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Tax Treatment of Household Debt

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AUSTRALIA

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Under Australian tax law, a general deduction provision allows interest costs to be deducted where they are incurred in gaining taxable income, provided that the expenditure is not of a capital, private, or domestic nature. The interest on loans used to finance income-earning investments, including rental properties and shares, will therefore be deductible. However, mortgage interest is not deductible where it relates to the purchase of a taxpayer's private residence. Programs are in place to provide assistance to first-time homebuyers. Deductions are not limited by the amount of income actually gained and can therefore offset other income. Deductions are not available if the interest costs relate to gaining exempt income.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The Income Tax Assessment Act 1997 (ITAA 1997) provides for "general" and "specific" deductions.[1] There are no specific deductions that apply solely to household interest expenses. Whether interest is deductible will therefore generally depend on the application of section 8-1 of the ITAA 1997 to the particular circumstances. This provision sets out two tests for allowing general deductions, referred to as the positive and negative limbs. The positive limbs state that taxpayers can deduct from their gross taxable income[2] any expense to the extent that

(a) it is incurred in gaining or producing taxable income, or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing taxable income.[3]

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[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) Div 8, *available at* http://www.comlaw.gov.au/Details/C2011C00374. *See also* AUSTRALIAN MASTER TAX GUIDE 846 (CCH Australia, 47th ed. 2010).

[2] Gross taxable income is called "assessable income" in Australia. An Australian resident's assessable income includes income derived from all sources, including employment, business, investment, and foreign source income. Once deductions are taken out the net taxable income is then called "taxable income" in Australian tax law. For clarity, however, references to taxable income in this report are to gross taxable income only. *See What is Income?*, AUSTRALIAN TAXATION OFFICE (ATO), http://www.ato.gov.au/content/48101.htm (last visited June 1, 2011). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 364, 856.

[3] ITAA 1997 s 8-1(1).

The first positive limb "has been interpreted as applying to non-business taxpayers, whereas the second limb is seen as providing a less restrictive deduction principle applicable to businesses."[4]

The negative limbs provide that a taxpayer cannot deduct an expense to the extent that

- it is of a capital nature,
- it is of a private or domestic nature,
- it is incurred in relation to gaining or producing various categories of exempt income, or
- there is a provision in the legislation that prevents it from being deductible.[5]

Whether interest is deductible is therefore determined by looking at the purpose of the loan and the use to which it is put, although these two things will often coincide.[6] The tests mean that interest on residential mortgage loans that is incurred by an individual in relation to his own private residence is not deductible.[7] However, a deduction may be claimed for interest incurred on a mortgage loan for a residential investment property from which the person derives rental income.[8] Interest expenditure relating to other personal debts that does not satisfy the requirements of section 8-1, whether because the borrowing is private or domestic in nature or does not have the required connection to the production of taxable income (e.g., employment or investment income),[9] such as home equity loans, auto loans,[10] credit card debt, and student loans,[11] will also not be deductible.

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[4] Dr. Justin Dabner, *Interest Deductibility - Australia and Canada Compared*, 2(3) J. AUS. TAX. 172 (1999), *available at* http://www.austlii.edu.au/au/journals/JlATax/1999/15.html. *See also* R.L. DEUTSCH ET AL., AUSTRALIAN TAX HANDBOOK 531(2009). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[5] ITAA 1997 s 8-1(2). *See also* DEUTSCH ET AL., *supra* note 4, at 531.

[6] DEUTSCH ET AL., *supra* note 4, at 564.

[7] *Id.* at 553 and 565.

[8] *See id.* at 53 and 560. *See also* Tom Toryanik, *Australia – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). The Australian Taxation Office (ATO) provides information about deducting mortgage interest in relation to investment properties at *Rental Properties – Claiming Interest Expenses*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00113233.htm (last modified Mar. 26, 2009); *and* ATO, RENTAL PROPERTIES 2010, *available at* http://www.ato.gov.au/content/downloads/IND00237831N17290610.pdf.

[9] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 956.

[10] Motor vehicle expenses, including interest on a car loan, are deductible if incurred in the course of deriving taxable income or in carrying on a business. *See* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 909-18.

[11] "Self-education expenses," including loan interest, are generally deductable under section 8-1 if there is a sufficient connection with the taxpayer's income-producing activities. *See* DEUTSCH ET AL., *supra* note 4, at 571, 548. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 927.

A particular item of expenditure "may have to be apportioned into its deductible and non-deductible components."[12] This may occur where, for example, "expenditure is incurred in deriving both assessable and exempt income, or where expenses are incurred partly for income-producing purposes and partly for private purposes."[13]

The ITAA 1997 does provide for a specific deduction for expenses incurred by a taxpayer in borrowing money to the extent that the borrowed money is used for the purpose of producing taxable income.[14] This provision applies only to the cost of borrowing and not to the interest on the loan.[15] The legislation also provides that expenses incurred in discharging a mortgage given as security for a loan that was used for the purpose of gaining taxable income are deductible.[16] This includes any penalty interest for early repayment of the loan.[17]

B. Incentives for the Lender

There do not appear to be any incentives provided to lenders under Australian tax law.

C. Related Tax Benefits or Subsidies

Australian state governments administer and fund a First Home Buyer Grant program in each state.[18] This program was introduced to offset the effect of Goods and Services Tax (GST) on home ownership. It provides a one-time grant of up to AU$7,000 (about US$7,485) to first-time homebuyers that satisfy the eligibility criteria.[19]

Individual states may also provide additional assistance to homebuyers. For example, in New South Wales a duty exemption of up to AU$17,990 (about US$19,240) is available under

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[12] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[13] *Id.* *See supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[14] ITAA 97 s 25-25. *See also* DEUTSCH ET AL., *supra* note 4, at 588. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963. *See also* Toryanik, *supra* note 8, ¶ 1.8.1.1. Examples of borrowing expenses are procuration fees, loan establishment fees, mortgage protection insurance, legal expenses, stamp duty, valuation and survey fees, commissions paid to brokers, and underwriters' fees.

[15] DEUTSCH ET AL., *supra* note 4, at 589.

[16] ITAA 1997 s 25-30. *See also* DEUTSCH ET AL., *supra* note 4, at 587. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963-64 (referring to Taxation Ruling TR 93/7).

[17] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 964.

[18] *First Home Owner Grant General Information*, FHOGONLINE, http://www.firsthome.gov.au/ (last visited May 24, 2011).

[19] *First Home Owner Grant Scheme*, NEW SOUTH WALES (NSW) OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/eligibility/ (last updated Dec. 3, 2010). *See also* NSW Office of State Revenue, Factsheet: First Home Owner Boost Scheme (Dec. 2010), http://www.osr.nsw.gov.au/lib/doc/factsheets/fs_fhob2.pdf.

the First Home Plus Scheme[20] and a $3,000 supplement is available for people that build or purchase new homes.[21]

In addition to the state programs, the federal government operates a First Home Saver Accounts program to assist people to save for their first home.[22] This program involves a low tax rate (15 percent) on the interest earned on money in the account as well as government contributions equal to 17 percent of personal contributions each year (up to a maximum of $935 for the 2010/11 financial year).[23] Withdrawals from these accounts are not subject to further tax if used for the purchase of a first home that will be used as a person's own residence.

Most domestic undergraduate students in Australia are required to pay only a contribution to the cost of their education, while the Australian federal government contributes the majority of the cost.[24] The federal government also operates student loan programs for domestic students to use in paying their student contributions or fees.[25] There is no interest rate charged on the loans. Instead, a person's debt is indexed annually to reflect changes to the Consumer Price Index.[26] The loans are repaid over time through the tax system, with the rate of repayment based on an individual's taxable income.[27] This means that repayments are deferred until a person is earning above a particular income threshold, at which point there will be compulsory minimum repayment percentages depending on the person's income level.[28] Voluntary repayments can

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[20] *First Home Plus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/fhplus/ (last updated July 9, 2010).

[21] *NSW Home Builders Bonus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/nbb/ (last updated May 12, 2011). *See also First Home Benefits*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/ (last updated May 16, 2011).

[22] *First Home Saver Accounts*, THE AUSTRALIAN TREASURY, http://homesaver.treasury.gov.au/content/default.asp (last visited May 24, 2011). *See also First Home Saver Account – Home*, ATO, http://www.ato.gov.au/individuals/pathway.aspx?sid=42&pc=001/002/066 (last visited May 24, 2011).

[23] *Guide to First Home Saver Accounts – Benefits*, ATO, http://www.ato.gov.au/individuals/distributor.aspx?menuid=0&doc=/content/00250962.htm&page=1#P26_2695 (last modified Apr. 28, 2011).

[24] *Going to Uni – Undergraduate*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/Undergraduate/Default.htm (last visited May 31, 2011).

[25] *HELP Information for Payers*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/12115.htm&pc=001/002/008/013/001&mnu=0&mfp=&st=&cy (last modified Aug. 2, 2010). *See also Going to Uni – Paying For Your Studies (HELP loans)*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/Quickfind/PayingForYourStudiesHELPLoans/Default.htm (last visited May 24, 2011).

[26] *Going to Uni – Interest and Indexation*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Interest-Indexation.htm (last visited May 24, 2011). *See also Higher Education Loan Program (HELP) Indexation Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/74307.htm&pc=001/002/008/014/002&mnu=&mfp=&st=&cy=1 (last modified May 18, 2011).

[27] *See HELP and HECS Repayment Thresholds and Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8356.htm (last modified Apr. 19, 2011).

[28] *Going to Uni – Compulsory and Voluntary Repayments*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS,

also be made and result in a 10 percent bonus being added to each repayment by the government.[29] Both compulsory and voluntary repayments are not tax deductible.[30]

II. Deductibility of Debt Incurred to Finance Investments

Income from investments, including dividends,[31] interest, royalties, and rent, is included in a person's taxable income.[32] Therefore, under section 8-1 of the ITAA 1997, expenses incurred in the course of gaining or producing this income can be deducted, to the extent that the expenditure is not of a capital, private, or domestic nature.[33] This means that, as noted above, an individual may claim a deduction for the interest incurred on a mortgage loan that relates to a rental property. Section 8-1 also means that interest incurred on money borrowed to purchase other income-producing investments, such as stocks and bonds, is ordinarily deductible.[34]

As section 8-1 is general in nature, there have been a number of determinations, rulings, and cases related to the deductibility of interest incurred in borrowing funds for different investment products and arrangements.[35] This has also resulted in a list of tests that the courts will use to assist in determining whether a particular interest expenditure is deductible or not.[36]

Some of the rulings led to amendments to the legislation in relation to "capital protected" products and borrowings.[37] Specific provisions apply to

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http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Compulsory-Voluntary.htm (last visited May 24, 2011).

