

TD 2018/9 - Income tax: deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee

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Taxation Determination

Income tax: deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee

1 This publication provides you with the following level of protection:

This publication (excluding appendices) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this Determination, the Commissioner must apply the law to you in the way set out in the determination (unless the Commissioner is satisfied that the determination is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this Determination if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

Deductibility of interest expense

1. A beneficiary of a discretionary trust who borrows money, and on-lends all or part of that money to the trustee of the discretionary trust interest-free, is usually not entitled to a deduction for any interest expenditure incurred by the beneficiary in relation to the borrowed money on-lent to the trustee under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

2. It is only where:

- (a) the beneficiary is presently entitled to income of the trust estate at the time the expense is incurred¹, and
- (b) the expense has a nexus with the income to which the beneficiary is presently entitled

that some part of the interest expense might be deductible. Even then, the interest expense is likely to have been incurred in the pursuit of one or more objectives other than the derivation of assessable income by the beneficiary and will not be deductible to the extent of any non-income producing objective/s.

¹ *Case M36 80* ATC 280 at [3]-[5]; *Case U44 87* ATC 318 at [6]-[7]; *AAT Case 4487* (1988) 19 ATR 3695 at [3]; *Re Lindsay Brothers and Deputy Commissioner of Taxation* [2001] AATA 771; *Re: Antonopoulos and Federal Commissioner of Taxation* [2011] AATA 431; 84 ATR 311; 2011 ATC 10-186; *Re Lambert and Federal Commissioner of Taxation* [2013] AATA 442 at [62] and [111]; 94 ATR 903; 2013 ATC 10-322; *Forrest v. FCT* [2010] FCAFC 6 at [42]- [43]; 78 ATR 417; 2010 ATC 20-163.

3. Although this Determination is concerned only with interest deductibility, the principles described would also apply to other expenses incurred by a beneficiary of a discretionary trust to the extent that the beneficiary asserts the expense is deductible by reason of its connection to an expected receipt of a trust distribution. Such expenses might include (without limitation) motor vehicle expenses, stationery and telephone expenses.

Effect of early trustee resolution

4. An irrevocable resolution made by a trustee of a discretionary trust to exercise a power of appointment of income in favour of a beneficiary does not confer present entitlement to income of the trust estate on that beneficiary until such time as the income is received by the trustee and is legally available for distribution.

5. A resolution made towards the beginning of the income year (an 'early resolution') by the trustee of a discretionary trust is **not** ordinarily effective to make a beneficiary presently entitled to income of the trust estate at that time, given the uncertainty as to whether any distributable income will exist for the year.²

Relevance of entitlement to income of future years

6. Any assessable income derived, or anticipated to be derived, in respect of a future year by reason of being made presently entitled to income of the trust for that future year is too remote to provide a nexus with a current year interest expense incurred by a beneficiary.

Date of effect

7. This Determination applies to years of income commencing both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation

20 June 2018

² Whether or not the trustee has the power to make such a resolution depends on a proper construction of the deed.

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

8. Deductibility of interest is ordinarily determined by considering both the purpose of the borrowing and the use of the borrowed funds. The purpose of a borrowing can generally be determined from its use, and outgoings of interest on that borrowing ordinarily draw their character from that use. In determining deductibility of an interest expense, regard must be had to all of the objective circumstances surrounding the expense.

9. Where funds borrowed at interest are on-lent interest-free, the interest expenditure will only be deductible to the extent that the interest has a nexus with assessable income reasonably expected to be derived by the borrower from the use of the borrowed funds.

10. Until a beneficiary of a discretionary trust is made presently entitled to income, that beneficiary has no more than a right to be considered by the trustee in relation to the appointment of trust income. This right to be considered, or mere expectancy, is too contingent or uncertain to be a source of assessable income reasonably expected by the beneficiary.

