

# ***TR 2002/18 - Income tax: home loan unit trust arrangement***

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## Taxation Ruling

### Income tax: home loan unit trust arrangement

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#### ***Preamble***

*The number, subject heading, Class of person/arrangement, 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. The remainder of the document is administratively 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**

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1. The type of arrangement set out below was the subject of Taxpayer Alert 2001/1 – *Home Loan Unit Trust Arrangement*.
2. This Ruling examines arrangements where a taxpayer uses a unit trust to acquire a residential property for private or domestic use. Under such an arrangement, the taxpayer seeks to obtain the benefit of interest deductions for what is essentially private expenditure.
3. Under the arrangement, the trustee of the unit trust ('the trustee') includes rental income from a lease agreement entered into with the taxpayer and/or their family in the trust's assessable income. The trustee claims deductions for expenses on the residential property.
4. This ruling deals with deductions claimed by the taxpayer under such an arrangement.
5. The conclusions reached in this ruling in relation to the application of section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997') also apply to arrangements entered into prior to 1 July 1997, where deductions are claimed under subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936').

#### **Class of person/arrangement**

6. This Ruling applies to persons who enter into or carry out the following or similar arrangements:
  - a unit trust is established;
  - the taxpayer may be a director of the corporate trustee of the unit trust (or a trustee of the unit trust);

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- the trustee enters into a contract to acquire a residential property;
- the taxpayer borrows an amount of money;
- the taxpayer uses the funds to subscribe for units in the trust;
- the trustee guarantees the taxpayer's borrowings to the financier;
- the trustee uses the trust funds raised from the issue of the units to complete the purchase of the residential property;
- the trustee grants a mortgage over the residential property to the financier as security for the taxpayer's borrowings;
- the trustee then leases the residential property to the taxpayer and/or their family at a market rent;
- the taxpayer and/or their family pay rent to the trustee;
- the residential property is the home of the taxpayer and/or their family;
- the trustee claims deductions for expenses on the residential property such as water, council rates and insurance;
- the trustee claims depreciation and other capital allowance deductions that are available in respect of investment properties;
- the trustee makes a distribution to the taxpayer in accordance with the taxpayer's unit holdings;
- the taxpayer includes the distribution in their assessable income;
- there is a significant disproportion between the amount of the distribution from the trustee and the amount of the interest incurred by the taxpayer on the borrowings used to acquire the units in the unit trust;
- the taxpayer claims a deduction for the interest paid on the borrowings used to subscribe for the units in the unit trust; and
- as the trust distribution is less than the interest deduction, the resulting loss is offset against other income of the taxpayer.

7. The following diagram illustrates the key features of a typical arrangement.



8. This Ruling deals with a different factual arrangement to that considered in *FC of T v. Jammor Nominees Pty Ltd* 87 ATC 4813; (1987) 19 ATR 254 (*Jammor*). In that case, the trustee of a family discretionary trust, that also performed the services of a service company, obtained mortgage finance to purchase a residential property and incurred interest and other expenses. In the situation under consideration in this Ruling, an individual taxpayer borrows money to acquire units in a unit trust and incurs the interest expense – not the trustee.

9. In any event, the *Jammor* arrangement was entered into in 1979 prior to the enactment of either Part IIIA or Part IVA of the ITAA 1936. Part IVA of the ITAA 1936 has significant differences in operation and effect to section 260 of the ITAA 1936. Part IVA makes it clear that the choice principle no longer applies. If a deduction was allowable under subsection 51(1) of the ITAA 1936, section 260 did not operate. This is not a bar to the application of Part IVA. Therefore, any discussion in *Jammor* on the operation of section 260 does not provide any guidance on the application of Part IVA to home loan unit trust arrangements.

## Ruling

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### **Deductibility of the interest under section 8-1 of the ITAA 1997**

10. In relation to the Home Loan Unit Trust arrangement described in paragraph 6 above, the interest is not deductible under section 8-1 of the ITAA 1997 as it is a loss or outgoing of a private or domestic nature.

11. Alternatively, any interest deductible under section 8-1 of the ITAA 1997 is allowable only to the extent of the assessable trust distribution received by the taxpayer from the unit trust in each year.

### **General anti-avoidance provisions - the application of Part IVA of the ITAA 1936**

12. To the extent that the deductions claimed by the taxpayer are deductible, Part IVA applies to deny deductibility.

13. There is a scheme involving the trustee, the financier, the taxpayer and/or their family.

14. The taxpayer obtains a tax benefit of the interest deductions incurred on the borrowings.

15. Having regard to the eight factors in subsection 177D(b), a reasonable person would conclude that the sole or dominant purpose of a person or persons entering into or carrying out the scheme is to enable the taxpayer to obtain a tax benefit. Part IVA will therefore apply to deny the deductions claimed by the taxpayer.

