TD 2008/D16 - Income tax: is interest on a loan fully deductible under section 8-1 of the Income Tax Assessment Act 1997 when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others?

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This document has been finalised by TD 2009/17.

There is a Compendium for this document: **TD 2009/17EC** .

Draft Taxation Determination

Income tax: is interest on a loan fully deductible under section 8-1 of the *Income Tax Assessment Act 1997* when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others?

This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No. Interest on a loan used to settle moneys on trust to benefit the borrower and others cannot be deducted in full under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

2. The interest can only be deducted to the extent to which the taxpayer has used the borrowed moneys to gain or produce assessable income *of the taxpayer*. The interest will not be deductible to the extent that the taxpayer has used the borrowed moneys for the purpose of benefiting persons other than the taxpayer.

3. The conclusion that the taxpayer has used the borrowed moneys to benefit others will usually follow objectively from the terms upon which the taxpayer has settled the borrowed moneys on trust for the benefit of the taxpayer and others.

4. Likewise, the terms of the trust will usually provide an objective basis for characterising whether the taxpayer has used the borrowed moneys to acquire an interest in the trust that is conducive to the production of assessable income. This, in turn, will assist in ascertaining whether the taxpayer borrowed the moneys for a purpose of gaining or producing assessable income.

5. Where the terms of the trust indicate that the borrowed moneys have been used to benefit both the taxpayer and the other beneficiaries, apportionment of the deduction will be required.

6. The interest expense is not deductible at all where the terms of the trust are such that no connection is perceived between the outgoing incurred by way of interest and the assessable income of the taxpayer, or where section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) applies.

Date of effect

7. 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 75 to 77 of Taxation Ruling TR 2006/10).

Example 1

8. *Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

9. *Paul borrows $1 million from a bank, in his own name, and settles it on the trust. The trustee issues 500,000 units to Paul and 500,000 units to Paul's wife. The trustee uses the $1 million to purchase a rental property.*

10. *The trust deed provides that unit holders are entitled to a proportionate share of the income of the trust based on their unit holdings.*

11. *The units acquired by Paul and his wife are redeemable at the discretion of the trustee. The units are redeemable for an amount equal to each unit holder's proportionate share of the trust fund calculated by reference to the net asset value of the fund as at the date of redemption.*

12. *Only 50% of Paul's interest expense is deductible (see explanation at paragraph 41 of this draft Determination). The terms of the trust indicate that Paul has used the borrowed money in part to benefit his wife and in part to acquire an interest in the trust that is of a kind that is likely to be productive of assessable income.*

Example 2

13. *Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

14. *Paul borrows $1 million from a bank, in his own name, and settles it on the trust. The trustee issues 1 million units to Paul. Paul's wife and children are discretionary objects of the trust. The trustee uses the $1 million to purchase a rental property.*

15. *The trust deed provides that in so far as there is income of the trust available for distribution at the end of an accounting period the trustee is to hold the income for the benefit of unit holders in the following amounts: the lesser of: (a) the total income of the trust that is available for distribution; and (b) an amount equal to the unit holder's interest expense plus a nominal amount. Any income to which the unit holder is not entitled is distributable amongst the trust's discretionary objects at the trustee's discretion.*

16. *The units acquired by Paul are redeemable at the discretion of the trustee. The units are redeemable for an amount equal to the sum settled by Paul on the trust.*

17. *Paul's interest expense is not deductible in full. The terms of the trust indicate that Paul has used the borrowed money in part to create a fund for the benefit of his family. It may be inferred from the terms of the trust that the purpose of benefiting his family is the main purpose for which the money has been borrowed and used. Accordingly, the interest will largely not be incurred in gaining or producing Paul's assessable income. Because a subsidiary purpose of gaining Paul's assessable income is also to be inferred (that is Paul will derive some assessable income if the trust produces net income) a small part of the interest will be deductible (see explanation at paragraph 42 of this draft Determination).*

Example 3

18. *Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

19. *Paul borrows $1 million from a bank, in his own name, and settles it on the trust. The trustee issues 1 million units to Paul. Paul as well as being a unit-holder is also a discretionary object together with his wife and children. The trustee uses the $1 million to purchase a rental property.*

20. *The trust deed provides that the trustee holds all or part of the income of the trust, for the benefit of the unit holders at the end of the accounting period. The deed also provides that the trustee can appoint realised capital gains to the trust's discretionary objects.*

