TD 2009/17EC - Compendium

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Ruling Compendium – TD 2009/17

This is a compendium of responses to the issues raised by external parties to draft TD 2008/D16 – Income tax: is interest on a loan fully deductible under section 8-1 of the *Income Tax Assessment Act 1997* when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	Tax Office Response/Action taken
1.	Interest expense should be fully deductible if it is likely that, over the life of the investment, the taxpayer will obtain sufficient income from the trust to at least offset their interest expense. This is consistent with *Fletcher v. FC of T* 91 ATC 4950; (1991) 22 ATR 613. The examples should therefore include a consideration of the likelihood of the taxpayer receiving income. The taxpayer's interest expense will be fully deductible where the units provide the taxpayer with an annual, cumulative entitlement to an amount of income which is calculated to exceed the taxpayer's interest cost.	Example 2 has been modified to make the unit holder's entitlement to income cumulative (paragraph 17 of Taxation Determination TD 2009/17 (the Determination)). A loss or outgoing is not deductible where it is incurred to gain or produce benefits for other persons.[1] It therefore remains necessary to determine what the expenditure is objectively for.[2] The prospect of the taxpayer making a profit from their investment may simply mean that it is unnecessary to consider subjective purpose. 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'.[3] Accordingly, interest expense is not deductible to the extent that the borrowed money has been used to benefit others.

[1] See *Federal Commissioner of Taxation v. Munro* (1926) 38 CLR 153; [1926] HCA 58; (1926) 32 ALR 339 (*Munro's Case*).
[2] *Federal Commissioner of Taxation v. Roberts & Smith* (1992) 37 FCR 246; 92 ATC 4380 at 4388; (1992) 23 ATR 494 at 504; *Kidston Goldmines Ltd v. Federal Commissioner of Taxation* (1991) 30 FCR 77; 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177; *Hayden v. Federal Commissioner of Taxation* (1996) 68 FCR 19; 96 ATC 4797 at 4801; (1996) 33 ATR 352 at 356.
[3] *Ure v. Federal Commissioner of Taxation* (1981) 50 FLR 219; 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 488.

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2.	The following cases indicate that it is not correct to apportion an outgoing merely because a non-deductible purpose can be identified: • *Service v. FC of T* 2000 ATC 4176; (2000) 44 ATR 71 • *FC of T v. Firth* 2002 ATC 4346; (2002) 50 ATR 1, and • *Hart v. FC of T* 2002 ATC 4608; (2002) 50 ATR 369.	Apportionment is required where the taxpayer's objective purpose is to provide benefits to others. Refer issue 1 above. In *Service v. FC of T* [2000] FCA 188; 2000 ATC 4176 at 4186; (2000) 44 ATR 71 at 81, the Full Federal Court provided that it is necessary to consider the essential character of an expenditure when deciding whether the expenditure in question was excluded from deductibility under the exclusory limbs of the subsection. The Full Federal Court also held that objective purpose is relevant in determining whether an expenditure is deductible (see ATC at page 4187, ATR at page 83). Similarly in *Hart v. FC of T* [2002] FCAFC 222; 2002 ATC 4608; (2002) 50 ATR 369*,* the Court held the objective facts must be considered when characterising an expense. In *FC of T v. Firth* [2002] FCA 413; 2002 ATC 4346; (2002) 50 ATR 1, Hill J stated that where a loss or outgoing has some connection with the gaining or production of assessable income but also has some other connection, it will be necessary to apportion the loss or outgoing. Both Hill J, and the joint judgment of Sackville and Finn JJ, referred to *Ure* v. *FC of T* (1981) 50 FLR 219; (1981) 11 ATR 484; 81 ATC 4100, when providing that it will be sometimes necessary to go beyond the legal rights and obligations for the purposes of seeing whether interest incurred by a taxpayer as an outgoing falls within the first limb of former subsection 51(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). The question is what is the interest paid for? This is to be ascertained by looking at the whole of the circumstances of the bargain. To the extent to which interest is paid for the purpose of benefiting others, it is not incurred in gaining or producing the taxpayer's assessable income, or is of a private or domestic nature, that portion is not deductible.
3.	It does not matter whether a taxpayer earns the same return on their units as is earned by the trust from the direct investments acquired with the invested money. This is not important, provided the expectation of a return on the investment provides a commercial explanation for the expenditure.	If the borrowed money is used to establish or contribute to a fund for the benefit of both the taxpayer and others then the advantage obtained specifically for the taxpayer is unlikely to be explicable by reference to the whole of the amount so contributed.