16. Compensating adjustments will be considered having regard to the circumstances of each case.

## Date of effect

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17. This Ruling applies to years of income commencing both before and after its date of issue.

18. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a 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).

## **Explanations**

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### **Deductibility of the interest under section 8-1 of the ITAA 1997**

#### ***Private or domestic expenditure***

19. Interest will generally be a deduction to the taxpayer if its essential character is that of expenditure that has a sufficient connection with the operations or activities that more directly gain or produce the taxpayer's assessable income. This is the case provided that the expenditure is not of a capital, private or domestic nature. The essential character of interest is a question of fact to be determined by reference to all the circumstances.

20. In the arrangement described in paragraph 6 above, the essential character of the interest expenditure is of a private or domestic nature and no deduction is therefore allowable under section 8-1 of the ITAA 1997<sup>1</sup>. This is because funds are borrowed to facilitate the purchase of a residential property for private or family use.

#### ***Purpose***

21. Alternatively, if the essential character of the interest is not of a private or domestic nature, it may be necessary to consider the taxpayer's purpose in incurring that expense because the trust distribution is less than the interest deduction: see *Fletcher & Ors v. FC of T* (1991-1992) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 ('*Fletcher*').

22. If the arrangement described at paragraph 6 continued indefinitely the arrangement would become tax positive, that is, the taxpayer's assessable trust distribution would exceed the deductible outgoings. However, the reasonable expectation is that the arrangement will not continue because the taxpayer will be liable for tax on trust distributions derived from rent paid by the taxpayer and/or their family from their own after-tax income.

23. As the arrangement is entered into for a number of purposes including, but not limited to:

- providing a home for the taxpayer and/or their family;
- generating an income tax deduction available to be offset against other income of the taxpayer;

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<sup>1</sup> However, an alternative argument is that the interest expenditure is incurred for the purpose of deriving assessable income in the form of distributions from the unit trust – therefore, the necessary connection exists between the expenditure and the gaining or producing of assessable income.

- asset protection in the event of litigation and to protect assets in the event of the taxpayer being made bankrupt;
- providing for retirement through asset accumulation; and
- derivation of income by the trust,

it is necessary to carefully consider all of the circumstances including, the direct and indirect objects and the advantages sought by the taxpayer. The indirect objects may include private or domestic purposes (see *Ure v. FC of T* 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 488-9) or the manufacturing of a tax deduction (see *FC of T v. Ilbery* 81 ATC 4661; (1981) 12 ATR 563).

### ***Apportionment***

24. In these cases, it could reasonably be concluded that the disproportion between the interest outgoing and the trust distribution is explained by the pursuit of the purposes set out in paragraph 23. Accordingly, the interest deduction must be apportioned: see *Fletcher*.

25. Similarly, in these cases, a common sense weighting would mean that deductions for the interest expense would be limited to the extent of the assessable trust distribution returned in that year.<sup>2</sup>

### **General anti-avoidance provisions – the application of Part IVA of the ITAA 1936**

26. For the general anti-avoidance provisions to apply, there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C) and it must be concluded that the scheme was entered into or carried out by a person or persons for the sole or dominant purpose of enabling the relevant taxpayer to obtain the tax benefit (section 177D): see *FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344, and *FC of T v Spotless Services Ltd & Anor* (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183 ('*Spotless*').

### ***Scheme***

27. The 'scheme', for the purposes of Part IVA, is the arrangement described in paragraph 6.

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<sup>2</sup> A similar argument that relied on *Ure's* case was distinguished in *Janmor*. However, *Janmor* was decided prior to *Fletcher*.

28. The parties to the scheme include the trustee, the financier, the taxpayer and/or their family.

***Tax benefit***

29. A ‘tax benefit’ is obtained by the taxpayer from the scheme.

30. The taxpayer obtains a tax benefit of the deductions for interest incurred on the borrowings.

31. The deductions would not have otherwise been allowable, or might reasonably be expected not to have otherwise been allowable, to the taxpayer if the scheme had not been entered into or carried out.

***Dominant Purpose***

32. Part IVA applies where the taxpayer, or another person or persons, entered into or carried out the scheme, or a part of the scheme, for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. This is determined having regard to the eight factors referred to in subsection 177D(b).

33. As observed by the High Court in *Spotless*, a scheme ‘may be ... both “tax driven” and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a “scheme” for the “dominant purpose” of enabling a taxpayer to obtain a “tax benefit”’ (*Spotless* 186 CLR 404 at 415; 96 ATC 5201 at 5206; 34 ATR 183 at 188).

34. The conclusion to be reached under s177D is that of a reasonable person (*Spotless* 186 CLR 404 at 422; 96 ATC 5201 at 5210; 34 ATR 183 at 192).

35. The factors discussed in the following paragraphs indicate that the sole or dominant purpose of a taxpayer or trustee participating in such an arrangement would be to obtain a tax benefit. On that basis, Part IVA will apply.