[29] *Id.*

[30] *Id.*

[31] Dividends paid to shareholders are taxed under an imputation system. Individuals that receive franked dividends include the amount of the dividend and the franking credits in their taxable income, with the franking credits able to be claimed as a franking tax offset. *See Refunding Franking Credits – Individuals*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8651.htm&pc=001/002/002/013/005&mnu=44711&mfp=001/002&st=&cy= (last modified June 29, 2010).

[32] *See* Toryanik, *supra* note 8, ¶ 1.5.

[33] DEUTSCH ET AL., *supra* note 4, at 565. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 948.

[34] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960; *see also* 948 and 955. *See also* DEUTSCH ET AL., *supra* note 4, at 561; ATO, D8 – Dividend Deductions, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00222869.htm (last modified June 28, 2010).

[35] DEUTSCH ET AL., *supra* note 4, at 565, 568. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960-62.

[36] *See* Grant Richardson & Ken Devos, *The Deductibility of Interest in Anglo-American Countries: A Comparison and Review of Policy*, 2 REV. L. J. 33 (1999), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1999/2.pdf. *See also* Karen Burford, *Going out on a Second Limb – An Analysis of the Deductibility of Interest by Recognising the Distinction Between the Positive Limbs of s 51(1)*, 5(1) REV. L. J 100 (1995), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1995/5.html; Dabner, *supra* note 4.

[37] *About Capital Protected Products and Borrowings*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/44515.htm&pc=001/002/013/009/004&mnu=44692&mfp=001/002&st=&cy (last modified July 25, 2008). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960.

> investments in shares, units, stapled securities or beneficial interests in an entity holding such investments, where the investments (a) are listed on an approved stock exchange or in a widely held company or trust and (b) have a capital protection feature, that is a clause allowing the underlying investment to be sold for at least the invested amount.[38]

Interest costs incurred in borrowing funds used to purchase such investments may not be fully deductible: part of the interest costs are allocated to the capital cost of acquiring the option over the capital protected investment. This amount will be nondeductible "and will be taken into account in calculating a capital gain or loss on either the expiry of the option or disposal of the underlying investment in accordance with the capital gains tax rules."[39]

With regard to retirement savings and investments, the ITAA 1997 provides that the contributions of employers as well as personal contributions to pension funds are deductible, subject to limits.[40] Employers can also claim deductions for interest and borrowing costs connected with a contribution, but only if a deduction can be claimed for the contribution itself.[41] There is no similar specific provision for borrowing related to an individual's personal contributions.

A taxpayer can also deduct interest on money borrowed to pay a premium for a life insurance policy, but only if the risk component of the premium is the entire amount of the premium, and any amount that the insurer is liable to pay under the policy would be included in the taxpayer's taxable income.[42]

A. Annual Limits Relating to Investment Income

There does not appear to be an annual limit on deductions. To be deductible, "expenditure must be incurred, though not necessarily paid, in the year claimed."[43] The legislative provisions also mean that "the whole amount may be claimed in the year incurred even though the expenditure may help in the production of income in other years."[44] As long as expenditure is incurred in the course of gaining taxable income, "the Commissioner [of Taxation] cannot reduce the amount of the deduction simply because the expenditure is greater than the amount which would normally have been incurred by a prudent businessman."[45] However, where expenditure exceeds taxable income, or where it produces no income, this may mean that the reasons and motives of the taxpayer in incurring the expenditure will need to be

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[38] Tom Toryanik, *Australia – Corporate Taxation* ¶ 1.4.5., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). *See also* ITAA 1997 Div. 247.

[39] *Id.*

[40] ITAA 1997 ss 290-60, 290-150.

[41] *Id.* s 26-80.

[42] *Id.* s 26-85.

[43] Toryanik, *supra* note 38, ¶ 1.4.1. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[44] *Id.*

[45] *Id.* (referring to *Ronpibon Tin NL v. FCT; Tongkah Compound NL v. FCT* (1949) 4 AITR 236).

examined in order to determine whether it will be deductible. This exercise may lead to expenditure being apportioned "between that attributable to the pursuit of assessable income and that attributable to other aims."[46]

Negative gearing of investments is therefore possible in Australia[47] as long as borrowed funds are used for a genuine income-producing purpose, such as to obtain rent from an investment property, interest will be deductible even if it exceeds the actual income gained.[48] Any excess interest may therefore be used to offset other taxable income of the taxpayer.[49] However, if another purpose of the borrowing is established (such as a private purpose),[50] or where there is "no objective expectation that income will exceed interest over the life of the arrangement," interest will be not be deductible either as a whole or in part.[51]

B. Deductions for Exempt or Tax-Favored Income

The general rule contained in the second limbs of section 8-1 of the ITAA 1997, as set out above, means that "no deduction is available for interest on borrowings relating to the production of exempt income."[52] However, a deduction is allowed for interest incurred in relation to deriving foreign dividend income that is classified as non-taxable income under provisions relating to foreign non-portfolio dividends and dividends from previously attributed Controlled Foreign Corporation or Foreign Investment Fund income.[53]

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

A list of provisions that allow a tax offset (or rebate) for different income and personal situations is set out in section 13-1 of the ITAA 1997. This includes offsets arising from franked dividends[54] and foreign income tax offsets.[55] There do not appear to be specific rules denying or

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[46] *Id.* (referring to Taxation Ruling TR 95/33). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 857, 962. See *supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[47] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 955. *See also Rental Properties 2009-10 – Negative Gearing*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237831.htm&page=17&H17 (last modified June 29, 2010).

[48] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 947, 962.

[49] Toryanik, *supra* note 38, ¶ 1.4.5. *See generally* Jim O'Donnell, *Quarantining Interest Deductions for Negatively Geared Rental Property Investments*, EJ. TAX. RESEARCH (2005), *available at* http://www.austlii.edu.au/au/journals/eJTR/2005/4.html#Heading9.

[50] Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Ure v. FCT* (1981) 11 ATR 484).

[51] *Id.* (referring to *Spassked Pty Ltd v. FCT (No 5)* (2003) 52 ATR 337).

[52] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 954. *See also* DEUTSCH ET AL., *supra* note 4, at 566 (referring to Taxation Ruling TR 2005/11). *See also* ITAA 1997 s 6-15 (notes).

[53] Toryanik, *supra* note 38, ¶ 1.4.5.

[54] *See You and Your Shares 2009-10: How Dividends Are Taxed*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=5&H5 (last modified June 29, 2010).

[55] *See Guide to Foreign Income Tax Offset Rules 2009-10*, ATO, http://www.ato.gov.au/content/00238031.htm (last modified June 29, 2010).

limiting these offsets where deductions are available in relation to borrowing to finance the investment.[56]

D. Other Limits on the Deductibility of Interest for Private Investments

In addition to general anti-avoidance provisions in the legislation,[57] there are various provisions that may limit the deductibility of interest.[58] However, in relation to debt deductions incurred in deriving investment income, it appears that the rules (for example, thin capitalization rules) primarily relate to income obtained through business activities.[59]

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

The Australian legislation contains debt forgiveness rules that relate to "commercial debt."[60] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."[61] The rules are targeted at remedying the effective duplication of tax deductions that might otherwise arise. Such duplication could occur because, for example, a creditor may be entitled to a deduction when a debt is forgiven, while the debtor is not taxed on any gain arising from the debt being cancelled and could continue to claim deductions relating to undeducted expenditures.[62]

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[56] *See, e.g.*, *You and Your Shares 2009-10: Allowable Deductions from Dividend Income*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=12&H12 (last modified June 29, 2010).

[57] *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) Pt IVA. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 878. These provisions mean that the Commissioner of Taxation may reduce the amount of a deduction otherwise allowable under s 8-1 where a tax avoidance scheme is involved. The High Court has found that the anti-avoidance provisions applied to disallow the tax benefits obtained under a split-loan arrangement, i.e., where a mortgage had been split into both a home loan for a private residence and an investment loan to refinance a rental property. Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Federal Commissioner of Taxation v Hart and Anor* [2004] HCA 26).

[58] *See* DEUTSCH ET AL., *supra* note 4, at 778-79. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 959.

[59] *See, e.g.*, *D16 – Other Deductions*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00217609.htm (last modified June 29, 2010) (containing information on debt deductions relating to foreign income).

[60] ITAA 1997 Div 245. A debt is defined for these purposes as "an enforceable obligation imposed by law on a person to pay an amount to another person, and includes accrued interest." DEUTSCH ET AL., *supra* note 4, at 779.

[61] *CGT and Debt Forgiveness*, ATO, http://www.ato.gov.au/content/36559.htm (last modified May 18, 2011). *See also* DEUTSCH ET AL., *supra* note 4, at 779.

[62] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 980.

Under the debt forgiveness rules, the amount of debt that is forgiven is applied to reduce certain deductions of the debtor.[63] Specifically, a forgiven amount may reduce, in the following order: a taxpayer's prior income year revenue losses; net capital losses from earlier years; deductible expenditure; and cost base and reduced cost base of assets.[64]

The commercial debt forgiveness rules do not apply where the debtor is a shareholder of the company. The forgiveness of the debt in these situations results in an amount being deemed dividends and therefore included in the taxable income of the debtor.[65] The waiver of a debt will also result in an amount being considered taxable income where it constitutes a fringe benefit provided to an employee.[66] In most other cases, an act of debt cancellation will not result in the amount forgiven being treated as ordinary income of the debtor.[67]

The commercial debt forgiveness rules also do not apply if the debt is forgiven as a result of an action under bankruptcy law, in a deceased person's will, or for reasons of natural love and affection.[68]

Prepared by Kelly Buchanan
Foreign Law Specialist
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[63] DEUTSCH ET AL., *supra* note 4, at 779. *See also* ATO ID 2003/27, *Commercial Debt Forgiveness: Applying Total Net Forgiven Amount – Individual Debtor* (Feb. 14, 2003), *available at* http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID200327/00001.

[64] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

[65] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 126-27.

[66] *Id.* at 980.

[67] Such a result did occur in a case where a company's debt was forgiven and the resulting gain was deemed to be inextricably linked to the trading activities of the company, but this is not a common outcome. Roger Timms and Weiran Wang, *The Application of the Commercial Debt Forgiveness Provisions*, THE TAXPAYER (Jan. 18, 2010), *available at* http://www.taxpayersassociation.com.au/docman/small-business/debt-forgiveness-provisions/details.html (click on "Download" at bottom of page).

