

1-1-1999

The Deductibility of Interest Expense in Anglo-American Countries : A Comparison and Review of Policy

Grant Richardson

Ken Devos

Follow this and additional works at: <http://epublications.bond.edu.au/rlj>

Recommended Citation

Richardson, Grant and Devos, Ken (1999) "The Deductibility of Interest Expense in Anglo-American Countries : A Comparison and Review of Policy," *Revenue Law Journal*: Vol. 9 : Iss. 1 , Article 3.
Available at: <http://epublications.bond.edu.au/rlj/vol9/iss1/3>

This Journal Article is brought to you by the Faculty of Law at [ePublications@bond](mailto:EPublications@bond). It has been accepted for inclusion in Revenue Law Journal by an authorized administrator of [ePublications@bond](mailto:EPublications@bond). For more information, please contact [Bond University's Repository Coordinator](#).

The Deductibility of Interest Expense in Anglo-American Countries : A Comparison and Review of Policy

Abstract

The deductibility of interest expense has been one of the most controversial issues in taxation law over the past decade, which raises the issue of modification. The purpose of this article is twofold. Firstly, to broadly analyse and compare the laws of a number of Anglo-American countries including Australia, Canada, New Zealand, the United Kingdom and the United States of America, which govern the deductibility of interest. Secondly, to review certain taxation policy arguments for either restricting or denying a deduction for interest in those Anglo-American countries. The study revealed that no coherent general principle of application in the area of the deductibility of interest was achievable in taxation law. Furthermore, a review of taxation policy in this area also revealed that interest incurred on borrowings of a private purpose represented the only restriction that should be placed on interest deductibility. Therefore, a general statutory approach may be the best solution to achieving this result.

Keywords

taxation law, taxation policy, income tax, policy

THE DEDUCTIBILITY OF INTEREST EXPENSE IN ANGLO-AMERICAN COUNTRIES: A COMPARISON AND REVIEW OF POLICY

Grant Richardson and Ken Devos
Department of Business Law and Taxation
Monash University

The deductibility of interest expense has been one of the most controversial issues in taxation law over the past decade, which raises the issue of modification. The purpose of this article is twofold. Firstly, to broadly analyse and compare the laws of a number of Anglo-American countries including Australia, Canada, New Zealand, the United Kingdom and the United States of America, which govern the deductibility of interest. Secondly, to review certain taxation policy arguments for either restricting or denying a deduction for interest in those Anglo-American countries. The study revealed that no coherent general principle of application in the area of the deductibility of interest was achievable in taxation law. Furthermore, a review of taxation policy in this area also revealed that interest incurred on borrowings of a private purpose represented the only restriction that should be placed on interest deductibility. Therefore, a general statutory approach may be the best solution to achieving this result.

1 INTRODUCTION

Arguably, one of the most controversial issues in taxation law over the past decade has been the deductibility of interest on borrowed funds. It appears that the courts and policy makers in Anglo-American countries for example, have struggled to define consistent principles on this issue due to the inherent nature of borrowed funds.

The purpose of this article is twofold: firstly, to broadly analyse and compare the laws governing the deductibility of interest in a number of Anglo-American countries including Australia, Canada, New Zealand, the United Kingdom and the United States of America; secondly, to review certain taxation policy arguments for either restricting or denying a deduction for an interest expense in Anglo-American countries.

(1999) 9 Revenue LJ

Section two of the article provides a critique of Anglo-American laws governing the deductibility of interest. Section three details a comparison of those laws. Section four presents an analysis of the various taxation policy arguments concerning the deductibility of interest. Finally, Section five provides some overall conclusions.

2 SUMMARY OF ANGLO-AMERICAN LAWS GOVERNING THE DEDUCTIBILITY OF INTEREST EXPENSE

Australia

In Australia, there is no specific provision of the Income Tax Assessment Act 1997 that provides for the deductibility of an interest expense. Rather, interest is claimed under the general deduction section of the Act, being s 8-1. This section consists of two positive limbs and four negative limbs.¹

Along with this general statutory provision, there has been a significant body of case law, which has also been utilised in determining the deductibility of interest expense. From these decisions, certain unlegislated tests of deductibility have developed and can be summarised into four fundamental tests:

- the “use” test or “tracing through purposes” test;
- the “subjective purpose” or “motive” test;
- the “substitution of funds” test; and
- the “timing” test.

These tests can be viewed as a series of unlegislated tests in descending order of importance. In most cases the “use” test or “tracing through purposes” test remains the primary criterion for determining the deductibility of an interest

¹ Furthermore, s 8-1(1) of this provision states the positive limbs which allow taxpayers to deduct from their assessable income any loss or outgoing to the extent that:

- it is incurred in gaining or producing your assessable income; or
- it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

Section 8-1(2) states that you cannot deduct a loss or outgoing under this section to the extent that:

- it is a loss or outgoing of capital, or of a capital nature; or
- it is a loss or outgoing of a private or domestic nature; or
- it is incurred in relation to gaining or producing your exempt income; or
- a provision of this Act prevents you from deducting it.

expense in Australia. That is, if the borrowed money is used to purchase an income-producing asset, then interest is deductible. On the other hand, if the borrowed money is used otherwise (for example, is used to purchase a principal place of residence), the interest expense is not deductible while the property is used for that other purpose.

The “use” test originally emerged in Australia from the Full High Court decision in *Munro v FCT*.² Knox CJ and the other members of the Court decided that the borrowed money was not wholly and exclusively laid out by the taxpayer to gain or produce his assessable income.³ The case suggested a rule of “tracing through purposes” to determine whether the interest expense was deductible.⁴

Since *Munro*, there has been a succession of other cases in Australia concerning the deductibility of interest which have not strictly employed the “use” test in order to determine whether or not interest was deductible. One of the first cases to depart from the general rule was *Begg v FCT*.⁵ The taxpayer was allowed a deduction for interest where a “real and substantial relationship” could be established between the interest expense incurred by the taxpayer and the production of assessable income.

Begg was also referred to with approval in the more recent case of *Yeung v FCT*.⁶ In this later case, Davies J may have derived a principle of general application to business enterprises, which reorganise their financial structure, replacing equity capital with debt capital, and consequently making a claim for the interest. Therefore, business taxpayers claiming a deduction for interest under the second positive limb of s 8-1 would be successful where the borrowing was undertaken to sustain or preserve the assets of the business which were solely directed to earning assessable income.

Further restrictions were placed on the “use” test in *Kidstone Goldmines Ltd v FCT*.⁷ Hill J indicated that where borrowed money was employed in a business to secure capital or working capital, which was devoted to the gaining or production of assessable income (or some part thereof), the interest expense (or at least some part thereof) incurred in relation to those borrowings would be deductible. The judge went on to argue that application of these tests is not

² (1926) 38 CLR 153. This case was decided under ss 23(1)(a) and 25(e) of the Income Tax Assessment Act 1922.

³ Ibid per Isaacs J at 197-198; Higgins J at 204; Rich J at 210; and Starke J at 217-218.

⁴ It should be remembered that the decision in *Munro* was consistent with determining “purpose” in an objective sense by reference to the use to which the borrowed monies were put.

