a borrowing usually will be determined from the use to which the funds are put.[184] In the case of a business, he cited the comments of Dixon J in *Texas Company (Australasia) Ltd v FCT*,[185] followed in *Total Holdings*, that:[186]

> Some kinds of recurrent expenditure made to secure capital or working capital are clearly deductible. Under the Australian system interest on money borrowed for the purpose [of securing capital or working capital] forms a deduction.[187]

This indicates a tendency to consider non business taxpayers in terms of the use test and business taxpayers separately in terms of the principles in *Magna Alloys*. This separate treatment of non business taxpayers and business taxpayers was further developed in *Fletcher*, as we have seen, but not in the most recent decision of *Roberts & Smith*.[188]

Roberts & Smith concerned the interest outgoing of a partnership carrying on a business which borrowed funds to repay capital contributions to existing partners to reduce the amount of entry capital for new partners. The Commissioner again argued a rigid tracing of the use of the borrowed funds and, as the funds were paid to the partners and used for private purposes, he argued that the interest was not deductible. The case was decided by the Full Federal Court. Hill J gave the principal judgment. He began by referring to *Riverside Road* and summarised the applicable principles, concluding that the analysis involves:

> identifying the essential character of the expenditure to determine whether it is in truth an outgoing incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business having the purpose of gaining or producing assessable income.[189]

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183 Ibid at 4545.
184 Ibid.
185 (1940) 63 CLR 382.
186 79 ATC 4279.
187 (1940) 63 CLR 382 at 468.
188 92 ATC 4380.
189 Ibid at 4386.

His Honour made the point that ordinarily interest incurred in relation to a borrowing relating to a business will be deductible, quoting from *Texas Company*.[190] Interestingly, His Honour immediately thereafter referred to *Munro*, notwithstanding that this case, as we have seen, related to a non business taxpayer. He stated that *Munro* determined "the circumstances when interest may be deductible"[191] and later that the case "looked to the purpose of the borrowing as providing the criterion of deductibility".[192] His Honour concluded that one must look to the use to which the borrowed funds have been put to determine the necessary connection between the outgoing and the assessable income. He said that this connection is generally determined objectively. However, reference was made to *Fletcher* to say that subjective purpose is relevant where no assessable income can be identified at the time the outgoing is incurred, or where assessable income is less than the outgoing.[193] His Honour noted that whilst these tests are useful:

> the issue continues to be whether the interest outgoing was incurred **in** the income producing activity or, in a case falling to be tested under the second limb, **in** the business activity which is directed towards the gaining or producing of assessable income...The characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds are put. However, a rigid tracing of funds will not always be necessary or appropriate.[194]

Hill J therefore indicated that the tracing of the use of the borrowed money or reference to subjective purpose is not always an appropriate test to adopt in the case of the deductibility of interest and provides some examples in the partnership context. In addition, he recognises the separate limbs of s 51(1) and that interest will generally be deductible to a business. However, with respect, His Honour failed to recognise that the use test was developed in the context of non business taxpayers and that the application of the test may not always be appropriate in the context of business taxpayers. Furthermore, he does not acknowledge that the relevance of subjective purpose is largely confined to first limb cases. The exception to this is in the limited circumstances discussed in *Magna Alloys* for second limb taxpayers.

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190 (1940) 63 CLR 382 at 468.
191 92 ATC 4380 at 4386.
192 Ibid at 4387.
193 Ibid at 4388.
194 Ibid, citing *Total Holdings* 79 ATC 4279 and Parsons, above n 71.

The result in *Roberts & Smith* establishes that where a partnership borrows to replace funds withdrawn by partners in circumstances where the partners are entitled to those funds, the interest on the borrowing is an allowable deduction, even though a rigid tracing of the use of the borrowed funds was for the personal purposes of the partners.[195] Hill J used principles established in first and second limb cases to allow the deduction. This conclusion may be drawn from his comments that interest on a borrowing to pay funds to which a partner is not entitled is not deductible, as the borrowing:

> lacks the essential connection with the income producing activities of the ... partnership business. Likewise, the interest incurred on the borrowing will not be incidental and relevant to the partnership business.[196]

There are issues to be resolved with regard to the meaning of "entitlement" from an accounting viewpoint. Entitlements would include the original partnership capital contribution plus further capital contributions, loans and profit distributions. By confining the deductibility of interest on a borrowing to repayments of "entitlements", Hill J may be considered to be relying upon the *Magna Alloys* principle, that is, a borrowing to pay money to partners to which they are not entitled pursuant to the partnership agreement is prima facie not directed to the ends of the business.[197] Accordingly, the borrowing should be considered in the context of the overall purpose of the business. As Mason CJ asked during the special leave application to the High Court in *Roberts & Smith*:[198]