[68] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

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CANADA

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Canada does not allow deductions to be taken for interest paid on mortgages or other personal expenditures, with an exception for certain student loans. Canada does not offer tax incentives to lenders to make personal use loans. Canada does have a Home Buyers' Plan that allows taxpayers to borrow money from their Registered Retirement Savings Plan and Registered Educational Savings Plan accounts, which is designed to encourage persons to purchase homes and pursue educational opportunities. Contributions to Registered Retirement Savings Plans and Registered Educational Savings Plans are limited, but the use of these plans can result in substantial tax savings.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Deductions for interest paid for personal use purposes are not allowed in Canada,[1] with an exception for student loans, as discussed below.

1. Residential Mortgage Loans

Canada has never allowed interest paid on residential mortgage loans to be deducted in calculating taxable income. Former Prime Minister Joseph Clark planned to create a limited deduction in 1980, but his government was defeated before it could be implemented.[2]

2. Home Equity Loans

The Income Tax Act[3] (I.T.A.) does not contain any provisions for the deduction of interest paid on home equity loans.

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[1] *Line 221—Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last modified Jan. 5, 2011).

[2] Stephen Gordon, *Why Canadians Should Be Glad Joe Clark Lost the 1980 Election*, WORTHWHILE CANADIAN INITIATIVE (Feb. 25, 2009), http://worthwhile.typepad.com/worthwhile_canadian_initi/2009/02/why-canadians-should-be-grateful-that-joe-clark-lost-the-1980-election.html.

[3] Income Tax Act, R.S.C. ch. 1 (5th Supp. 1989), http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html.

3. Auto Loans

Interest on auto loans is not deductible in Canada.

4. Credit Card Debt

Interest paid to credit card companies for personal purchases are not deductible in Canada.

5. Student Loans

In Canada, undergraduate tuition fees for Canadian residents vary from province to province and, to a lesser extent, from university to university and program to program. The range is from an annual low of approximately US$3,000 in Quebec to slightly over US$6,000 in Ontario for most resident undergraduates in most programs.[4]

Interest paid on a student loan received under the major student loan programs established by the federal and provincial governments in Canada is deductible.[5] If a taxpayer does not have income to offset in the year he or she pays interest on a student loan, he or she may carry the unclaimed amount forward for five years.[6] Interest on foreign student loans is not deductible,[7] however, and parents cannot deduct the interest they pay on their children's student loans.[8]

B. Incentives for the Lender

The I.T.A. does not contain special tax provisions designed to encourage lenders to make loans available for home mortgages, home equity investments, or autos. Credit card companies are not taxed at a special lower rate.

Student loan programs are government funded. Interest earned on student loans by federal and provincial governments is not taxed by those governments.

C. Related Tax Benefits or Subsidies

The major incentive Canada has to encourage home ownership is its Home Buyers' Plan (HBP). Under this plan, individuals can withdraw up to Can$25,000 (approximately US$25,556) from their Registered Retirement Savings Plan (RRSP) to "buy or build a qualifying home for

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[4] *Canada's Higher Education and Career Guide*, CANADIAN-UNIVERSITIES.NET, http://www.canadian-universities.net/Campus/Tuition-Fees.html (last visited June 1, 2011).

[5] *Line 319 – Interest Paid on Your Student Loans*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns300-350/319-eng.html (last modified Jan. 5, 2011).

[6] I.T.A. § 118.62.

[7] *Id*.

[8] CANADA REVENUE AGENCY, *supra* note 5.

[themselves] or a related person with a disability."[9] "Qualifying expenditures" are expenditures on housing units located in Canada or shares in a Canadian cooperative housing corporation.[10] Withdrawals from an RRSP must be repaid over a period of fifteen years.[11] Payments are in equal installments beginning with the second year following the withdrawal.[12] Failure to make an annual repayment will result in the amount due having to be declared as income because contributions to RRSPs, like contributions to Individual Retirement Accounts in the United States, are generally tax deductible up to certain limits.

The rules respecting RRSPs have become quite complex in recent years. The amount that a taxpayer can deduct from otherwise taxable income on account of contributions to an RRSP is called the taxpayer's "contribution room."[13] The Canada Revenue Agency calculates each taxpayer's contribution room for him or her. For 2010, the maximum RRSP deduction limit was Can$22,000 (approximately US$22,000).[14] However, unused contributions may be taken for the years 1991-2010 to greatly increase a taxpayer's contribution room.

Canada also has Registered Education Savings Plans (RESPs).[15] Under these plans, contributors or "subscribers" cannot deduct their contributions to a plan in the same manner that a taxpayer can deduct contributions to an RRSP. Income from the plans is paid to beneficiaries who are enrolled in a postsecondary school. This income, which may be in the form of interest, is taxable income to the beneficiary, but not to the subscriber.[16] Since most students do not pay income tax at high rates, RESP payments are usually subject to little, if any, income tax. Consequently, an RESP allows a parent, grandparent, or other older person to avoid taxation on income earned on money set aside for a child's education.

In addition, Canada has Registered Disability Savings Plans, which are generally similar to RESPs, but are only available to persons who are eligible for Canada's Disability Tax Credit.[17] Income earned by these plans is taxable in the hands of a beneficiary not when it is earned, but when it is paid out.[18] Again, the incentive is a tax savings through deferral rather than a reduction in tax on account of contributions, as in the case of an RRSP.

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[9] *Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/menu-eng.html (last modified Dec. 10, 2010).

[10] I.T.A. § 146.01.

[11] *Id*.

[12] *Repayments Under the Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/rpymnts/menu-eng.html (last modified Dec. 10, 2010).

[13] *How Much Can I Contribute and Deduct?*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/cntrbtng/lmts-eng.html (last modified Dec. 22, 2010).

[14] *Id*.

[15] I.T.A. § 146.1.

[16] *How an RESP Works*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/resp-reee/hw-eng.html (last modified Oct. 15, 2010).

[17] *Registered Disability Savings Plan*, CANADA REVENUE AGENCY, http://cwww.cra-arc.gc.ca/tx/ndvdls/tpcs/rdsp-reei/menu-eng.html (last modified Oct. 29, Oct. 29, 2010).

[18] I.T.A. § 146.4.

II. Deductibility of Debt Incurred to Finance Investments

Interest and dividends earned on private passive investment income must be included in income and is taxed at marginal rates unless it is received from a taxable Canadian resident corporation. Interest and dividends received from a taxable Canadian resident corporation are given a tax imputation credit on account of the fact that they have been paid out of after-tax earnings. The formulas for calculating tax imputation are very complicated, but their net effect is to tax interest and income received from taxable Canadian resident corporations at a rate that is very close to what the individual would pay if the income was a capital gain.[19] In Canada, 50 percent of capital gains must be included in income, and the total of other income and half of capital gains are taxed at marginal rates.[20]

Interest paid on money borrowed to earn passive income is a deductible expense.[21] Interest paid for the purpose of earning income from rental properties is a business expense and is also deductible. Interest on purchases that provide no income but can only produce a capital gain is not deductible.[22]

A. Annual Limits Relating to Investment Income

There are no limits on the amount of interest that can be deducted for the purpose of borrowing money to make passive investments to earn income.

B. Deductions for Exempt or Tax-Favored Income

As mentioned above, the interest on money borrowed to make passive investments to earn tax-favored eligible income is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

D. Other Limits on the Deductibility of Interest for Private Investments

N/A

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[19] *Line 120 – Taxable Amount of Dividends (Eligible and Other Than Eligible) from Taxable Canadian Corporations*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/120/menu-eng.html (last visited June 1, 2011).

[20] *Capital Gains 2010*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html (last visited June 1, 2010).

[21] *Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last visited June 2, 2011).

[22] *Id*.

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

Canada's I.T.A. provides that cancelled debts must be included in income in two situations. The first of these applies to forgiven employee loans.[23] The second applies to shareholders.[24] The rationale for the first rule is to "prevent employees from avoiding taxes by simply arranging to receive part of their wages or salary as fringe benefits rather than [as] cash remuneration."[25] The rationale for the shareholder inclusion also appears to be to prevent loan forgiveness to be used to avoid income tax.[26]

Aside from the two cases noted above, Canada does not have a general rule that forgiven loans must be included in the income of an individual taxpayer.

Prepared by Stephen F. Clarke
Senior Foreign Law Specialist
June 2011

[23] I.T.A. §§ 6(1)(a), 6(15).

[24] *Id*. § 15(1.2).

[25] Canadian Tax Reporter (CCH) ¶ 2303.

[26] *Id*. ¶ 4664c.

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FRANCE

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

French tax law has a marked preference for the use of tax credits instead of deductions. The French General Tax Code provides for limited tax credits on interest for residential mortgages and student loans. The 2011 Finance Law, however, abolished the tax credit granted in respect of interest incurred for loans obtained for the purchase or construction of the taxpayer's main residence. The abolition of this tax credit is not retroactive. It has been replaced by enhanced zero-interest loans for first-time homebuyers. The tax credit is granted instead to banks that provide this type of loan. Tax credits are granted for energy-saving equipment and equipment for disabled elderly persons purchased for the principal residence of the taxpayer. France also has two types of home savings plans that have substantial tax advantages, and a tax credit for school expenses. As a general rule, interest paid on debt incurred to finance investments is not deductable. Instead, tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed.

The French General Tax Code enumerates eight categories of income that are taken into account to determine the taxable income of an individual: industrial and commercial; professional; agricultural; real estate; investment; wages, salaries, pensions, and annuities; remunerations paid to majority shareholders of certain business organizations; and capital gains.[1] Each category is subject to various rules for calculating adjusted gross income and the resulting sums are then added together. Adjusted income is reduced by a few specifically authorized deductions. French tax law has a marked preference for the use of tax credits instead of deductions.[2]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The French General Tax Code does not authorize an individual taxpayer to take a deduction for interest paid on the types of debts listed below. Instead, it provides for limited tax

[1] CODE GENERAL DES IMPÔTS [C.G.I.] art. 1A, *available at* LEGIFRANCE, http://legifrance.gouv.fr/ (*Les codes en vigueur*).

[2] FRENCH TAX & BUSINESS LAW GUIDE (Sweet and Maxwell) ¶ 32310.

credits on interest for residential mortgage loans and student loans. In addition, since enactment of the 2009 Finance Law there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the two following amounts: €18,000[3] plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[4] Some tax benefits are excluded from that ceiling. They include those connected to the personal situation of the taxpayer or contributions made by the taxpayer out of disinterested generosity such as charitable gifts.[5]

1. Residential Mortgage Loans

Taxpayers are entitled to a tax credit for the initial five-year period of the loan on loans concluded between May 6, 2007, and January 1, 2011, for the acquisition or construction of their principal residence. The credit is equal to 40 percent of the loan interest for the first twelve months then 20 percent for each of the remaining years. This credit, however, is limited to €3,750 per year for a single person and €7,500 for a couple. It is increased by €500 per year for each dependent. These limits are doubled where one member of the family (the taxpayer, one of the spouses, or one of the dependents) is disabled.[6]

The tax credit rate is reduced from 40 and 20 percent to 30 and 15 percent respectively for a principal residence built or acquired between January 1, 2010, and January 1, 2011, that does not meet the low energy consumption building standards.[7]

The tax credit is raised to 40 percent of the interest paid over the initial seven years for a principal residence purchased or built on or after January 1, 2009, where the residence meets the low energy consumption building standards. [8]

The loans must have been obtained from a financial establishment located in France or in one of the member states of the Economic European Area (EU members, Iceland, and Norway) that have entered into a fiscal convention with France containing an administrative assistance clause to fight fiscal fraud.[9]

The 2011 Finance Law abolished the tax credit for interest incurred on loan offers issued on or after January 1, 2011, for the purchase or building of the taxpayer's main residence and, where the loan offer was issued before that date, for houses purchased after September 30, 2011. The abolition of the tax credit is not retroactive. The tax credit is replaced by enhanced

[3] At the current exchange rate, €1 is equal to approximately US$1.44.