⁵ (1937) 4 ATD 257. This case was decided under ss 23(1)(a) and 25(e) and (h) of the Income Tax Assessment Act 1922.

⁶ 88 ATC 4193.

⁷ 91 ATC 4538.

(1999) 9 Revenue LJ

irrelevant. Instead, they are tools to assist in the resolution of what is essentially a question of fact. Hill J warned that the appropriate test of deductibility is the statutory test appearing in the language of the sub-section, not necessarily unlegislated tests of deductibility developed by the courts.⁸

The “subjective purpose” test or “motive” test applies to transactions where the objective facts of a case do not provide a reasonable explanation for why interest is incurred: *Ure v FCT*.⁹ This may arise if the relevant assessable income is less than the interest expense incurred or there is no relevant assessable income at all: *Fletcher v FCT*.¹⁰ In such cases, all the circumstances should be weighed up, including the direct and indirect objectives and advantages, to determine whether borrowed funds are used in the production of assessable income.

If, after weighing all the circumstances, it can be concluded that the borrowed funds are genuinely, and not colourably, used in an assessable income producing activity, a deduction will be allowed for the interest on those funds. However, if it is concluded that the borrowed funds are used in an independent pursuit of some other objective, then the interest expense must be apportioned between the pursuit of assessable income and the other objective.¹¹

For business taxpayers only, the second positive limb of s 8-1 provides that interest will be deductible where it is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. If the rigid tracing of funds does not explain and provide for an interest deduction, it is possible to employ the “substitution of funds” test: *FCT v Roberts & Smith*.¹² That is, in a business, where equity capital¹³ is repaid, and loan capital replaces it, interest payable on the loan capital will be ordinarily deductible. The only proviso is that the assets of the business are wholly devoted to gaining or producing assessable income, otherwise apportionment will be necessary.

The timing of the deduction for an interest expense is also a relevant consideration in Australia with respect to both previous and later income years: the “timing” test. Interest paid in relation to the acquisition or creation of a capital asset, which is later used in income-producing activities, was held

⁸ For example, the “tracing through purposes” test.

⁹ 81 ATC 4100.

¹⁰ 91 ATC 4950 at 4958.

¹¹ Ibid.

¹² 92 ATC 4380.

¹³ In a partnership the equity capital that is repaid must represent capital in the traditional sense. If not, to the extent to which the capital repaid does not present this character, interest incurred on the borrowed funds used to replace it will not be deductible.

to be deductible in *Steele v DCT*.¹⁴ The taxpayer's "intention and purpose" was always entirely commercial, and to produce assessable income was the main objective, even if no income was produced. This decision followed the principle already laid down in *Travelodge Papua New Guinea v Chief Collector of Taxes*¹⁵ and distinguished the recent decision in *Wharf Properties Ltd v Commissioner of Inland Revenue (Hong Kong)*.¹⁶ Even where the initial purpose was not commercial, but became commercial at a later stage, the deduction could be apportioned accordingly.

The deductibility of interest expense in relation to later years of income was examined in *FCT v Brown*.¹⁷ The majority judgment in the Full Federal Court stated that:¹⁸

where interest is a recurrent payment to secure the use for a limited term of loan funds, it is proper to regard the interest as a revenue item and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.

This is consistent with cases that have decided that a taxpayer may be entitled to a deduction after a business has ceased, "provided the occasion of the business outgoing is to be found in the business operations directed towards the gaining or production of assessable income generally".¹⁹ The decision accorded with the principles already established in *AGC (Advances) Ltd*,²⁰ *Placer Pacific Management Pty Ltd*²¹ and *Riverside Road Pty Ltd (in liq)*.²²

Canada

In Canada, the laws relating to the deductibility of interest are set out in the Income Tax Act, RSC 1985 (5th Supp). Specifically, s 20(1)(c) of the Act allows a taxpayer to deduct interest in four circumstances:

- on borrowed money used for the purpose of earning income from a business or property;
- on an amount payable for property acquired for the purpose of gaining or producing income from the property or from business;
- on amounts paid to a taxpayer under an Appropriation Act for the purpose of advancing or sustaining scientific research and

¹⁴ 99 HCA 7.

¹⁵ 85 ATC 4432.

¹⁶ 97 ATC 4425.

¹⁷ 99 FCA 721.

¹⁸ *Steele v DCT*, above n 14 at paras 25-29.

¹⁹ *Placer Pacific Management Pty Ltd v FCT* 95 ATC 4459.

²⁰ 75 ATC 4057.

²¹ See above n 19.

²² 90 ATC 4567.

(1999) 9 Revenue LJ

- development of manufacturing industry, or for prospecting, drilling, and exploring for minerals; and
- on money to acquire an interest in certain annuities.

As in Australia, the fundamental test utilised by the courts in Canada for determining whether or not borrowed funds are used for the purpose of gaining or producing income from business or property, relies on “tracing” the borrowed funds. The taxpayer must demonstrate that the borrowed funds have been used for a qualifying purpose by physically tracing the use of the funds.

An exception to the “tracing” test was made in the Supreme Court of Canada in *Trans-Prairie Pipelines Ltd v MNR*.²³ The Court held that interest was deductible on borrowed funds used to replace capital previously contributed by shareholders (so that the total capital employed by the corporation was not diminished) even though application of the “tracing” test to such an arrangement would prove otherwise. Revenue Canada’s administrative practices sanctioned this exception.²⁴

Considerable attention has focused on the issue of the deductibility of interest in Canada following the Supreme Court decision in *The Queen v Bronfman Trust*.²⁵ The Court disallowed the deduction for interest because the direct use of the borrowed money was to effect a distribution rather than being retained by the trust to earn income. The Court’s reasoning was devastating for business taxpayers: the *Trans-Prairie Pipelines* exception to the general tracing rule for the deductibility of interest, and the administrative practices of Revenue Canada based upon that exception, could no longer be relied upon.

Revenue Canada’s reaction to the *Bronfman Trust* decision was prompt. To comply with the Supreme Court’s decision, it withdrew Interpretation Bulletin IT-80, dealing with the deductibility of interest on money borrowed to redeem shares or pay dividends. Additionally, the Canadian Department of Finance introduced a “notice of ways and means motion”.²⁶ This notice was intended to preserve Revenue Canada’s administrative practices as they existed before the *Bronfman Trust* decision, pending an extensive review of the deductibility of interest. The notice was continued on three occasions so that Revenue Canada’s administrative practices remained in force for

²³ 70 DTC 6351.

²⁴ For example, see (27 November 1972) *Interpretation Bulletin IT-80*, “Interest on Money Borrowed to Redeem Shares, or to Pay Dividends”.

²⁵ 87 DTC 5059.

