

Tax deductibility of interest incurred to acquire trust interests

PART 2 – HYBRID TRUSTS.



INTRODUCTION

Part 1 of this article looked at the general principles of the tax deductibility of interest and particularly deductibility of interest on money borrowed by a taxpayer to acquire units in what is commonly referred to as a unit trust. Part 2 considers the deductibility of interest on money borrowed to acquire interests in trusts of a more complex nature which are commonly referred to as “hybrid trusts” and which incorporate discretionary features. Whilst the expression “hybrid trust” may not yet have a commonly accepted meaning it is often used to describe trusts where some of the interests in the trust have fixed rights (or are fixed in the absence of the trustee exercising a discretion to the contrary) and others where the interest of a beneficiary is substantially the same as that of a general beneficiary under a purely discretionary trust.

References in this article to persons having fixed, vested or absolute rights to income or capital of a trust are subject to the High Court’s decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue*¹ regarding the prior rights conferred by a trustee’s right of indemnity.

UNIT TRUST WITH CLASSES OF BENEFICIARIES CAPABLE OF RECEIVING BOTH INCOME AND CAPITAL

This is essentially a unit trust having also a class or classes of discretionary beneficiaries, commonly with one class for each unit holder. The unit holders are entitled to their proportionate share of both income and capital except that the trustee has the discretion to distribute all or part of the income to the class or classes of beneficiaries (and as between the

members of those classes, in such shares as the trustee determines). The trustee also has the discretion to distribute capital to the classes of beneficiaries in the same way. A taxpayer acquiring units in such a trust may not be concerned in relation to the trustee’s discretion if he effectively controls the trustee.

Despite that effective control (and it may not exist where there are several unit holders) the taxpayer does not have an absolute right to any trust income. Whilst technically the right of the unit holder to its proportionate share of the trust income may be vested subject to divestment, the fact that divestment can occur through the action of another party, being the trustee, raises a real question as to deductibility of any interest incurred on money borrowed by the unit holder to acquire the units. The question is whether “it is incurred in gaining or producing” assessable income as required by s 8-1(1) of *ITAA 1997*.

Even if the income is in fact received and it exceeds the amount of the interest outgoing it may be that the interest was not incurred for the purpose of gaining that income where the income was received only because the trustee elected not to exercise the discretion to distribute the income to the classes of beneficiaries rather than leave it with the unit holder. If the unit holder has no absolute right to the income, is the receipt of it any different in nature to the receipt of income from a purely discretionary trust where that is a consequence of the exercise of the discretion of the trustee or as a result of being a default beneficiary that receives income as a result of the trustee not exercising its discretion at all? In our view there is probably not sufficient nexus

between the incurring of the interest expense and the receipt of the income for it to be said that the interest was “incurred in gaining or producing” the income. That reasoning would apply whether the income received was greater or lesser than the amount of the interest.

The position can be contrasted with the views expressed in Fletcher’s case² and Ure’s case³ where there was an absolute entitlement to income but there was such a disparity between the amount of interest outgoing and the income received that it raised a question as to whether the whole of the borrowing was for the purpose of gaining assessable income or for that purpose and some other purpose. In each case the interest was deductible only to the extent of the income received on the basis that in considering the totality of the circumstances the borrowing was not wholly for the purpose of gaining or producing assessable income but was for other purposes also. In the case of the form of trust described the units do not carry a right to any income which could be the basis for any apportionment of the interest in the event that it exceeded the income received. It would seem that the matter does not get to that point as the nexus required between investment of the money in acquiring units and the derivation of income from them as required by s 8-1 is not there.

As with a direct investment in real property whether the assessable income derived will exceed the outgoings incurred in the derivation of that income will at least to some extent be determined by fluctuations in the value of the real property; if the value of the real property increases, on the assumption that the

proportionate rental return on capitalisation remains constant, the assessable income derived from the real property will increase. But that increase in the capital value of the real property, which will determine whether there is net taxable income or a net tax loss in respect of the real property, will have no bearing on the question as to whether an interest expense incurred on funds borrowed to acquire the property are deductible. Any net capital gain made on the disposal of real property will be included in assessable income under s 102-5 of *ITAA 1997* and in the calculation of that net capital gain any interest expense incurred in the derivation of assessable income will be included in the cost base of the real property for the purposes of the calculation of the net capital gain⁴. The question of the derivation of a capital gain is one of capital and accordingly any interest expense incurred for the purpose of deriving the capital gain will not be deductible.

If the purpose of an expense is the derivation of assessable income then it will be deductible.