> why does it matter that the actual moneys paid out in satisfaction of the dividend declared came from borrowed moneys when the decision is made that the company, as a going concern, is going to be conducted to a greater extent on debt than capital?[199]

The Commissioner had compared interest on the borrowing by the partnership with the borrowing by a company to pay a dividend which at the time was viewed by the Commissioner as not deductible. The High Court judges disagreed that the borrowing by

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195 Ibid at 4388.
196 Ibid at 4390.
197 Such a payment may in effect be regarded as a loan to the partner at nil interest.
198 Special leave to appeal to the High Court was denied.
199 Transcript of Proceedings on 13 November 1992 at 7.

a company to pay a dividend was not directed to the ends of the business, using *Magna Alloys* principles.[200]

6 The Commissioner's Response

The Commissioner's response to the refusal by the High Court to allow special leave to appeal in *Roberts & Smith*[201] was to issue Draft Taxation Ruling TR 93/D38 concerning the deductibility of interest. Almost two years passed before the final Taxation Ruling TR 95/25 was issued on 29 June 1995, entitled "Deductions for Interest Under Subsection 51(1) of the Income Tax Assessment Act 1936 Following *FCT v Roberts; FCT v Smith*". There are some notable differences between the final Taxation Ruling and the draft. In certain respects the final Taxation Ruling supports the position taken in this article. In particular, the final Taxation Ruling distinguishes between business and non business taxpayers and separately discusses the two positive limbs of s 51(1).

The Taxation Ruling begins by setting out the general principles relevant to determining the deductibility of interest. These principles may be summarised as follows:

1. The essential character of the expenditure must have a nexus with assessable income.[202] Generally the essential character of the expenditure is determined from the objective circumstances but, for taxpayers subject to the first limb, subjective purpose or motive may sometimes be relevant.[203] Where the taxpayer carries on a business the second limb requires that there be a relevant connection between the expenditure and the business. To assist in this inquiry the Taxation Ruling refers to *Magna Alloys* and *The Midland Railway of Western Australia*, amongst other decisions.[204]

2. Like the Draft Taxation Ruling, the final Taxation Ruling specifically endorses a tracing of the borrowed money to an income producing use, at the same time acknowledging that

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200 Exposure Draft Taxation Ruling EDR 73 which disallowed a deduction for interest on a borrowing to fund a dividend was withdrawn. Taxation Ruling TR 95/25 para 15 allows a deduction in these circumstances.

201 Above n 199.

202 TR 95/25 para 3.

203 Ibid at para 23.

204 Ibid at para 24-25.

> rigid tracing of the borrowed funds to an income producing use "will not always be necessary or appropriate".[205]

Roberts & Smith is regarded as an example of the circumstances where tracing is not necessary. An important difference between the Draft Taxation Ruling and the final Taxation Ruling is the recognition that tracing is usually only appropriate for non business taxpayers.[206] However, the final Taxation Ruling continues to regard the use test as the starting point for determining the essential character of interest expenditure, whilst acknowledging the warnings by Hill J in *Roberts & Smith* and in *Kidston Goldmines*[207] against substituting the words of the legislation with tests.[208] Furthermore, the final Taxation Ruling specifically dismisses the maintenance of income producing assets test based on Hill J's comments in *Roberts & Smith* referred to above.[209]

The final Taxation Ruling has corrected some of the flaws contained in the Draft Taxation Ruling. The draft had read down *Roberts & Smith* by stating that it is merely as an exception to the general rule that tracing is applicable.[210] However, the final Taxation Ruling recognises Hill J's statement that a "rigid" tracing will not always be appropriate and his warning against replacing the words of the legislation with "tests".[211]

In addition, the Draft Taxation Ruling did not distinguish between taxpayers carrying on a business and non business taxpayers and defined "business" for the purposes of the draft to mean "the assessable income producing activities of the entity", whether or not those activities were carried on as a business.[212] This meant that all taxpayers, both business and non business, were considered together and, as a consequence, the Draft Taxation Ruling made no distinction between the two limbs of s 51(1). It is submitted that considering non business and business taxpayers together led the drafters of the ruling to consider, in the first example on partnerships, that a partnership which is not carrying on a business may borrow to repay "equity" to partners for their private use and obtain a tax deduction for the interest.[213] As a partnership does not

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205 Ibid at para 3(d).
206 Ibid at para 3(c).
207 91 ATC 4538.
208 TR 95/25 at para 27.
209 Ibid at paras 3(e) and 28-33.
210 Draft Taxation Ruling TR/D38 at para 3.
211 92 ATC 4380 at 4388.
212 Above n 210.
213 Ibid at paras 32-37.