²⁶ Arnold and Edgar, “The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis” (1992) *Canadian Tax Journal* at 271, citing *Notice of Ways and Means Motion to Amend the Income Tax Act* (2 June 1987, Canada, Department of Finance).

borrowings up to the end of 1991.²⁷ Instead of continuing the notice again, on 20 December 1991 the Minister of Finance introduced draft legislation.²⁸

The draft legislation considers four situations in which the deductibility of interest in relation to Revenue Canada's administrative practices had been called into question as a direct result of the Supreme Court decision in the *Bronfman Trust* case. They are:

- amendments to para 20(1)(c) with respect to certain interest-free loans to shareholders and employees;²⁹
- the addition of new para 20(1)(qq) dealing with interest on money borrowed which is used to acquire fixed-dividend shares;³⁰
- the addition of new s 20.1 dealing with interest on money borrowed by a corporation or partnership to make a distribution; and
- the addition of new sub-sections 20(3.1) and 20(3.2) that consider interest on borrowed money used by shareholders and partners to fund corporations and partnerships.

The draft legislation confirmed that the Canadian Government had rejected the "tracing" test as the only criterion for ascertaining the deductibility of interest. The legislation demonstrates that the general test of interest deductibility based on directly tracing borrowed funds has been retained, together with certain exceptions for those cases that were conceded as exceptions by Revenue Canada on an administrative basis before the Supreme Court handed down its decision in *Bronfman Trust*.

Some tax commentators³¹ have questioned the need for such legislation since, for the most part, it simply restored the status quo, prior to the Supreme Court decision in *Bronfman Trust*. Taxpayers, Revenue Canada and the Department of Finance were all reasonably content with the situation before this case. The general provision relating to the deductibility of interest and Revenue Canada's administrative practices worked. An advantage of the legislation is that it provides legislative authorisation for Revenue Canada's longstanding administrative practices and explains some facets of those practices. Whether

²⁷ Ibid, citing Canada, Department of Finance, *Notice of Ways and Means Motion to Amend the Income Tax Act* (29 September 1988); *Notice of Ways and Means Motion to Amend the Income Tax Act* (24 November 1989); *Notice of Ways and Means Motion to Amend the Income Tax Act* (20 December 1990).

²⁸ Arnold, "Is Interest a Capital Expense?" (1992) 40 *Canadian Tax Journal* at 539, citing Canada, Department of Finance (20 December 1991).

²⁹ For example, see *DWS Corporation v MNR and Business Art Incorporated v MNR* 86 DTC 1842.

³⁰ For example, see *Ludner v R* 98 DTC 6045.

³¹ For example, see Arnold, above n 28 at 303.

(1999) 9 Revenue LJ

the draft legislation, once it is enacted, is able to restore the status quo remains to be seen.³²

Recently, Canadian legislation permits the continued deduction of interest where the source of income is eroded or eliminated.³³ Where income-earning property or business is disposed of at a loss, or becomes worthless, interest will still be deductible as long as the proceeds (if any) from the disposal are used for income-producing purposes or to repay the original loan (*Tennant v MNR*).³⁴ The basis of the interest deduction is not the value of the replacement property, but rather the amount of the original loan. This principle distinguishes the previous decision in *Emerson v The Queen*.³⁵

New Zealand

In New Zealand ("NZ"), existing laws pertaining to the deductibility of interest are contained in ss DD1(b) of the Income Tax Act 1994. This provision sets down three discrete tests. In general terms, it provides that a deduction is not allowed for interest except in so far as the Commissioner is satisfied that the interest is payable:

- in deriving the taxpayer's gross income (s DD1(b)(i)); or
- in carrying on a business for the purpose of deriving gross income (s DD1(b)(ii)); or
- by one company included in a group of companies in respect of money borrowed to acquire shares in a group company (s DD1(b)(iii)).

The former s 106 (1)(h) of the Income Tax Act 1976 was amended in 1987³⁶ to align it with the former s 104, now s BD2(1)(b) of the 1994 Act,³⁷ the general deduction provision. This meant that any deemed interest under the

³² 1998 Canadian Master Tax Guide (Don Mills: CCH Canadian Ltd); the draft legislation has remained unchanged and, as yet, has not been enacted.

³³ Section 20 1(1) ITA 1985.

³⁴ 96 1 FCR 305.

³⁵ 86 DTC 6184.

³⁶ The Income Tax Amendment Act (No 2) 1987 enacted the previous form of s 106(1)(h) which had effect from the income year commencing 1 April 1987.

³⁷ This section provides that:

An amount is an allowable deduction of a taxpayer to the extent that it is expense or loss -

- (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
- (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
- (iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits), or M (Tax Payments).

accrual rules could satisfy the fundamental test of deductibility. In particular, this amendment encompassed deemed interest from financial arrangements where there was no underlying principal amount, such as interest rate swaps.

Previously, s 106(1)(h) provided that interest could be deducted only if it was “payable on capital employed in the production of the assessable income”. It seems that this language was carried over from earlier legislation on the deductibility of interest and therefore employed a “tracing” approach³⁸ in order to determine whether interest was deductible. Even though the language of s 106(1)(h) was amended in 1987, the alteration obviously was not intended to change the existing law, but rather to expand it to include interest payable from financial arrangements.³⁹

The Valabh Committee’s report⁴⁰ suggested that all interest expense should be deductible except where the borrowed funds are used to produce private or domestic benefits. The Committee noted that this recommendation would codify existing law, involve minimal revenue loss, and would avoid further litigation of well-settled case law.⁴¹ The Committee also considered that interest incurred by a non-resident branch of a business in NZ should only be deductible if the interest had a strong connection with the derivation of NZ source income. The NZ Government is still contemplating the Committee’s proposals on interest deductibility.⁴²

The timing of the deduction for interest expense in NZ is also a critical issue. Since *Pacific Rendezvous v C of IR*⁴³ found that there would be no apportionment of interest where the sum could not be divided between income and capital receipts, the Courts have applied a more liberal approach.

³⁸ For example, see *Pacific Rendezvous Ltd v C of IR* (1986) 8 NZTC 5146; *Eggers v C of IR* (1988) 10 NZTC 5153; and *C of IR v Brierley* (1990) 12 NZTC 7184.

³⁹ New Zealand Inland Revenue Department, “Interest Deductibility” (June 1992) *Tax Information Bulletin* vol 3 no 9 at 15 and Appendix B.

⁴⁰ The New Zealand Government, Valabh Committee: *Final Report of the Consultative Committee on the Taxation of Income From Capital* (October 1992 Government Printer).

⁴¹ *Ibid* ch 7 at 60-67.

⁴² Valabh Committee, above n 40, accompanying statement by the Minister of Finance (Ruth Richardson) and the Minister of Revenue (Wyatt Creech) at para 20. Moreover, there is a proposal to rewrite Parts C, D and E of the Income Tax Assessment Act 1994, with s DD 1(b) to be entirely removed from the Act. This would mean that the deductibility of interest would be subject to the rule that prohibits deductions of a capital nature. The discussion document expresses the view that “this would not have any practical impact in most cases”. If the capital employed in a business, eg, is not used in the production of income, then interest cannot be deductible. However, the change is significant, as it is not necessary for a taxpayer seeking to deduct an interest expense to satisfy the statutory requirements of ss BD 2 (1)(b) and DD (1)(b). The prohibition on deductions of a capital nature does not apply to interest deductions.

⁴³ 86 8 NZTC 5, 146.