11. Therefore, if the beneficiary borrows money at interest and lends that money interest-free to the trustee, in the absence of a present entitlement to income at the time interest is incurred on the borrowing, that interest will not have a nexus with the derivation by the beneficiary of assessable income from the trust. Moreover, any entitlement to income from the discretionary trust that may arise in a future year is too remote to serve as a basis for the deductibility of interest, as it is conditional on both the derivation of future income and a future exercise of the trustee's discretion in the beneficiary's favour.

12. In the unlikely event that a beneficiary has a present entitlement to income in the current year at the time the expenditure is incurred, the beneficiary must also demonstrate that the expenditure has a nexus with the derivation of that income. To the extent that the expenditure is directed at objects other than the gaining of the income, it will not be deductible; apportionment of the expenditure is required where the expense is incurred in respect of objectives other than the derivation of assessable income.

Present entitlement and the effect of an early resolution

13. A beneficiary is only presently entitled to income if they have:

- (a) an interest in the income which is both vested in interest and vested in possession, and
- (b) a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.³

³ *FCT v. Bamford* [2010] HCA 10 at [37]; 75 ATR 1; 2010 ATC 20-170; *Harmer v. FCT* (1991) 173 CLR 264 at [271]; 22 ATR 726; 91 ATC 5000. Whether or not a resolution is irrevocable depends on the deed and whether by making the resolution appointing particular income in exercise of a power under the deed, the power is then spent.

14. Until income is derived by the trust to which a beneficiary can be made entitled and an **irrevocable** resolution has been made by a trustee of a discretionary trust to appoint income in favour of a beneficiary, that beneficiary cannot be presently entitled to income of the trust estate.⁴ Ordinarily, present entitlement will not arise until the end of the income year, even if the income is appointed under an early resolution. This is because ordinarily it is not possible to know until at or after year end whether there is any income of the trust in respect of the year available to be distributed.

15. It is possible that an early resolution appointing income to a beneficiary may satisfy the conditions to make the beneficiary presently entitled to trust income at a point prior to the end of the income year.⁵ In those circumstances, if, having become presently entitled, the beneficiary incurs interest on borrowings advanced to the trustee interest-free, and it is reasonably expected that the use of the advanced funds will contribute to income received by the beneficiary, the interest expense may be partly or wholly deductible.

16. If the beneficiary becomes presently entitled to an amount specified in an early resolution, that present entitlement cannot serve as the basis for deductibility of interest incurred on a borrowing taken out by the beneficiary after that entitlement arises. The later advance has necessarily not contributed to the earlier income entitlement and any future income entitlement remains a mere expectancy.

Apportionment

17. Interest is only deductible to the extent that it is incurred in gaining or producing assessable income. Where the conditions in paragraph 2 of this Determination are met, the beneficiary must nevertheless determine whether some or all of the interest expense referable to the on-lent borrowings is precluded from deductibility.

18. For instance, an interest expense is not fully deductible in situations where the expected amounts of income on which the beneficiary will be assessable do not provide an obvious commercial explanation for incurring the interest expense. Whether there is such an explanation will need to be considered where, for example, the total amount of income on which the beneficiary is assessable in the year in which the interest expense is incurred is less than the total interest expense.

19. In these circumstances, it is necessary to consider all of the circumstances, including the direct and indirect objects and advantages sought by the taxpayer in incurring the expenditure, to determine whether the expense is fully deductible. Indirect objects may include:

- (a) private or domestic purposes⁶
- (b) the manufacturing of a tax deduction⁷, and
- (c) especially significant in the context of a discretionary trust, benefiting other beneficiaries of the trust.⁸

⁴ *FCT v. Bamford* [2010] HCA 10 at [39]; 2010 ATC 20-170 at [10809]; *Cajkusic v. FCT* [2006] FCAFC 164 at [34] and [36]; 64 ATR 676; 2006 ATC 4752; *FCT v. Totledge Pty Ltd* (1982) 40 ALR 385 at [393]; 82 ATC 4168.

⁵ An example of this situation would be where, as a matter of fact, it is clear at a certain point before the end of the income year that the trust has distributable income for that year and an irrevocable resolution has been made to appoint that income to a beneficiary.

