TR 2002/D2 - Income tax: home loan unit trust arrangement

This document has been finalised by TR 2002/18.

Draft Taxation Ruling
Income tax: home loan unit trust arrangement

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. The type of arrangement set out below was the subject of Taxpayer Alert 2001/1 – *Home Loan Unit Trust Arrangement*.

2. This Ruling examines these arrangements where a taxpayer uses a unit trust to acquire a residential property for private or domestic use. Under such an arrangement, the taxpayer seeks to obtain the benefit of interest deductions for essentially private expenditure.

3. Under the arrangement, the trustee of the unit trust ('the trustee') includes rental income from a lease agreement entered into with the taxpayer and/or their family. The trustee claims deductions for expenses on the residential property.

4. This ruling deals with deductions claimed by the taxpayer and the trustee under the arrangement.

5. The conclusions reached in this ruling in relation to the application of section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997') also apply to arrangements entered into prior to 1 July 1997, where deductions are claimed under subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936').

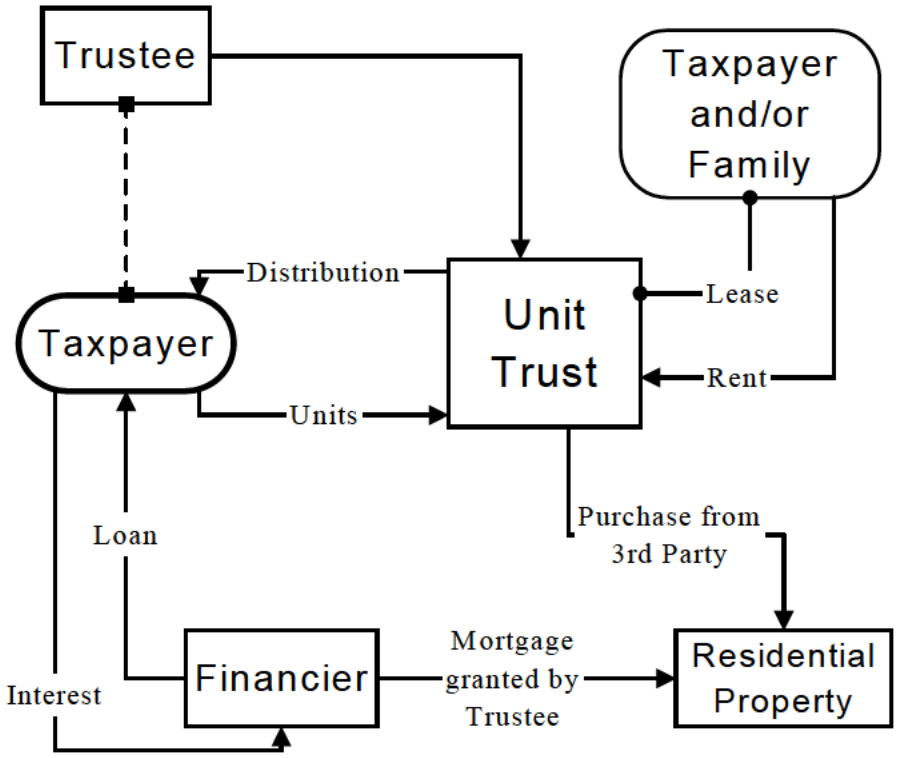
Class of person/arrangement

6. This Ruling applies to persons who enter into or carry out an arrangement having essentially the following features:

- a unit trust is established;
- the taxpayer may be a director of the corporate trustee of the unit trust (or a trustee of the unit trust);
- the trustee enters into a contract to acquire a residential property;

