

IT 2684 - Income tax: deductibility of interest on money borrowed to acquire units in a property unit trust



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Taxation Ruling

Income tax: deductibility of interest on money borrowed to acquire units in a property unit trust

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contents	para
What this Ruling is about	1
Ruling	3
Date of effect	16
Explanations	17
Examples	37

What this Ruling is about

1. This Ruling considers the circumstances in which interest on money borrowed to acquire units in a property unit trust (including a split property unit trust) is an allowable deduction under subsection 51(1) of the *Income Tax Assessment Act 1936*.
2. In this Ruling, the expression 'split property unit trust' is used to refer to a property unit trust which offers an investor a choice between:
 - (a) income units, which offer a return that consists wholly of assessable income or consists of assessable income with a very small percentage of capital growth;
 - (b) growth units, which primarily offer capital growth but also produce some assessable income; or
 - (c) combined units, which offer returns of both assessable income and capital growth.

Ruling

Split property unit trusts

3. 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 under subsection 51(1). The exceptions to this general treatment are each of the following situations:

- . Where only negligible income is produced by growth units in a split property unit trust - in which case the interest may only be deductible up to the extent of the assessable income actually received.

. Where apportionment of the interest expenses is necessary.

4. Interest expenses incurred wholly to produce assessable income are generally deductible in full under subsection 51(1) by a unitholder in a split property unit trust even if the amount of interest incurred is greater than the amount of assessable income derived from holding the units for the particular income year (but see the situations where apportionment is necessary; paragraphs 7 - 14).

5. Interest expenses incurred wholly to produce assessable income are generally deductible in full under subsection 51(1) by a unitholder in a split property unit trust even if a distribution from the unit trust consists of both assessable income and non-assessable distributions (but see the situations where apportionment is necessary).

Growth units with negligible income

6. If growth units in a split property unit trust are expected to produce only negligible income, interest expenses incurred in borrowing money to purchase the units are deductible under subsection 51(1) only up to the extent of the assessable income actually received.

Where apportionment of interest expenses is necessary

7. An interest expense is apportionable if the money is borrowed for the purpose of, or applied in, producing both assessable and non-assessable income, rather than producing only assessable income (see *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47 at 59; 8 ATD 431 at 437; *Kidston Goldmines Ltd v. FC of T* 91 ATC 4538 at 4544-46; (1991) 22 ATR 168 at 175-177). This is a question of fact.

8. In those cases where apportionment is required, interest is deductible in the same ratio as the assessable income component of any distributions for the particular income year bears to the total distributions (see *Adelaide Racing Club Inc v. FC of T* (1964) 114 CLR 517).

9. An interest expense is not fully deductible in those cases where the expected return from the units, both income and capital growth, does not provide an obvious commercial explanation for incurring the interest. This may arise in situations where the total amount of income and capital growth which can reasonably be expected from the units is less than the total interest expense, especially if the amount of assessable income expected is disproportionately less than the amount of the interest expense.

10. In the type of situation referred to in paragraph 9, it is necessary to carefully examine all of the circumstances of the case, including the direct and indirect objects and advantages sought by the unitholder in

acquiring the units and in making the interest outgoing. The indirect objects may include private or domestic purposes (e.g. *Ure v. FC of T* 81 ATC 4100; (1981) 11 ATR 484), or the manufacturing of a taxation deduction (e.g. *FC of T v. Ilbery* 81 ATC 4661; (1981) 11 ATR 827). If it can be concluded that the interest expense is incurred for dual or multiple purposes, including private or domestic purposes, it is necessary to apportion the expense.

11. In determining whether an interest expense has the character of an outgoing incurred in gaining or producing assessable income, the motive of the taxpayer (or the end which the taxpayer subjectively had in view) in incurring it may be a relevant factor (*Fletcher & Ors v. FC of T* 91 ATC 4538 at 4957; (1991) 22 ATR 613 at 622). In a case where the taxpayer's motive or purpose is relevant, it will be necessary to look at the motive or purpose at the time the interest outgoing was incurred (*FC of T v. Total Holdings (Australia) Pty. Ltd.* 79 ATC 4279 per Lockhart J. at 4283; (1979) 9 ATR 885 at 891).

