PR 2011/15 - Income tax: deductibility of interest in relation to investment in a Property Investor Trust

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Product Ruling

Income tax: deductibility of interest in relation to investment in a Property Investor Trust

Contents Para

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

No guarantee of commercial success

The Commissioner **does not** sanction or guarantee this product. Further, the Commissioner gives no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential participants must form their own view about the commercial and financial viability of the product. The Commissioner recommends a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

Terms of use of this Product Ruling

This Product Ruling has been given on the basis that the entity(s) who applied for the Product Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling section apply to the defined class of entities, who take part in the scheme to which this Ruling relates. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

2. In this Product Ruling the scheme is an investment in a Property Investor Trust (the Trust) offered by Chan & Naylor Australia Pty Ltd by way of subscription for Units in the Trust using borrowings on arm's length and commercial terms from an independent or related party, or both.

3. This Product Ruling does not address:

- the tax consequences for any entity other than a Registered Holder;
- the tax consequences of any borrowings not in relation to the acquisition or subscription for Units in the Trust, such as borrowings to pay for fees, commissions and other costs;
- the tax consequences of fees, commissions and other costs paid by the Registered Holder, other than borrowing expenses incurred by the Registered Holder to fund the Registered Holder's subscription for Units in the Trust (see paragraph 16(e) of this Ruling);
- the deductibility of prepaid interest on funds borrowed to acquire or subscribe for Units in the Trust;
- the capital gains tax consequences arising from the issue of new Units in the Trust, or the transfer or redemption of a Registered Holder's Units in the Trust;
- a Registered Holder's entitlement to franking credits; and
- whether this scheme constitutes a financial arrangement for the purposes of Division 230 (Taxation of financial arrangements).

Class of entities

4. This part of the Product Ruling specifies which entities can rely on the tax benefits set out in the Ruling section of this Product Ruling and which entities cannot rely on those tax benefits. In this Product Ruling, those entities that can rely on the tax benefits set out in this Ruling are referred to as the Registered Holder.

5. The class of entities who can rely on those tax benefits consists of those entities:

- that begin to participate in the scheme described in paragraphs 17 to 21 of this Product Ruling by virtue of the execution of the Property Investor Trust Deed and their allotment of Units in the Trust on or after the date the Product Ruling is published and on or before 30 June 2014; and
- at the time of entering into the scheme, they must have a genuine intention of holding onto their Units in the Trust until such time as they derive assessable income from the investment that exceeds the deductible expenditure that they incur in order to invest in the scheme.

6. The class of entities who can rely on the tax benefits set out in the Ruling section of this Product Ruling does **not** include entities who:

- do not have a genuine intention of holding their Units in the Trust until such time as they derive assessable income from the investment that exceeds the deductible expenditure that they incur in order to invest in the scheme;
- begin to participate in the scheme specified and are allotted Units in the Trust before the date of this Ruling or after 30 June 2014;
- are General Beneficiaries other than a Registered Holder, or are Remainder Beneficiaries; or
- are subject to Division 230 in respect of this scheme. Division 230 will generally not apply to individuals, unless they have made an election for it to apply to them.

Superannuation Industry (Supervision) Act 1993

7. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA). The Commissioner gives no assurance that the scheme is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product Ruling as to whether investment in this scheme may contravene the provisions of SISA.

Qualifications

8. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 17 to 21.

9. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Product Ruling may be withdrawn or modified.

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Date of effect

11. This Product Ruling applies prospectively from 27 July 2011, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 27 July 2011 and whose Units in the Trust are allotted on or before 30 June 2014. This Product Ruling provides advice on the availability of tax benefits to the specified class of entities for the income years up to 30 June 2014 being its period of application. This Product Ruling will continue to apply to those entities even after its period of application has ended for the scheme entered into during the period of application.

12. However the Product Ruling only applies to the extent that there is no change in the scheme or in the entity's involvement in the scheme.

Changes in the law

13. Although this Product Ruling deals with the income tax laws enacted at the time it was issued, later amendments may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to that extent, this Product Ruling will have no effect.

14. Entities who are considering participating in the scheme are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

15. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes such as this. In keeping with that intention the Commissioner suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling has issued.