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4.	In order to determine the deductibility of interest, the purpose for which the borrowed funds were applied is relevant. Where there is more than one purpose, the primary purpose is determinative.	No action. If the interest is incurred for a dual purpose then it should be apportioned between what can properly be regarded as incurred in gaining or producing assessable income and as not being of a private or domestic nature and what cannot properly be so.[4]
5.	It is not correct to say that the taxpayer borrows money to settle it on trust. Rather, the only purpose of the borrowing is to acquire the legal rights attaching to the taxpayer's units: *Europa Oil (NZ) Ltd (No. 1) v. IRC* 70 ATC 6012; (1970) 1 ATR 737 (*Europa Oil No. 1*).	In *Europa Oil (NZ) Ltd.(No. 1) v. IRC* [1971] AC 760; 70 ATC 6012; (1970) 1 ATR 737 *(Europa Oil No.1)*, the Privy Council held that the taxpayer's deduction for oil had to be reduced by reference to tax exempt benefits it received under a collateral agreement. The case tends to support, rather than contradict, the proposition that apportionment is required where expenditure is incurred with a view to obtaining benefits which are unrelated to the production of the taxpayer's assessable income. In *Europa Oil (NZ) Ltd (No. 2) v. IRC* [1976] 1 AllER 503; 76 ATC 6001; (1976) 5 ATR 744 (*Europa Oil No. 2*), the Privy Council declined to require apportionment in relation to a variation of the *Europa Oil (No. 1)* arrangement. It was held that deductibility was to be determined by reference to legal rights associated with the taxpayer's purchase contracts, viewed in isolation from any other benefits it obtained under other contracts. However, as Brennan J observed in *Magna Alloys v. FC of T* [1980] FCA 150; 80 ATC 4542 at 4547; (1980) 11 ATR 276 at 282, that principle applies '… where the relevant expenditure is incurred solely in acquiring an asset or a legal right under a contract or in discharging an antecedent legal liability'. According to his Honour there may be '… cases where expenditure is not incurred solely to acquire an asset or legal right under a contract ….'. A case in point is *Federal Commissioner of Taxation v. Munro* [1926] HCA 58; (1926) 38 CLR 153; (1926) 32 ALR 339 (*Munro's Case*). In that case, a father who used borrowed money to purchase shares for himself and his sons could not obtain a deduction for the whole of the interest expense.

[4] For example, *Ure v. FC of T* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484.