21. *The units acquired by Paul are redeemable at the discretion of the trustee. The units are redeemable for an amount equal to the sum settled by Paul on the trust.*

22. *Paul's interest expense is not deductible in full. The terms of the trust indicate that Paul has used the borrowed money in part to create a fund for the benefit of his family. It may be inferred from the terms of the trust that the purpose of benefiting his family is the main purpose for which the money has been borrowed and used. Accordingly, the interest will largely not be incurred in gaining or producing Paul's assessable income. Because a subsidiary purpose of gaining Paul's assessable income is also to be inferred (that is Paul will derive assessable income if the trust produces net income) some part of the interest will be deductible (probably a greater part than in Example 2 at paragraphs 13 to 17 of this draft Determination) (see explanation at paragraph 42 of this draft Determination).*

Example 4

23. *Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

24. *Paul borrows $1 million from a bank, in his own name, and settles it on the trust. The trustee issues 1 million units to Paul. Paul is also a discretionary object of the trust, together with his wife and children. The trustee uses the $1 million to purchase a rental property.*

25. *The trust deed provides the trustee with a discretion to appoint the income of the trust to the discretionary objects. Absent such an appointment, no beneficiary is presently entitled to income. Unit holders are, however, entitled to share in amounts which are attributable to realised capital gains of the trust, in proportion to their unit holdings.*

26. *The units acquired by Paul are redeemable at the discretion of the trustee. The units are redeemable for an amount equal to the sum settled by Paul on the trust.*

27. *Paul's interest expense is not deductible at all. The terms of the trust indicate that Paul has used the borrowed money in part to create a fund for the benefit of his family. The interest will not be deductible to that extent. Nor can a connection be perceived between the incurring of the interest and the production of assessable income for Paul (other than net capital gains: see section 51AAA of the ITAA 1936) merely because it is possible that the trustee might make a gift of income to the taxpayer in a future income year; see also Taxation Ruling IT 2385 (see explanation at paragraph 43 of this draft Determination). Accordingly, the interest is not deductible.*

Commissioner of Taxation
19 November 2008

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Arrangements with which this draft Determination is concerned

28. This draft Determination is concerned with the deductibility of interest expense relating to investments in uncommercial trust arrangements of the kind described in Taxpayer Alert TA 2008/3. Arrangements of that kind typically display some or all of the following features:

(a) The taxpayer arranges for the establishment of a trust. The trustee of the trust is either the taxpayer, or is controlled by the taxpayer and/or associates of the taxpayer.

(b) The beneficiaries of the trust are the taxpayer and his or her associates (the other beneficiaries). The other beneficiaries are members of the taxpayer's family, and/or entities which the taxpayer and/or the taxpayer's associates control; they do not usually contribute any capital to the trust, nor do they provide money or property to the taxpayer.

(c) The taxpayer borrows money at interest and settles it on the trust. The trustee issues units to the taxpayer. The units carry particular rights to trust income and/or capital.

(d) The trustee uses the money in subparagraph (c) to purchase one or more income-producing assets. Typically, the assets comprise real estate or shares.

(e) The trust deed and/or the trustee acting under authority of the trust deed determines how much of the income of the trust is available for distribution to beneficiaries.

(f) The taxpayer's units do not give the taxpayer an entitlement to all of the benefits which may reasonably be expected to be produced by the asset(s) in subparagraph (d). Alternatively, an objective implication to be drawn from the trust deed is that the taxpayer cannot reasonably expect to receive all such benefits.

(g) For example, the taxpayer's units:

  (i) may carry no entitlement to share in realised capital gains of the trust;

  (ii) may carry no entitlement to share in anything other than realised capital gains of the trust;

  (iii) may carry an entitlement to share only in part of the income of the trust; or

  (iv) may be redeemable, at the trustee's discretion, for an amount which fails to reflect the taxpayer's contribution to the trust (for example the cost of the units or their market value, where such value reflects the limited nature of the rights which the units carry).

(h) For a number of income years, the amounts included in the taxpayer's assessable income because of his or her unit holding are significantly less than the interest expense on the borrowing. The taxpayer claims that the interest expense is deductible in full under section 8-1 of the ITAA 1997.

