

Edited version of private ruling

Authorisation Number 88113

This ruling is a private ruling for the purposes of Division 359 of Schedule 1 of the Taxation Administration Act 1953.

What this ruling is about:

1. Is the interest expense incurred by the applicant a loss or outgoing incurred in gaining or producing the applicant's assessable income?
2. Is the interest expense incurred by the applicant fully deductible to the applicant under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) in the year in which the interest expense is incurred?
3. Is the loan made to the trust a qualifying security within the meaning of Division 16E of the *Income Tax Assessment Act 1936* (ITAA 1936)?
4. If the Loan made to the trust is a qualifying security, is the applicant required to include the anticipated return on the accruals basis prescribed in Division 16E of the ITAA 1936?

Ruling:

1. Is the interest expense incurred by the applicant a loss or outgoing incurred in gaining or producing the applicant's assessable income?

Yes.

2. Is the interest expense incurred by the applicant fully deductible to the applicant under section 8-1 of the ITAA 1997 in the year in which the interest expense is incurred?

3.

No.

4. Is the loan made to the trust a qualifying security within the meaning of Division 16E of the ITAA 1936?

Yes

5. If the loan made to the trust is a qualifying security, is the applicant required to include the anticipated return on the accruals basis prescribed in Division 16E of the ITAA 1936?

Yes

Year(s) of income or period(s) to which this ruling applies:

Year ended 30 June 2008

Year ended 30 June 2009

Commencement date of scheme:

1 July 2007

The scheme that is the subject of the ruling:

The applicant will arrange for the establishment of a trust on the terms set out in the trust deed provided.

The applicant will borrow funds (external loan) and advance the full amount of the loan to the trustee for the trust under the terms set out in the document titled loan agreement (trust loan).

The trustee for the trust will use the funds advanced by the applicant to acquire a residential investment property.

The applicant has an expectation that the investment property will generate sufficient profit in the long term to cover all interest paid or accrued on the external loan.

The applicant is the primary beneficiary of the trust.

As per the trust deed:

- Before accumulating or distributing any portion of the net income in any year to other beneficiaries, the Trustee must make a specified distribution to the applicant from the net income of a set amount.
- Once the specified distribution has been made in a year to the applicant, the Trustee retains full discretion as to the distribution of the remaining net income of that year.
- If the trustee does not determine to distribute or accumulate the whole of the net income, then the portion not distributed or accumulated will be held on trust for the primary beneficiaries.
- The settlor, any children of the settlor and the personal representative of the settlor are excluded from all benefits under the trust.
- The trustee will not be required to pay interest on the trust loan.
- The trustee must make a distribution to a beneficiary who makes a loan in the year in which the loan is made and in each subsequent year.
- The amount to be distributed for each loan will be determined by agreement between the trustee and the lender.
- If the trust loan has been repaid, the trustee has an obligation to continue to pay any distribution owing in related to that loan in subsequent years until any accumulated distribution amount has been paid in full.
- Where the trustee has entered into a loan agreement with a beneficiary, the trustee may not enter into (or attempt to enter into) another loan with another beneficiary unless:
 - the first loan has been repaid in full; and
 - the beneficiary who advanced the first loan has received the full Distribution to which the beneficiary is entitled.

Loan agreement (trust loan)

- The amount to be distributed as per the loan agreement in each financial year is the amount equal to the interest payable on the external loan in that financial year plus a small margin provided that, if the actual distribution for a financial year is less than the amount to be distributed for that financial year, the shortfall will be added to and form part of the amount to be distributed for the following financial year.
- The amount to be distributed as per the loan agreement is also the distribution amount for the purposes of the trust deed that established the trust.
- The beneficiary making the trust loan may make demand for payment of the loan or any part of the loan at any time.
- The trustee must repay the balance of the trust loan on or before the due date for payment of the external loan.

Relevant provisions:

Income Tax Assessment Act 1997 Section 8-1.

Income Tax Assessment Act 1936 Subsection 159GP(1).

Income Tax Assessment Act 1936 Subsection 159GP(3).

Income Tax Assessment Act 1997 Subsection 6-5(2).

Income Tax Assessment Act 1997 Subsection 6-5(4).

Income Tax Assessment Act 1936 Section 159GX.

Income Tax Assessment Act 1936 Section 159GQ.

Part IVA of the *Income Tax Assessment Act 1936* is a general anti-avoidance rule that can apply in certain circumstances if you or another taxpayer obtains a tax benefit in connection with an arrangement and it can be concluded that the arrangement, or any part of it, was entered into or carried out by any person for the dominant purpose of enabling a tax benefit to be obtained. If Part IVA applies the tax benefit can be cancelled, for example, by disallowing a deduction that was otherwise allowable.