(1999) 9 Revenue LJ

This has been assisted by the amendment to former s 106 (1)(h) of the Income Tax Assessment Act 1976, now s DD 1(b) of the 1994 Act. The section clarifies that assessable income to be produced by the borrowing can arise in a future year and does not have to be produced in the same year as the interest expense incurred.

The United Kingdom

In the United Kingdom ("UK"), the laws relating to interest deductibility are contained in the Income and Corporation Taxes Act 1988. This Act contains detailed legislation regarding interest relief for both individual and business taxpayers. Income tax relief for interest is available to individual taxpayers under s 353(1) when the interest is:

- annual interest chargeable to tax under Case III of Schedule D; or
- interest payable in the UK or Republic of Ireland on an advance from a bank, member of stock exchange, or discount house carrying on a bona fide business in the UK or Republic of Ireland.

As well as the general limitations for individual taxpayers, there are restrictions on the categories of interest which fall within this sub-section upon which interest relief is available. Those categories are:

- loans to purchase machinery or plant (s 359);
- loans to acquire interest in a close company (s 360);
- loans to acquire an interest in a co-operative (s 361);
- loans to invest in an employee-controlled company (s 361);
- loans to acquire an interest in a partnership (s 362);
- loans to pay inheritance tax (s 364); and
- loans to purchase a life annuity (s 365).

In order to obtain interest relief, taxpayers must firstly make a claim.⁴⁴ The interest expense is then deducted or set off against income for the year in which the interest is paid. For interest paid on overdraft or credit card arrangements, relief for the payment of interest is not available under s 353. Where interest paid by a taxpayer is at a rate that exceeds a reasonable commercial rate of interest, the excess is ineligible for relief.⁴⁵

Mortgage interest relief is also available under s 353 of the Act for individual taxpayers who take out loans to acquire land and buildings (including certain caravans and houseboats). This relief is subject to numerous conditions and restrictions, which are contained in ss 354 to 358. Usually, relief is applicable where land and buildings are let commercially or where land and buildings are

⁴⁴ Sections 353(1) and 366(1).

⁴⁵ Section 353(3)(a) and (b).

the only or main residence of the borrower. In relation to the second type of loan, viz, loans to acquire an individual's residence, relief is normally given through the mortgage interest relief at source ("MIRAS") system. To qualify for relief, the borrowed money must have been applied to:

- purchase land or buildings (including certain caravans and houseboats);
- improve or develop land or buildings (on borrowings taken out before 6 April 1988); or
- pay off another loan in respect of which interest was eligible for relief.⁴⁶

The UK legislation governing the deductibility of interest expense for individual taxpayers makes no direct reference on how interest is allocated or traced to the specific categories of deductibility. Thus, the legislation appears to be incomplete and open to abuse: individual taxpayers can arrange their financial affairs in ways to maximise interest deductions.

Income tax relief for interest is less restricted for business taxpayers. Ordinarily, for an expense to be deductible for business taxpayers, it must be wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation.⁴⁷ A qualification of this general rule is found in relation to an expense on capital account, which is either withdrawn or employed in a business.⁴⁸ Furthermore, yearly interest is allowed specifically as a deduction.⁴⁹

Thus, interest paid by business taxpayers is generally deductible as a business expense, whether it is incurred on long-term⁵⁰ or short-term basis. This means that relief is available for interest on bank overdrafts, on other temporary financial facilities, as well as on long-term loans which provide capital assets for the business. It is not necessary for a loan to fall within one of the categories in respect of which an individual taxpayer is permitted to deduct interest from total income, although interest which receives relief under these specific provisions cannot also be deducted in determining business profits. To do so would give double relief.⁵¹

The United States of America

In the United States of America ("USA"), the Tax Reform Act of 1986 placed major restrictions on the deductibility of interest payments for both corporate and non-corporate taxpayers. As a result, the USA Internal Revenue Code classifies interest into five categories for non-corporate taxpayers:

⁴⁶ Section 354(1).

⁴⁷ Section 74(a).

⁴⁸ Section 74(f). However, it should be noted that the qualification does not include a deduction for interest.

⁴⁹ Section 74(m).

⁵⁰ That is, yearly interest.

⁵¹ Section 368(4).

(1999) 9 Revenue LJ

- qualified residence interest;
- trade or business interest;
- investment interest;
- interest attributable to a passive activity; and
- personal interest (all other interest).⁵²

Depending upon the classification of debt interest, a taxpayer may be subject to various restrictions. If interest falls within the first category, it obtains the most favourable taxation treatment, and so on down the list. Thus, when interest falls within the fifth category, that is, personal interest, no deduction for interest is allowed. As such, the criteria used for classifying (or allocating) interest into the five different categories of deductibility are critical.

The Internal Revenue Service ("IRS") has issued temporary regulations, which impose rules for the allocation of debt. The allocation of debt, in turn, decides the tax treatment of the related interest expense. The general rule is that debt is allocated by tracing disbursements of the debt proceeds to specific expenses⁵³ and is not affected by property used to secure the debt.⁵⁴ Normally, the temporary regulations allocate debt and the interest related thereto between five classes of expense:

- trade or business expense;
- investment expense;⁵⁵
- passive activity expense;
- portfolio expense; and
- personal expense.

Once a debt is allocated to one of these expenses, it will continue to be allocated to that specific expense until the debt is repaid or is re-allocated.⁵⁶ An exception to the tracing rules applies to "qualified residence interest". If interest comprises qualified residence interest under s 163(h), it is deductible without regard to the tracing rules.⁵⁷

The major limitations imposed on the deductibility of interest by the Tax Reform Act of 1986 generally do not apply to corporate taxpayers.⁵⁸ Where

⁵² Section 163(h)(2). The Code also provides for a sixth category, viz, interest imposed for the late payment of particular estate taxes (s 163(h)(2)(E)). This category is not considered in this article.

⁵³ TR s 1 173-8T(a)(3).

⁵⁴ TR s 1 163-8T(c)(1).

⁵⁵ Investment expense and portfolio expense are both subject to "investment interest" limitations.

⁵⁶ TR s 1 163-8T(c)(2)(i).

⁵⁷ TR s 1 163-8T(m)(3).

⁵⁸ An exception to this conclusion relates to "closely held corporations", ie, a corporation in which five or fewer persons, directly or through attribution, own at least 50% of the shares (ss 465(a)(1)(B), 469(j)(1) and 542(a)(2)). In this case, the

corporate taxpayers incur interest in trade or business, that interest is deductible from the gross income derived. However, corporations are subject to specific legislation that either prohibits or limits the deductibility of interest in certain situations such as earnings stripping payments, debt financed portfolio shares and the purchase of certain other securities.

Since the 1986 legislation was enacted on interest deductibility, many tax commentators⁵⁹ have protested about the complexity of it and the tracing regulations, which apply to non-corporate taxpayers. Apart from the complexity of the legislation, numerous taxpayers would find the interest allocation requirements difficult to achieve in practice unless they established separate bank accounts for each debt and limited expense from those accounts to one category of expense.⁶⁰

The manufactured distinctions which the legislation makes among categories of interest and the temporary regulations mechanical tracing approach to allocate interest to those categories, invites manipulation and uneconomic behaviour.⁶¹ The fungible nature of money encourages taxpayers that carry on a business, to pay business expenses with borrowed funds and make personal expenses with business receipts. Taxpayers with sufficient liquidity might be encouraged to make business and investment expenses with borrowed funds and personal expenses with personal funds. Moreover, the rules encourage taxpayers to complicate even the most common transactions to maximise interest deductions. Even if one agrees with applying the mechanistic tracing rules, in practice those rules are arbitrary and incomplete. They do not apply, for example, to qualified residence interest as such interest is deductible without resort to rules. Moreover, the rules do not apply to corporate taxpayers.

