TD 2017/D4 - Income tax: deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest free to the trustee

Draft Taxation Determination

Income tax: deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest free to the trustee

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Ruling

Deductibility of interest expense

1. A beneficiary of a discretionary trust who borrows money, and on-lends all or part of that money to the trustee of the discretionary trust interest-free, is usually not entitled to a deduction for any interest expenditure incurred by the beneficiary in relation to the borrowed money on-lent to the trustee under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

2. It is only where:

(a) the beneficiary is presently entitled to income of the trust estate at the time the expense is incurred[1], and

(b) the expense has a nexus with the income to which the beneficiary is presently entitled

that some part of the interest expense might ever be deductible. Even then, the interest expense is likely to have been incurred in the pursuit of one or more objectives other than the derivation of assessable income by the beneficiary and will not be deductible to the extent of any non-income producing objective/s.

[1] *Case M36* 80 ATC 280 at [3]-[5]; *Case U44* 87 ATC 318 at [6]-[7]; *AAT Case 4487* (1988) 19 ATR 3695 at [3]; *Re Lindsay Brothers and Deputy Commissioner of Taxation* [2001] AATA 771; *Antonopoulos and Commissioner of Taxation* [2011] AATA 431; 84 ATR 311; 2011 ATC 10-186; *Re Lambert and Federal Commissioner of Taxation* [2013] AATA 442 at [62] and [111]; 94 ATR 903; 2013 ATC 10-322; *Forrest v. FCT* [2010] FCAFC 6 at [42]- [43]; 78 ATR 417; 2010 ATC 20-163.

Effect of early trustee resolution

3. An irrevocable resolution made by a trustee of a discretionary trust to exercise a power of appointment of income in favour of a beneficiary does not confer present entitlement to income of the trust estate on that beneficiary until such time as the income is received by the trustee and is legally available for distribution.

4. A resolution made towards the beginning of the income year (an 'early resolution') by the trustee of a discretionary trust is **not** ordinarily effective to make a beneficiary presently entitled to income of the trust estate at that time given the uncertainty as to whether any distributable income will exist for the year.[2]

Relevance of entitlement to income of future years

5. Any assessable income derived, or anticipated to be derived, in respect of a future year by reason of being made presently entitled to income of the trust for that future year is too remote to provide a nexus with a current year interest expense incurred by a beneficiary.

Date of effect

6. 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 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
13 December 2017

[2] Whether or not the trustee has the power to make such a resolution depends on a proper construction of the deed.

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.

7. Deductibility of interest is ordinarily determined by considering both the purpose of the borrowing and the use of the borrowed funds. The purpose of a borrowing can generally be determined from its use and outgoings of interest ordinarily draw their character from that use. In determining deductibility of an interest expense, regard must be had to all of the objective circumstances surrounding the expense.

8. Where funds borrowed at interest are on-lent interest free, the interest expenditure will only be deductible to the extent that the interest has a nexus with assessable income reasonably expected to be derived by the borrower from the use of the borrowed funds.

9. Until a beneficiary of a discretionary trust is made presently entitled to income, that beneficiary has no more than a right to be considered by the trustee in relation to the appointment of trust income. This right to be considered, or mere expectancy, is too contingent or uncertain to be a source of assessable income reasonably expected by the beneficiary.

10. Therefore, if the beneficiary borrows money at interest and lends that money interest free to the trustee, in the absence of a present entitlement to income at the time interest is incurred on the borrowing, that interest will not have a nexus with the derivation by the beneficiary of assessable income from the trust. Moreover, any entitlement to income from the discretionary trust that may arise in a future year is too remote to serve as a basis for the deductibility of interest, as it is conditional on a future exercise of the trustee's discretion in the beneficiary's favour.

11. In the unlikely event that a beneficiary has a present entitlement to income in the current year at the time the expenditure is incurred, the beneficiary must also demonstrate that the expenditure has a nexus with the derivation of that income. To the extent that the expenditure is directed at objects other than the gaining of the income, it will not be deductible. Apportionment of the expenditure is required where the expense is incurred in respect of other objectives and the derivation of the income.

