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The refinancing principle as applied to trusts

The scope of the "refinancing principle" with respect to trusts, which refers to the ability of a trust to modify its funding mix from equity to debt and obtain associated interest deductions, has recently been clarified by the Commissioner

INTRODUCTION

Taxation Ruling TR 2003/9 ("the Ruling"), dated 30 July 2003, deals with the situations in which a trustee of a trust estate may obtain interest deductions in respect of funds borrowed and utilised to repay capital to beneficiaries of a trust estate for the purposes of ascertaining the "net income" of a trust estate under subs 95(1) of the *Income Tax Assessment Act 1936* (Cth) ("the 1936 Act").

The Ruling is the result of a recommendation by the Board of Taxation, issued on 12 December 2002, within its report entitled Taxation of Discretionary Trusts, which requested that the Commissioner "... clarify and publish his views about the deductibility of interest on borrowings used to finance non-assessable distributions to beneficiaries of discretionary trusts". Following the recommendation, the Treasurer in Press Release No. 081 stated that "[t]he Government has requested clarification and will, if the rulings are unable to deal with the matter, consider a legislative solution".

Whilst the Ruling is presented in a different manner to the draft which proceeded it, being Draft Taxation Determination TD 2003/D4 ("Draft Determination"), the general thrust of the Ruling is that deductibility is determined according to the nature of the funds being refinanced. The Ruling seeks to target the practice of paying tax free distributions financed by borrowing against an unrealised revaluation of assets or internally generated goodwill. This article will discuss the principles outlined in the Ruling. In doing so, general principles in respect of deductibility and issues pertaining to the taxation of trusts will briefly be discussed. Difficulties relating to the characterisation of a trust (ie the definition of fixed and non-fixed trusts) will not be considered.

NET INCOME OF A TRUST

Liability with respect to income derived within a trust estate is determined under Part III, Div 6 of the 1936 Act. Beneficiaries of a trust estate are assessed on their share of the net income of the trust estate. Net income is determined under subs 95(1) of the 1936 Act,

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being the total assessable income of a trust estate calculated as if the trustee were the taxpayer in respect of the income and a resident of Australia, less all allowable deductions.[1] Therefore, in calculating the net income of a trust estate, the allowable deductions, such as interest expenses, need to be determined.

DEDUCTIBILITY OF INTEREST EXPENSE

General

The starting point is the general deduction provision of s 8-1 of the 1997 Act. The section provides that losses or outgoings that are incurred in gaining or producing assessable income, or that are necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, are deductible. That is, expenditure is deductible if its essential character has a "sufficient connection" with the operations and activities of directly gaining or producing assessable income, provided that the expenditure is not of a capital, private or domestic nature. In order to have "sufficient connection", it needs to be demonstrated that the expense is "incidental and relevant" to the production of income/ business, and it has the "essential character" of a income producing/business expense.

Deductibility of Interest Expense for Trust Estates

In ascertaining whether interest expenses incurred by a trustee is deductible, it needs to be determined whether there is a "sufficient connection" between the interest expense and the income producing/business activity of the trustee. Interest incurred on money borrowed that is considered "incidental and relevant" to

the derivation of assessable income, will be an allowable deduction for the taxpayer. In particular, in the event of a refinancing of a trust estate, the issue to be determined is whether the interest incurred in respect of the borrowings is deductible in the hands of a trustee of a trust estate.

The Ruling contends that interest expenses incurred by a trustee of a trust estate in respect of borrowed funds used to discharge an obligation to pay distributions to a beneficiary will not, of itself, result in the interest expense being deductible. It is irrelevant that the obligation arises due to a statute or the trust instrument. The Ruling cites *Hayden v FCT* 96 ATC 4797 ("*Hayden's case*") as authority for this proposition.

In *Hayden's* case, a court ordered a trust estate to pay an amount under family maintenance provisions. The trustee borrowed an amount of money on which interest was incurred so as to satisfy the court order, rather than selling income producing assets. It was held that the mere fact that a trustee has an obligation to make a distribution does not make interest on borrowings sufficiently related to the income producing activities.

Paragraph 6 of the Ruling states that the requirement of "sufficient connection" will be met if "…the use of the borrowed funds, when viewed objectively, is to repay to the beneficiary an amount previously invested by the beneficiary in an assessable income earning activity, or business, carried on by the trustee, in the capacity of trustee of the trust estate…". However, this is subject to two conditions, being that:

1. the beneficiary must be entitled to withdraw the amount, and
2. the amount must have been actually used in the assessable income earning activities of the trust estate.

