

Deductibility of interest and Taxpayer Alert TA 2008/3



THE TAX DEDUCTIBILITY OF INTEREST INCURRED TO ACQUIRE TRUST INTERESTS IS AGAIN UNDER REVIEW AS A RESULT OF THE COMMISSIONER'S RECENT TAXPAYER ALERT AND RELEVANT CASE LAW.

INTRODUCTION

The general principles of the deductibility of interest incurred to acquire a trust interest were recently considered in two articles published in *Taxation in Australia* last year.¹ Taxpayer Alert 2008/3: Uncommercial use of certain trusts² identified features of trust arrangements which are of concern to the Commissioner. These arrangements include circumstances in which a taxpayer may seek to obtain a deduction for interest incurred in acquiring an interest in a trust.

This article will consider the application and effect of TA 2008/3 on the deductibility of interest incurred in acquiring particular types of interests in certain trusts.

Legislative references are to the *Income Tax Assessment Act 1936* (ITAA36) and the *Income Tax Assessment Act 1997* (ITAA97).

SUMMARY OF PREVIOUS ARTICLES

A general tax deduction is allowed for any loss or outgoing to the extent that it is incurred in gaining or producing assessable income, but not to the extent it is capital or private or domestic in nature, is incurred to produce exempt income or is otherwise specifically limited.³

The courts determine deductibility objectively and the taxpayer's subjective motivation is not ordinarily relevant, unless there is no relevant assessable income or the assessable income is less than the amount of the outgoing.⁴ Assessable income includes income derived in the current year and assessable income that the investment might be expected to produce in a future year.⁵

The courts have (correctly in our view) been reluctant to look at the taxpayer's subjective intent, unless there is no relevant assessable income or the outgoing grossly exceeds the current year derived income or the reasonably anticipated future assessable income to be derived (or both)⁶ Consistent with this, in *Ure*⁷ the Court held that the disparity between the interest outgoing at 12.5 per cent and assessable income at 1 per cent on the loan to the taxpayer's wife and related company evidenced a private and domestic nature denying the deduction. The degree of disparity before one can consider subjective intent is unclear. Arguably, the Commissioner is readily predisposed to consider subjective intent.

An outgoing incurred solely to derive a current or future year capital gain is a non-deductible capital outgoing.⁸ Some entitlement or potential entitlement to non-capital gains receipt is required for an outgoing to be deductible. If the interest outgoing is not a general deduction it will be included in the cost base of the relevant asset for capital gains tax purposes.⁹

The Commissioner appears to assert that deductibility requires some entitlement or potential entitlement to capital gains receipt.¹⁰ There is no statutory basis for this requirement.

Apportionment of the deduction is required to the extent the taxpayer does not have the requisite purpose of gaining or producing assessable income or the outgoing is capital or capital, private or domestic in nature, is incurred to produce exempt income or is otherwise specifically limited. Further, the Commissioner asserts that collateral purposes such as an asset protection motive or desire to obtain the tax deduction require apportionment of the outgoing.

AUTHORITIES AND STATEMENTS

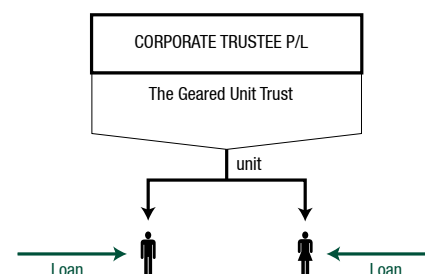
Negative gearing

Negative gearing requires an individual to borrow money at commercial rates to acquire an interest in a trust (such as a unit) where the incurred current year interest deduction exceeds the current year derived assessable income on the interest in the trust. The arbitrage is set-off against the individual's assessable income from other sources (such as employment income).

A beneficiary under a discretionary trust is unable to deduct interest generally or in respect of a capital gift to the discretionary trust as the beneficiary has a mere expectancy of receiving income or capital (or both) and was not presently entitled to income of the trust when the expenditure was incurred.¹¹

As demonstrated by *Ure*,¹² the arbitrage cannot arise through back-to-back loans to the trust at reduced interest rates.

