TR 2005/12 - Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries

This document has changed over time. This is a consolidated version of the ruling which was published on *6 July 2005*

Taxation Ruling

Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries

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Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect,** and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling explains the principles to be applied in determining whether a trustee of a trust estate is entitled to a deduction when calculating the net income of the trust estate under section 95 of the *Income Tax Assessment Act 1936* ('the Act') in respect of interest expenses incurred on funds borrowed in connection with the payment of distributions to beneficiaries.

2. The class of persons to which this Ruling applies are trustees that incur interest expenses on such borrowings.

Date of effect

3. This Ruling applies to arrangements entered into both before and after its date of issue. However, to the extent to which Taxation Ruling TR 2003/9 is more favourable to taxpayers, this Ruling applies only from 2 March 2005. This Ruling also does 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 Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Previous Rulings

4. This Ruling replaces Taxation Ruling TR 2003/9 which was withdrawn on and from 2 March 2005.

Definitions

5. The term 'returnable amount'[1] is used in this Ruling to refer to money or property forming part of the trust estate that:

(a) is employed by the trustee in gaining or producing the assessable income of the trust estate, or in carrying on business for that purpose; and that

(b) a beneficiary of the trust estate is entitled to require to be returned to that beneficiary; and that

(c) is or represents money or property that was previously transferred by the beneficiary (or another person on the beneficiary's behalf) to the trustee of the trust estate, including money or property previously retained by the trustee out of funds to which the beneficiary was presently entitled.[2]

Ruling

6. The incurring of interest expenses by a trustee of a trust estate in respect of borrowed funds used by the trustee to discharge an obligation to pay a monetary distribution to a beneficiary will not, of itself, result in the interest expense being deductible. This is the case regardless of whether the borrowing of funds by the trustee allows income producing assets to remain part of the trust estate.[3]

7. In order to be deductible, the interest expenses incurred by a trustee must be sufficiently connected with the assessable income earning activity, or business, carried on by the trustee as trustee of a particular trust estate. The onus rests upon the trustee to show that a sufficient connection exists.

[1] The phrase 'returnable amount' is not found in either the tax legislation, or in the relevant case law, but is a useful shorthand phrase covering a variety of situations in which a beneficiary may loosely be said to have 'invested' an amount in a trust in the relevant sense (see *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380; 23 ATR 494). See paragraph 9 of this Ruling for illustrations of situations where there is a 'returnable amount'.

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

[3] See paragraph 3(e), and paragraphs 28 to 33A, of TR 95/25.

8. The interest expenses will be sufficiently connected if the purpose of the trustee in borrowing funds, when viewed objectively, is to refinance a 'returnable amount'.[4] Whether the objective purpose of the trustee in borrowing funds is to refinance a returnable amount depends on the facts of each case.[5]

9. The following factual situations illustrate circumstances in which money or property is a returnable amount in the sense that that expression is used in this Ruling:

- an individual has subscribed money for units in a unit trust and has a right of redemption in relation to the units, and the money is used by the trustee to purchase income producing assets;
- a beneficiary has an unpaid present entitlement to some or all of the capital of a trust estate, or some or all of the net income of the trust estate, and the amount to which the beneficiary is entitled has been retained by the trustee and used in the gaining or producing of assessable income of the trust; and
- a beneficiary lends an amount to the trustee who uses the money for income producing purposes (for example, by depositing it at interest in a bank).

10. Internally generated goodwill or unrealised revaluations of assets are not, in the relevant sense, amounts provided to the trustee by, or on behalf of, a beneficiary of the trust estate and do not constitute returnable amounts in the sense in which that term is used in this Ruling.

11. The interest expenses will not be sufficiently connected if the objective purpose of the trustee in borrowing funds is merely to discharge an obligation to make a distribution.[6] Accordingly, where a beneficiary becomes entitled to an amount and the borrowing and distribution by the trustee is contemporaneous (or nearly so) with that entitlement coming into existence, it would be difficult to show that a sufficient connection exists. In such a case it would ordinarily be concluded that the purpose of the trustee in borrowing funds was only to make the distribution. However, if the trustee is required to return a returnable amount earlier than had been expected as a result of an

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[4] This is so regardless of whether the trustee pays the returnable amount to a beneficiary who uses those funds for private purposes.

[5] Paragraphs 8 and 9 are an exposition of how basic principles discernable in cases such as *FC of T v. JD Roberts; FC of T v. Smith* 92 ATC 4380; 23 ATR 494 apply in the context of a trust estate. The result obtained by the application to companies of the principles discussed in this ruling is to be distinguished from the result obtained in respect of trust estates. The general legal and taxation positions of trustees and companies, their beneficiaries and shareholders, and of trust distributions and dividends, differ in many fundamental ways, as may the relevant accounting treatment. For the application of the principles to companies see Taxation Ruling TR 95/25.