Present entitlement and the effect of an early resolution

12. A beneficiary is only presently entitled to income if they have:

(a) an interest in the income which is both vested in interest and vested in possession, and

(b) a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.[3]

[3] *FCT v. Bamford* [2010] HCA 10 at [37]; 75 ATR 1; 2010 ATC 20-170; *Harmer v. FCT* (1991) 173 CLR 264 at [271]; 22 ATR 726; 91 ATC 5000. Whether or not a resolution is irrevocable depends on the deed and

13. Until income is derived by the trust to which a beneficiary can be made entitled and an **irrevocable** resolution has been made by a trustee of a discretionary trust to appoint income in favour of a beneficiary, that beneficiary cannot be presently entitled to income of the trust estate.[4] Ordinarily, present entitlement will not arise until the end of the income year, even if the income is appointed under an early resolution. This is because ordinarily it is not possible to know until after year end whether there is any income of the trust in respect of the year available to be distributed.

14. It is possible that an early resolution appointing income to a beneficiary may satisfy the conditions to make the beneficiary presently entitled to trust income at a point prior to the end of the income year.[5] In those circumstances, if, having become presently entitled, the beneficiary incurs interest on borrowings advanced to the trustee interest-free, and it is reasonably expected that the use of the advanced funds will contribute to income received by the beneficiary, the interest expense may be partly or wholly deductible.

15. If the beneficiary becomes presently entitled to an amount specified in an early resolution, that present entitlement cannot serve as the basis for deductibility of interest incurred on a borrowing taken out by the beneficiary after that entitlement arises. The later advance has necessarily not contributed to the earlier income entitlement and any future income entitlement remains a mere expectancy.

Apportionment

16. Interest is only deductible to the extent that it is incurred in gaining or producing assessable income. Where the conditions in paragraph 14 are met, the beneficiary must nevertheless determine whether some or all of the interest expense referable to the on-lent borrowings is precluded from deductibility.

17. For instance, an interest expense is not fully deductible in situations where the expected amounts of income on which the beneficiary will be assessable do not provide an obvious commercial explanation for incurring the interest expense. Whether there is such an explanation will need to be considered where, for example, the total amount of income on which the beneficiary is assessable in the year in which the interest expense is incurred is less than the total interest expense, especially if the amount of assessable income is disproportionately less than the amount of the interest expense.

18. In these circumstances, it is necessary to consider all of the circumstances, including the direct and indirect objects and advantages sought by the taxpayer in incurring the expenditure, to determine whether the expense is fully deductible. Indirect objects may include:

(a) private or domestic purposes[6]

(b) the manufacturing of a tax deduction[7], and

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whether by making the resolution appointing particular income in exercise of a power under the deed, the power is then spent.

[4] *FCT v. Bamford* [2010] HCA 10 at [39]; 2010 ATC 20-170 at [10809]; *Cajkusic v. FCT* [2006] FCAFC 164 at [34] and [36]; 64 ATR 676; 2006 ATC 4752; *FCT v. Totledge Pty Ltd* (1982) 40 ALR 385 at [393]; 82 ATC 4168.

[5] An example of this situation would be where, as a matter of fact, it is clear at a certain point before the end of the income year that the trust has distributable income for that year and an irrevocable resolution has been made to appoint that income to a beneficiary.

[6] *Ure v. FCT* (1981) 11 ATR 484 at 488-9; 81 ATC 4100 at 4104.

[7] *FCT v. Ilbery* (1981) 12 ATR 563; 81 ATC 4661.

(c) especially significant in the context of a discretionary trust, benefiting other beneficiaries of the trust.[8]

19. The way in which the trustee uses the borrowed monies may also be relevant to establishing deductibility.[9] Use that is not likely to generate income of the trust estate to which the beneficiary is presently entitled may indicate the pursuit of some other objective that will limit deductibility. Where expenditure has both an income-producing purpose and a non-income-producing purpose, the expense must be apportioned on a fair and reasonable basis.[10]

Apportionment to be considered separately each year

20. The question of apportionment needs to be considered separately each subsequent year, and the appropriate conclusion may vary between years (depending on the circumstances then existing). Relevantly:

(a) a beneficiary of a discretionary trust does not have any relevant interest or property that could be expected to produce income for the trust[11]

(b) a loan to the trustee neither bolsters the beneficiary's ability to produce assessable income from an interest or asset already owned, nor gives the beneficiary a relevant asset from which assessable income may be gained or produced

(c) the beneficiary's ability to gain or produce assessable income in an income year, as a result of the on-lent borrowed funds, is contingent on a decision being made by the trustee to make an irrevocable resolution in favour of the beneficiary

(d) until such time as the beneficiary is presently entitled in an income year, any interest expense incurred is preliminary to, and has no nexus with, the gaining or producing of assessable income, and

(e) in any given income year, the trustee might exercise their discretion differently (potentially for the benefit of other beneficiaries, and to the exclusion of the beneficiary who has made the loan).

