TD 2003/D4 - Income tax: In what circumstances can a trustee of a trust estate obtain a deduction for interest expenses incurred on borrowed funds used to pay distributions to beneficiaries when calculating the net income of the trust estate under section 95 of the Income Tax Assessment Act 1936 ('the Act')?

Draft Taxation Determination

Income tax: In what circumstances can a trustee of a trust estate obtain a deduction for interest expenses incurred on borrowed funds used to pay distributions to beneficiaries when calculating the net income of the trust estate under section 95 of the *Income Tax Assessment Act 1936* ('the Act')?

Preamble

Draft Taxation Determinations (DTDs) represent the preliminary, though considered, views of the Australian Taxation Office. DTDs may not be relied on by taxpayers and practitioners. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.

1. Section 95 of the Act defines the net income of a trust estate to mean the total assessable income of the trust estate calculated under the Act as if the trustee were a taxpayer in respect of the income and were a resident, less all allowable deductions (subject to certain exceptions).

2. In order for an interest expense to be deductible, the interest expense must have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income and not be of a capital, private or domestic nature (*Charles Moore & Co (WA) Pty Ltd v. FC of T* (1956) 11 ATD 147 at 149; (1956) 95 CLR 344 at 351; *FC of T v. DP Smith* (1981) 147 CLR 578 at 586; 81 ATC 4114 at 4117; (1981) 11 ATR 538). The test is one of characterisation. The essential character of the expense is a question of fact to be determined by reference to all the circumstances (*Lunney & Anor v. FC of T* (1958) 11 ATD 404 at 413; (1957-1958) 100 CLR 478 at 499; *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4958; (1991) 22 ATR 613; *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47 at 56)[1].

3. Where the obligation to pay distributions to a beneficiary[2] is not sufficiently connected with the assessable income earning activity, or business, carried on by a trustee in the capacity of the trustee of a particular trust estate, interest on borrowed funds used to make distributions will not be deductible (*Hayden v FC of T* 96 ATC 4797 at 4804; 33 ATR 352 at 360). This will be the case regardless of whether the obligation arises as a result of statute (for example, family maintenance provisions), or as a result of the instrument giving rise to the trust estate (see *Hayden* ATC at 4803 and 4804; ATR at 360).

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[1] See also *Steele v. DFC of T* 99 ATC 4242 at 4251; 41 ATR 139 at 151; *Roberts and Smith* 92 ATC 4380 at 4388; 23 ATR 494 at 503-504; and *Kidston Goldmines Ltd v. FC of T* 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177.

[2] For the purposes of this Taxation Determination 'beneficiaries' includes the object of a discretionary power in respect of whom the discretion has been exercised.

4. In *Hayden's case*, a son, after the death of his father, commenced proceedings in the Supreme Court of Queensland claiming that his father had failed to make adequate provision from his estate for the proper maintenance and support of his son. The Court ordered that the estate pay the son $150,000. In order to pay the son, the executor borrowed $150,000. By borrowing the sum of money, the executor was able to comply with the court's order without selling the income producing assets of the estate (two properties). The executor argued that the interest incurred on these borrowings was deductible.

5. In holding that the interest incurred was not deductible, Spender J stated[3]:

> Here, the borrowed funds were used to discharge an obligation by the estate [to pay an amount ordered by a court under family maintenance provisions]. I can see no difference in the present case from a case where an individual taxpayer, in order to discharge an obligation such as school fees, borrows funds on which interest is paid rather than sell income-producing assets and from the proceeds discharge the obligation. The paying of school fees requires funds, on which interest might be otherwise earned; that fact does not make interest on funds borrowed for the purpose of paying school fees deductible. The discharge of the obligation is a purpose quite independent of the property.

6. In some cases beneficiaries may have previously invested money in the income producing operations of a trust, either by settling an amount as trust capital, or by allowing income to which they are presently entitled to remain undrawn. The beneficiaries may further be entitled to call for some or all of these amounts. If, in these circumstances, the beneficiary calls for the capital or income to be distributed to him or her, and the trustee borrows money at interest to finance that distribution, the borrowing by the trustee to fund the payment of the amount withdrawn by a beneficiary could be characterised as a replacement of money invested in the income producing operations of the trust. This may be the case even though:

- the actual borrowed money is paid to the beneficiary withdrawing the funds rather than being used directly in the income earning activities of the trust, and/or
- the moneys refunded to the beneficiary are used by them for private purposes.

Accordingly, in these types of cases, the interest expense paid or payable in respect of the borrowed funds may have the requisite connection with the production of assessable income. This is more likely to be the situation in relation to unit trusts or other fixed trusts rather than in relation to non-fixed trusts, as the relationship of trustee and beneficiary in the first two situations is relevantly analogous to the relationship of the partners dealt with in the case of *Roberts and Smith* (because the trustee, like the partnership, simply carries on business on behalf of the beneficiaries with their invested capital).