[6] The obligation may arise, for example, as a result of statute (for example, family maintenance provisions), as a result of the instrument giving rise to the trust estate, or by operation of law (for example, an obligation under a constructive trust).

unforeseen change in circumstances, then the interest expense may still be deductible (see Example 8 below).

12. There may be practical difficulties in establishing that an amount was used to produce assessable income, particularly where funds are mixed[7] and a portion of the funds is used to gain exempt income, is used for private family purposes,[8] or is otherwise used in a non-income producing way. However, a rigid tracing is not necessary where all the funds have been used as part of the recurrent operations of the business of the trust estate.[9]

Explanation

13. 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).

14. 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 essential character of the interest 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).[10]

15. In determining whether some or all of the interest incurred by a trustee on funds borrowed in connection with the payment of distributions to beneficiaries is deductible, in accordance with well established general principles the following two propositions are relevant:

- the mere fact that the trustee may have an obligation to make a distribution and, absent the borrowing, would be obliged to sell or dispose of income producing assets, does not suffice to render the interest deductible (see *FC of T v. Munro* (1926) 38 CLR 153; *Hayden v. FC of T* (*Hayden's case*) 96 ATC 4797 at 4804; 33 ATR 352 at 360); and

[7] In this context, apportionment of the interest expense will be necessary where the borrowed funds are put to more than one use, and one or more of those uses is non-income producing.

[8] For example, where funds to which a beneficiary is presently entitled are used by the trustee for the ongoing upkeep and maintenance of a holiday home used exclusively by the beneficiaries of the trust estate.

[9] Except where there are specific powers or directions in the trust deed or loan agreement that require the funds to be used for non-income producing purposes.

[10] See also *Steele v. DFC of T* 99 ATC 4242 at 4251; 41 ATR 139 at 151; *FC of T v. JD Roberts; FC of T v. 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.

- the refinancing principle discussed in *FC of T v. JD Roberts; FC of T v. Smith*[11] (*Roberts & Smith*).

Hayden's case

16. 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.

17. In holding that the interest incurred was not deductible, Spender J stated:

> 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.[12]

Roberts & Smith

18. In *Roberts & Smith*, a partnership of solicitors wished to admit a new partner, Mr McKay, to the firm, and decided that commencing with Mr McKay all future partners would have to pay a sum to enter the partnership. As Mr McKay did not have the amount required to enter the partnership, the partners resolved to reduce their capital input into the partnership so that Mr McKay could buy into the partnership at a much reduced level. The partnership borrowed from a bank to fund this capital reduction.

19. In deciding that interest on the borrowings taken out by the partnership was deductible, Hill J commented that:

> … let it be assumed that there are undrawn partnership distributions available at any time to be called upon by the partners. The partnership borrows from a bank at interest to fund the repayment to one of the partners who has called up the amount owing to him … The funds to be withdrawn in such a case [are] employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of

[11] 92 ATC 4380; 23 ATR 494.
[12] 96 ATC 4797 at 4804; 33 ATR 352 at 359.

> assessable income … In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense … Similarly, where moneys are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible …[13]

The objective purpose for borrowing and the use of the money

20. The primary rule is that the deductibility of interest on borrowed moneys follows the purpose and use of the money (for example, the discharging of an obligation to pay a distribution). By way of exception, when the objective purpose of the trustee in borrowing funds is to refinance money previously invested in the production of income, whether or not the interest expense is deductible is determined by the use to which the amount being refinanced was previously put.

21. It will not always be a simple matter to determine which of the two possible outcomes (deductible/non-deductible) arises in any particular case. Ultimately this question can only be answered by determining the objective purpose of the trustee in borrowing the funds. To the extent that the objective purpose of the trustee was to replace an amount that had previously been provided to the trustee by, or on behalf of, a beneficiary of the trust estate, and had previously been used in an assessable income earning activity, or business, carried on by the trustee in the relevant capacity, then the principle set out in *Roberts & Smith* will apply. On the other hand, where the borrowing is simply to discharge an obligation to pay a monetary distribution to a beneficiary, then it is likely that interest incurred on the borrowing will not be deductible. *Hayden's case* is illustrative of this proposition.

22. While the objective purpose of the trustee in borrowing funds can only be determined having regard to the full facts of each individual case, the following general observations can be made:

- if a beneficiary lends an amount to the trustee of a trust estate, and the amount is used by the trustee in the assessable income earning activities of the trust estate, interest expenses incurred by the trustee in respect of funds used by the trustee to repay the loan made by the beneficiary are deductible. In this case the usual rule for borrowings applies, and the status of the lender as beneficiary and the borrower as trustee is irrelevant; and

[13] 92 ATC 4380 at 4388; 23 ATR 494 at 504.