12. Interest is incurred day to day (*FC of T v. Australian Guarantee Corp. Ltd.* 84 ATC 4642 per Beaumont J at 4658-4660, and Toohey at 4645-4648; (1984) 15 ATR 982 at 1003 and at 986-91). Each income year therefore must be considered separately, i.e. the extent of apportionment may vary from income year to income year depending on the circumstances of the case.

13. Situations may arise where in a particular income year interest ceases to be deductible in full and in later income years is either no longer deductible or (because of the need for apportionment) is only deductible in part.

14. If a split property unit trust has investments in Australia and overseas, it may be necessary to apportion interest expenses incurred by the unitholders. The amount by which the interest which relates to the earning of foreign income exceeds the foreign income component of any distribution (made up of both foreign and Australian income) is not deductible in the income year in which it is incurred. Instead, the excess is carried forward to be offset against foreign income of the same class received in future income years.

Other property unit trusts

15. If units in a property unit trust produce for a 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).

Date of effect

16. This Ruling sets out the current practice of the Australian Taxation Office. It applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Explanations

Split property unit trusts

17. All property unit trusts by their very nature have the potential to generate both income and capital growth. Income is generated by rental income from trust rental properties, for example, while capital growth is brought about by changes in the value of the rental properties held by the unit trust. An increase in value of trust assets is not usually manifested by an actual distribution of money but rather by way of an increase in the purchase and redemption price of the units. The unitholder receives the benefit of this increase in value on disposal of the units.

18. The share of the net trust income derived by a holder of income units in a split property trust may include a cash distribution equal to, say, 8% of the cost of the unit. This will be assessable income of the unitholder. In some cases the amount of the cash distribution may vary from year to year. It could be that a return of, say, 6% may be in cash and there may be a 2% increase in the value of the unit, i.e. a part of the return is in the form of capital growth in the value of the unit.

19. For a holder of growth units in a split property trust, the reverse situation would exist. It may be that a 8% return is entirely by way of accretion to the value of the unit. Alternatively, in a given year a unitholder may receive a small amount of income, say, 1% or 2%, with the balance received as capital growth.

20. Combined units in a split property trust may offer a return in a given year of, say, 4% income and 4% growth. Investors may also have the option to switch from one type of unit to another.

21. In some instances, particularly with older split property unit trusts, unitholders may be presently entitled to amounts that represent profits made on the sale of property acquired before 20 September 1985 which are not income according to ordinary concepts and which are not included in the net income of the trust by virtue of the former section 25A or section 26AAA. In other cases, the trust income available for distribution may be greater than the net income of the trust for tax purposes because of the level of deductions in respect of capital expenditure on buildings under Division 10D of Part III or the

depreciation of plant and articles. That is, there is excess accounting income. As well, a unitholder may be negatively geared, i.e. the annual interest expense on money borrowed to acquire units is greater than the unitholder's distribution from the trust in a particular year.

22. For interest expenses to be deductible under subsection 51(1) (if a business is not being carried on), the expenses must be wholly or partly incurred in gaining or producing the assessable income. The relationship or connection between the interest expenses and the assessable income must be such that the interest expenses bear the character of an outgoing (wholly or partly) incurred in gaining or producing assessable income. Interest expenses will have that character if they are (wholly or partly) incidental and relevant to the end of gaining or producing assessable income. An outgoing of interest is incidental and relevant to the gaining of assessable income if the borrowed money is laid out for the purpose of gaining that income (*FC of T v. Munro* (1926) 38 CLR 153 and *Texas Co. (Australasia) Ltd v. FC of T* (1940) 63 CLR 382).

