

# Tax deductibility of interest incurred to acquire trust interests

## PART 1 – GENERAL PRINCIPLES.



### INTRODUCTION

These articles deal with the tax deductibility of interest payable on money borrowed to acquire interests in trust structures. Part 1 looks at the general principles of tax deductibility of interest and particularly the deductibility of interest on money borrowed by a taxpayer to acquire units in what is commonly referred to as a unit trust.

Part 2 will consider the deductibility of interest incurred on money borrowed to acquire an interest in trusts of a more complex nature than the usual form of unit trust, those sometimes incorporating discretionary features and referred to as “hybrid trusts”.

### THE LEGISLATION

The primary statutory provision governing whether a loss or outgoing is deductible is now s 8-1 of the Income Tax Assessment Act 1997 which in practical terms is identical to s 51(1) of the Income Tax Assessment Act 1936 which it replaced. The relevant part of it is set out below:

8-1(1) You can deduct from your assessable income any loss or outgoing to the extent that:

- (a) it is incurred in gaining or producing your assessable income; or
- (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

8-1(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

- (a) it is a loss or outgoing of capital, or of a capital nature; or

- (b) it is a loss or outgoing of a private or domestic nature; or ...

Section 8-1(1)(a) will more usually be the relevant provision in considering the deductibility of interest incurred on funds borrowed to acquire interests in trust structures. It is commonly referred to as the “first limb” of the provision, that being a reference to the manner in which the earlier s 51 was drafted. Section 8-1(1)(b) corresponds to what was known as the “second limb” of s 51.

Deductibility under the first limb requires that the outgoing of interest be incurred by the taxpayer in gaining or producing assessable income. In determining whether this requirement is satisfied the Courts have generally applied an “objective” test in looking at the totality of the transaction rather than looking to the actual intent of the taxpayer in question. There is a preparedness however to look at the intent of the individual taxpayer in certain cases.

The position is set out in the High Court decision of *Fletcher v Federal Commissioner of Taxation*:<sup>1</sup>

“...it is commonly possible to characterise an outgoing as being wholly of the kind referred to in the first limb of s 51(1) without any need to refer to the taxpayer’s subjective thought processes. That is ordinarily so in a case where the outgoing gives rise to the receipt of a larger amount of assessable income. In such a case, the characterisation of the particular outgoing as wholly of a kind referred to in s 51(1) will ordinarily not be affected by consideration of the taxpayer’s subjective motivation....”

The position may, however, well be different in a case where no relevant assessable income can

be identified or where the relevant assessable income is less than the amount of the outgoing. Even in a case where some assessable income is derived as a result of the outgoing, the disproportion between the detriment of the outgoing and the benefit of income may give rise to a need to resolve the problem of characterisation of the outgoing for the purposes of the subsection by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayers sought in making the outgoing....”

Deductibility accordingly depends to a substantial extent on the use to which the borrowed money is put. Interest is ordinarily on revenue account even though the money borrowed is applied to acquire a capital asset.<sup>2</sup> It is the purpose to which the borrowed money is put not the security that is given to the lender that is relevant. In *Ure v Federal Commissioner of Taxation*<sup>3</sup> it was said that:

“an outgoing of interest may be incidental and relevant to gaining assessable income where the borrowed money is laid out for the purpose of gaining that income .... 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 him from its use.”

In *Ure*’s case there was a large disparity between the size of the interest outgoing and the amount of assessable income generated from the use to which the borrowed funds were put. The taxpayer borrowed funds at rates up to 12½ per cent and on lent them to his spouse and a family company at 1 per cent. A deduction was claimed for the full amount of the interest

but the Commissioner allowed it only to the extent of the 1 per cent assessable income derived. The Commissioner was successful in the Federal Court which found that by on lending at such a lower rate the purpose to which the borrowed funds were applied was substantially a private or domestic purpose.

### **ACQUISITION OF INTERESTS IN TRUST STRUCTURES**

One of the common circumstances in which a taxpayer may borrow money to acquire an interest in a trust is in the acquisition of units in what is commonly referred to as a “unit trust”. Whilst unit trusts contain many forms, perhaps the most common form of private unit trust is that used by a number of taxpayers to contribute funds to be used by the

trustee of the unit trust in the acquisition of assets or the conduct of a business. It normally provides that the trust property is notionally divided into a specified number of units and that each of those units confers upon the holder of them an entitlement to the proportionate share of the income and capital of the trust fund as that single unit represents to the total number of units on issue. Such deeds commonly confer on the trustee the power to issue further units (whether for a consideration determined by the trustee or some other means) to future investors. They frequently also provide that the trustee may, usually with the sanction of a special resolution of unitholders, issue units to which preferential or other rights to income may attach.

Assuming that only ordinary units are on issue the entitlement to a deduction for the interest incurred by a unitholder on funds borrowed to purchase the units will depend on the application of the law as set out in Fletcher’s case. It will not be fatal to the deductibility of the interest if the investment does not immediately produce assessable income of a corresponding or greater amount. The reference to assessable income in s 8-1 will include assessable income that the investment might be expected to produce in future years (Fletcher).