- assuming that the trust estate is employed in gaining or producing assessable income, then, all other circumstances being equal, the longer the period between the exercise of a discretion that results in a person becoming entitled to an amount of capital and/or income of a trust estate, and the discharge of that entitlement, the more likely it is that some or all of the amount representing that entitlement objectively has been used by the trustee in the production of income for the trust estate (that is, the more likely it is that some or all of the amount will be a returnable amount).[14]

23. From an evidentiary perspective the refinancing principle in *Roberts & Smith* relies on properly drawn trust accounts and/or loan documentation showing the sources and outlays of the relevant trust funds.[15]

24. The onus rests upon the trustee to provide evidence to show both that there is a 'returnable amount' and that the sole objective purpose of the trustee in borrowing funds is to refinance that amount. While it is not for the Commissioner to prescribe the documents or other evidence necessary to discharge this onus, the application of the law to a particular factual scenario will be more obvious if the taxpayer is able to point to documents[16] that adequately demonstrate both that there is a 'returnable amount',[17] and the relevant objective purpose. In this context, the Commissioner recognises that there can be practical difficulties in demonstrating the extent to which borrowed funds have been used to replace an amount provided by, or on behalf of, a beneficiary that objectively has been used in the income producing activities, or business, of the trust. These difficulties are likely to be particularly acute where the trustee is regularly turning over assets and receiving income, and/or operating a substantial overdraft account out of which beneficiary distributions as well as

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[14] As it is always a question of fact as to whether an unpaid present entitlement has been used in the income earning activities of the trust estate, the length of time between the creation of a present entitlement and the discharge of that entitlement will not necessarily be determinative. However, a short, or token, delay will not of itself be sufficient to ensure the deductibility of interest payable on borrowed funds used to make the discharge. As Example 8 below shows, whether the interest payable is deductible will depends on all the facts of each particular case.

[15] Other documents that may be relevant include trustee resolutions, minutes of directors' meetings of a corporate trustee, and written advice to a trustee from the trust's bankers or professional advisers.

[16] For example, documents (such as written loan agreements) evidencing loan or other agreements between a beneficiary and the trustee relating to the investment of unpaid present entitlements; documents establishing how and when the assets representing a beneficiary's present entitlement are used in the income producing activities of the trust (for example, books of account prepared in accordance with generally accepted accounting principles); separate identification in the trust's books of account of funds used for private purposes; and documentary evidence as to the reasons for borrowing funds.

[17] It is not a requirement of the law that a beneficiary and the trustee have entered into an express agreement regarding the use of an unpaid present entitlement. For example, it may be clear from all of the relevant information that the beneficiary knew of their present entitlement and acquiesced in the trustee retaining the amount of that entitlement for use in the income earning activities of the trust.

expenses and outgoings are paid.[18] While the law does not require a rigid tracing of funds in all circumstances, the trustee will need some reasonable basis upon which to substantiate the character of the interest expense having regard to the specific facts of the particular case. The examples below may be of assistance in this regard.

The refinancing principle is inapplicable to borrowings used to distribute amounts attributable to internally generated goodwill and unrealised revaluations of assets

25. Internally generated goodwill and unrealised revaluations of assets are not, in the relevant sense, amounts provided to the trustee by, or on behalf of, a beneficiary of the trust estate (see *Roberts & Smith* ATC at 4389 and 4390; ATR at 505-506 for the analogous position for partnerships). The amount provided to the trustee by, or on behalf of, a beneficiary of the trust estate is not the same as the property of the trust. At any specific point in time, the amount so provided is fixed by reference to the trust deed and any express or implied additional agreements between the relevant parties (for example, an agreement between the beneficiaries to settle additional capital on the trust). 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 & 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 amounts provided to the trustee by, or on behalf of, a beneficiary of the trust estate.

Alternative view

26. There is an alternative view that the refinancing principle advanced in *Roberts & Smith* applies invariably any time a trustee borrows funds to make a distribution to a beneficiary. A slightly different argument has also been made to the effect that *Roberts & Smith* applies when it can be shown that:

- a trustee borrows funds to make a distribution to a beneficiary;
- that distribution represents a payment of an amount that has been used in the income producing activities of the trust (for whatever length of time);[19] and
- the beneficiary is entitled to that amount.

[18] See Taxation Ruling TR 2000/2 for a discussion of these types of issues.
[19] It has been suggested by some commentators that the length of time during which the amount has been used in the income producing activities of the trust estate is irrelevant.