Ruling

Application of this Ruling

16. Subject to paragraph 3 and the assumptions in paragraph 21 of this Ruling:

(a) The Registered Holder is assessable under section 97 of the *Income Tax Assessment Act 1936* (ITAA 1936) on so much of that share of the net income of the trust estate (as adjusted by Division 6E of the ITAA 1936) to which the Registered Holder is presently entitled. The present entitlement of the Registered Holder will reflect the Registered Holder's fixed rights to income and capital gains derived from the Unit Asset(s) which are commensurate to the proportion of the Trust's capital funded by the Registered Holder in order for the Trustee to acquire the Unit Asset(s);

(b) The Registered Holder is assessable under Division 102 on so much of the share of the net capital gain of the Trust as determined by Subdivision 115-C. The Registered Holder's share of the net capital gain of the Trust will include fixed rights to capital gains derived from the Unit Asset(s) related to their Units;

(c) The Registered Holder is assessable under Subdivision 207-B on so much of its share of the franked distributions and franking credits of the Trust. The Registered Holder's share of the franked distributions and franking credits of the Trust will include fixed rights to franked distributions and franking credits derived from the Unit Asset(s) related to their Units;

(d) Interest expenses incurred by the Registered Holder in respect of borrowings taken out to fund the Registered Holder's subscription for Units in the Trust are wholly deductible under section 8-1 in the income year incurred;

(e) Borrowing expenses incurred by the Registered Holder in respect of borrowings taken out to fund the Registered Holder's subscription for Units in the Trust are wholly deductible under section 25-25;

(f) Section 51AAA of the ITAA 1936 will not apply to deny the Registered Holder a deduction for interest expenses allowable under section 8-1 of the ITAA 1997 or a deduction for borrowing expenses allowable under section 25-25 of the ITAA 1997; and

(g) The anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny the deductibility of the interest or borrowing expenses incurred by the Registered Holder so as to fund their acquisition of Units in the Trust.

Scheme

17. The scheme that is the subject of this Ruling is identified and described in the following documents:

- application for a Product Ruling as constituted by documents and information received on 22 December 2010; 27 May 2011, 16 June 2011 and 13 July 2011;
- draft pro-forma Property Investor Trust Deed, received on 13 July 2011;
- draft pro-forma trust resolution to establish the Trust, received on 16 June 2011;
- draft Information Memorandum entitled ‘Conducting a Property Investor Trust’, received on 13 July 2011;
- draft Trustee’s Companion for Property Investor Trust, received on 13 July 2011; and
- draft pro-forma trust resolution to issue Units and Unit Certificate, received on 16 June 2011.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

18. For the purposes of describing the scheme to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Registered Holder or any associate of a Registered Holder, will be a party to, which are a part of the scheme.

19. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

20. Following is a summary of the scheme:

(a) The Registered Holder or an associate of the Registered Holder causes a Trust to be established by Deed of Settlement for the principal purpose of acquiring, holding and dealing with one or more income producing assets (Unit Assets). The Trustee of the Trust may be the Registered Holder or an associate of the Registered Holder;

(b) The Trust is a hybrid trust where the Trustee has both an ability to issue Units that confer on a unit holder (the Registered Holder) fixed rights to specified trust income (including capital gains) and capital and an absolute discretion to distribute the balance (if any) of the income and/or capital of the Trust to discretionary trust beneficiaries;

(c) Beneficiaries who are able to become absolutely or contingently entitled to any interest in the Trust Fund or the income of the Trust Fund are comprised of General Beneficiaries, including the Registered Holder and persons and entities related to the Registered Holder, and Remainder Beneficiaries;

(d) The entity wishing to become a Registered Holder will subscribe for Units in the Trust at a price representing their market value. The part of the Trust Fund that represents money paid by the Registered Holder will be associated with a Class or Classes of Units;

(e) The Trustee uses these subscribed funds together with other trust funds (if any) to acquire the Unit Asset(s). Each Unit Asset acquired by the Trustee will be referable to a separate Class of Unit;

(f) The Trustee will issue a Unit Certificate to the Registered Holder setting out, amongst other appropriate information, the number and Class of Units held by the Registered Holder and the rights and entitlements of that Class of Units;

(g) Subject to the payment of proper expenses of the Trust Fund, that part of the net income of the Trust Fund (as specified or described in the Unit Certificate) that is attributable to each Class of Unit Asset will be held by the Trustee, upon trust for the Registered Holder of the corresponding Class of Units, in accordance with the rights attached to and in proportion to the number of Units held by the Registered Holder;

(h) The Registered Holder's Units confer fixed rights to the Registered Holder to that part of the net income of the Trust Fund which is represented by a formula set out in the draft pro-forma Unit Certificate referred to in paragraph 17 of this Ruling. A Registered Holder's right to income is a right to a fixed proportion of the Trustee's income which is referable both to the net income (including ordinary income and statutory income) derived on the Unit Asset to which the Units are related and the extent to which the amount of capital contributed by the Registered Holder via their subscription for Units in the Trust contributed to the market value acquisition price of that Unit Asset at the time of subscription;