The fact that the taxpayer may not receive any trust income as a consequence of the capacity of the trustee to distribute that elsewhere is compounded by the power of the trustee to distribute the capital to the classes of beneficiaries and so permanently reduce the amount of income the unit holder may receive or eliminate the possibility entirely. Even if the discretionary powers of the trustee did not extend to the capital so that the unit holder was entitled to a return of capital, either with or without participating in any capital gain, on the winding up of the trust would not alter the position in relation to the deductibility or otherwise of interest on borrowings to acquire the units because of the substantially discretionary nature of the income.

TRUSTS WITH UNITS CARRYING FIXED RIGHTS TO A SPECIFIC PROPORTION OF THE INCOME BUT THE RIGHT TO CAPITAL IS DISCRETIONARY

A hybrid trust of this nature was recently the subject of a private ruling⁵. Under the deed the trustee had the power at any time to create capital or income units in the trust but once income units had been created those units carried the entitlement

to all of the income of the trust and the trustee could not issue further units of any kind without the written consent of the unit holders. The question was whether a deduction could be obtained for interest payable on money borrowed by the taxpayer to subscribe for income units when the interest was expected to be approximately three times the amount of the anticipated income. It was stated that capital distributions were discretionary. It was not entirely clear whether that just related to capital gains or whether the whole of the capital could be dealt with at the discretion of the trustee as in the other form of trust discussed above. Given that the unit holder had a fixed right to income it is probable that the trustee's discretion extended only to capital gains.

The ruling stated because there was not a fixed entitlement to capital the trust did not have the features of "split property trusts" as described in IT 2684.

The Commissioner also relied on Fletcher's case and Ure's case and others in support of the approach that because there was a significant disparity between the estimated interest expense and the estimated income to be derived the overall circumstances had to be considered to determine whether the taxpayer had some purpose other than the derivation of assessable income. The ruling was that the interest was only deductible up to the level of the income received. The other purpose was stated to be the private purpose of "asset protection" which was apparently the reason for the units carrying no right to capital appreciation.

As indicated in part 1 of this article, in our view it is probable that the prospect of capital gain is entirely irrelevant to the question of deductibility of interest under s 8-1(1). If that is the case then the fact that the unit holder may not participate in any appreciation in the capital value of the assets of the trust but only receive the return of its subscribed capital should not have a bearing on the deductibility of interest where there is an absolute right to the relevant proportion of the trust income.

It is relevant here that no deduction would be available in respect of interest on borrowings in respect of a purely capital gain in any event, the outgoing being of a capital nature. How then can it be contended that the lack of a right to

participate in the capital appreciation of the trust's assets is relevant to the deductibility of interest on money borrowed to acquire units with a fixed right to income?

This is not to suggest that Fletcher and Ure were not correctly decided, clearly in those cases other purposes were involved. In the context of the trust described however asset protection may just be a feature of the structure and provided that the investor is entitled to a return of the original sum subscribed how can the feature of asset protection reasonably be described as a private purpose which would properly give rise to an apportionment under the principles outlined in Fletcher and Ure?

In the case of the trust subject to the ruling the proposed investment was tenanted real estate and whilst the investment by the unit holder in units would initially be negatively geared it may in time have become neutrally or positively geared.

COULD PART IVA APPLY?

Where there is a trust with units or interests having different rights in respect of capital and income could there be a scheme to which Part IVA of *ITAA 36* could apply to disallow or reduce the interest deduction in the way it did to the split loan arrangements in Hart's case⁶? In our view probably not.

For Part IVA to apply a taxpayer must obtain a tax benefit in connection with the scheme⁷. Relevantly, a tax benefit will be taken to be obtained by a taxpayer in connection with a scheme:

1. Where an amount has not been included in the assessable income of a taxpayer if the amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
2. Where there has been an allowable deduction to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out⁸.

The entitlement to the interest deduction will stand or fall on whether it is within s 8-1(1). If the structure results in some party other than the borrower/taxpayer receiving the benefit of a capital gain there is still no tax benefit by way of reduction in income or increase in deductions available to the taxpayer/borrower. The other party would receive that benefit as a consequence of their interest in or entitlement under the trust structure and will have the liability for any capital gains tax arising.

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Reference notes:

- 1 (2005) 224 CLR 98
- 2 *Fletcher & Ors. v FC of T* 90 ATC 4559
- 3 *Ure v FC of T* 81 ATC 4100
- 4 Section 110-25(4) ITAA97
- 5 No. 66298
- 6 *Hart v FC of T* 2004 ATC 4599
- 7 Section 177D ITAA36
- 8 Section 177C ITAA26