[4] C.G.I. art. 200-0 A.

[5] *Id*.

[6] *Intérêts des prêts contractés pour l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_051.html#dgibro.ir2011.ud51.171.7 (last visited May 27, 2011); C.G.I. art. 200 quaterdecies.

[7] *Id*.

[8] *Id*.

[9] *Id*.

zero-interest loans (*prêt à taux zéro plus*) issued under strict conditions.[10] (See also Part I(C), "Related Tax Benefits or Subsidies.")

2. Home Equity Loans

No deduction is allowed for interest paid on home equity loans.

3. Auto Loans

No deduction is allowed for interest paid on an auto loan. (See also Part I(C), "Related Tax Benefits or Subsidies.")

4. Credit Card Debt

No deduction is allowed for interest paid on credit card debt.

5. Student Loans

Students in France do not pay any tuition at the university level. University students may nonetheless benefit from an education tax credit for loans they obtained to finance other costs related to their studies if they obtained the loan between September 1, 2005, and December 31, 2008, and they were twenty-five years old or under on January 1 of the year in which the loan was issued. The tax credit is equal to 25 percent of the loan's interest for the initial five-year period of the loan. This credit, however, is limited to €1,000 per year. The student must be registered at a university and domiciled in France during the years he or she requests the tax credit.[11] (See also Part I(C), "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

As seen above, the tax credit that was granted to individuals on their mortgage interest has been replaced by a tax credit granted to banks that provide mortgages for qualifying low-income borrowers purchasing their first home with a zero interest loan.

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[10] Loi n° 2010-1657 du 29 décembre 2010 de finances pour 2011 [2011 Finance Law] art. 90, *available at* LEGIFRANCE, http://legifrance.gouv.fr/affichTexte.do;jsessionid=6ACD821A554DA9CC6E58ED4B902537B9.tpdjo04v_1?cidTexte=JORFTEXT000023314376&categorieLien=id#JORFARTI000023315060.

[11] *Intérêts des prêts contractés par les étudiants*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_053.html#dgibro.ir2011.ud53.177.21 (last visited May 27, 2011); C.G.I. art. 200 terdecies.

C. Related Tax Benefits or Subsidies

1. Principal Residence

Energy Saving Equipment

Investments by individuals in their personal residence for qualifying major household equipment, such as energy-saving and energy-producing heating systems and thermal insulation, that are made over a consecutive five-year period between January 1, 2005, and December 31, 2012, give rise to a tax credit equal to 15, 25, or 50 percent depending on the nature of the equipment.[12] These rates are reduced by 10 percent for the taxation of 2011 income by the 2011 Finance Law. The tax credit is 15 percent for low-temperature heating devices, 25 percent for equipment used to connect to certain renewable energy or cogeneration sources, and 50 percent for equipment that produces energy from renewable energy sources or from certain heat pumps. The total credit amount, however, is limited to €8,000 for a single person and €16,000 for a couple. It is increased by €400 for each dependent.[13]

Equipment for Disabled or Elderly Persons

The acquisition of equipment for disabled and/or elderly persons for the taxpayer's principal residence purchased between January 1, 2005, and December 31, 2011, also gives rise to a tax credit. For expenses incurred during the year 2010, the tax credit is equal to 15, 25, or 30 percent depending on the equipment. The overall limits of the tax credit are €5,000 for a single person and €10,000 for a couple. The limit is increased by €400 for each dependent.[14]

Enhanced Zero-Interest Loans

Enhanced zero-interest loans (*prêt à taux zéro plus*) are reserved for first-time homebuyers. The term "first-time homebuyers" is understood as covering buyers who did not own their main residence within the two years preceding the loan request or who are disabled or were victims of a catastrophe. The loan may either finance the purchase of a new or old dwelling or the construction of the taxpayer's residence.[15]

These loans are subject to means testing. The annual income ceilings depend on the make-up of the household and the geographic zone where the property is located. The amount of the loan granted depends on several criteria including, for example, the age of the property, the

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[12] *Dépenses en faveur de la qualité environnementale de l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_049.html#dgibro.ir2011.ud49.162.1 (last visited May 27, 2011); C.G.I. art. 200 quater & 18 bis de l'annexe IV.

[13] *Id*.

[14] *Dépenses d'équipement de l'habitation principale en faveur d'aide aux personnes*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2009/brochures_ir2009/ud_057.html (last visited May 27, 2011); C.G.I. art. 200 quater A.

[15] MINISTERE DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, LE PRET A TAUX ZERO (Jan. 2011), http://www.developpement-durable.gouv.fr/IMG/pdf/Plaquette_PTZ_.pdf.

income of the purchaser, and the make-up of the household. The repayment period depends on the income of the purchaser and can be from six years to twenty-two years. These loans are complementary funding and are granted as a supplement to the main mortgage loan. They are financed by credit establishments that have signed a convention with the state. The state grants the establishment a tax credit equivalent to the amount of the interest it would have earned.[16]

Home Savings Plans

The home savings plans (*plans compte d'epargne logement*) were established in 1965 to encourage private individuals to build up their savings for homeownership. There are two types of plans: the property savings account and the property savings plan.

- The property savings account is a deposit account with a deposit ceiling of €15,300. After eighteen months of saving, the holder of the account may obtain a loan of up to €23,000 with a below-market rate. The state also provides for a bonus of €1,144.[17]

- The property savings plan allows the holder to save up to €61,200 during four years at which time he may be granted a loan at a below-market rate for a maximum amount of €92,000.[18] The state also pays a bonus of €1,525.

In both cases, the below-market rate depends upon the rate of interest accrued during the period of saving. There is no tax payable on the interest that accrues while one is saving. This interest is also capitalized at the end of each year. If the amounts saved are then used for the intended purpose, they can be withdrawn free of income tax.[19]

2. Auto Loans

Taxpayers who acquire environmentally friendly cars are rewarded with a tax bonus of up to €5,000 (the amount depends on the CO_2 emission level) by way of a price discount.[20]

3. School Expenses

A tax credit for school expenses is granted to taxpayers residing in France whose dependent children are continuing their secondary or higher education. The amount of the tax

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[16] *Id*.

[17] *Compte épargne logement*, MINISTERE DU DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/Phase-epargne.html.

[18] *Plan épargne logement*, MINISTERE DU LOGEMENT DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/spip.php?page=article&id_article=17909.

[19] MINISTÈRE DU LOGEMENT DE L'ECOLOGIE, DU DÉVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, *supra* notes 16 & 17.

[20] Marc Henderson, *France–Individual Taxation* ¶ 1.8.3.2, *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX ANALYSIS, http://online.ibfd.org/kbase/ (by subscription) (last visited Apr. 15, 2011).

credit is €153 for a student attending a high school and €183 for a child attending an establishment of higher learning.[21]

II. Deductibility of Debt Incurred to Finance Investments

Investment income (*revenus de valeurs mobilières*) is subdivided into two categories: dividends and interest. As a general rule, 40 percent of dividends received by an individual from a company subject to corporate income tax or equivalent tax whose registered office is located in France or in an other EU member state, or in a country that entered into a double taxation treaty with France containing an administrative assistance clause, is exempt from tax. An additional €1,525 for a single taxpayer or €3,050 for a married couple is also exempt from tax. The remaining dividends are subject to income tax at the ordinary tax rate. Expenses are not deductable. The taxpayer, however, may elect a 19 percent withholding tax.[22]

Interest on current accounts, loans, government and corporate bonds, and similar debt instruments are taxable at the ordinary tax rate. The taxpayer may also elect a 19 percent withholding tax. No further tax is due on dividends or interest where a withholding tax is paid. Interest on certain types of saving schemes—for example, home savings plans—are exempt from tax.[23]

France does not appear to favor the deduction of interest as an incentive for investment by individuals. It prefers instead to grant tax credits. Only the following instances of deductibility of interest for individual taxpayers could be found; some are borderline between investments and other categories of income:

- Part of the interest paid on a small business loan taken by an individual to purchase capital in a non-quoted company that gives the individual a majority of voting rights with the goal of allowing him/her to exercise the function of director. The General Tax Code allows the deduction of 25 percent of the interest up to €20,000 for a single person and €40,000 for married couples.[24]

- Interest on debts contracted for the conservation, acquisition, construction, reparation, or improvement of real property.[25] This deduction relates to the real estate income category.

- Interest on loans granted to French citizens for their reinstallation in France when returning from a stay abroad.[26]

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[21] C.G.I. art. 199 quarter F.

[22] *Id.* ¶ 1.5.1.

[23] *Id.* ¶ 1.5.2.

[24] *Intérêt d'emprunt pour reprise d'une société*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/ brochures_ir2011/ud_071.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-0B.

[25] C.G.I. art. 31 I(d).

[26] *Id*. art. 156 II 1º.

- Interest paid in connection with loans taken for business purposes, which is deductable when accrued.[27] This deduction is found in the General Tax Code under industrial and commercial income.

A. Annual Limits Relating to Investment Income

There is no specific annual limit relating to investment income. As mentioned in Part I, there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the following two amounts: €18,000 plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[28]

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

Tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed. Examples are provided below.

Small Business Investment Funds

Individuals are encouraged to invest in small business investment funds (*fonds d'investissement de proximité*) through a tax credit. These funds invest in small- or medium-sized enterprises within the geographic area specified by the mutual fund. The tax credit is equal to 25 percent of the amount invested in such funds, up to a limit of €12,000 for a single person and €24,000 for a married couple.[29]

Investments in Innovation Mutual Funds

The General Tax Code provides for a 25 percent tax credit to taxpayers who invest in specialized innovation mutual funds between calendar years 1997 to 2012. As above, the

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[27] *Id*. art. 39 I 1º.

[28] *Id*. art. 200-0 A.