(i) Amounts so set aside for the Registered Holder will no longer form part of the Trust Fund but will be held by the Trustee as a trust separate from the Trust Fund on trust for the Registered Holder absolutely;

(j) As a General Beneficiary, the Registered Holder may also derive income from the Trust as a discretionary beneficiary should the Trustee exercise its discretion to partly or wholly distribute the remainder of the income of the Trust Fund of a particular Accounting Period not held for the Registered Holder as a fixed entitlement;

(k) The Registered Holder's subscription for Units in the Trust will be funded on arm's length and commercial terms by an independent or related party, or both. The Registered Holder may during the term of a loan refinance their loan on arm's length and commercial terms with an independent or related party, or both. The Unit Asset may or may not be used as security for the Registered Holder's borrowing;

(l) The Registered Holder, or any other entity wishing to become a Registered Holder, may at a later time choose to use the Trust to acquire another Unit Asset. The relevant Registered Holder may borrow to subscribe for Units in the Trust to assist with the funding of such additional Unit Assets in the same manner as described in paragraph 20(k) of this Ruling. The Class of Units issued to the relevant Registered Holder in respect of an additional Unit Asset will confer on that Registered Holder a fixed right to that part of net income of the Trust Fund in the same manner as described in paragraphs 20(g) and (h) of this Ruling;

(m) The Trust is an open ended trust with a termination date no later than the time required to prevent the trust from breaching the rule against perpetuities (if applicable) in the relevant Australian state or territory in which the Trust is established; and

(n) The Registered Holder may transfer, or request redemption of, some or all of their Units at market value by notice in writing to the Trustee.

Assumptions

21. This Ruling is made on the basis of the following necessary assumptions:

(a) the Registered Holder and the Trust are Australian residents for taxation purposes;

(b) the Registered Holder is not under a legal disability for the purposes of Division 6 of Part III of the ITAA 1936;

(c) Units issued to the Registered Holder are issued at market value;

(d) the Registered Holder is not a trader in investments and is not treated for taxation purposes as trading in interests or Units in the Trust, carrying on a business of investing in the Trust, or holding their interests or Units in the Trust as trading stock or a revenue asset;

(e) the Registered Holder will not enter into the scheme with the intention of disposing their Units in the Trust at a time prior to deriving assessable income from the investment in excess of deductible expenditure;

(f) money used by the Trustee of the Trust that relates to the borrowings by the Registered Holder in subscribing for Units in the Trust will be used only to invest in income producing assets for the dominant purpose of deriving assessable income for the Registered Holder from their Units in the Trust which exceeds total expenses incurred by the Registered Holder with respect to their investment;

(g) the Registered Holder will derive assessable income other than, or in addition to, capital gains from their Units in the Trust;

(h) interest expenditure incurred by the Registered Holder in respect of borrowings taken out to fund their subscription for Units in the Trust is not prepaid beyond the income year in which the expenditure is incurred;

(i) the Registered Holder's fixed rights to income and capital gains derived from Unit Assets related to their Units cannot be defeated by the Trustee exercising a discretion to distribute income and/or capital gains to other beneficiaries;

(j) Units issued to the Registered Holder will have fixed rights to income and capital gains as outlined in the Unit Certificate issued to the Registered Holder by the Trustee;

(k) where additional Units are issued following the initial issue of Units to the Registered Holder, there will be no variations to the existing rights and entitlements that are attached to those initial Units held by the Registered Holder;

(l) the scheme will be executed in the manner described in this Ruling and in accordance with the scheme documentation mentioned in this Ruling;

(m) all relevant documentation pertaining to this scheme, as provided by Chan & Naylor Australia Pty Ltd to the class of entities which can rely on the tax benefits set out in this Ruling, will be executed without any amendment, addition or alteration beyond the recording of information to identify the Registered Holder, the details of the Trustee, the date when the Trust was established, the date when the Trustee resolves to issue the Units, the date of issue of Units, the Unit Asset(s), the number of Units issued to the Registered Holder and the quantities required by the formula set out in the Unit Certificate referred to in paragraph 17 of this Ruling;

(n) all dealings between the Registered Holder and Trustee in relation to the scheme will be at arm's length;

(o) all dealings by the Registered Holder and/or Trustee with related parties in relation to the Units Assets or scheme, will be at arm's length and not of a private or domestic nature;

(p) the loan that the Registered Holder enters into in order to subscribe for Units in the Trust will be on arm's length and commercial terms from an independent or related party, or both, and any dealings between the Registered Holder and the lender/financier will be at arm's length, including any refinancing of such a loan; and

(q) the Registered Holder is not subject to Division 230 in respect of this scheme.