In this context however Steele’s case is relevant. That case involved interest paid on the unpaid balance of purchase money under a contract for the purchase of land which was proposed to be developed. Difficulties arose with the development,

it did not proceed and the taxpayer disposed of her interest in the land. She then claimed a deduction for interest on the unpaid balance of purchase money over the preceding 7 years. Whilst the High Court remitted the matter to the AAT to determine whether on the facts the interest outgoing was sufficiently connected with the production of assessable income the view was expressed that it certainly could be. It was also commented however that an outgoing could be entirely preliminary to the gaining or producing of assessable income so that there was not sufficient connection between the incurring of the outgoing and the actual or projected receipt of income for it to be deductible. It depends entirely on the circumstances of each case. There would seem to be no reason why the reasoning in Steele's case could not also be applied to interest incurred on funds borrowed to acquire units in a unit trust which invested in real estate, the development or sale of which was then delayed.

In Taxation Ruling IT 2684 concerning "split property unit trusts" there is the statement under the heading "Other property unit trusts" that:

*If units in a property unit trust produce for each unitholder no assessable income in a particular income year and there is no reasonable expectation that assessable income will be produced in the future, no amount of interest is deductible under subsection 51 (1)."*

In IT 2684 the expression "split property unit trust" is used to refer to a property unit trust which offers investors a choice between income units, growth units or combined units. Income units being those which offer a return consisting substantially of income rather than capital growth, growth units offering substantially capital growth with less income.

The ruling states that interest expenses incurred on borrowed funds used to purchase income, growth or combined units in a split property unit trust are generally an allowable deduction even if the amount of the interest incurred is greater than the amount of the assessable income derived from the units for the particular income year except in some specified instances where it is stated that an apportionment of the interest expense is necessary. Those situations include:

1. Where only negligible income is produced by growth units, in which case the interest may only be deductible up to the extent of the assessable income.
2. Where the expected return from the units, both income and capital growth, does not provide an obvious commercial explanation for incurring the interest, especially if the amount of assessable income expected is disproportionately less than the amount of interest expense.

Interest incurred on money borrowed to acquire an asset (eg vacant land) with the intent simply to hold it in the expectation of a capital gain has never been deductible on the basis that the transaction is on capital rather than revenue account and is excluded from deductibility by s 8-1(2)(a). The issue is not that the borrowed money is used to acquire a capital asset but that the asset is not used in a manner which would cause the interest to be deductible under either limb of s 8-1(1).

Section 51 of ITAA 1936 pre dates capital gains tax but the words were not altered in any material respect when it was reproduced as s 8-1. Section 1-3 of ITAA 1997 provides that if ITAA 1936 expressed an idea in a particular form of words and ITAA 1997 appears to express the same idea in a different form of words in order to use a clearer or simpler style the ideas are not taken to be different just because different forms of words were used. Whilst the CGT regime has the effect of including net capital gains in the assessable income of the taxpayer it did not affect the law governing the deductibility of outgoings incurred in the acquisition or ownership of those assets; the transactions producing the gains remain on capital account and interest on funds borrowed to acquire the assets is not deductible under s 8-1.

Section 51 AAA enacted at the time CGT was introduced ensured that expenses incurred in relation to an asset would not be deductible solely because of the inclusion of a net capital gain in assessable income. On the basis of the comments above there is, in our view, a real question whether the section was necessary.

Originally when the CGT regime was introduced non-deductible outgoings (including interest) were not included in

the cost base of the related assets. This apparent oversight was subsequently rectified in respect of assets acquired after 20 August 1991 with outgoings incurred in the ownership of an asset being on capital account then being included in the cost base of the asset.<sup>4</sup>

Quite clearly under s 8-1 the deductibility of interest or any other outgoing for that matter will be determined by the answer to the question of whether it has been incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. In our view, at law the entitlement to a deduction is not determined by the prospect of a capital appreciation of the asset to which the outgoing relates. From his comments in IT 2684 it would seem the Commissioner may not share this view.

Despite the suggestion in IT 2684, in our view it is probable that the prospect of a capital gain is entirely irrelevant to the question of deductibility of interest under s 8-1. On that basis it may be that the deductibility of interest on borrowings applied to acquire units or interests in an ordinary unit trust should be determined on the principles set out above without regard to any possible capital gain on the disposal of the units.

Part 2 of this article will consider the application of these principles in relation to the acquisition of interests in trusts where the holders of those interests acquire differing interests and entitlements under the terms of the trust.

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**Reference notes:**

<sup>1</sup> *Fletcher & Ors. v FC of T 90 ATC 4559*

<sup>2</sup> *Steele v FC of T 99 ATC 4242*

<sup>3</sup> *Ure v FC of T 81 ATC 4100*

<sup>4</sup> *ITAA 97 s 110-25(4)*