The negative gearing arrangement for a unit trust is illustrated by the following diagram:



IT 2684: Units in a property unit trust

IT 2684 (issued 6 April 1992) discusses the deductibility of interest on loans to acquire split property unit trust income units, growth units and combined units, ruling that an interest deduction for acquiring:

1. growth units with negligible income entitlements are limited to the assessable income actually received;¹³
2. units which produce no assessable income are wholly non-deductible;¹⁴
3. income units with negligible capital entitlements or combined units with equal income and capital entitlements are generally wholly deductible, unless apportionment is otherwise necessary.¹⁵

Further, IT 2684 states that apportionment may be necessary where:

1. the loan is used for producing both assessable income and non assessable income;¹⁶
2. the expected income *and* capital returns together does not provide an obvious commercial explanation for incurring the interest;¹⁷
3. the assessable income is disproportionately less than the amount of interest and the purpose of acquiring the units and making the interest outgoing includes private or domestic purposes or a tax deduction motive or purpose¹⁸

IT 2684 acknowledged (correctly in our view) that:

1. the entitlement to a deduction is determined annually or prospectively;¹⁹
2. negative gearing does not necessarily preclude the deduction or, of itself, require an apportionment of interest outgoings;²⁰ and
3. section 51AAA ITAA36 denies the interest deduction for the acquisition of units that produce capital growth only.²¹

TA 2008/3: Uncommercial use of certain trusts

TA 2008/3 may be interpreted to state that interest may not be wholly or partially deductible because it is not sufficiently reasonably certain that current and future year's assessable income²² will exceed/recoup the interest deduction where:

1. the trust instrument permits or can be amended to permit the issue²³ or redemption/extinguishment²⁴ of units or interests at less than market value or the subsequent issue of units or interests with priority to or permitting diversion of income or capital;²⁵ or
2. the trust instrument permits an entitlement to income or capital (or both)

to be divested by the exercise of the trustee's discretion of appointment.²⁶

Further, interest may not be wholly or partially deductible because (presumably) the unit holder did not have the necessary sufficient income production purpose or had a capital or capital, private or domestic purpose where the unit holder:

3. has no or a reduced proportionate entitlement to a share of capital evincing an intention to divert that capital to another person to obtain a tax benefit;²⁷ or
4. has no or a reduced proportionate entitlement to a share of income evincing an intention to divert that income to another person to obtain a tax benefit.²⁸

It is unclear whether the use of the trust's assets to secure the unit holder's loan is relevant to determining deductibility, particularly, because it shows a collateral capital or capital, private or domestic purpose.²⁹ *Munro*³⁰ would indicate that security is irrelevant to determining deductibility of interest.

TA 2008/3 also identifies the Commissioner's concerns regarding the application of the revocable trust specific avoidance rules³¹ and general anti-avoidance rules.³²

Comparison of IT 2684 and TA 2008/3

IT 2684 provides technical context and explanation for and is largely consistent with the statements made in TA 2008/3.

However, TA 2008/3 arguably goes further (incorrectly in our view) without citing authority by requiring apportionment or denial of the interest deduction where:

1. a unit does not have equal income and capital entitlements; or
2. the trust instrument contains an unexercised power or can be amended to include a power to effectively divest or divert future income or capital entitlements.

Collateral purpose

Apportionment is required where there is a collateral purpose other than to derive assessable income, such as where the interest expense was incurred for a private or domestic motive or purpose.

IT 2684 asserts that the collateral purpose of obtaining a taxation deduction is sufficient to require apportionment of the interest outgoing.³³ However, we consider the taxpayer's subjective taxation deduction motivation which is not ordinarily relevant, only becomes relevant where there is a disparity in the taxpayer's income entitlement such that objectively it was not sufficiently clear that the current and future year's income will exceed/recoup the interest deduction.

An example of a collateral motive is TR 2002/18: Income tax: home loan unit trust arrangement where a taxpayer borrows money, acquires units in a unit trust which then purchases a main residence to be leased to the unit holder (or relative) to be used as their main residence.

TR 2002/18 states that the interest outgoing incurred by the taxpayer is not deductible as its essential character is of a private or domestic nature because the borrowing was to facilitate the purchase of a residential property for private or family use.³⁴

TYPE OF TRUST INTERESTS

Classification of trust interests

Whether the interest incurred on the borrowing to acquire a trust interest (such as a unit) is deductible is dependent on the type of trust interest acquired.