27. The Commissioner does not agree with the alternative view for the reason that the decision of the Federal Court in *Hayden's case* demonstrates that there will be factual situations where the refinancing principle in *Roberts & Smith* does not have an invariable application. Importantly, in *Hayden's case*, there was nothing indicating any original loan or contribution nor the retention of any specific amount after it had been allocated to the son as a result of the Supreme Court's order. Moreover, for the refinancing principle to apply, the amount owing to the beneficiary has to have been objectively used by the trustee (or the trustee has to have objectively intended to use the amount) in the trust's assessable income producing activity or business.

28. It is also argued by some commentators that the decision in *Begg v. FC of T* (*Begg*) (1937) 4 ATD 257 provides support for the view that interest will be deductible where borrowing by the trustee allows for certain income producing assets to remain part of the trust estate.

29. This alternative view is not accepted as the reasoning underlying the decision in *Begg* is inconsistent with the decision of the High Court in *FC of T v. Munro* (1926) 38 CLR 153 (see also the discussion of *Begg* in *Hayden's case* at ATC 4803 and 4804; ATR 358 and 359).

Examples

Example 1 – unrealised profits

30. The trustee of a trust carries on a business of owning and operating a small local store. Under the trust deed establishing the trust, the trustee has a discretionary power to apply moneys to discretionary objects of the trust for their advancement in life. The trustee exercises this discretion to make a distribution from the capital of the trust for that purpose (and does so only once).

31. The distribution is not assessable income in the hands of the beneficiary. In the trust's books of account, the distribution is debited to the capital 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 in respect of the borrowed funds.

32. The interest expense is not deductible to the trustee when calculating the net income of the trust estate.

33. The interest would not be deductible even if the facts were altered so that the beneficiaries had fixed interests in all of the capital and income of the trust. The amount being distributed objectively represents unrealised profits of the trust and such profits are not, in the relevant sense, amounts provided to the trustee by, or on behalf of, a beneficiary of the trust estate.

Example 2 – objective purpose of refinancing (unit trust)

34. Mr and Mrs Silver are the only beneficiaries of a unit trust, the trustee of which runs a small business of supplying motor vehicle spare parts. A nominal number of units were issued at the time the trust was created. Mr and Mrs Silver were subsequently jointly issued 200,000 units at $1.00 each. These latter units are redeemable at the option of Mr and Mrs Silver.

35. The proceeds from the issue of the units provided capital used by the trustee to carry on the business. The trustee borrowed an additional $300,000 for use in the business. Mr and Mrs Silver now 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.

36. Not all the income is distributed on a yearly basis: some is retained by the trustee for use as working capital (as demonstrated by the trust's books of account which are drawn up in accordance with generally accepted accounting principles). In addition to their right to redeem the 200,000 units, Mr and Mrs Silver remain entitled to withdraw, at call, all or part of the undistributed income. As a consequence, Mr and Mrs Silver between them have a right to receive undistributed income of $40,000 ($20,000 each) from earlier years. (Mr and Mrs Silver have been assessed on these amounts under section 97 of the Act in the year of income in which they became presently entitled.)

37. In the middle of the current income year, the trustee distributes $100,000 to the beneficiaries after borrowing that sum from an unrelated third party. In the trust's books of account, the trustee debits the distribution first against the $40,000 unpaid present entitlement previously assessed to Mr and Mrs Silver; the remaining $60,000 of the distribution is debited against the $200,000 settled on the trust by Mr and Mrs Silver. A proportional number of the units held by Mr and Mrs Silver are cancelled.

38. The objective purpose of the trustee in borrowing $100,000 was to replace an amount (a returnable amount within the meaning of paragraph 5) that previously had been provided by Mr and Mrs Silver, and was used in the assessable income earning activities of the trust. Accordingly, the interest on the loan is fully deductible. This conclusion follows whether or not the money paid to Mr and Mrs Silver is used by them for private purposes.

Example 3 – objective purpose of refinancing (discretionary trust)

39. In his capacity of trustee of the trust, the trustee of a trust with a discretionary power to advance moneys to objects of the trust runs a small business of importing handbags. A nominal amount was settled on the trust at the time of its creation. The trustee borrowed $10,000 for use as working capital in the business. Under the trust deed, the trustee has a discretionary power to distribute some or all of

the capital and/or the income of the trust estate to Mr or Mrs Zinc. On an annual basis, as a result of an exercise by the trustee of his discretionary power to distribute, Mr and Mrs Zinc each become presently entitled to 50% of the net income of the trust.