Growth units with negligible income

23. If growth units in a split property unit trust are expected to produce only negligible income, the essential character of the interest expenses is for the gaining or producing of a capital gain rather than assessable income (see example at paragraph 38). The interest expenses in this situation are therefore deductible under subsection 51(1) only up to the extent of the assessable income actually received (see example at paragraph 37).

Where apportionment of interest expenses is necessary

24. In characterising the whole or part of a voluntary interest outgoing for the purposes of subsection 51(1), the taxpayer's subjective intention in incurring the outgoing may be relevant, and possibly decisive. However, if the outgoing gives rise to an amount of assessable income larger than the outgoing, its characterisation as one wholly incurred in gaining or producing assessable income is not ordinarily affected by considerations of intention (*Fletcher case 91* ATC at 4958; 22 ATR at 623).

25. On the other hand, if there is no assessable income or the assessable income is less than the interest outgoing, a commonsense weighing of all factors (including direct and indirect objects and advantages which the taxpayer sought in making the outgoing) is necessary to characterise the outgoing. If, as a result:

- . the whole outgoing can be characterised as 'genuinely and not colourably incurred in gaining or producing assessable income' (*Fletcher case 91* ATC at 4958; 22 ATR at 623) - the outgoing is deductible under subsection 51(1) in full unless it is excluded by the exception in the subsection for outgoings of

capital, or of a capital, private or domestic nature or outgoings incurred in gaining or producing exempt income: or

- . part only of the outgoing can be so characterised -
- apportionment between the pursuit of assessable income and
- of other objectives will be necessary (*Fletcher case* 91 ATC at 4958; 22 ATR at 623) (see example at paragraph 38).

26. Generally stated, interest expenditure incurred on borrowed funds used to purchase units in a split property unit trust are deductible in full under subsection 51(1). This is because the essential character of the expenditure is that of an outgoing wholly incurred in gaining or producing assessable income. The borrowed money is expended and the interest expenditure is incurred wholly for the purpose of gaining assessable income and hence the interest expenditure is incidental and relevant to that end (see example at paragraph 39).

27. The fact that an amount of capital growth may be received from units in a split property unit trust in a particular year is not considered sufficient to alter the essential character of the interest outgoing (see for example *In re A Taxpayer (NSW No. 1)* (1932) 2 ATD 210).

28. Even if the amount of interest is greater than the amount of assessable income, the interest is deductible in full if it is incurred wholly to produce the assessable income. It is immaterial that this situation may prevail for a number of years. Negative gearing does not necessarily preclude the deduction or, of itself, require an apportionment of the interest expense. In this regard, a holder of units in a split property unit trust is, as a matter of principle, in no different a position from an owner of other kinds of income producing properties e.g. property held for rental purposes or shares acquired for the purpose of producing assessable dividend income.

29. In determining the essential character of an interest expense, regard is had to both the purpose of the borrowing and the application or use of the borrowed funds (see *Ure case* 81 ATC at 4109-10; 11 ATR at 494-5; *Kidston Goldmines case* 91 ATC at 4545; (1991) 22 ATR at 176; *Fletcher case* 91 ATC at 4958-61; 22 ATR at 623-6).

30. An entire interest outgoing is deductible in full, even in a situation where a distribution received by a unitholder in a split property unit trust consists of both assessable income and non-assessable distributions, if the outgoing is able to be characterised as one which is wholly incurred in gaining or producing the assessable income.

31. Interest may cease to be deductible in full and become either no longer deductible or only deductible in part. If a change occurs in the purpose of a borrowing and in the use of the borrowed funds, an

interest outgoing may no longer be able to be characterised as one wholly incurred in gaining or producing assessable income.

32. If a change occurs in a split property unit trust as a result of which units held by a unitholder no longer produce assessable income in a given income year, and there is no longer any expectation of assessable income being produced in future, no amount of interest would be deductible in later income years (see example at paragraph 40).

