IT 2512 - Income tax: financing unit trusts

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TAXATION RULING NO. IT 2512

INCOME TAX: FINANCING UNIT TRUSTS

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211589	FINANCING UNIT TRUSTS	25(1)
	BANKS	25A
	INSURANCE COMPANIES	26AAA
	FINANCIAL INSTITUTIONS	160L(3)(b)
		Division 6
		Division 10D
		Division 16E
		Part IVA

PREAMBLE Recently there has been a proliferation of an arrangement, sometimes referred to as a 'financing unit trust', which is designed to substitute trust distributions that are claimed not to be assessable for interest income.

2. Under the arrangements a financier (or group of financiers) or entity controlled by a financier provides funds for a particular project such as a property investment/development by way of subscription for units in a unit trust. In some cases the arrangement is used to refinance an already completed project or existing business. This Ruling considers the taxation implications of payments received or receivable by the financier under the arrangements.

3. Two typical types of financing unit trusts are considered. There can be variations on each of these types. Common to both, however, are the following features. The financiers subscribing for units are generally banks, insurance companies or other financial institutions. The financier is guaranteed an agreed rate of return on its investment, the rate being calculated in much the same fashion as interest on a loan would be. From the financier's point of view, the investment may be regarded commercially as a substitute for the provision of loan funds upon which interest would be receivable. The various agreements entered into also provide for the financier's units to be purchased or redeemed at a predetermined date for a predetermined price reflecting the repayment of the financier's original outlay and the agreed rate of return. This is essentially the limit of the financier's involvement in the unit trust.

4. The financier undertakes few of the risks of ownership. These risks are undertaken by one of the other parties to the arrangements, usually the property investor/developer, who is

also liable to 'top up' any shortfall in the funds required to meet the agreed rate of return to the financier. This guarantee may be contained in the trust deed constituting the unit trust or in a separate contractual agreement. Another common feature is that the financier is indemnified against any liability to third parties arising out of the trust activities and against any "losses" if there is a denial of the contemplated tax benefits as described in paragraph 11 of this Ruling.

5. Usually, property investors/developers who enter into financing unit trust arrangements are entities who are themselves unable to obtain the full and immediate benefit of deductions for plant depreciation, building amortisation and interest expense. It is also normal for the financier in the arrangement to commit funds for a fixed period of, e.g., five to seven years, sometimes referred to as the finance period.

6. The two typical types of financing unit trust arrangements are described below.

TYPE 1

7. In this type of financing unit trust the trustee purchases the subject property or business from the property investor/developer. Typically the trustee derives assessable income by operating the business or leasing the property. Often the investor/developer's continuing role in the arrangements will be as manager running the business for the trustee or as the lessee of the property from the trustee.

8. As indicated in paragraph 4, if the trust receipts are insufficient to meet the required level of distributions to the finance unitholder(s), the property investor/developer generally will be expected to meet the shortfall. Conversely, if the lease payments exceed the required level of distributions, the excess is generally paid to the property investor/developer by way of, for example, a bonus for 'successful management' of the property or business.

9. In most, if not all, income years covered by the finance period the income derived by the trustee never exceeds the income tax deductions claimed in respect of the ownership of plant and equipment and buildings which form part of the trust property. In other words, the arrangements are founded on the basis that deductions for depreciation for plant and for building amortisation under Division 10D of Part III of the Act lead to losses being carried forward in the trust at least for the initial years of the arrangements. The arrangements may be structured so that the losses will be recouped within, say, five years.

10. It is a feature of these arrangements that when the finance period has ended (which often coincides with the recoupment of any losses), the units held by the financier are redeemed by the trustee or acquired by the property investor/developer or some other party for a predetermined amount. In some circumstances the units may be held not by the financier directly but by a

subsidiary of the financier. The shares in the subsidiary are disposed of instead of the units in the trust. Where the units or shares are sold, this may be effected by a call option being exercised by the property investor/developer, or by the financier exercising a put option.

11. For most of the years of the arrangements, the availability of deductions not involving actual cash outlays has the effect that the net accounting income of the trust estate exceeds the 'net income', as defined in subsection 95(1) of the Act, for income tax purposes. The amount of the excess is distributed to the finance unitholder(s) and is claimed to be tax free in its hands. The claim is based on an argument that Division 6 of Part III of the Act provides an exclusive code for the assessment of beneficiaries, and that as the amount is not assessable under section 97 and should not attract the operation of section 99B, no provision of the Act brings the amount into the assessable income of the finance unitholder(s).

12. The assessability of profit on disposal of the financier's units is said to fall for consideration under section 26AAA only and not section 25A, subsection 25(1) or the capital gains provisions. The reason for this is the granting, at the outset of the arrangements, of the option to acquire the units which is said to give rise to an application of subsection 26AAA(3). Subsection 26AAA(3) operates to bring within section 26AAA a sale of property made after the expiration of twelve months from the date of purchase where the sale was made in pursuance of an option granted within the twelve months period. Where section 26AAA applies to bring into assessable income a profit on disposal of an asset the capital gains provisions will not apply (paragraph 160L(3)(b) of the Act).