21. For these reasons, an interest expense of the kind under consideration could only have the requisite nexus (if at all) with the beneficiary gaining or producing assessable income in the year in which the beneficiary became presently entitled.

[8] *FCT v. Munro* (1926) 38 CLR 153.
[9] *FCT v. Total Holdings* (1979) 9 ATR 885; 79 ATC 4279.
[10] *Ronpibon Tin NL & Tongkah Compound NL v FCT* (1949) 78 CLR 47. A common sense weighting of factors will often lead to the deductible component of the interest incurred limited to the extent of the share of the trust's net income on which the beneficiary is assessed in that year. See *Ure v. FCT* (1981) 11 ATR 484.
[11] *Gartside v. Inland Revenue Commissioners* (1968) AC 553.

Appendix 2 – Your comments

22. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date or join the conversation on this ruling on the Public Advice and Guidance Community on Let's Talk.

23. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance 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
- be published on the ATO 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:	**16 February 2018**
Contact officer:	**Richard Mold**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Previous Rulings/Determinations:

IT 2385

Legislative references:

- ITAA 1997
- ITAA 1997 8-1
- TAA 1953

Cases relied on:

- AAT Case 4487 (1988) 19 ATR 3695; 88 ATC 697
- Re Antonopoulos and Federal Commissioner of Taxation - [2011] AATA 431; 2011 ATC 10-186; (2011) 84 ATR 311
- Federal Commissioner of Taxation v. Bamford - (2010) 75 ATR 1; [2010] HCA 10; (2010) 84 ALJR 266; (2010) 264 ALR 436; 2010 ATC 20-170; [2010] ALMD 5415; [2010] ALMD 5416; [2010] ALMD 5419; (2010) 240 CLR 481; (2010) 5 ASTLR 174
- Cajkusic v. Federal Commissioner of Taxation - [2006] FCAFC 164; (2006) 64 ATR 676; 2006 ATC 4752; (2006) 155 FCR 430; [2007] ALMD 5634
- Case M36 80 ATC 280
- Case U44 87 ATC 318
- Federal Commissioner of Taxation v. Ilbery - (1981) 58 FLR 191; (1981) 38 ALR 172; (1981) 12 ATR 563; 81 ATC 4661
- Federal Commissioner of Taxation v. Munro - (1926) 32 ALR 339; (1926) 38 CLR 153; [1926] HCA 58
- Federal Commissioner of Taxation v. Total Holdings (Aust) Pty Ltd - (1979) 43 FLR 217; (1979) 24 ALR 401; (1979) 9 ATR 885; 79 ATC 4279; [1979] FCA 30
- Federal Commissioner of Taxation v. Totledge Pty Ltd - (1982) 60 FLR 149; (1982) 40 ALR 385; (1982) 12 ATR 830; 82 ATC 4168; [1982] FCA 64
- Forrest v. Federal Commissioner of Taxation - [2010] FCAFC 6; 2010 ATC 20-163; [2010] ALMD 4697; [2010] ALMD 4709; (2010) 78 ATR 417
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- Harmer v. Federal Commissioner of Taxation - (1991) 173 CLR 264; (1991) 66 ALJR 89; (1991) 104 ALR 117; (1991) 22 ATR 726; 91 ATC 5000; [1991] HCA 51
- Re Lambert and Federal Commissioner of Taxation - [2013] AATA 442; 2013 ATC 10-322; (2013) 94 ATR 903
- Re Lindsay Brothers and Deputy Commissioner of Taxation [2001] AATA 771
- Ronpibon Tin NL v. Federal Commissioner of Taxation - (1949) 78 CLR 47; (1949) 23 ALJ 139; (1949) 8 ATD 431; [1949] ALR (CN) 1055; [1949] ALR 785; [1949] HCA 15
- Ure v. Federal Commissioner of Taxation - (1981) 50 FLR 219; (1981) 34 ALR 237; (1981) 11 ATR 484; 81 ATC 4100; [1981] FCA 9

ATO references

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