33. If a change occurs in the purpose of a unitholder's borrowing and in the use of the borrowed funds as a result of which interest expenditure no longer is able to be characterised in a given income year as an outgoing incurred wholly in gaining or producing assessable income but has the character of an outgoing incurred to gain both assessable income and either non-assessable distributions or capital gains, the interest expenditure would need to be apportioned in later income years. The interest incurred on a day to day basis would no longer be wholly for the purpose of furthering the assessable income earning activities of the unitholder. Instead, the interest would be incurred for dual or multiple purposes (see *Total Holding case* 79 ATC at 4283; 9 ATR at 891; *F C of T v. Riverside Road Pty. Ltd. (in liq.)* 90 ATC 4576; (1990) 21 ATR 508).

34. As to a split property unit trust with overseas investments, under section 79D, deductions in respect of foreign income are limited to the amount of the relevant foreign income derived. Consequently, if unitholders receive assessable distributions made up of both foreign and Australian income, it is necessary to apportion the interest to determine the extent to which it relates to the earning of the foreign income.

Other property unit trusts

35. Interest expenditure incurred on borrowed funds used to purchase units in a property unit trust that produces no assessable income (and is not expected to produce any assessable income in the future) is not deductible under subsection 51(1). This is because the interest expenditure cannot be said to be incidental and relevant to the gaining or producing of the unitholder's assessable income (see example at paragraph 41).

36. Additionally, in the case of units in a property unit trust which produce only capital growth, section 51AAA denies a deduction for any interest expense incurred on borrowed money to purchase the units.

Examples

Example 1 : growth units with negligible income

37. A borrows money and incurs interest to buy growth units in a split property unit trust. The units have a face value of \$1000. On a yearly basis the units are expected to produce only \$1 of assessable income and \$99 of capital growth. The essential character of the interest is considered to be expenditure to assist in the making of a capital gain. The interest is deductible to the extent of the \$1 actually received (this is an example of the matter covered in paragraphs 6 and 23).

Example 2 : apportionment

38. B borrows money and incurs a large sum of interest to buy combined units in a split property unit trust. It is clear, from the evidence available at the time of acquiring the units (e.g. from the prospectus, deed of trust, etc.), that the units would produce both a small amount of assessable income and non-assessable amounts (i.e. excess accounting income or non-assessable capital gains). B purchased the units in order to gain or produce both assessable income and non-assessable income. The interest would be apportioned (this is an example of the matter covered in paragraphs 7 and 25).

Example 3 : no apportionment

39. On the other hand, if, at the time of purchasing income units in a split property trust, the nature of the unit trust and the terms and conditions of the unit trust are such that C could reasonably expect that the units would produce only assessable distributions, the interest is fully deductible. This would be the case even in those income years in which the distribution included non-assessable amounts (this is an example of the matter covered in paragraphs 3, 5, 24, 26 and 27).

Example 4 : interest no longer deductible

40. D borrowed money and incurred interest in income years to 1990-91 to buy income units in a split property unit trust. D received in those years assessable cash distributions in amounts which exceeded the amounts of the outgoings and also received modest capital growth. The interest was deductible. Under the terms of the deed of trust for the unit trust, unitholders could opt to switch from one type of unit to another. D decided on 30 June 1991 to switch to growth units that are expected to produce negligible, if any, income. Interest accruing on and from 1 July 1991 would not be deductible by D, the interest no longer being incurred on a day to day basis to further D's assessable income earning activities (this is an example of the matter covered in paragraphs 13, 31 and 32).

Example 5 : other property unit trust

41. A borrows money and incurs interest to buy units in a property trust which provides unitholders only with capital growth and no right to share in the income of the trust. The essential character of the interest expense is to gain or produce a capital gain and not to produce assessable income (this is an example of the matter covered in paragraphs 15, 35 and 36).

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- ITAA 51(1)
- ITAA 51AAA
- ITAA 79D

case references

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- FC of T v. Australian Guarantee Corp. Ltd 84 ATC4642; (1984) 15 ATR 982

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