We have not fully considered the application of Part IVA to the arrangement you asked us to rule on, or to an associated or wider arrangement of which that arrangement is part

If you want us to rule on whether Part IVA applies we will first need to obtain and consider all the facts about the arrangement which are relevant to determining whether Part IVA may apply.

Explanation: (This does not form part of the notice of private ruling)

Deductibility of Interest

Section 8-1 of the ITAA 1997 allows a deduction for all losses and outgoings to the extent to which they are incurred in gaining or producing assessable income except where the outgoings are of a capital, private or domestic nature.

An outgoing of interest may be deductible under section 8-1 of the ITAA 1997 when borrowed money is laid out for the purposes of gaining assessable income (*FC of T v. Munro* (1926) 38 CLR 153, (*Munro's Case*)). In most cases, the deductibility of interest is determined by reference to the use of the borrowed funds. In *Ure v. FC of*

T (1981) 11 ATR 484 (*Ure's Case*) it was established that the purpose of a borrowing will be determined objectively having regard to such matters as how the taxpayer arranged the use of the funds and his subsequent actual use of the funds.

Section 8-1 of the ITAA 1997 is concerned with whether the connection between the incurring of the interest expense and the producing of assessable income is sufficient to make the expenditure incidental and relevant to the production of that income. That is, the expenditure must be incidental and relevant to the earning of the assessable income of the taxpayer (*Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47 at 56 (*Ronpibon Tin*)).

Use of borrowed funds

The applicant will borrow funds from an external lender and advance the full amount, so borrowed, to the trustee. With the funds provided by the applicant, the Trust will acquire an income producing residential property.

Under the trust deed, the provision of the loan will give the applicant a vested entitlement to a prescribed part of the income which may be derived by the Trustee. The trustee's ability to distribute to beneficiaries other than the applicant, will be subject to the distribution to be made to the applicant.

Thus the applicant's claim for a deduction is supported by the fact that the interest expense he incurs on the external loan is a loss or outgoing incurred in gaining or producing his assessable income from on lending those funds to the trust. However such a loss or outgoing is deductible under section 8-1 of the ITAA 1997 only 'to the extent' that it is incurred in gaining or producing his assessable income (subsection 8-1(2)).

Intrinsic in the operation of section 8-1 of the ITAA 1997 is a general rule that a loss or outgoing is not deductible under the section unless it is incurred in gaining or producing the assessable income of the person who incurs it (*Munro's Case*).

The trust deed allows the trustee to determine the destination of a distribution of any trust income, in excess of the amount to which the applicant is entitled to under the deed. The trust deed, dealing with default of exercise of discretion, only operates to distribute the income to the primary beneficiary, the applicant, if the trustee does not make a determination to distribute or accumulate the income.

Deputy President R Nicholson, in *Case 2/2008*, 2008 ATC 1-001; [2008] AATA 325 at paragraph 42, noted in relation to the exercise of a trustee's discretion:

The problem for the applicant is that the power is provided for in very wide terms so that, until its exercise, it is not possible for it to be known in what terms the Trustee has accepted a particular item of income. Consequently, there cannot be any present entitlement. To establish present entitlement it cannot be assumed that because the power can only be exercised lawfully in one particular way that it has in fact been so exercised.

Therefore, until a determination is made in the applicant's favour or the default clause is utilised, the applicant cannot establish any entitlement to this excess income, for there exists the real possibility or, perhaps, a strong likelihood, that the trustee will distribute the excess to a beneficiary other than the applicant.

Importantly for the applicant, he can only achieve an unapportioned deduction under section 8-1 of the ITAA 1997 by establishing that he reasonably expects to receive all income from the trust. It is not enough for him to establish that he expects to receive some income, or that the total amount of income he expects to receive is likely to exceed the total amount of his interest expense. A loss or outgoing is not deductible where it is incurred in order to gain or produce assessable income of another entity. This proposition does not cease to apply if a taxpayer can show that he or she expects to recoup his or her expense from assessable income: a father who subscribes borrowed money to fund the issue of 90% of a company's shares to his sons does not enjoy an unapportioned interest deduction merely because he expects to recoup his interest expense from dividends on his 10% shareholding (*Munro's Case*).

If interest expense is designed to fund the incomes of both the applicant and other beneficiaries, that expense has a dual aspect. Part of the applicant's expenditure has a private or domestic nature and a fair apportionment to each object of the actual expenditure is required.

Apportionment

As there is a dual purpose in incurring the interest expense, it is considered appropriate to calculate the applicant's interest deduction in each income year by limiting the deductible amount to the amount of income from the Trust to which the applicant is presently entitled in that year.