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5. cont		The clear relationship between the use of the borrowed funds to establish (or contribute to) a fund for the taxpayers own benefit and the benefit of other persons indicates that the interest outlaid is, in a real sense, a cost of providing the benefits to the other persons, just as it is a cost of obtaining benefits for the taxpayer. In these cases the interest expense will be apportionable.[5] Refer to issue 1 above.
6.	TD 2008/D16 fails to distinguish between the purposes of a settlor in establishing a trust and that of a subscriber for units in an existing trust. The 'dual purpose' of a subscription to an existing trust cannot be objectively ascertained from the trust deed. The trust deed relates to the establishment of the trust rather than its funding.	Paragraphs 4, 39 and 41 of the Determination clarify that no distinction is drawn between: (a) the initial settlement of a trust; and (b) a subsequent contribution of capital to an existing trust. A taxpayer may settle borrowed money on trust for the benefit of themselves and others at the time of the trust's creation or alternatively, at a later time. In either case, the regime of rights and obligations which attach to the borrowed moneys when settled upon or contributed to the trust provide an objective basis for characterising the interest expense.
7.	TD 2008/D16 is inconsistent with the Tax Office's treatment of interest on borrowings used to acquire shares in *Income Tax Ruling* IT 2606. In considering the deductibility of interest on borrowings used to acquire shares, no reference is made to the purpose for which the company would use the money. The interest is fully deductible even if another shareholder receives a benefit from the proceeds of the share issue. To adopt the view in TD 2008/D16 would require the conclusion that a contribution to acquire cumulative preference shares, by an arm's length shareholder, is partly to benefit other shareholders.	No action. The Determination is concerned with arrangements where the taxpayer subjects the borrowed moneys to trust obligations capable of benefiting other persons who have not contributed to the trust. In contrast, an arm's length subscriber for shares would expect to obtain rights the value of which are commensurate with the subscription price. Put another way, unless the subscription price is grossly excessive it should be capable of being attributed to the advantage specifically contracted for and obtained by the subscriber. Other members of the company will be expected to have provided similar consideration for their shares. Accordingly, the subscription for shares could not be, objectively, characterised as being for the benefit others.

[5] See, for example, *Kidston Goldmines Ltd v. FC of T* (1991) 30 FCR 77; 91 ATC 4538 at 4546; (1991) 22 ATR 168 at 177. Refer also to *Munro's Case,*- decided on the basis of the *Income Tax Assessment Act 1922* (ITAA 1922). The ITAA 1922 provided for the deduction of 'interest actually incurred in gaining or producing the assessable income' (paragraph 23(1)(a) of the ITAA 1922). It also contained an express prohibition against any deduction in respect of 'money not wholly and exclusively laid out or expended for the production of assessable income' (paragraph 25(e) of the ITAA 1922). In contrast, section 8-1 of the ITAA 1997 calls for apportionment.

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8.	A consideration of exactly what rights are obtained or what type of return is expected is not necessary in determining whether interest is fully deductible. If a taxpayer on-lent borrowed funds to a discretionary trust at a small margin to their funding cost, they would be entitled to deduct all of their interest outgoings, even though they may not enjoy all of the benefits flowing from the capital they have funded.	No action. A loan to a trust on commercial terms could not be, objectively, characterised as being for the benefit of others. The lender obtains a contractual right to payments of principal and interest for themselves. The loan does not increase the net assets of the trust. To the extent that assets are held subject to the trustee's right to reimbursement or exoneration, they are not 'trust assets' or 'trust property', in the sense that they are held solely upon trusts binding the trustee in favour of the beneficiaries.[6] A loan by the taxpayer to a trust made on other than commercial terms would pose a different question. If the benefits passing to the taxpayer under the loan do not provide an objective commercial explanation for the loan then the loan alone will not suffice, without more, to characterise the interest expense.
9.	TD 2008/D16 is inconsistent with *Income Tax Ruling* IT 2684 because it does not require a re-assessment of the use of the borrowed money from year to year. Instead, TD 2008/D16 requires an assessment of the use of borrowed money by reference to events that may or may not happen in the future. Apportionment is not appropriate in income years in which no net income has actually been applied to benefit persons other than the taxpayer.	No action. The split property trust units in Taxation Ruling IT 2684 provide *the taxpayer* with a combination of income and/or capital growth. In contrast, the Determination is concerned with the use of borrowed money to fund a trust for the benefit of *both the taxpayer and others*. The terms of the trust are known from the outset. They do not depend on future events. Future events may determine the ultimate recipients of income in some cases, for example, a unit holder may share in trust income because he or she is also a discretionary object. However, in such a case there would not be a perceived connection between the income and the interest outgoing; see paragraph 46 of the Determination. Where the interest has been incurred for a dual purpose some degree of apportionment will be required. If apportionment is required, what will be appropriate will be essentially a question of fact, to be determined in each case. There must be 'a fair apportionment to each object of the… actual expenditure'. The extent of apportionment may vary from income year to income year. See discussion at paragraphs 43-45 of the Determination.

