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Practice Update

I thank you for your support and would like to wish you and your family all the best for a safe and well rested holiday. I wish you a joyous festive season and a Happy New Year!

I have enjoyed the financial year to date and I am happy that the business is growing and I hope that it continues to do so. I appreciate all the referrals that I have received. I have been fortunate enough to continue to meet people who want better service from their accountant allowing me to gain new clients. I expect that business activity will quieten over the Christmas period while people spend time with their families. Hopefully the New Year brings an opportunity for people to assess their situation over the past twelve months and make some changes to better position themselves going forward. I'll certainly be looking for new businesses to assist.

Interest rates and commercial bills

I recently engaged in discussions with two of the major banks regarding a commercial bill facility and thought I'd share some interesting information.

The bank bill swap reference rate (BBSW) is an independent benchmark for market interest rates calculated by averaging rates provided by various banks. Banks charge a "margin" over this amount which then determines the bank bill rate charged to customers. To competitively price banks against each other, you need to confirm they use this method and ask each bank what their margin is. This allows you to look for lower margins at other banks (you also need to take into account the bank charges on each rollover). The other trick the banks tend to use is to make to making you pay interest in advance rather than in arrears!

A client was paying interest both quarterly and in advance. At the first meeting I had with the bank, I questioned the payment frequency and the bank agreed to change it from quarterly to monthly. Due to the size of the client's debt, this deferred two months interest payments of about $70,000 to subsequent months, which is a huge (and needed) boost to cashflow! The bank is the process of considering changing the facility from in advance to in arrears.

Article – Borrowing to pay an income tax debt

Please find attached an article from the National Tax & Accountants Association about claiming a tax deduction for interest on money borrowed to pay taxation liabilities in different situations.

Lodgement Dates

The end of the second quarter will easily be forgotten over the Christmas period so you should be aware of the following dates:

- 28 January 2011 Superannuation due for the December quarter
- 28 February 2011 BAS due for the December quarter

Did you know that if your Tax Agent lodges your quarterly business activity statements (BAS) electronically, you get a four week electronic lodgment and payment concession? Unfortunately this isn't available for the December BAS as the normal due date is extended by four weeks after the Christmas period.

Kind regards,
Nick

Borrowing to pay an income tax debt

Question

For taxpayers that borrow to pay their tax debts, the question that arises is whether the interest on those borrowings is tax deductible.

Note that all references are to the ITAA 1997, unless otherwise stated.

Answer

The short answer is sometimes yes, sometimes no, depending on the taxpayer in question.

A **company** taxpayer that is **in business** *is* able to claim a deduction in respect of interest expenses incurred in relation to a borrowing taken out to fund an income tax liability under S.8-1. In this regard, at paragraph 6 of IT 2582, the Commissioner states that:

> "…where a taxpayer **carries on a business** [and] ….. borrows money to pay income tax (whether to preserve the assets of the business, maximise the return on them, retain sufficient money to fund the business or otherwise) then it is considered that the interest incurred on those borrowings is a **normal incident** of conducting that business. That is, such an expense is an expense incurred in carrying on that business and hence qualifies for deduction …" **[Emphasis added]**

The ruling further states that no deduction is available in relation to interest on borrowings that are not connected with the carrying on of a business. Refer paragraph 7 of IT 2582.

Similarly, in ATO ID 2006/269, the Commissioner confirms that a **sole trader** is **also** entitled to a tax deduction under S.8-1 for interest incurred on moneys borrowed to pay income tax, as follows:

> "… while IT 2582 has a reference to companies carrying on a business, the same approach is applicable to an individual **carrying on a business** as a sole trader." **[Emphasis added]**

However, ATO ID 2002/607 provides that no deduction is allowable to an individual under S.8-1 for interest on funds borrowed to pay a tax debt related to the derivation of investment income because it was not incurred in deriving assessable income and it is private in nature. A deduction would also be denied for an **employee** claiming interest in these circumstances on the same basis.

ATO ID 2002/607 also considered whether a deduction would be available under S.25-5(1) in these circumstances. Section 25-5(1) provides taxpayers with a deduction for tax related expenses such as the cost of managing their tax affairs. However, S.25-5(2)(c) provides that no deduction is allowed for expenditure for borrowing money (including payments of interest) to pay an amount of income tax.

The interest would also not qualify for the write-off under the "blackhole" provisions contained in S.40-880 as this provision only applies to capital expenditure and the payment of interest is considered to be revenue in nature.

Reference should also be made to ATO IDs 2010/159 – 161 which deal with the deductibility of a 'credit card payment' which was charged by the ATO because the **employee taxpayer** in question paid their income tax liability using a credit card. Note that the Commissioner concludes that such a payment is not deductible under S.8-1, S.25-5 or S.25-25.

Unfortunately, a **partner** in a partnership is **not** entitled to claim a deduction under S.8-1 for interest incurred on borrowings to pay personal income tax. In this regard, paragraphs 2 and 3 of the TD 2000/24 state:

> "Any borrowing by the individual **partner** on account of income tax relates to that partner's personal income tax obligation and **lacks any direct connection** with the business or income activities of the partnership. See Case 14/98 98 ATC 201.
>
> Nor can it be said that the interest expense is incurred in deriving assessable income. A payment of income tax plays no part in the derivation of assessable income." **[Emphasis added]**.

One strategy that a partner can employ to overcome this problem involves the partnership paying the partners their full profit share thereby allowing each partner to pay their income tax debts without borrowing. The partners can then borrow and contribute this as capital to the partnership to fund its working capital requirements (i.e., the interest incurred in relation to this arrangement would be deductible to the partner under S.8-1).

Interest deductibility on loans to pay income tax

Taxpayer	Category / Scenario	Interest deduction?[1]
Individual	Investor / Retiree	N
	Employee	N
	Sole trader (i.e., carries on business)	Y
Company	Investor	N
	Business	Y
Partner	Tax law partnership	N
	General law partnership (i.e., carries on business)	N

1 *If the tax debt is attributable to both business and non-business income, apportionment may be necessary.*