[29] *Souscription au capital des FIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_068.html (last visited May 27, 2011); C.G.I. art. 199 tercedies OA, VI.

ceilings are €12,000 for a single person and €24,000 for a married couple. The taxpayer must hold his investment for at least five years to avoid recapture.[30]

Purchasing Shares in Certain Qualifying Small- and Medium-Sized Companies

Purchasing shares in certain newly created or already existing small- or medium-sized companies before December 31, 2012, entitles the taxpayer to a tax credit equal to 25 percent of the amount of his investment within an annual limit of €20,000 for a single person and €40,000 for a married couple. The taxpayer must hold his investment for at least five years or the credit will be recaptured.[31]

Similar tax credits are given for investments in overseas territories,[32] investments in residential premises intended for letting,[33] the purchase of shares in qualifying cinema and television production companies (SOFICAs),[34] the purchase of shares in finance companies for traditional fishing (SOFIPECHEs),[35] and investment in forests.[36]

IV. Treatment of Cancelled Debt

French tax law only contains debt forgiveness rules that relate to the industrial and commercial income category of the taxpayer. Under these rules, the taxpayer must include the amount of the debt forgiven in its profits.[37]

Prepared by Nicole Atwill
Senior Foreign Law Specialist
June 2011

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[30] *Souscription au capital des FCIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_067.html (last visited May 27, 2011); C.G.I. art. 199 terdecies 0 A-VI bis, VI quater, VI quinquies.

[31] *Souscription au capital des PME*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_065.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-OA-I to V.

[32] Henderson, *supra* note 20, ¶ 1.8.3.5.

[33] *Id*. ¶ 1.8.3.6.

[34] *Id*. ¶ 1.8.3.17.

[35] *Id*. ¶ 1.8.3.18.

[36] *Investissements forestiers*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_063.html (last visited May 27, 2011); C.G.I. art. 99 decies H.

[37] II LAMY FISCAL, IMPOTS SUR LE REVENU § 610 (Lamy 2011).

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GERMANY

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Currently, Germany does not treat any interest from a personal, non-business-related loan as tax-deductible. Germany does not grant income tax deductions for interest on residential mortgages, student loans, or consumer loans. Germany, however, provides other tax benefits and subsidies for homeownership and education.

For owner-occupied housing, portions of the acquisition or improvement costs can be deducted under an incentive program for retirement savings, and states and municipalities provide various subsidies for low-income housing.

For education expenses, some tax deductions are granted. For students from low-income families, generous cash grants and loans with little or no interest are available. Moreover, most universities charge little or no tuition.

Since January 1, 2009, passive investment income is taxed with a final withholding tax and no interest or other expenses can be deducted from this withheld tax.

Interest or other expenses cannot be deducted if they are attributable to the generation of tax-exempt income.

German law does not treat the forgiveness of a personal debt that is not related to the taxpayer's business as earned income.

Explanatory Remarks – Definition of Income

The German Income Tax Code defines the income of individual taxpayers by enumerating seven categories of income. Receipts obtained by individuals are taxed only if they fall within one of the following income categories:

1. Income from agriculture and forestry;
2. Income from trade or business;
3. Self-employment income;
4. Employment income;
5. Investment income;

6. Income from rents and royalties; and
7. Specified types of other income (including gains from annuities and from miscellaneous contractual relationships).[1]

Income is computed within each category according to different rules, and the deductibility of interest and other expenses varies within these categories.[2] An individual's taxable income is the sum of the income from the different categories, minus miscellaneous personal deductions.[3]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Interest paid on loans incurred for personal purposes is not tax-deductible, and this principle applies to residential mortgage loans, home equity loans, auto loans, credit card loans, and student loans. Expenses related to these private purposes fall into the category of living expenses for which no relief is granted to taxpayers,[4] unless the law specifically makes an exception from this principle.[5]

Until 1996, generous tax benefits for new homeowners were available. These, however, have been reduced over the last twenty-five years. (See Part I(C), below, "Related Tax Benefits or Subsidies"). Although student loans are not tax advantaged, relief for educational expenses is granted through tax deductions and other benefits. (See Part I(C), below, "Related Tax Benefits or Subsidies").

B. Incentives for the Lender

There are no specific tax advantages for the lenders of consumer loans, residential mortgages, or student loans.

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[1] Einkommensteuergesetz [EStG], *repromulgated* Oct. 8, 2009, BUNDESGESETZBLATT [BGBL.] I at 3366, *last amended by* Gesetz, Apr. 5, 2011, BGBL. I at 554, § 2.

[2] EBERHARD RICK ET AL., LEHRBUCH EINKOMMENSTEUER 89 (2006).

[3] Andreas Perdelwitz, *Germany – Individual Taxation*, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY SURVEYS, http://online.ibfd.org (by subscription) (last updated Apr. 1, 2011).

[4] EStG § 4(1).

[5] Deductible personal expenses are child care expenses; contributions to various social security or pension programs; contributions to various retirement savings programs (EStG § 4f & 10); donations to charity (EStG § 10b); and relief from various hardship situations, including educational expenses of dependants (EStG §§ 33–33b).

C. Related Tax Benefits or Subsidies

1. Housing

In the last twenty-five years, Germany has reduced the level of tax benefits and subsidies granted for individual homeownership. Significant income tax deductions were granted for the purchase or the construction of a taxpayer's home that was acquired before 1996. These amounted to a deduction of 6 percent of the cost of acquisition during each of the first four years following acquisition, and another 5 percent in each of the next four years, up to a maximum annual amount of approximately US$7,000 during the first four years and an annual maximum of approximately US$5,500 during the next four years.[6] Additional deductions were granted to homeowners with children.[7]

Under this scheme of granting tax relief to new homeowners, the deductibility of mortgage interest played a short and minor role for homes acquired between 1991 and 1994.[8] The provisions were restrictive and proved unpopular as compared to the other tax benefits that were available.[9]

In 1996, the tax benefits for homeownership were replaced by cash grants for lower- and middle-class homeowners.[10] Since January 1, 2006, the cash grant for homeowners is no longer given for new investments, but earlier investments will continue to enjoy the benefit until its scheduled termination after a maximum of eight years.[11]

Currently, income tax deductions are granted to homeowners who acquire or improve housing in urban planning areas or that qualify for historic protection. Over a nine-year period, close to one-half of such costs can be deducted.[12] In addition, tax credits or deductions for investments in owner-occupied dwellings are also granted within the framework of a subsidy program that encourages individuals to save for their retirement.[13] Altogether, these subsidies aim to replace, to some extent, the cash grants for homeownership that were abolished in 2006.[14]

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[6] Einkommensteuergesetz, in the repromulgated version of Aug. 8, 1961, and as in effect through April 28, 1997, § 10e; EStG § 52(14), as currently in effect.

[7] EStG, as in effect through Dec. 27, 1996, § 34e.

[8] EStG § 10e(6a).

[9] LUDWIG SCHMIDT, EINKOMMENSTEUERGESETZ 861 (27th ed. 2008).

[10] Eigenheimzulagengesetz [EigZulG], *repromulgated* Mar. 26, 1997, BGBL. I at 734, *as amended*.

[11] EigZulG § 9.

[12] EStG §§ 10f & 10g.

[13] Eigenheimrentengesetz, Aug. 1, 2008 BGBL. I at 1509. Currently, the deduction for retirement savings that can be used to deduct home acquisition costs is limited to a maximum amount of €2,100 (about US$3,040). *See* EStG § 10a.

[14] H. Nüssgens, *Selbst genutzte Wohnungsimmobilien werden in die Riester-Förderung einbezogen,* SOZIALE SICHERHEIT 259 (2008).

A few other federal subsidies are still being granted, among them, various opportunities to obtain subsidies for building savings contracts[15] that encourage potential homebuyers to save for several years before building or buying a home.[16] In addition, many states and local communities provide loans at subsidized interest rates for home purchases or improvements. These often employ preferences for young families; income limits and limits on the size of the subsidized housing also apply.[17]

2. Education

For several reasons the cost of higher education is less burdensome in Germany than in the United States. Most universities are owned and operated by the German states and they either charge no tuition or they limit tuition to about €500 (about US$650) per semester.[18] Moreover, a comprehensive federal program supports students from low-income backgrounds with cash grants and loans with little or no interest.[19] In addition, children qualify as dependents until age twenty-five if they are studying, and this grants to the parents an annual income tax-reducing allowance. Educational expenses for adults are also deductible up to certain limits.[20,]

II. Deductibility of Debt Incurred to Finance Investments

Private investment income is taxable income.[21] Until 2009, expenses incurred in the process of generating private passive investment income were deductible from the investment income,[22] and interest was one of the deductible expenses.[23] Since January 1, 2009, however, private investment income from securities has been taxed with a final nonadjustable withholding tax, and investment-generating expenses can no longer be deducted.[24]

Since 2009, the only tax benefit that accrues to the private investor is an income-reducing allowance of €801 (about US$1,050) of the annual investment income. This allowance is

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[15] Fünftes Vermögensbildungsgesetz, Mar. 4, 1994, BGBL. I at 406, *as amended*, § 8.

[16] Gesetz über Bausparkassen, *repromulgated* Feb. 15, 1991, BGBl I at 454, *as amended*, http://www.gesetze-im-internet.de/bausparkg/BJNR020970972.html.

[17] For Munich, *see* MÜNCHEN REFERAT FÜR STADTPLANUNG UND BAUORDNUNG, GEFÖRDERTER WOHUNUNGSBAU IN MÜNCHEN (Jan. 2011), http://www.muenchen.de/cms/prod2/mde/_de/rubriken/Rathaus/75_plan/06_stadtsanierung/pdf/mbt_e_vi.pdf.

[18] Verwaltungsgerichtshof für Baden-Württemberg, Feb. 16, 2009, No. 2 S 1855/7, available by subscription at the German legal database JURIS; *Hessen schafft Studiengebühren wieder ab*, FINANCIAL TIMES DEUTSCHLAND (June 3, 2008), available by subscription at the German legal database JURIS.

[19] Bundesausbildungsförderungsgesetz, *repromulgated* Dec. 7, 2010, BGBL. I at 1852.

[20] EStG §§ 10, 32.

[21] Section 20 of the Income Tax Code (EStG § 20) lists as taxable income what appears to be all conceivable forms of income from capital interest, dividends, related distributions, annuities, and other unspecified returns on capital.

[22] EStG § 9.

[23] RICK ET AL., *supra* note 2, at 732.