Despite the detailed legislative approach the USA followed to prevent abuses caused by allowing general deduction for interest, in practice, it appears that the approach may not be workable. In fact, it has been said⁶² that there is some temptation to repeal the new provisions. Of course, whether such an approach is necessary is a matter of opinion. Two congressional tax-writing staffs⁶³ have

rules relating to passive activity interest and portfolio interest are applicable, but not the investment or personal interest rules (ss 469(e)(2), 163(d)(1), 163(h)(1)).

⁵⁹ For example, see Grace, "Proposals to Simplify Interest Deductions: An Admission Against Interest and Some Recommendations" (October 1990) *Taxes - The Tax Magazine* at 743-745; Block, "The Trouble With Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986" (Fall 1988) *University of Florida Law Review* at 692 and 739; and Weiner, "Allocation of Interest Expense" (1988) *Major Tax Planning* ch 8 at 8.66.

⁶⁰ Grace, above n 59 at 743.

⁶¹ *Ibid.*

⁶² Weiner, above n 59 at 805.

⁶³ That is, the Staff of the Joint Committee on Taxation and the Majority Tax Staff of the Committee on Ways and Means.

(1999) 9 Revenue LJ

formally recommended simplifying the interest deduction and allocation rules for non-business interest.⁶⁴

The Joint Committee on Taxation has suggested three alternative recommendations for simplifying the deduction for non-business interest expense:

- permit individuals to deduct a specified percentage of all non-business interest paid or incurred in a taxable year. The remaining percentage would not be deductible and would not be carried forward to another taxable year. For the purposes of this proposal, “non-business interest” includes personal interest, qualified residence interest and investment interest as defined under present law;
- as for the first alternative, except that instead of being limited to a percentage, non-business interest would be limited to net investment income for the year plus an additional dollar amount that the proposal does not satisfy. Disallowed non-business interest would not be carried forward to the next taxable year; or
- permit individuals to deduct non-business interest other than qualified residence interest up to the individual’s net investment income for the year. Under this option, non-business interest would encompass only personal interest and investment interest. Qualified residence interest would be dealt with separately and presumably would be permitted to the extent to which the current law provides. Disallowed non-business interest would be carried forward and subjected to the same rules and limitations in the next taxable year.

The Ways and Means Majority proposal dealt with the qualified residence interest rules and the interest allocation regulations. The committee proposed to:

- codify the various interpretations of the qualified residence interest rules issued by the IRS, while the rules for repayment of certain loans would be explained; and
- revise the regulations relating to the allocation rules.⁶⁵

To date, Congress has not implemented any of the above-mentioned recommendations. Despite this lack of action, it is clear that the immensely complex legislation and tracing rules have the unpleasant result of increasing compliance burdens (including costs) on non-corporate taxpayers as well as encouraging manipulation and uneconomic behaviour.

⁶⁴ Grace, above n 59 at 737.

⁶⁵ It was argued that the revised regulations would provide a simplified method under which taxpayers would allocate interest based on the predominant nature of expenses made from a bank account rather than on a precise day-to-day basis. Besides, appropriate anti-abuse rules would be developed to guard against particular transactions designed to artificially increase the amount of deductible interest.

3 COMPARISON OF LAWS GOVERNING THE DEDUCTIBILITY OF INTEREST IN ANGLO-AMERICAN COUNTRIES

A summary lending itself to a comparison of the laws concerning the deductibility of interest for Australia, Canada, New Zealand, the United Kingdom and the United States, is provided in Table 1.

Table 1

Comparison of Laws Concerning the Deductibility of Interest

Country	Provisions Dealing with the Deductibility of Interest		Tracing Test Directly Applied
	<i>General Provision</i>	<i>Specific Provisions</i>	
Australia	No	No	Yes
Canada	Yes	Yes	Yes
New Zealand	Yes	No	Yes
United Kingdom	Yes	Yes	No
United States	Yes	Pending	Yes

This comparison shows that of the countries considered in this article, Australia is the only country that does not have specific taxation legislation that directly considers the deductibility of interest expense. Rather, deductibility is resolved according to general principles under s 8-1 of the Income Tax Assessment Act 1997. This is at odds with nations such as New Zealand who have, at the very least, a general provision covering the deductibility of interest as an element of their taxation legislation. This contrasts with the United Kingdom and the United States of America, who have further restricted the deductibility of interest, and Canada who was forced to issue draft legislation on interest because of an unfavourable court decision.⁶⁶

Table 1 also shows that the “tracing test” of interest deductibility is directly applied in all of the Anglo-American countries reviewed in this article, except for the United Kingdom. The “tracing test” therefore represents a fundamental tool for resolving the issue of the deductibility of interest in occidental nations. However, it does seem that the deductibility of interest has been a contentious

⁶⁶ See *R v Bronfman Trust* 87 DTC 5059.

(1999) 9 Revenue LJ

issue in Anglo-American countries for some time, and may be in need of an overhaul.

The 48th Annual Congress of the International Fiscal Association (“IFA”)⁶⁷ recognised this need and made certain recommendations concerning the deductibility of interest. One of the most important recommendations made by the IFA, which has a major implications for the majority of Anglo-American countries reviewed in this article, was that if a country decided to limit interest deductibility, it could use either a tracing method or an allocation method to determine the amount of interest to be deductible against domestic and foreign-source income.

This recommendation is of concern for a number of reasons. Firstly, much disquiet has been raised by tax commentators in the USA with the application of such a tracing (or allocation) approach to the deductibility of interest. Secondly, there are both conceptual and practical difficulties associated with tracing borrowed money to particular assets or uses. Thirdly, many countries⁶⁸ have already unsuccessfully employed such a tracing approach as part of their taxation legislation so that any further attempts may be ineffective.

Conceptually, the tracing test assumes that certain assets and liabilities can be paired. Logically, however, assets and liabilities are viewed holistically. There is no economic or accounting significance for pairing certain assets and liabilities. This reasoning is supported when one considers the case of a large business with a range of assets and liabilities. On many occasions, borrowings are procured for general purposes rather than to fund specific assets or activities, while liabilities are constantly managed to minimise funding costs. On other occasions, large businesses may well raise specific finance to fund particular assets, although the ability of a business to raise debt is usually constrained by its ability to fulfil the financial criteria demanded by lenders of that debt. In turn, this depends upon the aggregate level of business debt and equity funding.

For any particular asset, as long as the general lending criteria are satisfied, debt and equity funding are substitutable. If some assets are debt funded, then other assets may be equity funded. Thus, while in some circumstances it may be possible to trace a specific loan to a particular asset, there is little economic or even accounting significance in such pairing. In the context of small businesses with few assets, the fungibility of debt and equity may not apply to the same degree. Nevertheless, like a large business, a small business can only borrow money to fund a particular asset if other assets are equity funded. It generally does not matter how individual assets are funded.

