IT 2356 - Income tax : deductibility of interest, assessment to trustee of undistributed trust income

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TAXATION RULING NO. IT 2356

INCOME TAX : DEDUCTIBILITY OF INTEREST,
ASSESSMENT TO TRUSTEE OF UNDISTRIBUTED TRUST INCOME

F.O.I. EMBARGO: May be released

REF H.O. REF: 83/5868 DATE OF EFFECT: Immediate

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1210088	INTEREST PAID - ACQUISITION OF INCOME EARNING ASSET TRUSTS - FAIL-SAFE CLAUSE	51(1) 97 98 99A

PREAMBLE This ruling deals with the decision of the Supreme Court of Victoria (Tadgell J.) in FCT v. Marbray Nominees Pty Ltd, 85 ATC 4750; 17 ATR 93 on appeal from a decision of Taxation Board of Review No.2 reported at Case R105, 84 ATC 692; 27 CTBR (NS) Case 155. The case concerned the extent to which interest and associated expenses paid by a corporate trustee of a family discretionary trust were an allowable deduction and the proper effect to be given to a fail-safe clause in a trust deed of the trust.

FACTS 2. Clause 3 of the trust deed of the family discretionary trust provided for the manner for dealing with the income of the trust. By sub-clause 3(1) the taxpayer, as corporate trustee, was empowered, before the end of the accounting period, to determine to deal with the income of the trust in various ways including paying, applying or setting it aside for any of the general beneficiaries or accumulating it.

3. Sub-clause 3(4), the fail-safe clause, provided as follows :

> "The trustees shall hold so much of the net income of the Trust Fund for each Accounting Period as shall not be the subject of a determination effectually made in relation to such Accounting Period in trust successively for the persons described in sub-clauses (1)(2)(3) and (4) of clause 4 hereof."

4. Clause 4 provided as follows :

> "As from the Vesting Day the Trustees shall stand possessed of the Trust Fund and the income thereof -
>
> (1) ...
>
> (2) insofar as any part of the Trust Fund shall not have

been disposed of in accordance with sub-clause (1) of this clause if one Specified Beneficiary is named ..... and if more than one Specified Beneficiary are so named or described in trust for such of the Specified Beneficiaries as shall be living on the Vesting Day as tenants-in-common in equal shares absolutely provided that any child living on the Vesting Day of any Specified Beneficiary who shall have died before the Vesting Day ....."

5. In the deed, 'Accounting Period' was defined to mean each 12 month period ending on 30 June in each year. 'Vesting Date' was specified to be 30 June 2020. 'Specified Beneficiaries' were defined to be the children of the family.

6. Before 1972 the two parents of the family successfully carried on in partnership a business related to the direct selling of cosmetics and other products to customers. In 1972 they acquired a farm property while continuing their direct selling business. In 1976 the direct selling business and (it seems) some farming stock and chattels were sold to the taxpayer and the price was credited to a partners' loan account in the taxpayer's books. The farm property was also sold by the parents to the taxpayer for its then market value of $244,000. No money changed hands, the partners' loan account again being credited.

7. In 1976 and 1978 the taxpayer obtained loans of $100,000 and $60,000 respectively from financiers, it was claimed, essentially for the purpose of enabling it to conduct its businesses. The manner in which the loan moneys were used was central to the aspect of the appeals relating to the deductibility in the years ended 30 June 1980 and 1981 of interest on, and certain expenses associated with, these loans.

8. More than half of the $100,000 loan and almost three-quarters of the $60,000 loan were debited to the partners' loan account in the taxpayer's books after having been disbursed by the taxpayer from time to time to meet private debts of the parents. When payments of this kind were made the loan account was correspondingly reduced.

9. Having had some difficulties with the management of the farm property, the taxpayer sold off the property partly in October 1980 and the balance late in 1981. The loan of $100,000 was repaid in January 1981 and this necessitated a payment of $5,862 by the taxpayer as consideration for the mortgagee agreeing to accept early repayment of the loan.