13. As a simple example of this type of arrangement, a financier might pay $100m for units in a unit trust. The money (apart from a relatively small amount earmarked for administrative expenses, etc) is used by the trustee to purchase a property or business from the property investor/developer which the property investor/developer continues to manage. Over a period of 5 years the trustee derives assessable income of $80m. After expenses of $30m the net accounting income of the trust estate over the period is $50m but after tax deductions for items such as depreciation which do not involve cash outlays, the amount of "net income" for income tax purposes is nil or negligible. The excess accounting income is distributed to the finance unitholder(s) over the finance period and claimed to be non-assessable in the finance unitholder's hands on the basis described earlier. At the end of the finance period, the property investor/developer purchases the units from the financier for $110m giving rise to a profit of $10m. When added to the $50m net accounting income the total profit or gain to the financier is $60m, of which $50m is claimed to be tax free.

TYPE 2

14. In this type of financing unit trust, the trustee does not

purchase the subject property. Instead, the trustee uses the major part of the subscription moneys to make an interest free loan to the property investor/developer. This allows the property investor/developer to retire some or all of the existing debt that it has in respect of the property.

15. Two classes of units are issued, the property investor/developer subscribing for one class and the financier subscribing for the other class. As in the Type 1 situation, the property investor/developer acquires, or the trustee redeems, the financier's units at the end of the finance period for a predetermined sum pursuant to an option agreement. If this option is not exercised, the trustee in some cases may be entitled to purchase the subject property.

16. During the finance period, i.e., the period up to the time at which the financier's units are disposed of, the trustee leases the property from the property investor/developer and sub-leases it to a third party, normally an associate of the property investor/developer. The rent that it receives approximates the rent that it has to pay.

17. The trustee also receives money from the property investor/developer in the form of repayments of the interest free loan. These amounts are distributed to the finance unitholder, and it is claimed that they are of a capital nature and are not taxable in its hands.

RULING

18. The main tax question in financing unit trusts is whether payments made by way of distributions by the trustee constitute assessable income in the hands of the finance unitholder(s). This question must be determined by reference to the nature of the receipt in the recipient's hands (cf. Scott v FC of T (1966) 14 ATD 286, 293 per Windeyer J.), and having regard to the nature of the arrangements, including any contractual agreements which ensure that the payments represented by the trust distributions are made to the financier.

19. The view is taken that in both Type 1 and Type 2 cases, the distributions are assessable to the finance unitholder under subsection 25(1) or section 25A. Participation by banks, insurance companies and other financial intermediaries in financing unit trust arrangements forms part of their commercial activities and profits from these arrangements are to be taxed accordingly. Investment of funds by banks, insurance companies and financial intermediaries in financing unit trust arrangements is as much a part of their respective businesses as is the sale of investments, the profits from which were held to be taxable in cases such as Colonial Mutual Life Assurance Society Ltd v. F.C. of T (1946) 73 CLR 604, London Australia Investment Co. Ltd v. FCT (1976-1977) 138 CLR 106, Chamber of Manufactures Insurance Ltd v. F.C. of T 84 ATC 4315; 15 ATR 599 and Punjab Co-operative Bank Ltd, Amritsar v Commissioner of Income-Tax, Lahore (1940) A.C. 1055 (see also Taxation Ruling No. IT2276). The character of the profits from the financing unit trust arrangements is fundamentally no different to profits resulting from the sale of these

investments.

20. It is claimed on behalf of finance unitholders that Division 6 of Part III of the Act is an exclusive taxing provision for beneficiaries/ unitholders in respect of shares of income of a trust estate and that, as the net accounting income distributions are not assessable in accordance with that Division, they are accordingly tax free. The scope of Division 6 was considered by the High Court in F.C. of T v. Belford (1952) 88 CLR 589 and Union Fidelity Trustee Co. v. F.C. of T (1969) 119 CLR 177. The majority view in Belford that it was not an exclusive code was affirmed in Union Fidelity. Amendments to the Division, particularly those in 1979 which inserted section 99B into the Act, did not alter this position (page 8 of the Explanatory Memorandum accompanying Income Tax Assessment Amendment Bill (No.5) 1978 refers). The view of this office, therefore, is that Division 6 is not an exclusive taxing provision in respect of a beneficiary's share of the income of a trust estate.

21. The argument referred to in paragraph 17, namely that the character of the distributions to finance unitholders is capital because that is the character of the moneys in the hands of the trustee, seeks to rely on Charles v. FCT (1954) 90 CLR 598. Neither the decision nor the discussion in Charles' case is wholly apposite to the present arrangements. There are fundamental distinguishing features. Firstly, and most importantly, the distributions received or receivable by the finance unitholders are contractual, predetermined payments made under a tripartite arrangement. It is also appropriate to make a distinction on the basis of the nature of the interest held by the finance unitholders in the trust. (See Tindal v. FCT (1946) 72 CLR 608 and Ewing v C of T (1928) ALJR 246 where the High Court made a distinction between "income only" beneficiaries and beneficiaries entitled to corpus and income. See also Case C57 71 ATC 250; 17 CTBR (NS) Case 54). In Charles' case, a unit conferred a proprietary interest in all the property which for the time being was subject to the trust of the deed. In financing unit trusts a financier's interest in the trust property is much more limited. Having regard to all the agreements entered into, including the trust deed and separate contractual agreements, the financier is effectively entitled only to the agreed amounts representing a repayment of subscription moneys plus the predetermined return on investment.