⁶⁷ IFA, *Deductibility of Interest and Other Financing Charges in Computing Income* (1994 Kluwer Law and Taxation Publishers).

⁶⁸ For example, see Table 1 above.

As tracing rules disregard the basic principle of the fungibility of money,⁶⁹ any attempt made by the legislature to deny deductions for interest can result in taxpayers engaging in manipulative behaviour to gain a deduction. For example, where a deduction for interest is denied in a particular situation, a taxpayer may liquidate business or investment assets, use the proceeds from the sales for the otherwise non-deductible interest expense, then instantly use borrowed funds to finance assets which qualify for a full interest deduction.

Only taxpayers that either fail to or cannot make these changes to their affairs because of lack of liquidity would be immediately affected by a tracing approach. Special anti-abuse rules, based on economic equivalence for example, might attack such manipulative behaviour. However, these rules would have to be able to distinguish between abusive and non-abusive tax behaviour, which may be difficult to achieve in practice. The administration of such rules may be quite demanding. Moreover, including special anti-abuse rules in the legislation to close the loophole may unnecessarily increase the complexity of the legislation.

Apart from tracing borrowed money and economic equivalence, other methods have been suggested to limit or restrict the deduction for interest, although these methods may also be flawed in some way. A pro rata allocation⁷⁰ of interest to all assets held by a taxpayer as a means of avoiding the manipulative behaviour of taxpayers fitting borrowings within deductible as opposed to non-deductible categories does offer some conceptual appeal. This method recognises that interest is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid.

However, this method has its share of problems. Firstly, there is no theoretically or practically satisfactory apportionment base. Apportionment based on fair market value requires burdensome and otherwise unnecessary annual valuations of assets. Secondly, the pro rata allocation of interest requires taxpayers to report either the basis or fair market value of all assets. Taxpayers may not identify all of their assets: especially those located offshore. Thirdly, unless some interest is allocated to non-capital expenses such as current business expenses, distortions may occur. Fourthly, a pro rata allocation method may distort certain economic decisions by ignoring the fact that such decisions are made by comparing the marginal cost of borrowing, the marginal return from an expense, and the opportunity costs of liquidating other assets in order to make the expense with unborrowed funds. Finally, such an approach could not cope with graduations between assets subject to full taxation of Haig-Simons income⁷¹ vis-a-vis those assets which produce income which is fully exempt.

⁶⁹ Block, above n 59 at 740.

⁷⁰ Ibid at 740-741.

⁷¹ For example, see Haig, *The Concept of Income - Economic and Legal Aspects*, reprinted in Musgrave and Shoup (eds) *Readings in the Economics of Taxation* (1959 George Allen and Unwin Ltd); and Simons, *Personal Income Taxation - the Definition of Income as a Problem of Fiscal Policy*, Third Impression (First

(1999) 9 Revenue LJ

Another suggested method⁷² is that interest be allocated to assets securing the debt. While this approach may mitigate some of the complexities of tracing where simplicity is desirable, it suffers from its own inherent problems. Firstly, the method categorically ignores the issue of the requirement of a “nexus” between interest expense and assessable income for interest to be considered deductible. The collateral allocation approach was unanimously rejected by the High Court of Australia in *Munro v FCT*.⁷³ Secondly, this approach would not operate in relation to unsecured debt. Other rules would have to be developed for such debt. Thirdly, several assets may secure a particular debt. The taxpayer would have the added complexity of allocating the debt amongst those assets. Fourthly, and perhaps more importantly, taxpayers may choose the particular collateral to secure loans such that manipulation of the rules is possible.

One other proposal, referred to in the tax literature as “matching”,⁷⁴ is certainly innovative. Relying on the accounting matching concept⁷⁵ for its operation, this matching approach declares interest payments to be deductible only upon the taxation of the income associated with those payments. Thus, interest paid to earn tax-exempt income would not be deductible, while the deduction for interest paid to earn tax-deferred income would be postponed until the income became assessable. Matching is a unique concept devised to deal with perceived imperfections in the gross income rules of an income tax system.

Defenders of matching believe that an interest payment is an inherently deductible expense in an ideal tax system. However, in an imperfect system in which certain classes of gross income are not taxed, they argue that a deduction for interest should be denied or deferred for interest matched with untaxed income. Consequently, matching may be difficult to support in practice. It is not useful either for the design of a pure Haig-Simons income tax system or for the design of tax-expense rules. Matching does suggest a method of resolving certain timing issues in relation to tax on realised income. However, it suffers from a fundamental operational weakness in that it accepts that specific interest payments can be linked with specific items of income without suggesting any advice on how to establish that linkage.⁷⁶

Published in 1938) (1955 The University of Chicago Press). The concept of Haig-Simons income is explained in more detail below.

⁷² For example, see Block, above n 59 at 733-734.

⁷³ (1926) 38 CLR 153.

⁷⁴ For example, see McIntyre, “Tracing Rules and the Deduction For Interest Payments: A Justification For Tracing and a Critique of Recent US Tracing Rules” (Fall 1992) *The Wayne Law Review* at 83.

⁷⁵ Defined in the *CCH Macquarie Dictionary of Business* (1993 CCH Australia Ltd) at 357 as:

the offsetting of expenses incurred in earning particular revenues against those revenues in the appropriate accounting periods, so that relevant income and expense is matched. The matching concept is an essential part of accrual accounting.

⁷⁶ McIntyre, above n 74 at 85.

Clearly, legislation in one form or another on the deductibility of interest represents an important element of any developed country's taxation laws. Therefore, one might ask the question, where do these assertions leave Australia on the issue of the deductibility of interest? Presently, there appear to be at least two alternatives open to the Federal Government in Australia for establishing legislation within the Income Tax Assessment Act 1997 on the deductibility of interest. Firstly, it could provide a general provision for the deductibility of interest within the Act. Such an approach is consistent with what has occurred in Canada⁷⁷ and NZ and appears to have worked well in practice. Secondly, the government could render detailed legislation, either restricting or denying the deductibility of interest in certain situations. In the USA, such an approach has been widely criticised on the grounds of legislative complexity and the inherent problems of compliance, manipulation and uneconomic behaviour. Implementation of either alternative would depend upon taxation policy arguments, which are now considered.

4 ANALYSIS OF THE TAXATION POLICY ARGUMENTS CONCERNING THE DEDUCTIBILITY OF INTEREST

At the forefront of any discussion regarding the taxation policy arguments⁷⁸ for either restricting or denying a deduction for interest where borrowed money is not utilised to derive assessable income, is whether such a notion is compatible with the conceptual basis of income tax. Many tax commentators⁷⁹ generally identify the Haig-Simons accretion model (ignoring compliance and administrative constraints), as the ideal tax base to which an equitable income tax system should aspire.

Simons defines income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question".⁸⁰ Simons' definition is, from time to time, quoted along with one promoted by Haig: "income is the money-value of the net accretion to economic power between two points of time".⁸¹

⁷⁷ This was the status quo in Canada before the Supreme Court of Canada handed down its decision in *R v Bronfman Trust* 87 DTC 5059.