General characterisation principles

29. Section 8-1 of the ITAA 1997 provides a taxpayer with a deduction for a loss or outgoing to the extent to which it is incurred in gaining or producing the taxpayer's assessable income. A loss or outgoing is not deductible to the extent that it is of a private or domestic nature.[1]

30. A loss or outgoing is not deductible where it is incurred to gain or produce benefits for other persons. This proposition was illustrated in *Federal Commissioner of Taxation v. Munro* (1926) 38 CLR 153; (1926) 32 ALR 339 (*Munro's Case*), where a taxpayer subscribed borrowed funds for shares in a company, 90% of which were issued to his sons. The borrowed funds were clearly spent to benefit other people, and the taxpayer's mortgage interest was not deductible.[2]

31. The essential character of interest expense is derived from the purpose of the borrowing and the application or the use of the borrowed funds.[3] The laying out of the borrowed money for the purpose of gaining assessable income 'furnishes the required connection between the interest paid upon it by the taxpayer and the income derived by him from its use'.[4] Accordingly, interest expense is not deductible to the extent that borrowed money has been used for the non-incidental purpose of benefiting others.

Use of borrowed money to provide benefits to others

32. In cases of the kind with which this draft Determination is concerned, the objective facts indicate that the borrowed money has been used for the purpose of benefiting both the taxpayer and the other beneficiaries. To the extent that it is used to settle on a trust to benefit the other beneficiaries, it has the characteristics of a gift. A transfer of property may bear 'all the marks of a family settlement' even though it is done under an arrangement which may produce assessable income for the taxpayer.[5] As such, a portion of the interest payable on the borrowed money is not incurred in gaining or producing the taxpayer's assessable income,[6] or it has a private or domestic nature.[7] That portion of the interest is not deductible.

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[1] Paragraph 8-1(2)(b) of the ITAA 1997.
[2] *Munro's Case* was decided on the basis of the *Income Tax Assessment Act 1922* (ITAA 1922). The ITAA 1922 provided for the deduction of 'interest actually incurred in gaining or producing the assessable income' (paragraph 23(1)(a) of the ITAA 1922). It also contained an express prohibition against any deduction in respect of 'money not wholly and exclusively laid out or expended for the production of assessable income' (paragraph 25(e) of the ITAA 1922). In contrast, section 8-1 of the ITAA 1997 calls for apportionment.
[3] *Federal Commissioner of Taxation v. Roberts & Smith* (1992) 37 FCR 246; 92 ATC 4380 at 4388; (1992) 23 ATR 494 at 504; *Kidston Goldmines Ltd v. Federal Commissioner of Taxation* (1991) 30 FCR 77; 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177; *Hayden v. Federal Commissioner of Taxation* (1996) 68 FCR 19; 96 ATC 4797 at 4801; (1996) 33 ATR 352 at 356.
[4] *Ure v. Federal Commissioner of Taxation* (1981) 50 FLR 219; 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 488.
[5] *Egerton-Warburton v. Deputy Federal Commissioner of Taxation* (1934) 51 CLR 568 at 574.
[6] Paragraph 8-1(1)(a) of the ITAA 1997. *Federal Commissioner of Taxation v. Isherwood & Dreyfus Pty Ltd* (1979) 46 FLR 1; 79 ATC 4031 at 4032; (1979) 9 ATR 473 at 474.
[7] Paragraph 8-1(2)(b) of the ITAA 1997.

33. The conclusion that borrowed money is being used to benefit entities other than the taxpayer follows logically from the connection between the money spent and the rights the taxpayer and the other beneficiaries obtain. The terms of trust indicate that the taxpayer will not enjoy, or cannot reasonably expect to enjoy, all of the benefits flowing from the trust capital which he or she has funded with the borrowed money. A consequence of this is that the borrowed moneys settled by the taxpayer on the trust are disproportionate to the benefits which might reasonably be expected to pass to the taxpayer under the trust deed.[8] To that extent, the expenditure lacks an obvious commercial explanation[9] but has an obvious private or domestic explanation and has an equally obvious family explanation.

Purpose to benefit others not merely incidental

34. The conclusion that borrowed money has been used to gain or produce benefits for other entities will affect the characterisation of the taxpayer's interest expense for the purposes of section 8-1 of the ITAA 1997. This follows because such use is not relevant to the production of the taxpayer's assessable income, nor is it merely incidental to the production of the taxpayer's assessable income.