Commissioner of Taxation
27 July 2011

Appendix 1 – Explanation

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

Assessability of Trust income

22. Under the terms of the Units issued, the Registered Holder has fixed rights to certain income and capital gains derived by the Trust in respect of the Unit Asset(s) that the Units are related to.

23. To the extent that the net income of the Trust constitutes net income other than capital gains or franked distributions, the Registered Holder shall be assessable under section 97 of the ITAA 1936 on so much of the share of that net income of the Trust as reflects the proportion of income of the trust estate to which the Registered Holder is presently entitled, as adjusted by Division 6E of the ITAA 1936.

24. Where the net income of the Trust includes a net capital gain, subsection 115-215(3) will deem the Registered Holder to have made a capital gain referable to their attributable gain as calculated under section 115-225 and as adjusted under subsection 115-215(3) to take into account certain capital gains tax concessions claimed by the Trustee.

25. Where the net income of the Trust includes a franked distribution, the Registered Holder shall be required under subsection 207-35(4) to include in its assessable income its attributable franked distribution as calculated under section 207-37 and its share of any franking credit on the distribution.

Section 8-1 – Interest expenses

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

27. For the purposes of section 8-1, the essential character of an interest expense is derived from the purpose of the borrowing and the application or the use of the borrowed funds. The laying out of the borrowed money for the purpose of gaining assessable income furnishes the required connection between the interest paid upon it by the taxpayer and the income derived by that taxpayer from its use (*Ure v. Federal Commissioner of Taxation* (1981) 50 FLR 219; 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 488).

28. Whilst interest paid on a borrowing used to acquire income producing assets such as units in a unit trust is generally treated as deductible under section 8-1 where it is expected that assessable income would be derived from the investment (see Taxation Ruling TR 95/33), a portion of an interest expense is not deductible to the extent that the borrowed money has been used to both acquire an income producing asset and to confer benefits on other persons (Taxation Determination TD 2009/17).

29. The interest incurred by the Registered Holder in respect of borrowings used to fund their subscription for Units in the Trust is wholly deductible under section 8-1 because the funds borrowed are not used to confer benefits on other persons (including other General Beneficiaries or any Remainder Beneficiaries).

30. This Ruling does not apply to Registered Holders who choose, or who are required to prepay interest under the borrowing taken out to subscribe for Units in the Trust. Subject to certain exclusions, amounts that are prepaid for a period that extends beyond the income year in which the expenditure is incurred may be subject to the prepayment provisions in Subdivision H of Division 3 of Part III of the ITAA 1936. Any Registered Holder who prepays such amounts may request a private ruling on the deductibility of interest in relation to their investment in the Trust.

Section 25-25 – Borrowing expenses

31. Borrowing expenses incurred by the Registered Holder in respect of borrowings used to fund their subscription for Units in the Trust will be deductible under section 25-25. Where the borrowing expenses are $100 or less, they are wholly deductible in the income year incurred. Where the borrowing expenses exceed $100, the deduction is spread on a straight line basis over the period of the shorter of:

- the term of the borrowing; or
- five years.

Section 51AAA

32. Under the scheme, it is contemplated that the Registered Holder will derive assessable income by way of capital gains and other than by way of capital gains from their Units in the Trust. As the interest and borrowing expenses incurred by the Registered Holder will be deductible under section 8-1 and 25-25 respectively notwithstanding the inclusion of a net capital gain in their assessable income, section 51AAA of the ITAA 1936 has no application to the Registered Holder.

Part IVA – anti-avoidance

33. Provided that the scheme ruled on is entered into and carried out in the manner described in the scheme documentation and in the Scheme section of this Ruling including the Assumptions (see paragraphs 20 to 21 of this Ruling), it is accepted that the scheme is an ordinary commercial transaction and that Part IVA of the ITAA 1936 will not apply.

Appendix 2 – Detailed contents list

34. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 95/33; TD 2009/17

Subject references:

- capital gains tax
- hybrid trusts
- income tax
- interest expenses
- product rulings
- public rulings
- taxation administration

Legislative references:

- ITAA 1936 51AAA
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 Pt III Div 6
- ITAA 1936 97
- ITAA 1936 Div 6E
- ITAA 1936 Pt IVA
- ITAA 1997
- ITAA 1997 8-1
- ITAA 1997 25-25
- ITAA 1997 Div 102
- ITAA 1997 Subdiv 115-C
- ITAA 1997 115-215(3)
- ITAA 1997 115-225
- ITAA 1997 Subdiv 207-B
- ITAA 1997 207-35(4)
- ITAA 1997 207-37
- ITAA 1997 Div 230
- SISA 1993
- TAA 1953
- Copyright Act 1968

Case references:

- *Ure v.* Federal *Commissioner of Taxation* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484

ATO references

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