40. In previous years, Mr and Mrs Zinc each became entitled to a total of $10,000 of undistributed income. Evidence shows that while Mr and Mrs Zinc are aware that they are presently entitled to a total of $10,000, neither party has required payment of the amounts to which their present entitlements relate. The amounts have accordingly been retained by the trustee for use in the assessable income earning activities of the trust. The accounts of the trust, drawn up in accordance with generally accepted accounting principles, provide prima facie evidence that the unpaid amounts have been used for this purpose.

41. In the 2002 income year, Mr and Mrs Zinc each call for payment of $5,000 of their unpaid present entitlement. After reviewing the financial affairs of the trust, the trustee decides to refinance the amounts contributed by Mr and Mrs Zinc by borrowing $10,000 from a bank rather than reducing the working capital of the business. The trustee's decision in this regard is reflected in relevant trust documents, including trust resolutions and the trust accounts.

42. The objective purpose of the trustee in borrowing $10,000 was to replace amounts that previously had been provided by Mr and Mrs Zinc, and were used in the assessable income earning activities of the trust. Accordingly, the interest payable by the trustee on the loan is fully deductible.

Example 4 – objective purpose of discharging an obligation to make a distribution (discretionary trust)

43. In his capacity as trustee of a trust, a trustee runs a small business of supplying the equipment for the breeding of tropical fish. Under the trust deed, the business is to be carried on by the trustee for the benefit of Mr Tin and his family. Mr Tin is listed as the sole primary beneficiary of the trust in a Schedule to the trust deed. The listed secondary beneficiaries include Ms Tin, a cousin of Mr Tin. The trust deed gives the trustee a discretionary power to distribute some or all of the capital and/or the income of the trust estate to the primary and/or secondary beneficiaries of the trust.

44. A nominal amount was settled on the trust at the time of its creation. Subsequently Mr Tin, the driving force behind the business, settled $100,000 on the trust for use as working capital in the business.

45. On 30 June 2002, the trustee exercises his power to distribute capital to Ms Tin making her presently entitled to $5,000 of the capital of the trust. On the same day, the trustee borrows $5,000 and distributes the amount to Ms Tin.

46. The trustee has not previously exercised his power to distribute in favour of Ms Tin, nor has Ms Tin provided any amount for use by the trustee in the assessable income earning activities of the trust[20] (for example, Ms Tin had never lent an amount to the trustee for use in the trust's assessable income earning activities).

47. Based on these facts, it is reasonable to conclude that the objective purpose of the trustee in borrowing $5,000 was merely to discharge an obligation to make a distribution. The position of Ms Tin is conceptually no different to the position of the son considered in *Hayden's case*. Accordingly, the interest payable by the trustee on the loan is not deductible.

Example 5 – objective purpose of refinancing (discretionary trust)

48. The corporate trustee of a trust with a discretionary power to advance moneys to discretionary objects of the trust runs a business of constructing and installing kitchens. In March 2000, the trustee sold a number of pre-CGT assets held by the trust, realising $20,000. On 30 June 2000, the trustee exercised its discretionary power to make a distribution in favour of Mr Iron, making Mr Iron presently entitled to $10,000 of the amount realised from the sale.

49. On the basis of an agreement reached with the trustee, Mr Iron leaves the amount to which he has become presently entitled in the hands of the trustee. On the basis of the trust's books of account (which have been drawn up in accordance with generally accepted accounting principles), the trustee can demonstrate that the unpaid amount was used to purchase specifically identified income producing assets.

50. In the 2002 income year, Mr Iron calls for payment of the $10,000 amount to which he is presently entitled. Mr Iron intends to use the money to pay for an overseas holiday.

51. Rather than reducing the funds available to the business, the trustee decides to borrow to refinance the amount contributed by Mr Iron. This decision is reflected in the minutes of a meeting of the directors of the trustee. Following this decision, the trustee takes out a loan of $10,000 and pays Mr Iron the $10,000. The trust accounts show that Mr Iron's trust entitlements are reduced by $10,000 and the lender is owed $10,000.

52. The objective purpose of the trustee in borrowing the $10,000 is to replace an amount (a returnable amount within the meaning of paragraph 5 above) that had previously both been provided by Mr Iron and used in the assessable income earning activities of the trust. Accordingly, the interest payable by the trustee on the loan is fully deductible. In these circumstances it is irrelevant that Mr Iron uses the payment for private purposes.

[20] This can be contrasted with the situation in example five where the taxpayer had agreed with the trustee that an amount to which a present entitlement relates was to be left invested in the trust estate.

53. By way of contrast, if Mr Iron called for payment of the $10,000 amount to which he is presently entitled on 5 July 2000, and the trustee borrowed that amount and discharged the present entitlement on 7 July 2000, the outcome would be different. In these circumstances the objective purpose of the trustee in borrowing the $10,000 appears to be the discharge of the present entitlement rather than the replacement of an amount that had previously been provided by Mr Iron and used in the assessable income earning activities of the trust. As a result, the interest incurred would not be deductible in these circumstances.