10. The Commissioner disallowed the interest outgoings and the redemption payment on assessment.

11. The taxpayer as corporate trustee determined after 30 June in each of the years under appeal to pay the net income of the trust to certain beneficiaries. The trust deed provided that the determination be made before 30 June in each year.

12. In the absence of a determination made within the time prescribed by the trust deed, the net income of the trust in each

year was assessed to the taxpayer under section 99A of the Income Tax Assessment Act because the opinion was formed that no person was presently entitled to the income under section 97 or section 98.

DECISION OF SUPREME COURT

13. Tadgell J. concluded that the taxpayer borrowed the money it did for the purpose of assisting it to buy the farm land, to acquire title to and possession of it and to provide what was in effect working capital to enable it to operate the farm and the direct-selling business. The interest on the loan was deductible under sub-section 51(1) of the Act.

14. Although the taxpayer applied a substantial part of the loan moneys in discharge of liabilities antecedently incurred to the parents in acquiring a business asset - the farm property - the outgoings to obtain the loans and to meet the interest liabilities as outgoings of the taxpayer were, in his Honour's opinion, obviously of a business character. The Commissioner's argument that the interest outgoings and loan expenses were of a private or domestic nature of the taxpayer was rejected. If the taxpayer had borrowed money and paid it immediately to the parents as part of the purchase price for the farm property, the expenses of the loan and interest would have been deductible irrespective of the use to which they put it when they received it.

15. Tadgell J. accepted that the lump sum payment on early repayment of the loan was incurred in order to rid the taxpayer of a recurring obligation to pay interest on a debt that was part of the expenses of conducting the business. It was a business expense deductible under sub-section 51(1) and was not of a capital nature.

16. As to the effect of the fail-safe clause in the trust deed, Tadgell J. said that whether the net income of the taxpayer was assessable in its hands as income to which no beneficiary was presently entitled in terms of section 99A depended on the proper construction of the deed. In particular, it depended on whether sub-clause 3(4) applied, in default of any effective determination by the corporate trustee to the contrary, to direct it to hold the net income for each year under appeal in trust for "the persons described" in sub-clause 4(2).

17. Tadgell J. accepted the taxpayer's argument that it held the net income for each year for the "Specified Beneficiaries", being the three children of the family as tenants-in-common in equal shares. Plainly, his Honour thought, "the persons described" in sub-clause 4(2) - for the purposes of sub-clause 3(4) - were the persons who answered the description of "Specified Beneficiaries" at the time sub-clause 3(4) operated. Sub-clause 3(4) was intended to be capable of operation, in the absence of a determination under sub-clause 3(1), on the net income of the trust fund from year to year.

18. His Honour rejected the Commissioner's contention that

the fail-safe clause failed for uncertainty in that the expression "persons described" in sub-clause 3(4) means the Specified Beneficiaries who shall be living on the Vesting Day and one could not tell until the Vesting Day whether any or which of the Specified Beneficiaries would then be living. So construed, Tadgell J. concluded that sub-clause 3(4) could not operate, as intended, from year to year. Sub-clause 3(4) was not concerned at all with the factual position on the Vesting Day but was concerned to identify individuals, alive at the time it operates, by reference to their description in clause 4.

19. It followed that the assessments under section 99A were unjustified and the taxpayer held the net income of the trust in each year under appeal on trust for the specified beneficiaries.

RULING

20. The decision of Tadgell J., insofar as it relates to the deductibility of interest and associated loan expenses, was made on the peculiar facts of the case. The decision turned on the appropriate characterization of those facts rather than on any question of principle. The decision has been accepted and leave to appeal to the Federal Court was not sought.

21. The Commissioner has also accepted the decision with respect to the interpretation of the fail-safe clause. Where there is ambiguity in the wording of a fail-safe clause it should, as a broad proposition, be construed so as to give effect to the settlor's intention.

22. Current assessing guidelines for the treatment of income of a trust estate where net income exceeds distributable income (as detailed in CITCM 884 (para 45), IT 2059, IT 2102 and the Trust Assessing Handbook) are consistent with the decision of the Court.

COMMISSIONER OF TAXATION
25 August 1986