TA 2008/3 - Uncommercial use of certain trusts

The Taxation Office view on the major issue in this arrangement is set out in Taxation Determination TD 2009/17

Taxpayer Alert

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FOI status: may be released

Taxpayer Alerts are intended to be an "early warning" of significant new and emerging tax planning issues or arrangements that the ATO has under risk assessment.

Taxpayer Alerts will provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform ATO officers of new and emerging tax planning issues. Not all potential tax planning issues that the ATO has under risk assessment will be the subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the ATO.

Taxpayer Alerts will give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and will highlight the features which the ATO considers give rise to taxation issues. These issues will generally require more detailed analysis to provide an ATO view to taxpayers.

The developers and marketers of an arrangement which is the subject of a Taxpayer Alert should provide the full facts of the arrangement to the ATO to enable the ATO to finalise its view.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert can seek a formal determination of the ATO's position through a Private Ruling. Such taxpayers might obtain their own advice and/or contact the ATO officer named in the Alert.

This Taxpayer Alert is issued under the authority of the Commissioner

TITLE: Uncommercial use of certain trusts

This Taxpayer Alert describes a non-arm's length arrangement under which a taxpayer uses borrowed funds to acquire an interest, such as units, in a certain type of trust, which uses the funds to purchase income-producing property. The arrangement seeks to provide income tax deductions to the taxpayer for all of their interest payments and other borrowing costs. The arrangement does not provide a sufficient connection between the expenditure and the production of future income and/or capital gains, which may be distributed to other beneficiaries of the trust, who may have a lower tax rate.

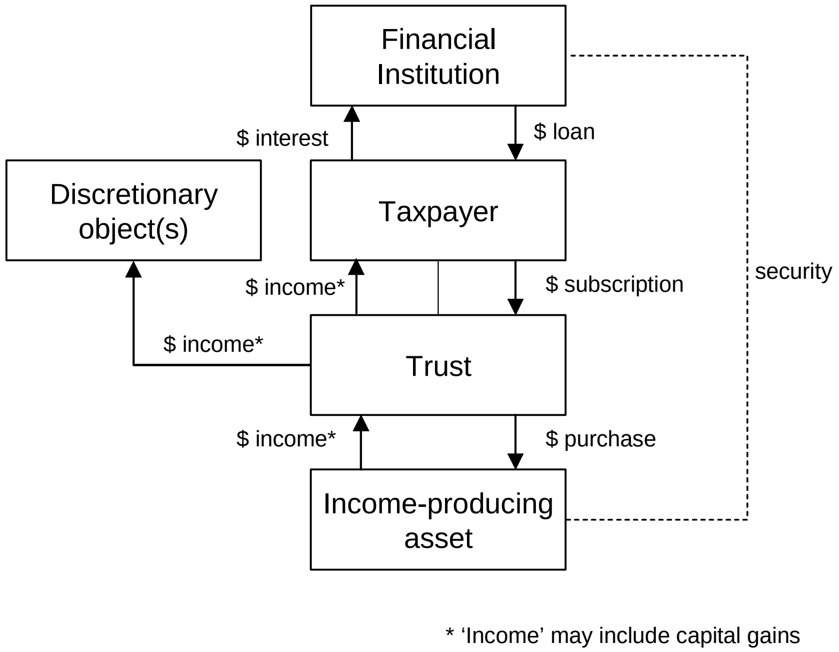
DESCRIPTION

The alert applies to arrangements which have some or all of the following features.