- the taxpayer borrows an amount of money;
- the taxpayer uses the funds to subscribe for units in the trust;
- the trustee guarantees the taxpayer's borrowings to the financier;
- the trustee uses the trust funds raised from the issue of the units to complete the purchase of the residential property;
- the trustee grants a mortgage over the residential property to the financier as security for the taxpayer's borrowings;
- the trustee then leases the residential property to the taxpayer and/or their family at a market rent;
- the taxpayer and/or their family pay rent to the trustee;
- the residential property is the home of the taxpayer and/or their family;
- the trustee claims deductions for expenses on the residential property such as water, council rates and insurance;
- the trustee claims depreciation and other capital allowance deductions that are available in respect of investment properties;
- the trustee makes a distribution to the taxpayer in accordance with the taxpayer's unit holdings;
- the taxpayer includes the distribution in their assessable income;
- there is a significant disproportion between the amount of the distribution from the trustee and the amount of the interest incurred by the taxpayer on the borrowings used to acquire the units in the unit trust;
- the taxpayer claims a deduction for the interest paid on the borrowings used to subscribe for the units in the unit trust; and
- as the trust distribution is less than the interest deduction, the resulting loss is offset against other income of the taxpayer.

7. The following diagram illustrates the key features of a typical arrangement.



8. This Ruling does not deal with an arrangement having the same facts as outlined in *FC of T v. Janmor Nominees Pty Ltd* 87 ATC 4813; (1987) 19 ATR 254 ('*Janmor*'). *Janmor* involved a service trust arrangement. In any event, the *Janmor* arrangement was entered into in 1979 prior to the enactment of either Part IIIA or Part IVA of the ITAA 1936.

Ruling

Deductibility of the interest under section 8-1 of the ITAA 1997

9. In relation to the Home Loan Unit Trust arrangement described in paragraph 6 above, the interest is not deductible under section 8-1 of the ITAA 1997 as it is a loss or outgoing of a private or domestic nature.

10. Alternatively, any interest deductible under section 8-1 of the ITAA 1997 is allowable to the extent of the assessable trust distribution received by the taxpayer from the unit trust in each year.

Deductibility of the expenses claimed by trustee

11. The expenses claimed by the trustee for the residential property referred to in paragraph 6 are deductible.

General anti-avoidance provisions - the application of Part IVA of the ITAA 1936

12. To the extent that the deductions claimed by the taxpayer and/or the trustee are deductible, Part IVA has application.

13. There is a scheme involving the trustee, the financier, the taxpayer and/or their family.

14. The taxpayer obtains a tax benefit of the interest deductions incurred on the borrowings. The trustee obtains a tax benefit of the deductions relating to the expenses for the residential property referred to in paragraph 6.

15. Having regard to the eight factors in subsection 177D(b), a reasonable person would conclude that the sole or dominant purpose of a person or persons entering into or carrying out the scheme is to enable the taxpayer and/or the trustee to obtain a tax benefit. Part IVA will apply to deny the deductions claimed by the taxpayer and/or the trustee.

Compensating adjustments

16. Compensating adjustments will be considered having regard to the circumstances of each case.

Date of effect

17. This Ruling applies to years of income commencing both before and after its date of issue.

18. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Deductibility of the interest under section 8-1 of the ITAA 1997

19. The nature of an interest expense was recently considered by the Full High Court in *Steele v. DC of T* 99 ATC 4242; 41 ATR 139

(*'Steele'*). The Court said, at 99 ATC 4242 at 4248; (1999) 41 ATR 139 at 148, that:

> '… interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v. FC of T* it is therefore ordinarily a revenue item.'

20. The character of interest is determined by the purpose of the borrowing. Generally, the purpose of a borrowing can be determined from the use of the borrowed funds. Outgoings of interest ordinarily draw their character from that use (see *Fletcher & Ors v. FC of T* (1991-1992) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 (*'Fletcher'*)). It may be appropriate to distinguish between the purpose of the taxpayer in borrowing the money and the use to which the borrowed funds are put in a particular case (see *Steele* 99 ATC 4242 at 4251; (1999) 41 ATR 139 at 150).

Private or domestic expenditure

21. Interest will generally be deductible if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income. It is deductible provided that the expenditure is not of a capital, private or domestic nature. The essential character of interest is a question of fact to be determined by reference to all the circumstances.