exist at law, the tax partnership may not borrow and therefore the individuals are borrowing for private purposes. Consequently, the usual nexus requirements of the first limb would need to be satisfied for the interest to be deductible. This example has been corrected in the final Taxation Ruling.[214] This approach was confirmed in the recent decision *Case 12/95*.[215]

This definition of "business" in the Draft Taxation Ruling is not contained in the final Taxation Ruling and, as indicated above, the ruling acknowledges the distinction between the limbs. Furthermore, the Taxation Ruling recognises that the use test is most relevant to non business taxpayers, although not going so far as to state that the use test is only applicable to the first limb and non business taxpayers, as has been argued in this article.

However, the recognition of a distinction between business and non business taxpayers in the final Taxation Ruling does not extend to sole traders. Whereas a partnership carrying on a business may borrow to repay partners' investments and obtain a tax deduction for the interest, as occurred in *Roberts & Smith*, a sole trader who borrows to enable the business to repay capital invested by the individual will not obtain a tax deduction if the funds are used by the individual for private purposes. The reason given in both the draft and final Taxation Ruling for disallowing the deduction is that you cannot borrow from yourself.[216] However, the same argument could be raised in respect of a partner borrowing from a partnership, which is not a separate legal entity. A partner in a two person partnership who borrows from the partnership is effectively borrowing half of the funds from themself. On this analysis the Taxation Ruling could be interpreted to mean that, where the partnership is carrying on a business, the interest on the funds borrowed from themselves would be non deductible, despite the authority to the contrary in *Roberts & Smith*.

This article argues the words of s 51(1) indicate a distinction between non businesses and businesses and that the latter can rely on the second limb and *Magna Alloys* principles. For an example, assume a sole trader carrying on a business borrows money to allow funds invested to be withdrawn. Where the sole trader is entitled to those invested funds, then the borrowing is necessary, for the ends

214 TR 95/25 at paras 43-45.

215 95 ATC 175 at 182.

216 Para 19 TR 95/25 and para 11 TR 93/D38. This issue was not addressed by Hill J in *Roberts & Smith* 92 ATC 4380, since he was dealing with a partnership, which is a separate tax entity.

of the business, to convert working capital provided by investment into working capital provided by debt. Tracing in these circumstances is irrelevant and it is arguable that the interest on the borrowing would be deductible. Similarly, the function test would allow a deduction in these circumstances.[217]

In conclusion, it is submitted that flaws contained in the Draft Taxation Ruling in enforcing the use test in the majority of circumstances by reading down *Roberts & Smith*, and in ignoring the difference between the limbs of s 51(1), have been rectified in the final Taxation Ruling.[218] However, further consideration needs to be given to the position of sole traders.

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217 Above n 137 at 269/270.

218 There are other differences between the Draft Taxation Ruling and the final Taxation Ruling which were not relevant to this article, such as the exclusion of trusts and the difference in treatment of subvention payments in para 17.

7 Function test or distinction between the limbs

Some commentators[219] have endorsed Parsons' function test,[220] which, therefore, deserves further comment. Relying on the judgment of Northrop J in the lower court in *Roberts & Smith*,[221] Parsons frames an analysis of interest deductibility in terms of a function test. This test argues that the interest on a borrowing to sustain or to continue to sustain the acquisition or holding of income producing assets is deductible. Applied to the facts of *Roberts & Smith*, the borrowing to repay partnership capital has the function of sustaining the continued holding of partnership assets for carrying on the business of the partnership. This function gives the interest expense the character of a working expense. The concept of "sustain" does not require tracing in the literal sense of the use of the borrowed funds and it is argued that it is within the concept of s 51(1).[222] Parsons' principle does not distinguish between the two limbs. Furthermore, the principle would allow the deductibility of interest in circumstances such as *Munro*,[223] if it had been argued that the borrowing sustained the holding of the rent producing property.

Distinguishing between the limbs takes all the advantages of the function test, as it would apply to a business without reversing longstanding authority in relation to non business taxpayers, such as *Munro* and various Board decisions.[224] It has been argued in this article that *Munro* was decided on the basis that the interest expenditure lacked the necessary nexus with the income from the rent producing property, and that, secondly, the exclusive provision of the earlier legislation applied. The nexus argument is equally applicable to the current legislation and has consistently been interpreted to disallow a deduction in circumstances similar to *Munro*.[225] In the case of a non business taxpayer, there needs to be a nexus between the borrowing and the derivation of assessable income, and the retention of an income producing property does not

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219 Clohessy, "Interest Deductions" (1993) WA Convention Papers 39 at 41; Wallschutzky and Richardson, above n 3, although the authors did not specifically refer to the function test, their reference to sustaining or preserving (at 12) in relation to *Roberts & Smith*, suggests agreement with the function test; Thomson, "Interest Deductions - The Use Test - *Roberts'* Case" (1993) 5 *CCH Journal of Australian Taxation* 26.