***Factors in paragraph 177D(b)***

(i) *The manner in which the scheme was entered into or carried out*

36. The features outlined in paragraph 6 above are relevant to the manner in which a scheme was entered into or carried out. These arrangements are offered to taxpayers highlighting the acquisition of a family home in a way that allows the mortgage interest to be deductible. It is reasonable to conclude that the rationale for the use of the unit trust in this arrangement is to convert what would otherwise be private or domestic expenditure, if the home is acquired

directly by the taxpayer, to expenditure that is claimed to be deductible. These features point to Part IVA applying.

*(ii) The form and substance of the scheme*

37. The form of the scheme, as outlined in paragraph 6, is that the taxpayer borrows an amount of money and subscribes for units to derive assessable income by way of a trust distribution. The trustee buys a residence and leases it to the taxpayer and/or their family. The trust is used only for this purpose. The trustee derives assessable income in the form of rent and claims deductions for expenses for the property. A distribution from the unit trust is then used to justify a claim for an interest deduction by the taxpayer.

38. The substance of the scheme is the purchase of the family home in a way that seeks to convert non-deductible interest to a deductible expense. Again, this points to Part IVA applying.

*(iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out*

39. Once the arrangement is put in place it is utilised over a number of years. The tax benefits from the conversion of a private or domestic expense to a deductible expense continue until the arrangement is terminated. The nature of the arrangement is that the scheme can be entered into at any time during the income year.

40. This feature on its own is neutral as to the application of Part IVA. However, a reasonable conclusion that may be drawn in regard to this arrangement is that it will be dismantled at an early stage: see paragraph 22. This conclusion points to Part IVA applying.

*(iv) The result in relation to the operation of the ITAA 1936 or the ITAA 1997 that, but for Part IVA, would be achieved by the scheme*

41. The taxpayer would be entitled to a deduction for the interest on the loan used to purchase the units in the unit trust.

42. The trustee would obtain deductions for expenses on the residential property.

43. The scheme results in a deduction to the taxpayer for essentially private or domestic expenditure. This points to Part IVA applying.

*(v) Any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme*

44. The taxpayer takes on a liability for the loan and the interest payments. The taxpayer receives trust distributions and claims a deduction for the interest payments. On its own, this is neutral as to the application of Part IVA, but, when coupled with the other factors, it reflects the substance of the scheme, which is to acquire an interest deduction for what is essentially private or domestic expenditure. This points to Part IVA applying.

*(vi) Any change in the financial position of any person who has, or has had any connection with the relevant taxpayer, being a change that has resulted, or will result, or may reasonably be expected to result, from the scheme*

45. The trustee receives the capital from the allocation of the units and uses the funds to acquire the residential property. The trustee receives rental income and distributes the net income of the trust to the taxpayer. This factor on its own would be neutral as to the application of Part IVA, but, in the context of the arrangement, it reinforces the conclusion that the substance of the arrangement is to engineer a tax deduction for what would otherwise be private or domestic expenditure. This points to Part IVA applying.

*(vii) Any other consequence for the relevant taxpayer, or for any person referred to in (vi), of the scheme being entered into or carried out*

46. A consequence of the scheme is that the main residence exemption is not available. However, there is uncertainty about what other consequences may follow as a result of the scheme. This factor on its own would be neutral for Part IVA.

*(viii) The nature of any connection between the relevant taxpayer and any person referred to in (vi)*

47. The trustee, the taxpayer and/or their family are related parties. This points to Part IVA applying.

**Detailed contents list**

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### **Commissioner of Taxation**

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*Previous draft:*

Previously released in draft form as TR 2002/D2

- ITAA 1936 51(1)

- ITAA 1936 177A

- ITAA 1936 177C

- ITAA 1936 177D

*Related Rulings:*

TR 92/1; TR 92/20; TR 97/16

- ITAA 1936 177D(b)

- ITAA 1936 Part IVA

- TAA 1953 Part IVAAA

*Subject references:*

- anti avoidance measures
- home loan unit trusts
- home loan interest expense
- interest expense
- private living expense
- private or domestic expense
- tax avoidance
- tax benefit under tax avoidance scheme
- trusts
- unit trusts
- unit trust distributions
- unit trust holders
- unit holders

*Case references:*

- FC of T v. Janmor Nominees Pty Ltd 87 ATC 4813; (1987) 19 ATR 254
- Fletcher & Ors v. FC of T (1991-1992) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613
- FC of T v. Ilbery 81 ATC 4661; (1981) 12 ATR 563
- Ure v. FC of T 81 ATC 4100; (1981) 11 ATR 484
- FC of T v. Peabody (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344
- FC of T v. Spotless Services Ltd & Anor (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183

*Legislative references:*

- ITAA 1997 8-1
  - ITAA 1936 Part IIIA
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## ATO references:

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