The Ruling considers that a beneficiary is entitled to withdraw amounts from a trust estate only if the beneficiary actually contributed to the trust or is entitled to amounts within the trust. The Ruling draws an analogy with the "refinancing principle" as enunciated in *FCT v Roberts*; *FCT v Smith* (1992) 23 ATR 494 ("*Roberts & Smith*") so as to provide eligibility for deductibility.

THE REFINANCING PRINCIPLE

General

Broadly, the refinancing principal allows for the modification of an entity's funding mix such that equity may be returned to the equity holders and substituted for debt, with interest attributable to the substituted debt being deductible in the hands of the entity making the substitution.

Roberts & Smith stands for the proposition that interest on borrowing incurred by a partnership, and used to repay capital contributed by the partners, which was initially used to provide business funding for the partnership is deductible in the hands of the partnership. The borrowings are used to maintain the capital of the partnership, replacing partnership capital with debt capital. Further, the use to which the partners put the repaid capital is viewed as irrelevant because it was merely a repatriation of the capital of the partnership.

Interest on borrowings used to refinance funds employed in a common law partnership is deductible if the funds represent partnership capital, which, according to Hill J in *Roberts & Smith* at 505 is

> "…the aggregate of the sums contributed by its members for the purpose of commencing or carrying on the partnership business, and intended to be risked by them in that business. The capital of the partnership is therefore not the same as its property…".

Taxation Ruling TR 95/25, which was released as a result of the decision in *Roberts & Smith*, allows common law partnerships and companies interest deductions in respect of funds borrowed for the purpose of replacing partnership or shareholder capital. TR 95/25 only allows interest on borrowings on funds to the extent that the funds refunded were previously invested in the entity to derive assessable income and does not extend to internally generated goodwill or a revaluation of assets.

In accepting the decision of *Roberts & Smith*, the Commissioner in TR 95/25 stated at para 4 that:

> … interest on a borrowing by a common law partnership to fund payment of moneys originally advanced by a partner and used as partnership capital will be deductible … to the extent the partnership capital was employed in a business of the partnership which was carried on for the purpose of producing or gaining assessable income.

At para 13 of TR 95/25, the Commissioner extended the refinancing principle to companies by stating that:

> … interest on a borrowing by a company may be deductible where the borrowing is used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purposes of deriving assessable income.

At para 10 of TR 95/25, with *Case 12/95* 95 ATC 175 as authority, the Commissioner submitted that the "refinancing principle" does not apply to joint owners of investment properties on the basis that they do not have a right to the repayment of capital.[2]

The Refinancing Principle as Applied to Trust Estates

The Ruling seeks to clarify the refinancing principle as applied to trust estates. In doing so, the Ruling distinguishes between borrowings by a trust estate used to refinance existing borrowings, and borrowings used to replace corpus.

Beneficiary Lending to Trust Estate – Refinancing Existing Borrowings of a Trust

The Ruling considers that, notwithstanding the type of trust, interest is deductible on borrowings of a trust estate which is used to repay a loan that a beneficiary had advanced to it. This is provided that the initial money was used for income producing purposes. According to the Ruling, a further condition in order to obtain deductibility is that the loan is a written agreement and on an arm's length basis. This requirement appears to be unwarranted as, provided the beneficiary can establish as a matter of law that a loan had been made, the interest should be deductible.

Settled Capital or Undrawn Income Presently Entitled – Refinancing to Replace Corpus Contributed by Beneficiaries

The Ruling considers that interest incurred on borrowings used to pay beneficiaries may be deductible in the hands of the trustee if it is capital which has been previously settled (or contributed) as corpus of the trust, or is undrawn income of the beneficiary to which the beneficiary is presently entitled. Paragraph 18 of the Ruling considers that such amounts will be deductible only if:

- the beneficiary exercises an entitlement to call for some or all of the amount;
- the trustee borrows money at interest to satisfy the call; and
- the amounts to be distributed represent amounts invested by the beneficiary in the income earning activities or business carried on by the trustee, as trustee for the trust estate.

Ostensibly, the Commissioner considers that eligibility to the deductions does not depend on the type of trust. Furthermore, the Ruling states that whether the borrowings are directly paid to the beneficiary and, to what use the beneficiary puts the funds to, are also irrelevant considerations when determining the question of deductibility. That is, the question to be answered is, when viewed objectively, whether the use by the trustee of the borrowed funds is to repay amounts which the beneficiary "invested" into an

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assessable income earning activity or business, carried on by the trustee. If so, the interest will be deductible.