Such an approach has regard to the assessable income which the applicant's interest expense in fact produces, while also recognising that present expenditure may gain or produce future assessable income which the applicant may not be entitled to receive.

Summary

The applicant will not be able to establish that the total interest expense incurred on the external loan was incurred solely to gain or produce his assessable income.

Apportionment of the applicant's interest deduction is required by subsection 8-1(2) of the ITAA 1997 as, on balance, one purpose of his expenditure is to provide benefits to beneficiaries of the trust other than himself. Apportionment cannot be avoided on the basis that the applicant expects to recoup his interest expense from the future assessable income he expects to derive from the trust.

Therefore the applicant's interest deduction in an income year will be limited to the amount of income from the trust to which the applicant is presently entitled in that year.

Qualifying security

In order to satisfy the definition of qualifying security within Division 16E of the ITAA 1936, there must first be a security as defined in subsection 159GP(1) of the ITAA 1936. The applicant has conceded that the trust loan is a security as defined in subsection 159GP(1) of the ITAA 1936.

Definition of qualifying security

Subsection 159GP(1) of the ITAA 1936 defines a qualifying security as any security:

- (a) that is issued after 16 December 1984;
- (b) that is not a prescribed security within the meaning of section 26C;
- (ba) that is not part of an exempt series;
- (c) the term of which, ascertained as at the time of issue of the security will, or is reasonably likely to, exceed 1 year;
- (d) that has an eligible return; and
- (e) where the precise amount of the eligible return is able to be ascertained at the time of issue of the security – in relation to which the amount of the eligible return is greater than 1½% of the amount ascertained by multiplying the amount of the payment or the sum of the payments (excluding any periodic interest) liable to be made under the security by the number (including any fraction) of years in the term of the security;

but does not, except as provided by subsection (10), include an annuity.

In this arrangement, paragraphs 159GP(1)(a) – (c) of the definition of qualifying security are satisfied, while paragraph 159GP(1)(e) has no application. Furthermore, the loan is not an annuity and subsection 159GP(10) is not applicable. The paragraph at issue is 159GP(1)(d), namely, whether the security has an eligible return.

Eligible return

Subsection 159GP(3) of the ITAA 1936 provides the following definition:

For the purposes of this Division, there shall be taken to be an eligible return in relation to a security if at the time when the security is issued it is reasonably likely, by reason that the security was issued at a discount, bears deferred interest or is capital indexed or for any other reason, having regard to the terms of the security, for the sum of all payments (other than periodic interest payments) under the security to exceed the issue price of the security, and the amount of the eligible return is the amount of the excess.

Issue price is defined in subsection 159GP(1) of the ITAA 1936 to mean, in relation to a security, the consideration (if any) for the issue of the security. The issue price for the applicant in this arrangement is the principal amount of the loan. The eligible return will therefore be any amount distributed in excess of the principal amount of the loan.

The required analysis is whether, having regard to the terms of the qualifying security, there is a return that is reasonably likely to exceed its issue price. The following paragraphs will analyse this requirement.

‘having regard to the terms of the security...’

Generally, the legal relationship and the ensuing rights and obligations intended by parties to an agreement are contained within the one instrument. In this arrangement, however, the legal relationship that is intended between the applicant and the trust is expressed within the two separate, but inter-dependant written instruments.

Where, as in this arrangement, the legal relationship and the attendant rights and obligations are embodied in separate documents, but together form “...one coherent commercial arrangement...”, the arrangement and its terms may be viewed as a coherent integrated whole (see *St George Bank Limited v Commissioner of Taxation*

2008 ATC 20-018; *per* Justice Allsop, at paragraph 48: similarly see TD 2008/D6 at paragraph 10 to Appendix 1).

The trustee's obligation to make a distribution to the applicant each financial year arises under the trust deed and provides that the distribution must equal a specifically defined amount.

In this arrangement, the loan agreement expressly provides that the amount to be distributed under the loan agreement is the distribution amount for the purposes of the trust deed. It follows that the intended loan relationship, and hence the qualifying security, can only be properly expressed by having regard to the terms of the two instruments, rather than by reference to the terms of the loan agreement alone. Furthermore, the two instruments incorporate each other by reference.

So, to give proper effect to the loan relationship, the relevant terms within the two instruments must therefore, in substance and for effectiveness, be integrated in order to determine the applicant's right to repayment of the principal and the trustee's obligation to make a distribution to the applicant.

As a consequence, the relevant terms governing the loan relationship between the parties and as expressed in the loan and the trust deed will together be considered as those of the qualifying security.