[6] *Chief Commissioner of Stamp Duties (NSW) v. Buckle & Ors* [1998] HCA 4;98 ATC 4097 at 4106; (1998) 37 ATR 393 at 403.

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9. cont		It is not appropriate to allow an unapportioned deduction in a particular income year merely because the taxpayer receives all of the trust's distributable income in that year. The 'assessable income' referred to in section 8-1 of the ITAA 1997 is the assessable income generally, as opposed to the assessable income of a particular income year.[7]
10.	There is currently no legislative limitation to negative gearing deductions. TD 2008/D16 seems to be at odds with the notion that interest on a borrowing to acquire an income producing investment is an allowable deduction.	No action. Draft TD 2008/D16 and the Determination confirm that interest on a borrowing used to acquire an income producing investment is deductible, to the extent that the interest is incurred in gaining or producing such income; refer to paragraph 8-1(1)(a) of the ITAA 1997.
11.	It should be explained what it is that makes Examples 2 and 3 'sinister'.	No action. Draft TD 2008/D16 did not seek to establish that the examples were 'sinister'. Examples 2 and 3 of the Determination illustrate trust arrangements in which borrowed moneys are used, in part, to benefit others.
12.	In Example 2, it is not clear why Paul's 'main purpose' is benefiting his family, whilst income production is only a 'subsidiary purpose'.	The words 'main purpose', 'largely', 'subsidiary purpose' and 'small part' have been removed from Example 2; refer to paragraph 19 of the Determination.
13.	In Example 3, it is not clear why Paul's 'main purpose' is benefiting his family, whilst income production is only a 'subsidiary purpose'. It is also not clear why 'a greater part' of Paul's interest expense will be deductible than in Example 2.	The words 'main purpose', 'largely', 'subsidiary purpose' and 'probably' have been removed, and the comparison between Examples 2 and 3 has been removed; refer to paragraph 25 of the Determination.
14.	In Example 3, Paul would be entitled to a 100% deduction if he is entitled to all of the income of the trust. The rights attached to the units may carry a sufficient commercial explanation, and apportionment may not be appropriate.	Example 3 now refers to 'the income of the trust'; refer to paragraph 23 of the Determination. Interest outgoings incurred to provide benefits to others will not be wholly deductible. An unapportioned deduction for interest is not appropriate in the facts of the example, since the borrowed funds have been used, in part, to establish a fund for the taxpayer's family.

[7] *Ronpibon Tin NL v. FC of T*; *Tongkah Compound NL v. FC of T* [1949] HCA 15; (1949) 78 CLR 47 at 56; *FC of T v. Snowden & Willson Pty Ltd* [1958] HCA 23; (1958) 99 CLR 431 at 437; *John Fairfax & Sons Pty Ltd v. FC of T* [1959] HCA 4; (1959) 101 CLR 30 at 35 and 46; *FC of T v. Finn* [1961] HCA 61; (1961) 106 CLR 60 at 68; *AGC (Advances) Ltd v. FC of T* [1975] HCA 7; 75 ATC 4057 at 4066; (1975) 5 ATR 243 at 253; *Fletcher v. FC of T* [1991] HCA 42; 91 ATC 4950 at 4957; (1991) 22 ATR 613 at 621.