Careful analysis of the trust deed is always required, but for illustrative purposes, consider the following classes of units with the following entitlements:

1. **Ordinary Units** conferring a fixed³⁵ entitlement to a share of income and capital in proportion to the number of Ordinary Units issued;
2. **Income Units** conferring a fixed entitlement to a share of income in proportion to the number of Income Units issued, but no entitlement to capital;
3. **Capital Units** conferring a fixed entitlement to a share of capital in proportion to the number of Capital Units issued, but no entitlement to income;
4. **Discretionary Income Units** conferring a fixed entitlement to a share of income in proportion to the number of Discretionary Income Units issued upon the exercise of the trustee's power of appointment in respect of income but no entitlement to capital;

5. Discretionary Capital Units conferring a fixed entitlement to a share of capital in proportion to the number of Discretionary Capital Units issued upon the exercise of the trustee's power of appointment in respect of capital but no entitlement to income;

6. Discretionary Units conferring an entitlement to income or capital (or both) in the absolute discretion of the trustee to one or more of the Discretionary Units upon the exercise of the trustee's power of appointment.

Modern trust instruments usually empower the trustee to accumulate income.

Deducting interest in respect of these classes of units is discussed below.

Terms of the trust instrument

Further, whether the interest incurred on the borrowing to acquire a trust interest (such as a unit) is deductible is arguably dependent on the terms of the trust instrument.

The power to reclassify a receipt by a trustee as capital or income in determining the income of the trust estate under s 97 ITAA36³⁶ may effectively disentitle the unit holder to an interest deduction, because the reclassification process may constitute a discretionary power to divest or redirect income or capital entitlements.

In *AAT Case*³⁷ the beneficiary borrowed to acquire units in a form of trust that had Income Units and Capital Units on issue. The trust instrument empowered the trustee to reclassify a receipt as income or capital, thus effectively allocating a particular receipt to the income unit holders or to the capital unit holders in the trustee's absolute discretion. The Tribunal held that the interest on borrowings to acquire the units was not deductible, because the discretion to reclassify a receipt was sufficient to redirect income or capital entitlements in a discretionary manner so there was insufficient certainty that current and future year's assessable income would exceed/recoup the interest deduction.

In the *Raftland* Special Leave Application³⁸ and the hearing,³⁹ Senior Counsel for the taxpayer sought to limit the application of the distributable income principle to trusts with successive estates, so that the rule did not apply to unit trusts with Ordinary Units. The decision has been reserved, but may impact upon the decision in *AAT Case*.

AAT Case does provide some authority for the Commissioner's statement in TA 2008/3. If correct, arguably, no interest deduction will apply where the unit trust has different income unit holder and capital unit holder entitlements and the unit trust instrument includes powers to reclassify income or capital in a manner to divest entitlements.

In a trust with different Income Units or Capital Units that empowers the trustee to accumulate income the process of accumulation appropriates what is otherwise income for the Income Units to the benefit of the Capital Units. This has a similar effect

We consider the position is even more compelling when the trust instrument does not contain such powers to divest or divert future income or capital entitlements (regardless of whether it can be amended to include such powers).

The below analysis regarding the deductibility of interest on acquiring an interest in a trust (such as a unit) for different classes of units assumes that the terms of the trust instrument do not necessarily require apportionment or denial of the interest deduction.

“ negative gearing does not necessarily preclude the deduction or, of itself, require an apportionment of interest outgoings ”

to a discretionary reclassification. If the *AAT Case* and TA 2008/3 are correct (which we doubt) then a power to accumulate will always mean the trustee has a power to divert income from the Income Units to the Capital Units resulting in the apportionment of the interest deduction.

Since the deductibility of interest is determined at the time the loss or outgoing was incurred having regard to all the objective circumstances of the matter, we consider that the existence in a trust instrument of an unexercised power to effectively divest or divert future income or capital entitlements by unit redemption, forfeiture, under value allotment, allotment of priority or discretionary units or variation of unit rights (without more) does not alter whether it is sufficiently reasonably certain that current and future year's assessable income will exceed/recoup the interest deduction.

Without the exercise of such powers or some evidence that the powers will actually be exercised to divest or divert future income or capital entitlements, we consider it is not possible to conclude objectively that the current and future year's assessable income will not exceed/recoup the interest deduction.

Ordinary Units

The holder of Ordinary Units will have a sufficiently fixed entitlement to the income and capital of the trust such that it is sufficiently reasonably certain that current and future year's assessable income will exceed/recoup the interest deduction.

Accordingly, with the requirements of IT 2684 and TA 2008/3 (whether or not supported by authority) the interest on acquisition of Ordinary Units will likely be deductible.