Example 6 – objective purpose of refinancing (discretionary trust)

54. The Brass Family Trust was set up for the purpose of benefiting the Brass family (Mr and Mrs Brass and their 3 minor children). A nominal amount was settled on the trust at the time of its creation. Subsequently, Mr Brass settled $200,000 on the trust. The trustee has invested all of the trust funds in dividend yielding shares. The trustee has a discretionary power to distribute some or all of the capital and/or the income of the trust estate to one or more of the members of the Brass family. To date, the trustee has only exercised this power to make distributions in favour of Mr and Mrs Brass.

55. In the 1999 income year, the net income of the trust was $10,000. The trustee exercised the discretionary power to distribute $10,000 to Mrs Brass. The exercise of the power gave rise to an obligation to pay the full amount to Mrs Brass. The amount was assessed in her hands under section 97 of the Act.

56. Shortly after the exercise of the discretionary power, Mrs Brass reached an agreement with the trustee to leave the full amount of her present entitlement (less an amount equal to the income tax payable by Mrs Brass in respect of the present entitlement)[21] in the hands of the trustee. The trust's books of account (which have been drawn up in accordance with generally accepted accounting principles) show that the trustee used the amount of the unpaid entitlement to invest in additional dividend yielding shares.

57. In the 2002 income year, Mr and Mrs Brass divorce. Mrs Brass calls for the payment of the unpaid present entitlement that she had agreed to leave in the trustee's hands. The trustee has received professional advice that there has been a temporary decline in the market value of the shares held by the trust. The trustee has also been advised that it is expected that the market value of the shares will increase in the medium term. Consequently, a disposal of those shares at their current price would result in the trust being financially disadvantaged. On the basis of this advice, the trustee decides that it would be financially better for the trust to refinance the payment by borrowing the funds. The trustee takes out a loan and uses this to pay Mrs Brass.

[21] Allowing distribution to Mrs Brass of sufficient money to pay the income tax arising from the creation of the present entitlement.

58. In the Commissioner's opinion, the only objective purpose of the trustee in borrowing is to repay an amount that both previously had been provided by Mrs Brass, and had been used in the assessable income earning activities of the trust. Accordingly, the interest payable by the trustee on the loan is fully deductible.

Example 7 – objective purpose of discharging an obligation to make a distribution (discretionary trust)

59. The Gold Family Trust was set up for the purpose of benefiting the Gold family (Mr and Mrs Gold and their two children). The trust estate was originally settled by Mr Gold's father. Under the trust deed, the trustee has a discretionary power to distribute some or all of the capital and/or the income of the trust estate to one or more of the members of the Gold family. The trust deed allows beneficiaries with unpaid present entitlements to demand payment from the trustee of all or a part of those entitlements at any time. Mr and Mrs Gold are default beneficiaries of the trust and have a present entitlement to all of the yearly income of the trust to which other beneficiaries are not presently entitled.

60. The trustee has invested all of the trust funds in rental properties and derives rental income accordingly. During the 2002 income year, all of the rental income derived by the trust estate was deposited into a bank account carrying a low rate of interest. Before the rental receipts for the 2002 income year were deposited, this account had a credit balance of $100. The low balance in the account was due to an ongoing maintenance expense which had now ceased. On 30 June 2002, the operation of the default clause resulted in Mr and Mrs Gold having an unpaid present entitlement to $4,000 each. The $8,000 total represented the full amount of the net income of the trust for that financial year.

61. On 10 July 2002, the trustee made a capital advancement to the children of Mr and Mrs Gold in the form of the payment of the children's university fees which amounted to $8,000. The full amount of this capital advancement was funded by a cheque drawn on the trust's bank account. This form of capital advancement, and the use of the bank account in this way, is permitted by the trust deed. By using money withdrawn from the bank account the trustee did not have to realise trust property in order to pay the university fees. However, this also meant that the undistributed net income to which Mr and Mrs Gold were presently entitled was not used to acquire additional trust assets or to carry on any assessable income earning activity.

62. In December 2002, Mr and Mrs Gold each called for the payment of $3,000 of their unpaid present entitlements. The trustee took out a loan for $6,000 in order to fund the payments to Mr and Mrs Gold.