⁷⁸ The ensuing review draws heavily on The New Zealand Government, Valabh Committee *Final Report of the Consultative Committee on the Taxation of Income From Capital* (October 1992 Government Printer) ch 7 at 60-67.

⁷⁹ For example, see McIntyre, "An Inquiry Into the Special Status of Interest Payments" (1981) *Duke Law Journal* at 768; Block, above n 59 at 693-694; and Galvin, "The Deduction of Nonbusiness Interest: An Exercise in Planned Confusion" (1988) *Tax Lawyer* at 803.

⁸⁰ Simons, above n 71 at 50.

⁸¹ Haig, above n 71 at 75.

(1999) 9 Revenue LJ

Interest receipts represent growth in the value of property rights and are thus included as part of the second component of the Simons definition. As for interest payments, it is important to note that even under the Haig-Simons income accretion model, taxes are intended to be based on net income as opposed to gross receipts. Thus, costs of earning income must be subtracted to arrive at a proper measure of income. Furthermore, it can be shown in a general mathematical proof that notwithstanding the purpose of a borrowing, interest expense should be deducted in calculating Haig-Simons income.⁸²

An argument that is typically raised for denying a deduction for interest is that non-deductibility compensates for the non-taxation of some forms of income. Where an activity or an asset produces non-taxed income or capital gains, taxpayers will be encouraged to engage or invest in that activity or asset. This action can reduce economic welfare by drawing investment into the tax-preferred area at the expense of investment in other activities, which may have a higher return to society. Thus, a basic objective of tax policy is to ensure that all forms of activity or investment are taxed in a similar way.

The most direct approach in following a neutrality objective is to remove the tax preferences open to taxpayers generally. If, for some reason, this objective is not obtainable, economic welfare may be enhanced by denying claims for interest incurred on borrowed money used to invest in a tax preference on the grounds that this action would reduce the extent of over investment in the preference. This approach is labelled a "second-best" policy since it is clearly inferior to the

⁸² For example, assume that a taxpayer's only wealth is the right to a payment of \$12,100 in two year's time and that the market rate of interest prevailing during this period is 10% per annum. Taking into account the time value of money, the payment is worth \$10,000 at the beginning of year 1 and \$11,000 at the end of that year. If the taxpayer chooses to save the \$10,000 at the beginning of year 1 and decides to consume \$1000, he would have to borrow that sum at the beginning of year 1 at the prevailing interest rate of 10%. Assuming that actual consumption during year one is \$1000, the taxpayer's Haig-Simons income in that year is \$1000 plus the change in the taxpayer's wealth.

Wealth at the beginning of year 1 was \$10,000. At the end of the year it is the value of the asset of \$11,000 less the value of the debt outstanding (ie, principal of \$1000 plus interest of \$100) giving wealth of \$9900. Hence, the change in wealth over the year is \$100. Haig-Simons income in year 1 is therefore consumption of \$1000 less the change in wealth of \$100, giving income of \$900.

Consider now how income for tax purposes needs to be defined to get the same result. The taxpayer's only source of income is the income accruing on his savings. In year 1, this is \$1000. To match the taxpayer's Haig-Simons income of \$900, a deduction has to be allowed for the taxpayer's interest expense of \$100, producing taxable income of \$900. Thus, the example symbolises the general conclusion that the deduction of interest expense is fully consistent with the Haig-Simons definition of income, irrespective of the purpose of the associated borrowing. Therefore, restrictions on the deductibility of interest must be supported on other grounds.

best policy of removing the tax preference. It is inferior because the approach targets only debt-funded investment in the tax preference, leaving equity investors unaffected. The second-best argument also has other drawbacks, which are now examined.

The second-best policy of denying deductions for interest can be examined from a number of different angles. For instance, whether it is internally consistent within a country's taxation legislation. If a tax preference is a deliberate act of government policy, any attempt to deny interest deductions to taxpayers that borrow money to invest in a preference can be seen as an act that is against the spirit of that policy. In Australia, an example is provided in relation to a number of incentives for capital expense incurred in producing an Australian film or by way of contribution by an investor to the cost of producing an Australian film.⁸³ For film expense incurred under contracts entered into on or after 25 May 1988, a 100% deduction is allowed in the year in which the expense is incurred. Partly as a result of this taxation policy initiative, the income tax base applying to Australian films is far removed from Haig-Simons income concepts.

If the second-best argument was applied to the incentives provided by the Australian Government for expense incurred on Australian films, deductibility of interest on money borrowed to finance the film investment would be restricted. Such logic would be inconsistent with the government's taxation policy, ostensibly underlying the Australian film regime, to encourage investment in this industry and, supposedly, not only by taxpayers who can fully finance the investment with their own equity.

Other examples of the Australian Government providing certain tax preferences to taxpayers, as a matter of policy, are in place in the Income Tax Assessment Act 1936 (Cth). Firstly, taxpayers in the mining industry obtain specific deductions in relation to certain expense of a capital nature incurred in mining activities.⁸⁴ Secondly, a number of concessions are granted to companies which incur expense on research and development activities.⁸⁵ Again, it would be inconsistent as a matter of government policy to attempt to deny deductions for interest incurred by mining companies who desire to invest in this tax preference.

The three examples just considered illustrate that if exploitation of a tax preference is unacceptable as a matter of government policy, it must be unacceptable taken alone, not simply because taxpayers care to borrow money to invest in the tax preference. In practice, tax systems generally depart from the Haig-Simons definition of income in at least two respects.⁸⁶ Firstly, they allow

⁸³ See Div 10BA, comprising ss 124ZAA-124ZAP of the Income Tax Assessment Act 1936 (Cth).

⁸⁴ See Div 10, comprising ss 122-122U of the Income Tax Assessment Act 1936 (Cth).

⁸⁵ In particular, see s 73B of the Income Tax Assessment Act 1936 (Cth).

⁸⁶ McIntyre, above n 74 at 74-75.

(1999) 9 Revenue LJ

for the postponement of gains derived from the appreciation of assets until the gains are realised. Secondly, they afford a special tax regime for foreign source income, either exempting that income, postponing tax on it until repatriation, or reducing the tax otherwise imposed on it through the allowance of a foreign tax credit.

Of course, there are many other instances where, by intention or otherwise, a country's income tax base may depart from the Haig-Simons income ideal. For example, where tax depreciation rates differ from true economic depreciation, a tax system will either over or under tax the income generated by the depreciable assets relative to a Haig-Simons income tax. Similarly, since changes in the market value of trading stock are not required to be included in assessable income each year, a tax system does not fully tax, in a Haig-Simons sense, the income produced from trading stock. Finally, the leakage from the tax base of capital gains realised from the sale of a taxpayer's principal place of residence, and the exemption of imputed income from home ownership represent further examples of departures from the Haig-Simons model.