22. In the arrangement described in paragraph 6 above, the essential character of the expenditure is the purchase of a residential property for family use. The loss or outgoing is therefore of a private or domestic nature and no deduction is allowable under section 8-1 of the ITAA 1997 (see *Handley v. FC of T* 81 ATC 4165 at p 4171, 4173 and 4176; (1981) 11 ATR 644 at 650-1, 652-3 and 656).

Purpose

23. Alternatively, if the essential character of the interest is not of a private or domestic nature, as the trust distribution is less than the interest deduction, it may be necessary to consider the taxpayer's purpose in incurring that expense.

24. The High Court in *Fletcher* discussed the relevance of a taxpayer's subjective purpose in the characterisation of expenditure and also discussed the question of apportionment. The High Court said 173 CLR 1 at 17-19; 91 ATC 4950 at 4957-8; 22 ATR 613 at 621-3:

'The question whether an outgoing was, for the purposes of subsection 51(1), wholly or partly "incurred in gaining or producing the assessable income" is a question of characterization. The relationship between the outgoing and the assessable income must be such as to impart to the outgoing the character of an outgoing of the relevant kind. It has been pointed out on many occasions in the cases that an outgoing will not properly be characterized as having been incurred in gaining or producing assessable income unless it was "incidental and relevant to that end". It has also been said that the test of deductibility under the first limb of subsection 51(1) is that "it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income". So to say is not, however, to exclude the motive of the taxpayer in making the outgoing as a possibly relevant factor in characterization for the purposes of the first limb of subsection 51(1). At least in a case where the outgoing has been voluntarily incurred, the end which the taxpayer subjectively had in view in incurring it may, depending upon the circumstances of the particular case, constitute an element, and possibly the decisive element, in characterization of either the whole or part of the outgoing for the purposes of the sub-section. In that regard and in the context of the sub-section's clear contemplation of apportionment, statements in the cases to the effect that it is sufficient for the purposes of subsection 51(1) that the production of assessable income is "the occasion" of the outgoing or that the outgoing is a "cost of a step taken in the process of gaining or producing income" are to be understood as referring to a genuine and not colourable relationship between the whole of the expenditure and the production of such income.

Nonetheless, it is commonly possible to characterize an outgoing as being wholly of the kind referred to in the first limb of subsection 51(1) without any need to refer to the taxpayer's subjective thought processes. That is ordinarily so in a case where the outgoing gives rise to the receipt of a larger amount of assessable income. In such a case, the characterization of the particular outgoing as wholly of a kind referred to in subsection 51(1) will ordinarily not be affected by considerations of the taxpayer's subjective motivation. If, for example, a particular item of assessable income can be earned by making a lesser outgoing in one of two possible ways, one of which is a loss or outgoing of the kind described in subsection 51(1) and the other of which is not, it will ordinarily be irrelevant that the taxpayer's choice of the

method which was tax deductible was motivated by taxation considerations or that the non-deductible outgoing would have been less than the deductible one. In such a case, the objective relationship between the outgoing actually made and the greater amount of assessable income actually earned suffices, without more, to characterize the whole outgoing as one which was incurred in gaining or producing assessable income. If the outgoing can properly be wholly so characterized, it "is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent".

The position may, however, well be different in a case where no relevant assessable income can be identified or where the relevant assessable income is less than the amount of the outgoing. Even in a case where some assessable income is derived as a result of the outgoing, the disproportion between the detriment of the outgoing and the benefit of the income may give rise to a need to resolve the problem of characterization of the outgoing for the purposes of the sub-section by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing. Where that is so, it is a "commonsense" or "practical" weighing of all the factors which must provide the ultimate answer. If, upon consideration of all those factors, it appears that, notwithstanding the disproportion between outgoing and income, the whole outgoing is properly to be characterized as genuinely and not colourably incurred in gaining or producing assessable income, the entire outgoing will fall within the first limb of subsection 51(1) unless it is either somehow excluded by the exception of "outgoings of capital, or of a capital, private or domestic nature" or "incurred in relation to the gaining or production of exempt income". If, however, that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterized by reference to the actual or expected production of assessable income, apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary.'