Income Units

The holder of Income Units will have a sufficiently fixed entitlement to the income of the trust such that it is reasonably certain that current and future year's assessable income will exceed/recoup the interest deduction. Further, any power in the trust instrument to reclassify a capital receipt as income for s 97 ITAA36 purposes will merely increase and not divest or divert that entitlement.

Accordingly, the interest on acquisition of Income Units will likely be deductible. We consider the requirements in TA 2008/3 that the unit must have more than a negligible entitlement or potential entitlement to capital or a proportionate entitlement to capital is not supported by authority.

Capital Units

The holder of Capital Units will not have any entitlement to the income of the trust. Further, s 51AAA ITAA36 will deny the deduction.

Accordingly, the interest on acquisition of Capital Units will not be deductible.

Discretionary Income Units or Discretionary Capital Units

The holder of Discretionary Income Units or Discretionary Capital Units will not have a sufficiently fixed entitlement to the income of the trust such that it is reasonably certain that current and future year's assessable income will exceed/recoup the interest deduction. The holder of Discretionary Income Units will have no more than a mere expectancy of receiving income. The holder of Discretionary Income Units will have no entitlement to income and no more than a mere expectancy of receiving capital.

Accordingly, the interest on acquisition of Discretionary Income Units or Discretionary Capital Units will likely not be deductible.

Discretionary Units

The holder of Discretionary Units will not have a fixed entitlement to any of the income or capital of the trust. The holder of Discretionary Units will have no more than a mere expectancy of receiving income or capital (or both).

Accordingly, the interest on acquisition of Discretionary Units will likely not be deductible.

Hybrid Unit Trusts

There is no single definition of a hybrid unit trust but for the purpose of this article assume that a hybrid unit trust (as opposed to a unit trust with discretionary units) is a unit trust with Ordinary Units but the trust instrument also incorporates a class or classes of discretionary beneficiaries (similar to a discretionary trust), commonly with one class of beneficiaries for related entities of each unit holder.

If the trustee is empowered to divest the income or capital and appoint it to one or more members of the class or classes of discretionary beneficiaries then the holder of Ordinary Units will not have a sufficiently fixed entitlement to the income or capital of the trust such that it is reasonably certain

that current and future year's assessable income will exceed/recoup the interest deduction. The holder of Ordinary Units will have no more than a mere expectancy of receiving income or capital.

The Commissioner ruled in Private Ruling 66298 on a hybrid trust with Income Units having fixed entitlements to income but capital could be appointed to the Income Units or to the class of discretionary beneficiaries.

After considering IT 2385 and IT 2684 the Commissioner ruled that interest on the borrowing used to acquire Income Units with a fixed entitlement to a specific proportion of the income was deductible. However, the Commissioner ruled that it was necessary to apportion the interest deduction because:

1. the taxpayer had acknowledged that the income return was only 2 per cent per annum and there was no fixed entitlement to capital such that there was no obvious commercial explanation for incurring the expense;
2. the taxpayer expressed a collateral asset protection purpose such that the outgoing was not fully incurred for the purpose of producing assessable income.

Arguably, the taxpayer's subjective asset protection motivation which is not ordinarily relevant, became relevant because it was not objectively reasonably certain that the 2 per cent assessable income per annum for the current and future year's would exceed/recoup the interest deduction. Without such disparity in income entitlement it would not have been necessary to consider the collateral asset protection purpose.

Revocable Trusts

In TA 2008/3 the Commissioner identifies the potential application of the revocable trust rules in s 102 ITAA36 to the establishment of trusts.

Section 102(1) provides:

Where a person has created a trust in respect of any income or property (including money) and:

- (a) he has power, whenever exercisable, to revoke or alter the trusts so as to acquire a beneficial interest in the income derived by the trustee during the year of income, or the property producing that income, or any part of that income or property; or

- (b) income is, under that trust, in the year of income, payable to or accumulated for, or applicable for the benefit of a child or children of that person who is or under the age of 18 years;

the Commissioner may assess the trustee to pay income tax, under this section, and the trustee shall be liable to pay the tax so assessed.

If a person has established a trust under which the income of the trust is, in a particular year of income, payable to, accumulated for or applicable for the benefit of a child or children of the person who is under the age of eighteen years, ss 102(1) could be applied by the Commissioner to that income.