35. The non-incidental nature of the taxpayer's intention to provide benefits to others is highlighted by the trust deed, which includes beneficiaries other than the taxpayer, and establishes a mechanism for enabling benefits from the trust property to be shared with persons other than the taxpayer. In arranging for this structure to be established, the taxpayer provides an objective indication that the provision of particular benefits to other persons or entities is a distinct purpose of his or her expenditure. If the provision of benefits to the other beneficiaries was considered insignificant, or merely incidental to the assessable income to be provided to the taxpayer, this complex structure would be unnecessary.

36. In this regard, the arrangements of the kind discussed in this draft Determination can be contrasted with cases in which a taxpayer uses borrowed money to purchase a single asset which produces assessable income and which may also result in a capital gain or loss on disposal of the asset. If the possibility of the taxpayer making a capital gain on the disposal of the asset is simply an incident of the acquisition and holding of the asset for the purpose of producing assessable income then the essential character of the interest expense will be for the gaining of assessable income rather than the capital gain.[10]

Dual Purpose

37. The use of borrowed funds to benefit the other beneficiaries affects the characterisation of the interest expense, even if the taxpayer expects the investment to produce an amount of assessable income which will exceed the amount of his or her interest payments. This is because, objectively, the expenditure has a dual purpose – one of which is income producing and one of which is not.

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[8] *Robert G Nall Ltd v. Federal Commissioner of Taxation* (1936) 57 CLR 695 at 706; (1936) 4 ATD 335 at 338, 340, and 342-343; *WD & HO Wills (Australia) Pty Ltd v. Federal Commissioner of Taxation* (1996) 65 FCR 298; 96 ATC 4223 at 4248; (1996) 32 ATR 168 at 193.

[9] *Ure v. Federal Commissiner of Taxation* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484; Taxation Ruling IT 2684, paragraph 9.

[10] See *In Re a Taxpayer (NSW No 1)* (1932) 2 ATD 210.

38. In the ordinary case, the deductibility of interest can be determined by reference to the fact that the outgoing gives rise to a larger amount of assessable income.[11] However, the use of borrowed money for a dual purpose, one of which is income producing and one of which is not, is not the ordinary case. In arrangements of the kind discussed in this draft Determination, the dual purpose of the taxpayer's interest payments can be discerned objectively from the trust deed, without the need for recourse to subjective considerations.

39. In this regard, the position of taxpayers in arrangements of the kind discussed in this draft Determination is similar to the position of the taxpayer in *Munro's Case*; refer to paragraph 30 of this draft Determination. A father who uses borrowed funds to purchase shares for himself and his sons cannot obtain a full deduction for his interest expense on the basis that he expects to recoup that expense from dividends payable on the shares that he holds. The clear relationship between the use of the borrowed funds and distinct benefits provided to other entities indicates that the interest is not deductible, or that apportionment is required.[12]

Apportionment

40. If apportionment is required, what will be appropriate will be essentially a question of fact, to be determined in each case.[13] There must be 'a fair apportionment to each object of the… actual expenditure'.[14]

41. Where the borrowing is used to fund trust entitlements with distinct and severable parts, the deduction can be determined on a proportionate basis (see Example 1 at paragraphs 8 to 12 of this draft Determination):[15]

> One kind [of outgoing] consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services.

42. In other cases, the expenditure may serve several objectives indifferently and may not be capable of arithmetical or rateable division. In these cases the result will depend to an even greater degree upon a finding of fact as to the extent to which the expenditure is incurred in gaining or producing assessable income.[16] In these cases, if income production appears to be a minor object of the taxpayer in borrowing the money upon which interest is incurred (and the benefiting of family members a main or prevailing purpose) only a small part of the interest will be fairly and properly attributable to gaining the assessable income of the taxpayer: as a rule of thumb, generally no more than the assessable income derived by the taxpayer in a particular year and in some cases less (see Examples 2 and 3, at paragraphs 13 to 17 and 18 to 22 respectively of this draft Determination).