[24] EStG § 20(9), *as enacted by* Unternehmenssteuerreformgesetz 2008, Aug. 14, 2007, BGBl I at 1912.

doubled in the case of spouses filing jointly. The allowance combines the previous allowance of €750 (about US$925) that aimed at encouraging savings and another allowance of €51 (about US$75) that formerly was a non-itemized lump sum deduction for investment-generating expenses.[25]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

Section 3c of the Income Tax Code provides that expenses are not deductible if they are incurred in relation to tax-exempt income.[26] This provision, however, appears to have little relevance for personal, non-business debt because none of it is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

The cancellation of a private debt is not taxable income.[27] It does not fall within one of the statutorily defined income categories. In particular, cancellation of a debt could not result in income if it could be considered a gift.[28]

An individual taxpayer, however, who is self-employed or operates a business, farm, or forestry enterprise realizes a taxable profit when a debt is cancelled that relates to these income-generating activities.[29] Technically, such a discharge from indebtedness must be entered on the books as a gain, to be included in the computation of the annual business profit.[30] Yet even the discharge of a business-related debt is not a taxable receipt if the creditor forgave the debt for personal reasons, such as family relations.[31]

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[25] SCHMIDT, *supra* note 9, at 1729.

[26] EstG § 3c.

[27] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

[28] SCHMIDT, *supra* note 9, at 1848.

[29] *Id*. at 204.

[30] EStG § 4.

[31] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

Prepared by Edith Palmer
Senior Foreign Law Specialist
June 2011

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JAPAN

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

A tax credit for interest paid on housing loans is available for homeowners in Japan who bought a home with a mortgage and moved into it between 1991 and 2013. Homeowners may also claim a tax credit for certain remodeling expenses and for qualified new homes.

With regard to debt incurred to finance investments, interest expenses on the acquisition of shares may be deducted from dividend income. Japanese law does not appear to provide for special treatment for other household debt or for debt cancellation.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The deductions that are allowed in calculating the taxable income of individuals are listed in Japan's Income Tax Law,[1] and expenses not listed therein are not deductible. Consequently, interest is not deductible if it is paid for the following types of loans:

1. Residential Mortgage Loans
2. Home Equity Loans
3. Auto Loans
4. Credit Card Debt
5. Student Loans

For interest paid on mortgage loans, however, a tax credit is granted (See Part I(C), below, "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

Japanese tax laws do not provide incentives for the lender.

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[1] Shotokuzei hō [Income Tax Law], Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, bk. 2, ch. 2, § 4 (arts. 72–88).

C. Related Tax Benefits or Subsidies

1. Residential Mortgage Loans

a. *Public Housing Financing System*

The Japanese government established its housing policy after the Second World War. As originally conceived, the policy had "three pillars":

(1) Homeownership promotion through low-interest loans provided by the Government Housing Loan Corporation (GHLC);

(2) Public rental housing for low-income people constructed by local governments with heavy subsidies from the central government; and

(3) Housing by the Housing Corporation for middle-income workers.[2]

The GHLC was abolished in 2007, and the Japan Housing Finance Agency (JHFA) was created and succeeded to GHLC's rights and obligations. The JHFA is an incorporated administrative agency owned by the government.[3] The JHFA does not provide loans directly to households except in special situations, such as houses rebuilt after a disaster.[4] Instead, it engages in the securitization business for housing loan products with a long-term, fixed interest rate, so that private financial institutions can more readily provide these loans.[5] Financial institutions that sell these housing loans are allowed to set their fee portions of the interest rates at their own discretion.

There are other public housing finance systems as well. Under the *Zaikei* (asset forming) Housing Savings System, workers who are employed by firms that participate in the System can make regular deposits to a participating financial institution for at least five years.[6] The deposit is made by the employer, who withdraws a set amount of money from the worker's salary and sends it to the financial institution.[7] Interest generated by the deposit is exempt from tax.[8] The deposit may be used only for the acquisition of a home. An eligible employee may borrow up to

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[2] Yosuke Hirayama, *Outline of Japanese Housing*, ASIA-PACIFIC NETWORK FOR HOUSING RESEARCH, THE JAPAN CHAPTER (Faculty of Human Development, Kobe University), http://www.edu.kobe-u.ac.jp/hudev-hiraken/apnhr/intro_apnhr.html (last visited May 27, 2011).

[3] JHFA has an English language website, at http://www.jhf.go.jp/english/index.html (last visited June 1, 2011).

[4] Dokuritsu gyōsei hōjin Jūtaku kin-yū shien kikō hō [JHFA Law], Law No. 82 of 2005, *last amended by* Law No. 79 of 2009, art. 13.

[5] *Id*.

[6] Kinrōsha zaisan keisei sokushin hō [Law to Promote Workers' Asset Forming], Law No. 92 of 1971, *last amended by* Law No. 26 of 2008, art. 6, para. 4.

[7] *Id*.

[8] Sozei tokubetsu sochi hō [Tax Special Measures Law], Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 4-2.

ten times the amount of the deposit (up to 40 million yen, or about US$490,000).[9] A public corporation, the Employment and Human Resources Development Organization of Japan (EHRD),[10] borrows money from participating financial institutions[11] and lends the money to the employers.[12] The employer then makes a loan contract with the employee. There are certain physical requirements for the home purchased.[13]

Local governments also provide housing loan support measures. In the past, many municipal governments had direct or indirect housing loan programs for eligible residents. It appears, however, that most of them abolished such programs due to financial difficulties.[14] There are still municipal governments that pay/reimburse a portion of housing loan interest for/to qualified residents, often for specific purposes. For example, in the 2011 fiscal year (ending March 31, 2012), the Tokyo Metropolitan government will pay 1 percent of the housing loan amount that was borrowed from designated financial institutions for ten years for qualified households that will demolish their homes in areas where homes made of wood are concentrated and rebuild fire-resistant homes.[15]

b. *Tax Credit*

i. Tax Credit for Housing Loan

A tax credit for interest paid on a housing loan is available for qualified homeowners who built or bought a qualified home and moved into it between 1991 and 2013.[16] The terms and maximum amounts of the tax credit vary depending on the year in which the homeowner moved in. The following requirements are based on the program applicable to homeowners who move into their homes during 2011. To qualify for the 2011 tax credit,

- the homeowner's taxable income must be 30 million yen (about US$370,000) or less;

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[9] Law to Promote Workers' Asset Forming, art. 9, para. 1; Kinrōsha zaisan keisei sokushin hō sekō rei [Enforcement Order of Law to Promote Workers' Asset Forming], Order No. 332 of 1971, *amended by* Order No. 58 of 2010, art. 33.

[10] The Organization does not have an English language website. Its website in Japanese is available *at* http://www.ehdo.go.jp (last visited June 1, 2011). Its *Zaikei* webpage is available *at* http://www.ehdo.go.jp/zaikei/zaikei.html (last visited May 27, 2011).

[11] Law to Promote Workers' Asset Forming art. 12.

[12] *Id*.

[13] *Id*.

[14] Jūtaku rōn jichitai yūshi tte? [What Is a Local Government Housing Loan?], Teishūnyū demo okane o tameru hōhō [Method to Save Money Even for Low-income People], http://money.fastingsky.com/2011/02/post_27.html (last modified Feb. 18, 2011).

[15] Heisei 23 nendo tōkyō to kojin jūtaku rishi hokyū josei no boshū [Opening of Housing Loan Interest Supplement by Tokyo Metropolitan Government], Tokyo Metropolitan Government, http://www.toshiseibi.metro.tokyo.jp/juutaku_seisaku/281buybuildB1.htm (last visited May 27, 2011).

[16] Tax Special Measures Law, Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 41, para. 1.

- the seller of the house may not be a spouse, family member, or other person who has a special relationship with the buyer/new owner;
- the homeowner must move into the house within six months from the date of purchase;
- the loan must be from a qualified loan provider;
- the term of the loan payment must be ten years or more; and
- the home must satisfy physical conditions that the Ministry of Finance Ordinance specifies.[17]

The amount of the tax credit is 1 percent of the amount of the loan as of December 31 of the applicable year, up to 400,000 yen (about US$4,900). The tax credit may be claimed for ten consecutive years as long as the owner continues living in the home and the taxable income of the owner is 30 million yen or less.[18]

There are variations to this tax credit system. When a person builds a house or buys a newly-built house that qualifies as a "long-lasting, high-quality home," more tax credit is available. This tax credit system varies by year. For example, if a person buys and moves into a qualified home during 2011, the amount of the tax credit is 1.2 percent of the amount of the home loan as of December 31 of the year, for a period of ten years. The maximum amount of the tax credit is 600,000 yen (about US$7,300) annually. This tax credit is available for people who buy a qualified home and move into it between June 4, 2009, and December 31, 2013. The amount of the tax credit will decrease for persons who move into a qualified home in 2012 and 2013 to 1 percent of the home loan.[19]

A tax credit is also available for certain housing loans for remodeling when the homeowner is fifty years old or older, needs daily living assistance, or is disabled, or lives with a family member who is sixty-five years old or older, needs daily living assistance, or is disabled and remodeling is undertaken to make these person's daily living easier (i.e., barrier-free).[20] Also, home insulation costs may be included in the remodeling fee if it is done at the same time as the barrier-free remodeling.[21] This tax credit is available for five years, and the amount of the tax credit is 2 percent of the loan of the first 2 million yen (about US$24,400) and 1 percent of the remainder, up to 8 million yen.

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[17] *Id*.

[18] *Id*. art. 41, para. 2, item 8.

[19] *Id*. art. 41, para. 5.

[20] *Id*. art. 41-3-2; Sozei tokubetsu sochi hō shikōrei [Tax Special Measures Law Enforcement Order], Order No. 43 of 1957, *last amended by* Order No., art. 26-4, para. 3.

[21] Tax Special Measures Law art. 41-3-2, para. 2; Tax Special Measures Law Enforcement Order art. 26-4, para. 7.

ii. Tax Credit for Housing Expense With or Without a Housing Loan

When a resident remodels his home to make it earthquake resistant or has an inspection of his home to measure how earthquake resistant it is under a local government's earthquake resistance project between April 1, 2009, and December 31, 2013, he or she may claim a credit against income tax of up to 200,000 yen (about US$2,440).[22]

When a person buys a newly-built home that qualifies as a "long-lasting, high quality home," 10 percent of the difference in cost (up to 10 million yen, or about US$122,000) between an ordinary home and a "long-lasting high quality home" may be deducted from income tax. When the person elects to claim a tax credit for the housing loan described in the previous section, the tax credit for newly-built homes cannot be applied, however.[23]

2. Home Equity Loans

N/A

3. Auto Loans

N/A

4. Credit Card Debt

N/A

5. Student Loans

N/A

II. Deductibility of Debt Incurred to Finance Investments

Interest expenses on the acquisition of shares may be deducted from dividend income.[24]

A. Annual Limits Relating to Investment Income

The amount of the interest expense deduction is limited to the amount of the investment income.[25] In other words, a taxpayer may not deduct a higher amount of interest than the annual income received from investments.