25. If the arrangement described at paragraph 6 was continued indefinitely, the loan would be repaid and the arrangement would be tax positive, that is, assessable income would exceed the deductible outgoings.

26. The reasonable expectation is that the arrangement will not continue as the objective purpose of the arrangement is to deduct interest which is essentially of a private or domestic nature. Accordingly, a reasonable person will conclude that the arrangement will not continue once the arrangement is tax positive (see *Fletcher* 173 CLR 1 at 23-24; 91 ATC 4950 at 4961; 22 ATR 613 at 626-7).

27. As the arrangement is entered into for a number of purposes including, but not limited to:

- providing a home for the taxpayer and/or their family;
- generating an income tax deduction available to be offset against other income of the taxpayer;
- asset protection in the event of litigation and to protect assets in the event of the taxpayer being made bankrupt;
- providing for retirement through asset accumulation; and
- derivation of income by the trust,

it is necessary to carefully consider all of the circumstances including, the direct and indirect objects and the advantages sought by the taxpayer. The indirect objects may include private or domestic purposes (see *Ure v. FC of T* 81 ATC 4100 at 4104; (1981) 11 ATR 484 at 488-9) or the manufacturing of a tax deduction (see *FC of T v. Ilbery* 81 ATC 4661; (1981) 12 ATR 563).

Apportionment

28. If it is concluded that the disproportion between the interest outgoing and the trust distribution is explained by the pursuit of the purposes set out in paragraph 27, the interest expense must be apportioned: see *Fletcher* 173 CLR 1 at 17-18; 91 ATC at 4957-8; 22 ATR at 621-3. We consider that in this case it can. Accordingly, the interest deduction must be apportioned.

29. When it is necessary to apportion a loss or outgoing, the appropriate method of apportionment will depend on the facts of each case. However, the method adopted in any particular case must be both 'fair and reasonable' in all the circumstances (*Ronpibon Tin NL and Paper Ltd v. FC of T*(1949) 78 CLR 47 at 59; 8 ATD 431 at 437). In Fletcher, it was 'fair and reasonable' to limit the amount of the deduction to the amount of the assessable income actually received in that year.

30. Taking into account all of the circumstances, a common sense weighting would mean that deductions for the interest expense would

be limited to the extent of the assessable trust distribution returned in that year.

General anti-avoidance provisions – the application of Part IVA of the ITAA 1936

31. For the general anti-avoidance provisions to apply, there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C) and it must be concluded that the scheme was entered into or carried out by a person or persons for the sole or dominant purpose of enabling the relevant taxpayer to obtain the tax benefit (section 177D). See, generally*, FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344, and *FC of T v. Spotless Services Ltd & Anor* (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183 ('*Spotless*').

Scheme

32. The 'scheme', for the purposes of Part IVA, is the arrangement described in paragraph 6.

33. The parties to the scheme include the trustee, the financier, the taxpayer and/or their family.

Tax benefit

34. 'Tax benefits' are obtained by the taxpayer and the trustee from the scheme.

35. The taxpayer obtains a tax benefit of the interest deductions incurred on the borrowings. The trustee obtains a tax benefit of the expenses for the residential property, referred to in paragraph 6.

36. The deductions would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer and/or the trustee if the scheme had not been entered into or carried out.

Dominant Purpose

37. Part IVA applies where the taxpayer, or another person or persons, entered into or carried out the scheme, or a part of the scheme, for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. This is determined having regard to the eight factors referred to in subsection 177D(b).

38. A scheme

> 'may be … both "tax driven" and bear the character of a rational commercial decision. The presence of the latter

> characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a "scheme" for the "dominant purpose" of enabling a taxpayer to obtain a tax benefit' (*Spotless* 186 CLR 404 at 415; 96 ATC 5201 at 5206; 34 ATR 183 at 188).