⁶ *Ure v. FCT* (1981) 11 ATR 484 at 488-9; 81 ATC 4100 at 4104.

⁷ *FCT v. Ilbery* (1981) 12 ATR 563; 81 ATC 4661.

⁸ *FCT v. Munro* (1926) 38 CLR 153.

20. The way in which the trustee uses the borrowed monies may also be relevant to establishing deductibility.⁹ Use that is not likely to generate income of the trust estate to which the beneficiary is presently entitled may indicate the pursuit of some other objective that will limit deductibility. Where expenditure has both an income-producing purpose and a non-income-producing purpose, the expense must be apportioned on a fair and reasonable basis.¹⁰

Apportionment to be considered separately each year

21. The question of apportionment needs to be considered separately each subsequent year, and the appropriate conclusion may vary between years (depending on the circumstances then existing). Relevantly:

- (a) a beneficiary of a discretionary trust does not have any relevant interest or property that could be expected to produce income for the trust¹¹
- (b) a loan to the trustee neither bolsters the beneficiary's ability to produce assessable income from an interest or asset already owned, nor gives the beneficiary a relevant asset from which assessable income may be gained or produced
- (c) the beneficiary's ability to gain or produce assessable income in an income year, as a result of the on-lent borrowed funds, is contingent on a decision being made by the trustee to make an irrevocable resolution in favour of the beneficiary
- (d) until such time as the beneficiary is presently entitled in an income year, any interest expense incurred is preliminary to, and has no nexus with, the gaining or producing of assessable income, and
- (e) in any given income year, the trustee might exercise their discretion differently (potentially for the benefit of other beneficiaries, and to the exclusion of the beneficiary who has made the loan).

⁹ For example in *FCT v. Total Holdings* (1979) 9 ATR 885; 79 ATC 4279 an interest-free loan was made that was incidental and relevant to income derived from the business activities of the beneficiary taxpayer.

¹⁰ *Ronpibon Tin NL & Tongkah Compound NL v. FCT* (1949) 78 CLR 47. A common sense weighting of factors will often lead to the deductible component of the interest incurred limited to the extent of the share of the trust's net income on which the beneficiary is assessed in that year. See *Ure v. FCT* (1981) 11 ATR 484.

¹¹ *Gartside v. Inland Revenue Commissioners* (1968) AC 553.

References

Previous draft:

TD 2017/D4

Related Rulings/Determinations:

TR 2006/10

Previous Rulings/Determinations:

IT 2385

Legislative references:

- ITAA 1997
- ITAA 1997 8-1
- TAA 1953

Cases relied on:

- AAT Case 4487 (1988) 19 ATR 3695
 - Federal Commissioner of Taxation v. Bamford [2010] 75 ATR 1; [2010] HCA 10; 2010 ATC 20-170
 - Cajkusic v. Federal Commissioner of Taxation [2006] FCAFC 164; (2006) 64 ATR 676; 2006 ATC 4752
 - Case M36 80 ATC 280
 - Case U44 87 ATC 318
 - Federal Commissioner of Taxation v. Ilbery (1981) 12 ATR 563; 81 ATC 4661
 - Federal Commissioner of Taxation v. Munro (1926) 38 CLR 153
 - Federal Commissioner of Taxation v. Total Holdings (Aust) Pty Ltd (1979) 9 ATR 885; 79 ATC 4279
 - Federal Commissioner of Taxation v. Totledge Pty Ltd (1982) 40 ALR 385; 82 ATC 4168
 - Forrest v. Federal Commissioner of Taxation [2010] FCAFC 6; 2010 ATC 20-163; (2010) 78 ATR 417
 - Gartside v. Inland Revenue Commissioners (1968) AC 553
 - Harmer v. Federal Commissioner of Taxation (1991) 173 CLR 264; (1991) 22 ATR 726; 91 ATC 5000
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 - Re Lambert and Federal Commissioner of Taxation [2013] AATA 442; 2013 ATC 10-322; (2013) 94 ATR 903
 - Re Lindsay Brothers and Deputy Commissioner of Taxation [2001] AATA 771
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