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[11] *Fletcher v. Federal Commissioner of Taxation* (1991) 173 CLR 1; 91 ATC 4950 at 4957-4958; (1991) 22 ATR 613 at 622.
[12] Refer to footnote 2 of this draft Determination.
[13] *Ronpibon Tin NL & Tong Kah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 59; *Fletcher v. Federal Commissioner of Taxation* (1991) 173 CLR 97; 91 ATC 4950 at 4957; (1991) 22 ATR 613 at 621.
[14] *Ronpibon Tin NL & Tong Kah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 60.
[15] *Ronpibon Tin NL & Tong Kah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 59.
[16] *Ronpibon Tin NL & Tong Kah Compound NL v. Federal Commissioner of Taxation* (1949) 8 ATD at 437.

Perceived connection

43. In some cases no relationship will be seen between the incurring of interest expense and the production of assessable income for the taxpayer. The existence of a sufficient nexus between an outgoing and the production of assessable income is essentially a question of fact. However, no perceived connection[17] will be found merely because it is possible that a trustee, in the independent exercise of fiduciary power, might appoint income in a future year of income to the taxpayer. In such a case, the income arises by reason of the exercise of the trustee's discretion; and therefore lacks a sufficient relationship to the outgoing (see Example 4 at paragraphs 23 to 27 of this draft Determination).

Part IVA

44. In the Commissioner's view, in arrangements of the kind discussed in this draft Determination the taxpayer's interest expense is not deductible in full under section 8-1 of the ITAA 1997. To that extent, therefore, the arrangements would not give rise to tax benefits within the meaning of section 177C of the ITAA 1936.

45. However, if a taxpayer was entitled to an unapportioned deduction, the Commissioner may consider whether Part IVA of the ITAA 1936 applies to the facts of the particular case. If the Commissioner concluded, based upon the facts of a particular case, that there was a scheme entered into for the sole or dominant purpose of obtaining a tax benefit, the Commissioner may determine that the whole or part of the deduction is not allowable to the taxpayer.

[17] *Federal Commissioner of Taxation v. Hatchett* (1971) 125 CLR 494; 71 ATC 4184 at 4187; (1971) 2 ATR 557 at 560.

Appendix 3 – Your comments

46. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

47. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **19 December 2008**

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References

Previous draft:

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Related Rulings/Determinations:

IT 2385; IT 2684; TR 2006/10

Subject references:

- allowable deductions
- apportionment
- hybrid trusts
- interest deductions
- trusts
- uncommercial trusts

Legislative references:

- ITAA 1936 51AAA
- ITAA 1936 Pt IVA
- ITAA 1936 177C
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(2)(b)
- ITAA 1922
- ITAA 1922 23(1)(a)
- ITAA 1922 25(e)

Case references:

- Egerton-Warburton v. Deputy Federal Commissioner of Taxation (1934) 51 CLR 568; (1934) 8 ALJ 233; (1934) 3 ATD 40; (1934) ALR 380
- Federal Commissioner of Taxation v. Hatchett (1971) 125 CLR 494; 71 ATC 4184; (1971) 2 ATR 557
- Federal Commissioner of Taxation v. Isherwood & Dreyfus Pty Ltd (1979) 46 FLR 1; 79 ATC 4031; (1979) 9 ATR 473
- Federal Commissioner of Taxation v. Munro (1926) 38 CLR 153; (1926) 32 ALR 339
- Federal Commissioner of Taxation v. Roberts & Smith (1992) 37 FCR 246; 92 ATC 4380; (1992) 23 ATR 494
- Fletcher v. Federal Commissioner of Taxation (1991) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613
- Hayden v. Federal Commissioner of Taxation (1996) 68 FCR 19; 96 ATC 4797; (1996) 33 ATR 352
- Kidston Goldmines Ltd v. Federal Commissioner of Taxation (1991) 30 FCR 77; 91 ATC 4538; (1991) 22 ATR 168
- In Re a Taxpayer (NSW No 1) (1932) 2 ATD 210
- Robert G Nall Ltd v. Federal Commissioner of Taxation (1936) 57 CLR 695; (1936) 4 ATD 335; (1936) 11 ALJ 204
- Ronpibon Tin NL & Tong Kah Compound NL v. Federal Commissioner of Taxation (1949) 78 CLR 47; (1949) 8 ATD 431; (1949) 23 ALJ 139
- Ure v. Federal Commissioner of Taxation (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484
- WD & HO Wills (Australia) Pty Ltd v. Federal Commissioner of Taxation (1996) 65 FCR 298; 96 ATC 4223; (1996) 32 ATR 168

Other references:

- Taxpayer Alert TA 2008/3

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