39. The conclusion to be reached under s177D is that of a reasonable person (*Spotless* 186 CLR 404 at 422; 96 ATC 5201 at 5210; 34 ATR 183 at 192).

40. The factors discussed in the following paragraphs indicate that the sole or dominant purpose of a taxpayer or trustee participating in such an arrangement would be to obtain a tax benefit. On that basis, Part IVA will apply.

Factors in paragraph 177D(b)

(i) The manner in which the scheme was entered into or carried out

41. The features outlined in paragraph 6 above are relevant to the manner in which a scheme was entered into or carried out.

(ii) The form and substance of the scheme

42. The form of the scheme is that the taxpayer borrows an amount of money and subscribes for units to derive assessable income by way of a trust distribution. The trustee buys a residence and leases it to the taxpayer and/or their family. The trustee derives assessable income in the form of rent and claims deductions for expenses for the property. A distribution from the unit trust is then used to justify a claim for an interest deduction by the taxpayer.

43. The substance of the scheme is the purchase of the family home.

(iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out

44. Once the arrangement is put in place it is utilised over a number of years. The tax benefits from the conversion of a private or domestic expense to a deductible expense continue until the arrangement is terminated. The nature of the arrangement is that the scheme can be entered into at any time during the income year.

(iv) The result in relation to the operation of the ITAA 1936 or the ITAA 1997 that, but for Part IVA, would be achieved by the scheme

45. The taxpayer would be entitled to a deduction for the interest on the loan used to purchase the units in the unit trust.

46. The trustee would be entitled to a deduction for the expenses for the property.

47. The scheme results in a deduction for essentially private or domestic expenditure.

(v) Any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme

48. The tax benefits from the deductions.

(vi) Any change in the financial position of any person who has, or has had any connection with the relevant taxpayer, being a change that has resulted, or will result, or may reasonably be expected to result, from the scheme

49. None apparent.

(vii) Any other consequence for the relevant taxpayer, or for any person referred to in (vi), of the scheme being entered into or carried out

50. As a result of claiming the tax deduction, the taxpayer can afford to service a larger loan than would otherwise be the case, and as such the financier will be willing to lend a greater amount.

(viii) The nature of any connection between the relevant taxpayer and any person referred to in (vi)

51. The trustee, the taxpayer and/or their family are related parties. The financier is not a related party.

Detailed contents list

52. Below is a detailed contents list for this Ruling:

Your Comments

53. You have until 10 April 2002 to make written comments on this draft. Please provide comments to:

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Previous draft:

Not previously released in draft form

Related Rulings:

TR 92/20; TR 95/33

Subject references:

- anti avoidance measures
- home loan unit trusts
- home loan interest expense
- interest expense
- private living expense
- private or domestic expense
- tax avoidance
- tax benefit under tax avoidance scheme
- trusts
- unit trusts
- unit trust distributions
- unit trust holders
- unit holders

Legislative references:

- ITAA 1997 8-1
- ITAA 1936 - Part IIIA
- ITAA 1936 51(1)
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1936 Part IVA

Case references:

- FC of T v. Janmor Nominees Pty Ltd 87 ATC 4813; (1987) 19 ATR 254
- FC of T v. Ilbery 81 ATC 4661; (1981) 11 ATR 827
- FC of T v. Peabody (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344
- FC of T v. Spotless Services Ltd & Anor (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183

- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- Handley v. FC of T 81 ATC 4165, (1981) 11 ATR 644
- Ronpibon Tin NL and Paper Ltd v. FC of T (1949) 78 CLR 47; 8 ATD 431
- Steele v. FC of T 99ATC 4242; (1999) 41 ATR139
- Sun Newspapers Ltd and Associated Newspapers Ltd v. FC of T (1938) 61 CLR 337
- Ure v. FC of T 81 ATC 4100; (1981) 11 ATR 484

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