[22] Tax Special Measures Law art. 41-19-2.

[23] *Id*. art. 41-19-4, para. 4.

[24] Income Tax Law, Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, art. 24, para. 2.

[25] *Id*.

B. Deductions for Exempt or Tax-Favored Income

Japanese law does not have a provision that limits individual interest deductions on debt incurred to purchase or carry tax exempt income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

There is no provision in the Income Tax Law regarding treatment of debt cancellation. However, cancelled debt is treated as a gift under the Inheritance Tax Law, so a person may have to pay gift tax for a forgiven or cancelled loan.[26] Cancelled debt is not regarded as a gift if the debtor has lost assets and it is very difficult to pay off the debt.[27]

Prepared by Sayuri Umeda
Senior Foreign Law Specialist
June 2011

[26] Sōzoku zei hō (Inheritance Tax Law), Law No. 73 of 1950, *last amended by* Law No. 6 of 2010, art. 8.

[27] *Id*.

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MEXICO

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Residential mortgage loans are deductible under Mexico's tax regime, but other types of consumer debt apparently is not. Starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible provided that applicable requirements are met. No information could be located concerning incentives for lenders. However, Mexico promotes its real estate market with incentives applicable to eligible Real Estate Investment Trusts. Expenses incurred by individuals to generate dividend income are not deductible. Cancelled debt is taxable.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

1. Residential Mortgage Loans

The amount of interest that is paid with respect to home mortgage loans contracted with financial system entities is deductible, as long as the amount of the mortgage loan does not exceed 1.5 million investment units[1] (equal to approximately US$588,978 as of June 3, 2011). Investment units "provide for a flexible currency unit to account for inflationary adjustments to Mexican currency."[2] Mexico's Central Bank (*Banco de México*) publishes the investment unit values periodically.[3] Financial institutions must inform the taxpayer, by February 15 of each year, of the amount of the interest paid in the tax year.[4]

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[1] Arturo Pérez Robles, *Mexico – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 1, 2011). *See also* Ley del Impuesto sobre la Renta [hereinafter, Income Tax Law] art. 176-IV, *as amended*, Diario Oficial de la Federación [DO], Jan. 1, 2002, available on the website of Mexico's House of Representatives *at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf.

[2] Jaime González-Bendiksen et al., Mexican Tax Guide (CCH) ¶ 6285.20, http://intelliconnect.cch.com (by subscription) (last visited June 1, 2011).

[3] *Id*.

[4] Pérez Robles, *supra* note 1, ¶ 1.8.1.1.

2. Home Equity Loans

No information could be located on the deductibility of home equity loans.

3. Auto Loans

The website of Mexico's Tax Administration Service indicates that investments in automobiles for personal use are not deductible.[5]

4. Credit Card Debt

No information could be located on the deductibility of credit card debt.

5. Student Loans

No information could be located on the deductibility of student loans. However, starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible, provided that applicable requirements are met.[6] In addition, Mexico's Income Tax Law provides the following income exclusion applicable to education expenses:

> Yields on property held in trust are not considered income to the extent such yields are allocated … to finance the education of straight-line descendants through the bachelor's degree level, provided that the studies have official recognition.[7]

Public universities are mostly free in Mexico, although some charge low fees.

B. Incentives for the Lender

No information could be located concerning incentives for lenders. However, Mexico provides incentives to eligible Real Estate Investment Trusts, as follows:

> To promote the Mexican real estate market, a number of incentives are granted to investments in Mexican real estate investment trusts, mainly:

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[5] *Al deducir sus gastos* [*The Deduction of Expenses*], GOBIERNO FEDERAL, SAT (Servicio de Administración Tributaria), http://www.sat.gob.mx/sitio_internet/asistencia_contribuyente/principiantes/errores/36_756.html (last visited June 1, 2011).

[6] Decreto por el que se otorga un estímulo fiscal a las personas físicas en relación con los pagos por servicios educativos [Decree granting a tax incentive to individuals with regard to payments for educational services], DO, Feb. 15, 2011, available on the website of Mexico Department of Treasury, *at* http://www.shcp.gob.mx/lashcp/MarcoJuridico/documentosDOF/2011/febrero/decreto_15022011.pdf. *See also Mexico Politics: Private Education Now Tax Deductible*, ECONOMIST INTELLIGENCE UNIT (Mar. 11, 2011), http://www.eiu.com/index.asp?layout=VWArticleVW3&article_id=957877680&region_id=1510000351&country_id=1520000152&channel_id=210004021&category_id=&refm=vwCh&page_title=Channel+Latest&rf=0 (by subscription).

[7] González-Bendiksen et al., *supra* note 2, ¶ 2505.80. *See also* Income Tax Law art. 106.

- Deferral on the income tax applicable on the capital gain resulting from contribution of real estate to the trust.
- The trust is not required to make estimated income tax payments.
- Foreign pension and retirement funds enjoy an exemption for income generated by the assets contributed to the trust and income from the sale of the participation certificates issued by the trust.
- Exemptions also apply for nonresidents and individuals who sell publicly traded participation certificates issued by the trust.[8]

C. Related Tax Benefits or Subsidies

The following services are exempt from Value Added Tax:

> Commissions and other payments made by the borrower to the lender under a loan secured through mortgage for the acquisition, extension, construction, or repair of real property destined to residential purposes, except for those payments arising after the corresponding loan has been granted and for payments from the borrower to third parties.
>
> …
>
> Interest derived from mortgage credits or credits with a trust guaranty for the acquisition, extension, construction or repairing of real property intended for residential purposes.[9]

Mexico's federal government provides financial aid to eligible low-income individuals for the purchase or construction of a home.[10]

II. Deductibility of Debt Incurred to Finance Investments

Dividends

According to the International Bureau of Fiscal Documentation (IBFD), dividends are taxed as follows:

> Investment income is normally included in the individual recipient's taxable base. Dividends must be accrued as any other income for the individual. This person can credit against its annual income tax the income tax paid by the distributing company, provided that this income tax is considered accruable income and the individual has the certificate issued by the distributing company regarding the dividend.[11]

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[8] González-Bendiksen et al., *supra* note 2, ¶ 1330.10.

[9] *Id.* ¶ 5205. *See also* Ley del Impuesto al Valor Agregado [Value Added Tax Law] art. 15 (I), (X-d), *as amended*, DO, Dec. 29, 1978, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/77.pdf (last visited June 2, 2011).

[10] *Esta es tu Casa* [*This Is Your Home*], GOBIERNO FEDERAL, COMISIÓN NACIONAL DE VIVIENDA, http://www.conafovi.gob.mx/programas-estrategicos/tu-casa (last visited June 2, 2011).

[11] Ricardo León & Mariana Eguiarte, *Mexico – Individual Taxation* ¶ 1.5.1., IBFD: COUNTRY SURVEYS, http://online.ibfd.org/kbase / (by subscription) (last visited June 2, 2011).

The *Mexican Tax Guide* further states that

> No deductions are allowable against dividend income, which is includable with other ordinary income, on a gross basis. Dividends paid out by Mexican entities are subject to no withholding tax at all.[12]

Interest

With regard to the treatment of interest, the *Mexican Tax Guide* explains that

> Taxpayers are required to recognize as ordinary income the "real" interest received during the tax year and add it to all other ordinary income of the taxpayer generated in the tax year.[13]
>
> . . .
>
> When the inflation adjustment to determine the "real" interest … is greater than the interest received, the result is deemed a loss. The loss may be subtracted from the other ordinary income generated in the tax year, except for income from dependent personal services … and income from business and professional activities …. The part of the loss not subtracted in the tax year may be carried forward to the five following tax years until exhausted, adjusted for inflation … from the last month of the tax year in which incurred to the last month of the tax year in which applied, or from the last inflationary adjustment made to the last month of the tax year in which applied, as the case may be.[14]
>
> . . .
>
> Real interest is the amount by which the interest exceeds the inflationary adjustment.…[15]
>
> . . .
>
> All corporations and individuals paying interest to individuals is required to withhold and pay in the tax withheld. …
>
> The tax withheld is considered an estimated payment.[16]

Income from Real Property

The IBFD provides the following guidance with regard to the taxation of income from real property:

[12] González-Bendiksen et al., *supra* note 2, ¶ 3165.

[13] *Id*. ¶ 3060.10.

[14] *Id*. ¶ 3060.30.

[15] *Id*. ¶ 3065.10.

[16] *Id*. ¶ 3070.10.

Rental income is taxed on its net amount, i.e. the gross rent received less related expenses (including the amount of the local property tax paid during the same tax year, maintenance expenses, construction and improvements, insurance premiums for insurance covering the immovable property, interest on loans to finance the acquisition of the property or construction of improvements). However, individuals may elect to deduct 35% of the rent as "constructive expenses" instead of deducting the substantiated expenses. All taxpayers can deduct the amount of the local property tax paid during the same tax year.[17]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

No information could be located on this topic.

IV. Treatment of Cancelled Debt

Pursuant to Mexico's Income Tax Law, "[t]he amounts forgiven by the creditor and the debts paid by a third party on the taxpayer's behalf"[18] are taxable income.[19]

Prepared by Gustavo Guerra
Senior Foreign Law Specialist
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[17] León & Eguiarte, *supra* note 11, ¶ 1.5.2.

[18] González-Bendiksen et al., *supra* note 2, ¶ 3200.10.

[19] Income Tax Law art. 167(I).

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UNITED KINGDOM

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

There are very few tax deductions that are permitted for household debt in the United Kingdom. Residential mortgage interest relief was removed in 2000. There are limited circumstances in which interest from loans may be deducted for tax purposes.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Tax deductions for interest paid in the United Kingdom (UK) have been severely restricted over the past twenty years. There are currently a very limited number of loans for which a deduction[1] may be taken on interest paid.[2]

1. Residential Mortgage Loans

The deduction for interest paid on residential mortgages (known in the UK as Mortgage Interest Relief) was withdrawn as of April 6, 2000.[3]

Individuals that own property that is rented out may deduct interest paid on the mortgage for that property as a business expense.[4]

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[1] Deductions, where applicable, are provided on the net income of the tax year in which the interest payment was made. Income and Corporation Taxes Act 1988, c. 1, § 353.

[2] BRITISH MASTER TAX GUIDE 2010-11, ¶ 1884.

[3] Telephone conversation with Inland Revenue, July 6, 2011, at 7:40am. *See also Mortgage Interest Relief*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/stats/mir/intro.pdf (last visited May 11, 2011); Inland Revenue, *Withdrawal of Mortgage Interest Relief* (Mar. 1999), http://archive.treasury.gov.uk/budget/1999/nr/ir2.txt.