63. In this example, the facts allow for the unpaid present entitlement of Mr and Mrs Gold to be traced through to a specific asset of the trust (namely the claim against the bank). On the basis of the facts, the objective purpose of the trustee in borrowing $6,000 is merely the discharge of an obligation to make a distribution to Mr and Mrs Gold. The net income of the trust (the net rental income) to which Mr and Mrs Gold were entitled was the source of funds used to make the capital advancement, and as such was not used for any significant period of time in the income earning activities of the trust estate. The fact that the unpaid present entitlement of Mr and Mrs Gold was only employed in the income earning activities of the trust estate for ten days prior to being used as the source for a capital advancement, while not determinative of the matter, suggests that the amount was not provided by Mr and Mrs Gold *and* used for income producing purposes in the relevant sense. The borrowed funds may be characterised as replacing funds provided by Mr and Mrs Gold and used to make the capital advancement. The interest incurred on the borrowing is not deductible.

Example 8 – objective purpose of refinancing (discretionary trust)

64. The Copper Trust was set up for the purpose of benefiting Mr Copper and his children. A nominal amount was settled on the trust at the time of its creation. Subsequently, Mr Copper settled $50,000 on the trust. The trustee has a discretionary power to distribute some or all of the capital and/or the income of the trust estate to one or more of the primary beneficiaries of the trust (defined to include Mr Copper). The trust deed allows a beneficiary with an unpaid present entitlement to demand payment from the trustee of all or a part of that entitlement upon reasonable notice being given to the trustee. In prior years all beneficiary entitlements have been immediately paid.

65. On 30 June 2001, the trustee exercised her discretionary power to distribute $10,000 to Mr Copper. Prior to making the decision to distribute this amount, Mr Copper had agreed that any amount to which he became presently entitled should be retained by the trustee. The trust accounts indicate that Mr Copper's $10,000 present entitlement was used to purchase Government bonds on 1 July 2001.

66. On 2 July 2001, Mr Copper's father unexpectedly died in an accident. Requiring money to cover certain funeral expenses, Mr Copper called on the trustee to pay the full $10,000 present entitlement.

67. The trustee borrowed $10,000 from a bank. The trustee used these funds to pay to Mr Copper $10,000.

68. In contrast to Example 7, the objective use to which the trustee has put the borrowed funds is not merely the discharging of an obligation to make a distribution to Mr Copper. While it is true that the $10,000 was paid to Mr Copper only 2 days after Mr Copper became presently entitled to the amount, the facts show that the trustee had objectively intended to use the unpaid present entitlement for income producing purposes, and had commenced to do so. The documents also show that but for the unexpected death of his father, Mr Copper would have chosen to leave his $10,000 present entitlement to be invested by the trustee.

69. The interest incurred on the borrowing is deductible. In these circumstances the fact that the money paid to Mr Copper is used by him for private purposes (namely, to cover funeral expenses) does not affect the deductibility of the interest.

Example 9 – loan by beneficiary to trust

70. Mr Bronze has a vested and indefeasible interest to one half of both the income and capital of a unit trust. Mr Bronze's interest arises from his having subscribed for half of the units in the trust estate.

71. In July 1998, in accordance with a loan agreement made between Mr Bronze and the trustee of the trust estate, Mr Bronze lent the trustee, in her capacity as trustee of the trust estate, $20,000. Under the terms of the loan agreement, the loan was repayable on 30 June 2003. A commercial rate of interest was charged on the loan.

72. The amount borrowed by the trustee from Mr Bronze was used by the trustee in the assessable income earning activities of the trust.

73. In June 2003, the trustee borrowed $20,000 from an unrelated third party. The trustee used the amount borrowed to repay the loan principal to Mr Bronze.

74. These facts indicate that the only objective purpose of the trustee in borrowing $20,000 was to replace an amount previously lent by Mr Bronze to the trust and used by the trustee in the assessable income earning activities of the trust. The interest payable by the trustee on the loan taken out to repay Mr Bronze is fully deductible.

75. The interest would still be deductible if Mr Bronze was a discretionary object of the trust rather than someone having a fixed entitlement to the income and/or capital of the trust.

Example 10 – objective purpose of refinancing (unit trust)

76. Mrs Nickel has a vested and indefeasible interest in one quarter of both the income and capital of a unit trust. Mrs Nickel's fixed interest arises from her having subscribed for one quarter of the units in the trust estate in 1998. Mrs Nickel paid $50,000 for the units. Under the terms of the trust deed, Mrs Nickel is entitled to demand, at the time of her choosing, a distribution of up to 100% of the amount

subscribed by her. Such a distribution results in the cancellation of a proportional number of the units in the trust held by her.

77. The accounts of the trust, which have been drawn up in accordance with generally accepted accounting principles, and other contemporaneous documents, provide prima facie evidence that the amount subscribed by Mrs Nickel has been used in its entirety in the assessable income earning activities of the trust.