7. However, internally generated goodwill or an unrealised revaluation of assets are not, in the relevant sense, amounts invested in the income producing operations of a trust by a beneficiary (see *Roberts and Smith* ATC at 4389 and 4390; ATR at 505-506 for the analogous position for partnerships). The amount invested in a trust consists of the sums contributed for the purpose of either establishing the trust, or funding the trust's ongoing income producing activities. The amount invested is not the same as the property of the trust. The amount invested is at any specific point in time fixed by reference to the trust

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[3] 96 ATC 4797 at 4804; 33 ATR 352 at 359.

deed and any additional agreements between the relevant parties (for example, an agreement between the beneficiaries to settle additional capital on the trust, or an agreement between the trustee and a beneficiary to invest in the income producing operations of the trust an amount to which the beneficiary has an unpaid present entitlement). The actual assets of the trust (that is its property) vary from day to day, and include everything owned by the trust and having monetary value (see *Roberts and Smith* ATC at 4389; ATR at 505 for a description of the equivalent partnership law position). While amounts attributable to internally generated goodwill or an unrealised revaluation of assets may represent the monetary value of assets of the trust, they do not represent sums contributed by the beneficiaries and are not normally distributable to beneficiaries during the life of the trust.

8. There may be situations where sufficient evidence will exist to establish that the objective use of the borrowed funds by the trustee of a non-fixed trust is to repay amounts previously invested in a business carried on by the trustee, in the capacity as trustee of a particular trust estate. However, generally speaking, the settlors of funds upon non-fixed trusts are making a gift, similar to the situation in *Hayden's* case, rather than investing money in a business to be carried on for their benefit, as was the situation of the partners in *Roberts and Smith*. In the case of a non-fixed trust where the objects do not, prior to the vesting of some or all of the income or capital of the trust in a particular object or objects (for example, as a result of the trust vesting):

- have a right to call for a distribution of either the income or capital of the trust, or
- invest amounts (for example, by settling amounts on the trust or by agreeing to invest an unpaid present entitlement in the income earning activities of the relevant trust) that are used in a business carried on by the trustee on behalf of the relevant trust estate,

a borrowing to make a distribution to a discretionary object cannot be likened to re-financing invested capital withdrawn by the person to whom it is owed. Interest on money so borrowed is not incurred for the purpose of gaining or producing assessable income. Rather the purpose of the borrowing will be merely to discharge an obligation to distribute or to preserve assets of the trust estate. Therefore the interest is not deductible.

Example 1

The trustee of a trust with a discretionary power to advance moneys to discretionary objects of the trust for their advancement in life exercises his discretion to make a distribution from the capital of the trust for that purpose (and does so only once). The distribution is not assessable income in the hands of the taxpayer. The trustee, in the capacity of trustee of the trust estate making the distributions, carries on a business of owning and operating a small local store. The distribution is debited to capital in the accounts of the trust estate; specifically it is debited to an asset revaluation reserve. The source of the distribution is therefore an unrealised profit from the appreciation of capital assets treated for trust law purposes as part of corpus. The trustee borrows the funds necessary to make the distribution from an unrelated third party, and incurs interest expenses in respect of the borrowed funds. This interest expense is not deductible to the trustee when calculating the net income of the trust estate.

Example 2

A taxpayer and his wife are the only beneficiaries of a unit trust, the trustee of which runs a small business of supplying motor vehicle spare parts. A nominal amount was settled on the trust at the time of its creation. Subsequently the taxpayer, and his wife, jointly settled $200,000 on the trust so as to provide capital for the business to be carried on for their joint benefit. The trustee borrowed $300,000 for use in the business. The taxpayer and his wife own all the units in the trust and, under the trust deed, jointly have a present entitlement to 100% of the net income of the trust. Not all the income is distributed; some remains for use as working capital by the trustee but the taxpayer and his wife remain entitled to withdraw, at call, all or part of the undistributed income as well as the amounts settled on the trust. As a consequence, the taxpayer and his wife each have undistributed income to which they are presently entitled invested in the trust totalling $20,000. (These amounts have been assessed in the hands of the taxpayer and his wife under section 97 of the Act.) The trustee distributes $100,000 to the beneficiaries after borrowing that sum from an unrelated third party. The distribution is debited first against the $40,000 unpaid present entitlement previously assessed to the taxpayer and his wife, and the remaining $60,000 is debited against the $200,000 settled on the trust by the taxpayer and his wife. The interest on the loan is fully deductible. This conclusion follows whether or not the moneys refunded to the taxpayer and his wife are used by them for private purposes.

Date of Effect

9. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

10. We invite you to comment on this Draft Taxation Determination. We are allowing 4 weeks for comments before we finalise the Determination. If you want your comments considered, please provide them to us within this period.

Comments by date: **26 March 2003**
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Commissioner of Taxation
26 February 2003

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations
TR 92/20

Subject references:
- deductions & expenses
- interest expenses

Legislative references:
- ITAA 1936 95
- ITAA 1936 97

Case references:
- Charles Moore & Co (WA) Pty Ltd v. FC of T (1956) 11 ATD 147; (1956) 95 CLR 344
- FC of T v. DP Smith (1981) 147 CLR 578; 81 ATC 4114; (1981) 11 ATR 538
- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- Hayden v. FC of T 96 ATC 4797; 33 ATR 352
- Kidston Goldmines Ltd v. FC of T 91 ATC 4538; (1991) 22 ATR 168
- Lunney & Anor v. FC of T (1958) 11 ATD 404; (1957-1958) 100 CLR 478
- Roberts and Smith 92 ATC 4380; 23 ATR 494
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47
- Steele v. DFC of T 99 ATC 4242; 41 ATR 139

ATO References
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