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15.	Examples 2 and 3 should include details of the amount of interest that may be claimed in each case. The terms 'largely', 'small part' and 'some part' in Examples 2 and 3 should be defined and/or quantified. A better approach is for the individual to obtain a deduction at least equal to the amount of income they receive or are entitled to receive.	Refer to issues 12 and 13 above. Paragraph 45 of the Determination provides a rule of thumb that where income production is a minor object of the taxpayer, the deduction will not generally exceed the amount included in the taxpayer's assessable income. If the taxpayer seeks a deduction in excess of this amount, they bear the onus of establishing that entitlement. A determination is a 'short form' ruling, addressing an issue which can be explained succinctly (as a 'yes' or 'no'). As such, it does not seek to address all of the factual circumstances which may arise in practice. The application of section 8-1 of the ITAA 1997 in the circumstances of each case is very much a matter of fact and degree: *FC of T v. Forsyth* [1981] HCA 15; (1980) 148 CLR 203 at 210; 81 ATC 4157 at 4161; (1981) 11 ATR 657 at 660; *FC of T v. Brixius* (1987) 16 FCR 359; 87 ATC 4963; (1987) 19 ATR 506.
16.	References to 'unit holders' and 'discretionary objects' cause confusion.	Various amendments have been made to remove references to 'discretionary objects'. It remains necessary to refer to 'unit holders', as the issue of units is a feature of all of the trust arrangements covered by the description in paragraph 2 of the Determination.
17.	Each example should indicate whether the trust is a unit trust, discretionary trust, or hybrid trust.	No action. The terms 'unit trust', 'discretionary trust', and 'hybrid trust' have no established legal definition[8] and no clear non-technical meaning. Such terms are descriptive rather than normative, taking their meaning from usage rather than doctrine.[9] The use of such terms would create, rather than reduce, uncertainty.

[8] The scope of the draft determination was not limited by reference to concepts such as those contained in section 272-5 of Schedule 2F to the ITAA 1936.
[9] *FC of T v. Vegners* (1989) 90 ALR 547; 89 ATC 5274 at 5278; (1989) 20 ATR 1645 at 1649.

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18.	An explanation should be provided of how the principles in *Ure v. FC of T* 81 ATC 4100; (1981) 11 ATR 484 and *Fletcher v. FC of T* 91 ATC 4950; (1991) 22 ATR 613 apply to apportionment of the interest deduction	References to *Ure v. FC of T* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484 and *Fletcher v. FC of T* [1991] HCA 42; 91 ATC 4950; (1991) 22 ATR 613 have been included in the discussion at paragraph 45 of the Determination.
19.	Since TD 2008/D16 focuses on the initial purposes of the taxpayer, it is not logical that the deduction would change each year, by reference to the amount included in the taxpayer's assessable income. A less problematic approach is to focus on the extent to which the expenditure lacks obvious commercial purpose.	No action. Draft TD 2008/D16 confirmed that the appropriate apportionment is a question of fact, to be determined in each case. A method based on the amount included in the taxpayer's assessable income is supported by judicial precedent,[10] but is only provided as a rule of thumb. Other methods may be appropriate in particular cases.
20.	Paragraph 28 of TD 2008/D16 should be moved to the beginning of the document, in order to clearly specify which taxpayers it applies to.	No action. This paragraph is merely illustrative of the kind of arrangements to which the Determination may apply. It is not, however, an exhaustive list. As such it should remain in the Explanation section of the Determination.
21.	Since the document is a tax determination, it should not be referred to as a ruling.	No action. Draft TD 2008/D16 was a draft tax ruling, and the Determination is a tax ruling for the purposes of the *Taxation Administration Act 1953*.
22.	The Determination should not deal with more than one issue.	No action. The scope of the Determination is considered to be appropriate.
23.	Examples should not appear in the substantive part of the Determination.	No action. The inclusion of examples in the substantive part of a determination is in accordance with ordinary Tax Office practice.

[10] *Fletcher v. FC of T* [1991] HCA 42; 91 ATC 4950; (1991) 22 ATR 613; *Ure v. FC of T* (1981) 50 FLR 219; 81 ATC 4100; (1981) 11 ATR 484.