22. The transaction in Charles' case was of a very different kind and on the evidence no question of a profit-making arrangement arose. The present tripartite arrangements are of a financing nature, with the return or profit being determined and guaranteed at the outset. The distributions received by the finance unitholders are clearly either business income according to ordinary concepts or profits from a profit making arrangement. The profits are assessable under section 25 or 25A. In this context it is to be noted that in the recent decision of the Full High Court in F.C. of T v. The Myer Emporium Ltd (1987) 163 CLR 199 the Court held that "a gain

made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income" under subsection 25(1) or section 25A.

23. It is also noted that there is an argument that Division 16E of Part III of the Act applies to the guaranteed return of income at the end of the contractual period. It is of course necessary to examine in detail all the facts of each case before a firm decision can be made as to the application of that Division.

24. The option to acquire the financier's units is said to attract the operation of section 26AAA rather than section 25A, subsection 25(1) or the capital gains provisions. As indicated in paragraph 12 above, the capital gains provisions will not apply to the disposal of an asset if section 26AAA applies (paragraph 160L(3)(b)). Section 26AAA does not, however, apply in the present circumstances. Section 26AAA was inserted in the Act to supplement, and not replace, existing provisions of the law under which short term profits or gains were in certain circumstances assessable. Accordingly, section 26AAA operates to assess short-term profits or gains only if they are not otherwise assessable under any other provision of the Act. Under the present arrangements, the financing unit trust activities, including the final disposal of the units, are part of the commercial activities of financiers and the profits or gains therefrom are properly assessable under section 25A or subsection 25(1) and, where appropriate, the capital gains provisions.

25. It should also be noted that section 26AAA has been amended by the Taxation Laws Amendment Act (No.4) 1988 (No. 95 of 1988) so that it will not apply to the disposal of assets after 25 May 1988.

26. The anti-tax avoidance provisions of Part IVA would be available against these arrangements if the primary view that the profits or gains are assessable under section 25, 25A or the capital gains provisions is incorrect. The tax benefit would be the amount of interest income (ie. the reward for the use of money) which would have been included in assessable income if these financing arrangements had not been entered into in this particular manner. Although each case will depend on its own facts, it would be apparent from a consideration of the reference matters listed in section 177D, that the sole or dominant purpose in implementing the tripartite contractual financing arrangements through a financing unit trust would be to obtain a tax benefit. The trust is the mere conduit for the payment of interest and the principal from the property investor/developer to the financier.

27. The view contained in this ruling as to how the law operates in relation to financing unit trusts is at variance with advance opinions that this office gave in a small number of particular cases. From representations made by interested parties

including those consulted in the course of preparing this Ruling, it appears that the advance opinions given in those cases were disseminated in the financial/building industries and among their taxation advisers as evidencing a general Taxation Office approach. Although not authorised to be used in that way the result was that some parties entered into these arrangements believing that they generally had a form of official clearance.

28. In view of these special circumstances, this Ruling will not disturb any prior advice given by this office as to the tax implications of a particular case where the arrangement is carried into effect on the factual basis on which the advice was formulated. Nor because of the special circumstances will this Ruling disturb arrangements entered into on or before 18 August 1988, the date on which Taxation Ruling No. IT 2500 was issued, where there are no material differences between those arrangements and those on which particular private rulings were given. There would of course be the need to examine these cases before ruling accordingly.

29. There are some cases where adverse rulings were given to particular enquiries, including where there were factual differences between the arrangements enquired about and the situations described in this Ruling. Any such arrangements that have proceeded will be considered taking into account the view of the law reflected in this Ruling.

30. Taxation Ruling IT 2500 has now made abundantly clear that in future private advance opinions given by the Commissioner cannot be relied upon by parties other than those who sought the opinions.

31. It should also be emphasised that this Ruling does not extend to situations where, in the case of an ordinary trust, a distribution is made in excess of the net income for tax purposes. The excess, which may be referable to allowable tax deductions, should not be assessed on the basis of this Ruling. An ordinary trust would in this context include a family trust whether the trustee made investments or carried on a business, or a trust created by a will or a unit trust where the beneficiaries or unitholders are entitled to both corpus and income of the trust i.e., they are effectively exposed to all the risks of ownership and participate in the profits of the trust. The interests in such a trust are not ones where it could normally be concluded that the beneficiary or unitholder is obtaining a return on commercial activities carried on by the beneficiary or unitholder.

COMMISSIONER OF TAXATION
20 December 1988