[4] Alan Holmans, Christine Whitehead & Kathleen Scanlon, Fiscal Policy Instruments to Promote Affordable Housing (Cambridge Centre for Housing and Planning Research, 2002), *available at* http://eprints.lse.ac.uk/29958/1/Fiscal_policy_instruments_to_promote_affordable_housing_%28LSERO%29.pdf. *See also* HM REVENUE AND CUSTOMS, *supra* note 3.

2. Home Equity Loans

There are no current tax deductions for interest paid on home equity loans. However, relief is provided for loans that were taken out before April 1988 for the improvement of a property that is the only, or main, residence of the borrower.[5]

3. Auto Loans

There are no tax deductions available for interest on loans taken out to purchase a personal vehicle.

4. Credit Card Debt

There are no deductions available for interest paid on credit card debt.[6]

B. Incentives for the Lender

There appear to be no tax incentives for lenders responsible for financing residential mortgage loans, home equity loans, auto loans, or credit card debt.

C. Related Tax Benefits or Subsidies

1. Student Loans

Student loans for UK students are provided through the Student Loans Company.[7] This is a Non-Departmental Public Body, which administers government funded loans on a not-for-profit basis to students across the UK.[8] The interest rate payable on these loans is subsidized by the UK government and set to the rate of inflation.[9] When these loans become due, they are payable through the tax system, and no tax deductions are permitted for either the interest or the payments.

2. Subsidies for the Purchase or Construction of a New Home

In terms of home ownership, the majority of tax incentives in the UK are geared towards ensuring that housing is affordable and accessible to all sectors of the population. For example, the transfer tax (known in the UK as Stamp Duty Land Tax), which applies to the purchase of a

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[5] HM REVENUE AND CUSTOMS, *supra* note 3.

[6] Her Majesty's Revenue and Customs, Helpsheet 340: Interest and Alternative Finance Payments Eligible for Relief on Qualifying Loans and Alternative Finance Arrangements 2 (2011), *available at* http://www.hmrc.gov.uk/helpsheets/hs340.pdf.

[7] Teaching and Higher Education Act 1998, c. 30, http://www.legislation.gov.uk/ukpga/1998/30/section/22; *Welcome*, STUDENT LOANS COMPANY, http://www.slc.co.uk/ (last visited May 18, 2011).

[8] *About Us*, STUDENT LOANS COMPANY, http://www.slc.co.uk/about%20us/index.html (last visited May 18, 2011).

[9] Teaching and Higher Education Act 1998, c. 30; *Welcome*, STUDENT LOANS COMPANY, *supra* note 8.

home, is waived if the home is below £125,000 (approximately US$160,000) for all home purchases, or £150,000 (approximately US$210,000) in specified disadvantaged areas.[10] First-time homebuyers are exempt from the transfer tax on properties up to £250,000 (approximately US$400,000) if purchased between March 25, 2010, and 25 March 2012.[11]

For the construction of new homes, as well as certain cases where buildings are converted or renovated, any Value Added Tax (VAT) (sales tax) that would be payable, which is currently rated at 20 percent, is zero rated. This applies to the labor and material costs used in constructing or renovating these buildings. VAT is chargeable at the standard rate of 20 percent if the home is to be used as a vacation home, or the buyer cannot live in it year round or use it as their private residence.[12]

Individuals that provide social housing may receive funding for the construction or purchase and rehabilitation of rental units from the Housing and Communities Agency,[13] a non-departmental government body, and Local Authorities (local government). These are funded by the central government and Local Authorities, respectively.

The government further offers a "Homebuy" program, through which a reduced fee loan provides for up to 30 percent of the value of a home for households that make under £60,000 (approximately US$96,000) per year and are either first-time homebuyers or are currently renting a council or housing association property and purchasing a house in a specified area.[14] This is known as an "equity loan" and becomes payable after five years. Fees are charged in the sixth year and are currently 1.75 percent of the loan's value, which increases each year by the Retail Price Index (RPI) plus 1 percent.[15]

II. Deductibility of Debt Incurred to Finance Investments

Income derived from dividends, interest, royalties, and immovable properties are all considered investment income, which is taxable under UK's income tax regime. According to the British Tax Guide, "income tax is charged on the full amount of the interest arising in the tax year. The person liable to tax is the person entitled to or receiving the interest."[16] Moreover, unless they are subject to a tax exemption, dividends and other distributions from a company are

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[10] Finance Act 2003, c. 14, § 57 & sch. 6. *See also Stamp Duty Land Tax Rates and Thresholds*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/sdlt/intro/rates-thresholds.htm (last visited May 21, 2011).

[11] Finance Act 2010, c. 13, § 6.

[12] Her Majesty's Revenue and Customs, Notice 708: Building and Construction (Feb. 2008), http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000513#P341_32640.

[13] *Our Funding*, HOMES AND COMMUNITIES AGENCY, http://www.homesandcommunities.co.uk/ourwork/our-funding (last visited May 25, 2011).

[14] *Low-Cost Home Ownership Schemes – A Guide*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_4001347 (last visited May 31, 2011).

[15] *Equity Loans – How They Work*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_171504 (last visited May 31, 2011).

[16] RAY CHIDELL & TREVOR JOHNSON, BRITISH TAX GUIDE: INCOME TAX 2010 at 269 (2010).

"generally chargeable as savings and investment income,"[17] irrespective of whether the source is a UK or non-UK company.

Deductions on interest payments on loans procured, *inter alia*, for investment purposes are deductable, however, only "in respect of certain specified loans."[18] According to the International Bureau of Fiscal Documentation Country Analysis for the UK,

> Interest paid by an individual is allowable as a general deduction from income if it is:
>
> - Loan interest, whether annual interest or not, but excluding interest on a bank overdraft and credit card interest, and
> - For a specified purpose.[19]

Under Part 8, Chapter 1 of the Income Tax Act 2007 (ITA 2007),[20] the purposes of the loans for which interest expenses can be deducted are listed as follows:

- To buy plant or machinery for partnership use
- To buy interest in closed company
- To buy interest in employee-controlled company
- To invest in a partnership
- To invest in a co-operative
- To pay inheritance tax.[21]

Interest payments on a loan used to purchase a life annuity are also tax deductable where certain conditions are satisfied. These include, *inter alia*, where the borrower is age 65 or over, and where the loan was taken out before March 9, 1999.[22]

A. Annual Limits Relating to Investment Income (and Other Limits on the Deductibility of Interest for Private Investments)

There do not appear to be any annual limits on deductions for interest payments with respect to loans for investment purposes under UK's income tax regime. However, schedule 30

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[17] *Id*. at 282.

[18] Belema Obuoforibo, *United Kingdom–Corporate Taxation* ¶ 1.8.1.1., *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX SURVEYS, http://ip-online.ibfd.org/kbase/ (last visited May 31, 2011).

[19] *Id*.

[20] Income Tax Act 2007, c. 3, *available at* http://www.legislation.gov.uk/ukpga/2007/3 (last visited May 31, 2011).

[21] HM Revenue & Customs, Savings and Investment Manual – SAIM10010 – Relief for Interest Paid: Introduction, http://www.hmrc.gov.uk/manuals/saimmanual/saim10010.htm (last visited May 7, 2011).

[22] CHIDELL & JOHNSON, *supra* note 17, at 65.

of the Finance Act 2009[23] introduced rules to the ITA 2007 that aimed to deny tax relief for loan arrangements "if the main purpose of the arrangements is to avoid tax."[24] Under section 384A of the ITA, tax relief with respect to interest payments is disallowed where loan arrangements are

> very likely to produce a "post-tax advantage," and the arrangements seem to have been made in order to reduce what would have been the borrower's income tax or capital gains tax liability (or such liability of a person in similar circumstances to the borrower), had the arrangements not been made.[25]

According to the European law firm, Field Fisher Waterhouse, the restriction is aimed at

> … schemes structured to utilise tax relief for interest paid to ensure that the borrower investor is virtually guaranteed to make an after-tax profit. This can arise where, for example, arrangements give rise to a payment to the borrower which, together with the amount of the tax relief from the borrower's interest payments, is equal to or more than the amount needed to meet the borrower's obligations under the loan.
>
> The new restriction denies tax relief for interest paid where the loan in question is made as part of arrangements "*which appear very likely to produce a post-tax advantage.*" A "*post-tax advantage*" will arise where an amount becomes payable to the borrower (or a connected person) or for the borrower's benefit which, taking into account the tax relief which would otherwise be available, equals or exceeds the borrower's obligations under the loan. The test is applied objectively and applies whether or not obtaining tax relief is a main purpose of the underlying transaction. Where the restriction applies, *no* interest deduction is allowed under section 383 ITA.[26]

Under section 384(2) of the ITA 2007, interest payments on a loan are also ineligible for deductions if they exceed a "reasonable commercial" amount. According to the British Tax Guide "a 'reasonable commercial' amount of interest on the loans for the relevant period is an amount which, together with any interest paid before that period (other than unrelieved interest) represents a reasonable commercial rate of interest from the date the loan was made to the end of that period."[27] The interest "representing the excess is not eligible for relief."[28]

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[23] Finance Act 2009, c. 10, sch. 30, *available at* http://www.legislation.gov.uk/ukpga/2009/10/schedule/30 (last visited May 31, 2011).

[24] CHIDELL & JOHNSON, *supra* note 17, at 57.

[25] Obuoforibo, *supra* note 19, ¶ 1.8.1.1.

[26] *Tax Update – Anti-Avoidance Targets 'Post-Tax' Advantages*, FIELD FISHER WATERHOUSE (May 2009), http://www.ffw.com/publications/all/alerts/anti-avoidance-targets.aspx (emphasis in the original).

[27] CHIDELL & JOHNSON, *supra* note 17, at 57.

[28] *Id.*

B. Deductions for Exempt or Tax-Favored Income

In the UK, "there is no general principle barring a deduction of expenses related to exempt income—it's all a matter of statutory interpretation for each category of income."[29] Nor does there appear to be any general rule that restricts deductions of interest expenses incurred to produce tax-advantaged income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

There do not appear to be any rules under UK's income tax regime that would limit other tax benefits with respect to tax-exempt income.

III. Special Treatment of Other Debt

Other than the items specified above there appears to be no other special treatment for other debt in the UK.

IV. Treatment of Cancelled Debt

Under the UK's income tax regime, cancelled debt is treated as income only in specific circumstances. According to Ault & Arnold:

> The *United Kingdom* continues to have restrictive rules on cancellation of indebtedness income. In general, income arises only if the loan was employment-related, made to a shareholder of a closely held corporation, or involved a liability that had previously been deducted (e.g., in the business income context).[30]

Prepared by Clare Feikert-Ahalt, Senior Foreign Law Specialist
and
Tariq Ahmed, Foreign Law Specialist
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[29] HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 292 (2010).

[30] *Id.* at 227 (emphasis in original).