220 Above n 71 and n 137.

221 91 ATC 5036.

222 TR 95/25 at 264.

223 (1926) 38 CLR 153.

224 *Case F34* 74 ATC 192; *Case L38* 11 TBRD 217 and above n 64.

225 Ibid.

always provide such a nexus.[226] Similarly, the first limb implies tracing from the outgoing to the derivation of assessable income such that the position of other income producing assets is irrelevant.

Furthermore, using an approach which distinguishes between the limbs provides clearer analysis of the relevance of subjective purpose. Following *Fletcher*,[227] subjective purpose is relevant to the first limb in certain circumstances and relevant only to the second limb, as determined by *Magna Alloys* ,[228] to define the business or to consider the business person's considerations in incurring the expenditure.

The role of subjective purpose in the application of the function test is less clear, Parsons noting that:

> Function is judged primarily, at least, by objective inference of purpose in the borrowing to be drawn in all the circumstances, including any traced use of the borrowed money.[229]

Parsons claims the word function "takes in all aspects of the circumstances in terms of purpose, subjective and objective, and in terms of tracing".[230] This implies that the relevance of subjective purpose is the same for both non business and business taxpayers despite the authority of *Magna Alloys* and *Fletcher*. Further, the test endorses tracing, even though it has been questioned in numerous cases[231] and, in particular for business taxpayers, in *Total Holdings*[232] and *Kidston Goldmines*.[233]

Accordingly, it is submitted that the principles for determining the deductibility of interest are as follows:

1 Non business taxpayers are subject to the first limb of s 51(1) and, based on *Munro* and *Begg*,[234] interest deductibility is determined by considering whether there is a sufficient connection or nexus between the interest and the derivation

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226 Note *Begg v DFCT* (1937) 4 ATD 257 as an exception.
227 91 ATC 4950.
228 80 ATC 4542.
229 Above n 137 at 263.
230 Ibid at 265.
231 *Total Holdings* 79 ATC 4279; *Carberry* 88 ATC 5005, *Kidston* 91 ATC 4538 and above n 65.
232 79 ATC 4279.
233 91 ATC 4538.
234 (1937) 4 ATD 257.

of assessable income. To determine whether a sufficient connection exists, the objective purpose of the expenditure is relevant. The tracing of the use of the funds is evidentiary of objective purpose, but should be used with care, the emphasis being on determining the nexus with assessable income. Subjective purpose is relevant as a further factor where a lesser or nil receipt of income is associated with the outgoing, as determined in *Fletcher*.

2 Whilst business taxpayers may also rely on the first limb, the principles established to interpret the second limb are more relevant to businesses. The approach in *Magna Alloys*[235] should be followed to determine whether the essential character of the expenditure is desirable or appropriate for the ends of the business. Subjective purpose is only relevant to determine the scope of the business or if the business person saw the expenditure as objectively necessary. In the case of interest, to determine whether interest is an outgoing directed towards the ends of the business, the general rule is that interest will be deductible as an outgoing of working capital or to sustain income producing assets in terms of Parsons' function test. Tracing of the use of the borrowed funds is not required. A business taxpayer includes a sole trader.

8 Conclusion

The issue of the deductibility of interest has been plagued by various tests developed by the courts and commentators starting with the use test, followed by the maintenance of income producing asset test and the function test. When considering the deductibility of interest, Hill J in *Kidston Goldmines*[236] and *Roberts & Smith* [237] raised the danger of substituting the words of the legislation with such tests. Furthermore, the question of the relevance of subjective purpose has also complicated the issue. Recognising a distinction between non business and business taxpayers, as indicated by the two positive limbs of s 51(1), would clarify the determination of whether interest is deductible. This would place more emphasis on the words of the legislation and less reliance on tests and would simplify the issue for taxpayers. This approach is supported by Taxation Ruling TR 95/25 and recent decisions such as *Riverside*

235 80 ATC 4542.
236 91 ATC 4538 at 4545-4546.
237 92 ATC 4380 at 4388.

Road,[238] *Kidston Goldmines* and *Fletcher*,[239] the latter two decisions both clearly distinguishing between the limbs in determining the issue of the deductibility of interest.

238 90 ATC 4567.
239 91 ATC 4950.