1. The taxpayer arranges for a trust to be established. The trustee of the trust is effectively controlled by the taxpayer and/or the taxpayer's associates. Typically, those associates are members of the taxpayer's family, some or all of whom bear a rate of tax which is lower than that of the taxpayer.
2. The taxpayer and his or her associates are beneficiaries of the trust or may become beneficiaries at a future date. The trust deed confers, or can confer in the future, interests or entitlements upon the taxpayer's associates for less-than-market-value consideration. It may achieve this in one of two ways.
3. First, the deed may provide the taxpayer with an entitlement to income or capital which appears fixed, but which can be defeated by the trustee exercising a discretion to distribute income and/or capital gains to the other beneficiaries. For that reason, the trust may be described as a 'hybrid trust' or 'hybrid discretionary trust'.
4. Alternatively, the trust deed may provide for, or enable, the issue of units or other interests to the taxpayer's associates for no consideration, or for consideration which falls short of the market value of such interests at the time of issue.
5. A taxpayer borrows money, at interest, from a financial institution. They use the borrowed funds to subscribe for an interest, such as units, in the trust. Other funds may also be subscribed to the trust, which have not been borrowed.
6. The trustee uses the funds subscribed by the taxpayer to purchase income producing assets (e.g. rental property). The assets may be used as security for the taxpayer's borrowings, even though the borrowings are in the taxpayer's own name.
7. The trustee earns income from the assets (e.g. rent) and pays associated expenses.
8. The taxpayer includes his or her share of the trust's net income, if any, in his or her assessable income.
9. Beneficiaries other than the taxpayer may, or may not, be entitled to trust income derived over the life of the investment. Where they are, the *taxpayer's* proportionate share of that income may be smaller than the proportion of the trust's capital which they funded using the borrowed money. In effect, this means that a proportion of the borrowed money is used to fund the production of income for other beneficiaries.
10. In the early years of the arrangement, the taxpayer's investment is negatively geared, since interest and other costs associated with the borrowing exceed the taxpayer's share of the trust's net income, if any. The taxpayer purports to deduct this excess from their other assessable income.
11. Having regard to the circumstances, it may be expected that the taxpayer's interest in the trust will be brought to an end before their costs of investment have been recouped. This may occur, either by:
    (a) the trustee exercising a discretion which effectively defeats the taxpayer's right to a share of the income of the trust; and/or
    (b) the issue of further interests in the trust to other beneficiaries; and/or
    (c) the redemption or extinguishment of the taxpayer's interest in the trust
12. Typically, the deed purports to deny the taxpayer any interest in capital gains of the trust, or the proportionate share of capital gains to which the taxpayer is entitled is smaller than the proportion of the trust's capital which they funded using the borrowed money. This is achieved by:
    (a) preventing or restricting the distribution of capital gains to the taxpayer; and/or
    (b) enabling the taxpayer's interest in the trust to be redeemed at face value, or face value, adjusted for inflation.
13. These restrictions may result in the taxpayer being unable to recoup their costs of investment. When the assets are sold, it may be expected that any capital gain will instead be distributed to one or more of the trust's other beneficiaries, who may have a lower tax rate.

14. Alternatively, the taxpayer's interest in the trust may be limited to capital gains made by the trustee. In such a case, income of a revenue nature may be distributed to the trust's other beneficiaries, who may have a lower tax rate.

15. The basic structure of the arrangement can be summarised diagrammatically as follows:



FEATURES WHICH CONCERN US

The Tax Office considers that the arrangement outlined above may give rise to taxation issues that include:

1. whether, and the extent to which, the taxpayer's borrowing costs are deductible under section 8-1 or section 25-25 of the *Income Tax Assessment Act 1997* (ITAA 1997);

2. whether a capital gain could arise under the capital gains tax provisions in Part 3-1 of the ITAA 1997 when trust interests are redeemed or new interests are issued;

3. whether the taxpayer has 'created' a trust in which the taxpayer or their children have an interest, such that the trust may be subject to section 102 of the *Income Tax Assessment Act 1936* (ITAA 1936); and

4. whether the general anti-avoidance provisions in Part IVA of the ITAA 1936 may apply to the arrangement, on the basis that its dominant purpose is to enable the taxpayer to obtain a tax benefit.

The Australian Taxation Office is examining these arrangements.

Subject References:
hybrid trust
unit trust
trust distributions
interest deductibility
rental expenses
capital gains

Legislative References:
Income Tax Assessment Act 1936
Part IVA
Income Tax Assessment Act 1997
Section 8-1
Section 25-25
Part 3-1

Related Taxpayer Alerts:
TA 2001/1

Date issued:	
Authorised by:	**Stephanie Martin** **Deputy Commissioner**
Contact Officer:	**Bruce Collins**
Business Line:	**Aggressive Tax Planning**
Section:	**Technical & Case Leadership**
Phone:	**(02) 6216 2710**