THE NATURE OF THE TRUST

The Ruling contends that the nature of the trust should not be an issue in determining the deductibility of interest on borrowings used to refinance capital contributed to corpus by a beneficiary. However, apart from the situation of refinancing an existing loan, it seems that the ATO does implicitly take into account the nature of the trust in determining deductibility of amounts concerned. Putting aside complications in the characterisation of different types of trusts,[3] it seems that in respect of discretionary trusts, settling money on such a trust does not entitle the settlor to demand repayment, and as the corpus is not used to earn assessable income for any particular beneficiary, the refinancing principle is hard to satisfy.

The thrust of the Ruling is that it needs to be determined whether the relevant beneficiary has "invested" into the trust, either by contributing capital to the corpus of a trust, or by having an unpaid present entitlement held by the trustee. In respect of ascertaining amounts invested by a beneficiary, the Ruling considers that the amounts are fixed according to the trust deed, and any additional agreements between the parties. In respect of discretionary trusts, it seems determinative that the beneficiaries do not have a right to receive amounts ultimately paid, as they are considered as mere objects of such trusts.

It is submitted that the Ruling is an improvement from the Draft Determination. The Draft Determination contended that interest expenses which unit trusts, or other "fixed trusts" incur are more likely to have the requisite connection with the production of assessable income, and therefore be deductible than will be the case of "non-fixed trusts".

The Draft Determination more overtly considered that the refinancing principle did not generally apply to discretionary trusts. The Commissioner explained the reasoning in the Draft Determination by contending that settlors of the corpus of a non-fixed trust make gifts. Therefore, it was considered that the objects of a non-fixed trust (before amounts are vested) do not have a right to call for a distribution or for the amounts previously invested. As such, borrowings to pay such distributions are not eligible for the refinancing principle. In discussion the requisite connection in order to determine deductibility, the Commissioner at para 6 of the Draft Determination stated that it was more likely to be found:

> ... in relation to unit trusts or other fixed trusts rather than in relation to non-fixed trusts, as the relationship of trustee and beneficiary in the first two situations is relevantly analogous to the relationship of the partners dealt with in the case of Roberts and Smith (because the trustee, like the partners, simply carries on business on behalf of the beneficiaries with their invested capital).

DOCUMENTARY EVIDENCE

The Ruling, unlike the Draft Determination, requires adequate documentation in order for the trust estate to be eligible for deductions. That is, in order to be able to demonstrate a sufficient connection between the interest expense and the assessable income earning activities of a trust, there must be documentary evidence showing [para 8]:

- proper characterisation of the interest expense incurred;
- the amounts replaced those previously invested by the beneficiary in the assessable income earning activities (business) carried on by the trustee on behalf of the trust estate; and
- the beneficiary was entitled to withdraw the amounts invested.

Such documentary evidence includes proper accounting records.

DISTRIBUTION OF AMOUNTS ATTRIBUTABLE TO INTERNALLY GENERATED GOODWILL AND UNREALISED REVALUATIONS OF ASSETS.

Internally generated goodwill and unrealised asset revaluations are not viewed as amounts invested in the assessable income earning activities of a trust by the beneficiaries. Rather, such amounts are characterised as property of the trust and are therefore not subject to the refinancing principle.

The Ruling contends that there is a distinction between the amount invested into a trust and the property of a trust. It is considered that the amounts which are invested into a trust is fixed at any point in time, whereas the actual assets of the trust, being the property of a trust, may vary from time to time. That is: "While amounts attributable to internally generated goodwill or an unrealised revaluation of assets may represent the monetary value of assets of the trust, they do not represent sums contributed by beneficiaries." [para 26 of the Ruling]

Because internally generated goodwill and unrealised revaluations of assets do not constitute amounts invested by a beneficiary, the Ruling considers that the refinancing principle will not apply to borrowings and distributions in respect of such amounts. This approach is consistent with Taxation Ruling TR 95/25, where it was stated that in the context of a partnership, it is only the partnership capital, being an amount which can never exceed the amount contributed, which is able to be subject to the refinancing principle. ◆

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Reference Notes

1 *This is subject to limitations. The following are not allowable deductions for the purposes of ascertaining "net income" under Subs 95(1) of the 1936 Act:*

(a) deductions relating to income equalisation schemes for primary producers; and

(b) in respect of beneficiaries who have no interest in the corpus of a trust estate, or life tenants of a trust, the deductions for tax losses of earlier income years which are to be met out of the corpus of the trust as provided for in Div 36 of the 1997 Act.

2 *note Yeung v FCT 88 ATC 4193 at 4204 which contradicted this reasoning.*

3 *for example fixed and non-fixed trusts, discretionary and hybrid trusts, etc.*