A trust can be established by settlement gift (such as a settled sum of \$20) or by subscription of units. Where the trust is established by settlement gift of an unrelated third party, the revocable trust rules cannot apply. Similarly, the revocable trust rules will not apply upon the subscription for units unless the children of the unit subscriber have an entitlement or potential entitlement under the trust. A child may have such an entitlement, arguably, where the child's father subscribes for units and the child is a member of a discretionary class of beneficiaries.

In *Truesdale*⁴⁰ the High Court considered whether s 102(1) ITAA36 could be applied by the Commissioner to gifts made to the trustee of trusts after their establishment, by the father of the infant beneficiaries. It was held the words in the sub-section "created a trust" did not "cover the making of contributions to a trust already created".

We consider that provided the children's parents were not initial subscribers to a hybrid trust, the revocable trust rules are unlikely to apply. After initial subscription, the parents could subscribe for further units under the *Truesdale* exclusion.

Conclusion

The determination of the deductibility of interest incurred on borrowings to acquire an interest in a trust is by no means a simple task. It requires careful consideration of the arrangement in question, including the type of trust interests involved, the entitlements of the taxpayer to the income and capital of the trust and the terms of the trust instrument.

TA 2008/3 arguably attempts to extend the circumstances that determine interest deductibility on the acquisition of a trust interest which requires further clarification. Until the Commissioner provides such clarification it is critical that the basic principles in determining whether there is a sufficient nexus between the incurrence of interest and the gaining or producing of assessable income are carefully considered and applied cautiously.

*Ron Jorgensen, Principal
Harwood Andrews Lawyers*

Reference notes:

- 1 *N. Mathison and R. Jeremiah, Taxation in Australia, Volume 42, No. 4, October 2007 and Volume 44, No. 5, November 2007.*
- 2 *Issued 26 March 2008.*
- 3 *Section 8-1 ITAA97 (formerly s 51(1) ITAA36).*
- 4 *Fletcher v FCT 91 ATC 4958 at 4958; (1991) 222 ATR at 623; Ure v FCT 81 ATC 4100.*
- 5 *Fletcher v FCT 90 ATC 4559.*
- 6 *Fletcher v FCT 90 ATC 4559.*
- 7 *Ure v FCT 81 ATC 4100.*
- 8 *Sections 51 and 51AAA ITAA36 as re-enacted as s 8-1 ITAA97 with the same intent: s 1-3 ITAA97.*
- 9 *Section 110-25(4) ITAA97.*
- 10 *TA 2008/3 at [12] but contrast example statement to the contrary in IT 2684 at [39].*
- 11 *IT 2385 at [5] and [7].*
- 12 *Ure v FCT 81 ATC 4100.*
- 13 *IT 2684 at [6] and [23].*
- 14 *IT 2684 at [15].*
- 15 *IT 2684 at [3] and [26].*
- 16 *IT 2684 at [7].*
- 17 *IT 2684 at [9].*
- 18 *IT 2684 at [10].*
- 19 *IT 2684 at [12] and [13].*
- 20 *IT 2684 at [32].*
- 21 *IT 2684 at [36].*
- 22 *See Fletcher v Commissioner of Taxation (Cth) [1991] HCA 42 at 23 regarding expectancy of the production of assessable income.*
- 23 *TA 2008/3 at [2] and [4].*
- 24 *TA 2008/3 at [11(c)].*
- 25 *TA 2008/3 at [11(b)].*
- 26 *TA 2008/3 at [3].*
- 27 *TA 2008/3 at [9] and [12].*
- 28 *TA 2008/3 at [14].*
- 29 *TA 2008/3 at [5], although this appears merely a description of the factual arrangement.*
- 30 *FCT v Munro (1926) 38 CLR 153.*
- 31 *Section 102 ITAA36.*
- 32 *Part IVA ITAA36.*
- 33 *IT 2684 at [10] citing FCT v Ilbery 81 ATC 4661.*
- 34 *See Re Peter Mario Tabone v FCT [2006] AATA 466.*
- 35 *Meaning vested and indefeasible.*
- 36 *Discussed in detail in R. Jorgensen, "Continuing Controversy Post Cajkusic", Taxation in Australia, Vol. 42, No. 6, December/January 2007 at 249.*
- 37 *AAT Case [2008] AATA 325*
- 38 *Raftland P/L v FCT [2007] HCA Trans 327 (21 June 2007).*
- 39 *Raftland P/L v FCT [2008] HCA Trans 009 & 010 (30 & 31 January 2008).*
- 40 *Truesdale v FCT 70 ATC 4056; (1970) 120 CLR 353*

QLD State Convention

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