78. In March 2002, Mrs Nickel informs the trustee that pursuant to her entitlements under the trust deed, she would like a distribution of $10,000 to be made to her by the end of the income year. This represents 20% of the amount subscribed by her. In June 2002, the trustee borrows $10,000. The trustee uses the borrowings to fund the distribution of the $10,000 previously subscribed by Mrs Nickel.

79. On these facts, the purpose of the trustee in borrowing the funds was to replace the $10,000 previously subscribed by Mrs Nickel and used by the trustee in the assessable income earning activities of the trust. Consequently, the interest payable by the trustee on the loan is fully deductible.

Example 11 – apportionment of interest expenses

80. The Cobalt Trust was set up for the purpose of benefiting the Cobalt family (Mr and Mrs Cobalt and their 4 children). A nominal amount was settled on the trust at the time of its creation. Subsequently, Mr Cobalt settled $100,000 on the trust. Under the terms of the trust deed:

- the trustee is permitted to invest the corpus and any undistributed income of the trust in any of a range of investments;
- the trustee has a discretionary power to distribute some or all of the capital and/or the income of the trust estate to one or more of the members of the Cobalt family; and
- beneficiaries with unpaid present entitlements may demand payment from the trustee of all or a part of that entitlement at any time.

81. An examination of recent investment activities of the trustee shows that the trustee has exclusively invested in short to medium term low risk securities. Investments have been regularly traded to optimise dividend yield and capital growth across the portfolio in accordance with a documented investment and risk management strategy. The dividends received and the net capital gains made from the investment activities of the trust estate constitute assessable income.

82. The trustee has access to an overdraft facility from a bank and regularly uses this finance facility to fund in part the trust's trading activity (including payment of stamp duty, brokerage fees and fees for financial advice associated with the trading activity). The trustee has

also drawn upon the overdraft facility to fund the payment of distributions to members of the Cobalt family. These actions are permitted by the trust deed. Debit balances under the facility attract a commercial rate of interest.

83. The financial statements from the past three years reveal the account is nearly always in debit. The records also establish that the overdraft facility is currently in debit as a result of the recent payment of brokerage fees. However, it is also clear from the trust's records that the overdraft facility has previously been used (including during the current financial year) to fund capital advancements. These capital advancements include the payment of the private school fees of the Cobalt children.

84. Over the years, Mr Cobalt has been made presently entitled to $10,000 of the net income of the trust that has remained undistributed. Following a call by Mr Cobalt for payment of the amount to which he has an unpaid present entitlement, the trustee uses the overdraft facility to fund the payment to Mr Cobalt.

85. The onus rests upon the trustee to provide evidence to show that a sufficient connection exists between the interest expenses and the assessable income earning activity, or business, carried on by the trustee.

86. The trustee keeps extensive documentary records (including trust accounts prepared using generally accepted accounting principles) concerning every aspect of the trust estate's investment activities. These records clearly demonstrate that dividends received from shares held by the trust estate, and the proceeds from the disposal of such shares, are only used for one or more of the following purposes:

- discharging any outstanding debt owed to the bank under the overdraft facility;
- depositing in an interest bearing account pending use in the securities trading activities; or
- investment in the trust's securities trading activities.

The trust's records also establish that unpaid present entitlements simply remain part of the trust's general pool of funds, and are used in one of the above activities.

87. While the trustee is unable to trace Mr Cobalt's unpaid present entitlements to particular income producing assets, the trustee can demonstrate through the relevant records that the unpaid entitlements objectively form part of the pool of fixed or circulating capital. However, the records also show that that pool has been used for a number of purposes some of which are not sufficiently connected to the trustee's assessable income earning activities (for example, the pool has been used to discharge the overdraft debit that arose from the payment of school fees). From the trust's records it is not possible to trace whether some or all of Mr Cobalt's present entitlement has been used in a non-income earning activity.

88. The purpose of the trustee in borrowing $10,000 is to repay an amount that previously has been provided by Mr Cobalt to the trustee. However, since Mr Cobalt cannot demonstrate that this entire amount was used by the trustee in the assessable income earning activities of the trust, it would be fair and reasonable to apportion[22] the interest expense. Accordingly, the interest payable by the trustee on the loan is partly deductible.

Detailed contents list

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[22] What constitutes a fair and reasonable apportionment ultimately turns on the particular circumstances of the individual case. However, in most cases it would be appropriate to disallow the interest deductions in the same proportion as the amount of the trust funds used for non-assessable income earning activities bears to the total pool of fixed and circulating capital.

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Related Rulings/Determinations:
TR 92/1; 92/20; TR 95/25; TR 97/16; TR 2000/2; TR 2003/9

Subject references:
- deductions & expenses
- interest expenses
- present entitlement
- trusts
- trust distributions

Legislative references:
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