The eligible return on the qualifying security will be the principal amount and the distribution amounts, as it is reasonably likely that the sum of these payments will exceed the issue price of the security. Therefore, the eligible return under the qualifying security in this arrangement will include the anticipated return from distributions from the trust to the applicant.

Periodic interest

Periodic interest payments are excluded from the sum of payments under the security when determining whether the security has an eligible return. The Commissioner's view in paragraph 13 of *Taxation Ruling TR 96/3 Income tax: 'periodic interest' in Division 16E* is that a payment that is economically equivalent to interest, but which is not interest, cannot be periodic interest.

The loan agreement stipulates that the trust is not required to pay interest to the applicant. The applicant is however, entitled to an accumulated distribution amount under the trust deed as determined by reference to an amount equal to the interest payable on the external loan plus a small margin. This is a payment that is economically equivalent to interest, but which is not interest in the context of Division 16E. These amounts do not, therefore, constitute periodic interest and are properly taken into account for the purposes of ascertaining the existence of an eligible return.

Conclusion on qualifying security

The distribution amount, whether accumulated or otherwise, will form the eligible return under the qualifying security as it is reasonably likely that the sum of these payments will exceed the issue price of the qualifying security. Accordingly, as paragraphs 159GP(1)(a)-(d) of the definition of qualifying security are satisfied, the loan made to the trust together with the relevant terms of the trust deed constitute the qualifying security for the purposes of Division 16E of the ITAA 1936.

Inclusion of the anticipated return on an accruals basis

Division 16E of the ITAA 1936 provides that the holder of a qualifying security is to be assessed on an accruals basis in respect of the accrued amounts derived under that qualifying security.

The loan made to the trust, together with the relevant terms of the trust deed, constitutes a qualifying security within the meaning of Division 16E of the ITAA 1936.

The applicant will therefore be required to include in his assessable income the accrual amounts for each accrual period worked out under Division 16E of the ITAA 1936 for each year of income the qualifying security is held.

The distributions

Section 159GQ of the ITAA 1936 requires the positive accrued amounts worked out for each accrual period to be included in the assessable income of the taxpayer in respect of the qualifying security. The distributions made by the trustee must therefore constitute assessable income of the applicant in respect of the qualifying security for Division 16E to apply: see section 159GX of the ITAA 1936. Generally, a distribution of trust income will be ordinary income of the taxpayer.

The trustee's obligation to make a distribution to the applicant each year arises under the trust deed and provides that the distribution must equal a specifically defined amount.

However, the distribution amount is determined under the loan agreement and expressly provides that the distribution amount determined under the loan agreement is the distribution amount for the purposes of the trust deed. The two instruments must therefore be read together in order to determine the trustee's obligation, the amount and the stakeholder's entitlement to receive a priority distribution.

As previously discussed in this ruling, the loan together with the relevant terms to the trust deed together constitute the qualifying security for the purposes of Division 16E of the ITAA 1936. The Commissioner will integrate the relevant terms in respect of the rights and obligations that pertain to the distribution and distribution amount in the trust deed and loan. The distributions to the applicant will therefore be assessable income in respect of the qualifying security.

Constructive derivation

Section 159GX of the ITAA 1936 limits the application of Division 16E to amounts that would constitute assessable income under the ordinary provisions of the income tax law.

Subsection 6-5(2) of the ITAA 1997 provides that assessable income for an Australian resident taxpayer includes the ordinary income derived directly or indirectly from all sources, whether in or out of Australia, during the income year. Moreover, subsection 6-5(4) of the ITAA 1997 stipulates that an amount of ordinary income is taken to be 'derived' or received as soon as it is applied or dealt with in any way on your behalf or as you direct.

Subsection 6-5(4) of the ITAA 1997 will apply to distributions of trust income that are credited for the benefit of a taxpayer but not yet received as the distributions are regarded as ordinary income (see *AAT Case T21*, 86 ATC 214). Distributions of trust

income to a taxpayer are therefore received or derived by the taxpayer for the purposes of subsection 6-5(2) of the ITAA 1997.

The trustees' distributions to the applicant will be derived as ordinary income and will thus constitute assessable income under subsection 6-5(2) of the ITAA 1936. Accordingly, section 159GX of the ITAA 1936 does not apply to limit the application of Division 16E in this case.

Conclusion on anticipated distributions

The loan made to the trust together with the relevant terms of the trust deed constitutes a qualifying security within the meaning of Division 16E of the ITAA 1936. The applicant will receive distributions under the relevant terms of the qualifying security. Division 16E will therefore require the accrual amounts for each accrual period as properly determined to be included in the applicant's assessable income for each year of income the 'qualifying security' is held.

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