The above examples show that where an income tax base fails to tax all gains on an accrual basis, provides a special tax regime for foreign source income, and/or fails to provide deductions for all losses on an accrual basis, that tax base departs from the Haig-Simons definition of income. Given the myriad of other departures, to attempt to compensate for these defects in a tax base by restricting the deductibility of interest in certain situations, particularly when that interest is incurred on borrowed money used to acquire assets which produce or are expected to produce assessable income and capital gains, would be arbitrary. For example, from 17 July 1985 to 1 July 1987, the Australian Government acknowledged the tax preferences available to taxpayers that received both income and capital returns from rental property investments, by placing limitations on deductions for interest on money borrowed to finance them.⁸⁷

In essence, the legislation limited the deduction for interest to the net rental income of a property, after taking into account all other expenses except building depreciation, and any taxable gains on the disposition of relevant rental property. To the extent that the interest exceeded the current deduction allowed, the interest was quarantined until the net rental income was sufficient to absorb it. The quarantined interest could have been carried forward indefinitely to offset future rental property income or taxable gains on the disposition of rental property.

⁸⁷ See ss 82KZC-82KZK of the Income Tax Assessment Act 1936 (Cth). It should be emphasised that the restrictions in place regarding the deductibility of interest under this legislation were confined to rental property investments. Apparently, the Australian Government saw no need to restrict the deduction of interest with respect to borrowings for other types of investments. Thus, it could be argued that legislative restrictions were, in fact, arbitrary and discriminated between different forms of income-producing investments.

Due to lack of investment in the rental property market, the legislation was amended to remove the limitation from 1 July 1987.⁸⁸ Thus, it could be argued that the Australian Government, on policy grounds, would not again wish to restrict the deductibility of interest on negatively-gearred investment property, notwithstanding the tax preference received. Moreover, with the introduction of the capital gains tax legislation in the Act from 19 September 1985, any net capital gain⁸⁹ obtained from an investment asset (apart from several exceptions) is subject to tax.

Another taxation policy argument regarding the allowance of a deduction for interest, where borrowed money is not employed in gaining or producing assessable income, is associated with interest incurred for private or domestic purposes. Personal assets typically differ from business assets in that the return they generate is partly pecuniary and partly non-pecuniary. This is evident when one considers the return for personal assets such as owner-occupied housing. Such assets generate the equivalent of partly pecuniary returns in the form of rent that would otherwise have to be paid and partly non-pecuniary returns in the form of personal enjoyment or satisfaction that the owner gains from the property. Since neither form of return is taxed in Australia, owner-occupied houses and other personal assets such as cars, and the like, accord important tax benefits on their owners.

Returns, which are non-pecuniary in form, cannot be reduced by other taxpayers' investment in housing. Rather, they are exclusively retained by the owner and are independent of the non-pecuniary returns savoured by other homeowners. Thus, the equilibrating effect of investment in other tax-preferred assets does not apply to this element of return. Refusing a deduction for interest for personal assets is consequently more likely to be effective in constraining investment than in the case of business and investment assets.

Nevertheless, it may not be fully effective for at least two reasons. Firstly, denying a deduction for interest would only slow the rate at which taxpayers invest in housing, although ultimately, they will reach their desired level of investment. Secondly, due to the fungible character of money, home owners who, in addition, own business enterprises will inevitably assign as much of the borrowings as possible to their business assets. Thus, as was discussed above, a tracing rule designed to deny deductions for interest may not be effective as against taxpayers who own business assets or, for that matter, investment assets.

⁸⁸ An alternative ground for the removal of this limitation is provided by Sandford, *Successful Tax Reform: Lessons From an Analysis of Tax Reform in Six Countries* (1993 Fiscal Publications) at 85-86. Sandford argues that the Federal Labor Government reversed its decision on negative gearing because of pressure applied by the NSW State Labor Government which was facing an imminent election. The legislation was believed to have reduced investment in rented property in Sydney, which led to higher rents.

⁸⁹ The cost base of the asset is indexed for inflation.

(1999) 9 Revenue LJ

Of greater consequence would be the impact on government fiscal revenue if deductions were allowed for interest expense incurred for private or domestic purposes. Research in the USA⁹⁰ found that, in 1984, itemised claims for home mortgage interest deductions totalled US\$102 billion and that this amount represented 65% of the total itemised claims for interest expense. While it should be acknowledged that some Anglo-American countries may not have the same fiscal weight as the USA, allowing a wholesale deduction for all interest expense incurred for private or domestic purposes would still be costly and could hardly be regarded as a government priority.

Despite the economic arguments, the cost on revenue for allowing interest to be deductible on private or domestic borrowings represents a major hurdle to overcome. Furthermore, given the culture of Australia's Income Tax Assessment Act, for example, where since its inception in 1915 a general deduction for expenditure incurred for private and domestic purposes has been categorically dismissed, any attempts made to allow a deduction for interest expense incurred for private domestic purposes become even more unlikely as a matter of tax policy. For these reasons, it appears that a deduction for interest incurred for private or domestic purposes should not be allowed.

Based on this review of the taxation policy arguments, it is clear that the only major restriction which should be placed on the deductibility of interest lies in the area of interest incurred for private or domestic purposes. With this thought in mind, it could be envisaged that a general section could be included in tax legislation which provides for the deductibility of interest in all circumstances where there is a nexus between the interest incurred and the gaining or producing of assessable income, except to the extent to which the interest is of private nature. That such a general provision has worked reasonably well in Canada and New Zealand adds some credibility to this argument.

5 CONCLUSION

The deductibility of interest has been a controversial issue in taxation law for some time. There is a need for modification. This conclusion was reached after examining the laws governing the deductibility of interest in Anglo-American countries.

The 48th annual congress of the IFA has acknowledged the need for change and has made certain recommendations. In particular, the IFA's recommendation dealing with the employment of a tracing or allocation method to determine interest deductible against domestic and foreign-source income is of concern, especially given the conceptual and practical difficulties associated with tracing borrowed money to particular assets or uses.

⁹⁰ Galvin, above n 79 at 824-825.

Other approaches to either limit or restrict the deduction for interest include:

- economic equivalence;
- a pro rata allocation of interest;
- allocation of interest to assets securing debt; and
- matching interest payments to interest receipts.

These further approaches have their own inherent problems and weaknesses. No coherent general principle of application in the area of the deductibility of interest seems attainable.

Of the Anglo-American countries examined in this study, Australia represents the only jurisdiction which does not have specific tax legislation which deals with the deductibility of interest. The other countries analysed have, at the very least, a general provision governing the deductibility of interest as a part of their taxation legislation, although the UK and USA have elected to further restrict the deductibility of interest and Canada has draft legislation pending.

From international experience, legislation in one form or another on the deductibility of interest represents an important element of any country's taxation laws. Perhaps Australia should consider this experience of other Anglo-American countries in drafting its own laws concerning interest deductibility.

Evaluating taxation policy arguments for either restricting or denying a deduction for interest expense involved consideration of:

- compatibility with the conceptual basis of income tax;
- second-best arguments such as policy consistency and arbitrariness; and
- interest incurred for private or domestic purposes.

The review made clear that the only major restriction that should be placed on the deductibility of interest relates to interest expense incurred on borrowings for private or domestic purposes. A general statutory approach may be the most acceptable tax policy solution in this area. Such an approach has worked well in some Anglo-American jurisdictions.