THE REFINANCING PRINCIPLE

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Subject:	**The Refinancing Principle**			
Author(s):	Christopher J Batten		Pages:	5
References:	Section 8-1 *Income Tax Assessment Act 1997* (*ITAA 1997*), s.6(1) *ITAA 1936*, *FCT v. Roberts; Smith* 92 ATC 4380, *Yeung & Anor v FCT* 88 ATC 4193, *Ure v FCT* 81 ATC 4100, TR 95/25, TR 93/D38, TD 40, IT 2684, IT 2512.			
Comments:	With the ability to refinance partnership capital greatly reduced since the decision in *FCT v. Roberts; Smith* and the issue of TR 95/25, especially for 'mum & dad' partnerships, an alternative approach is required.			

Arguably, one of the most important concepts in tax law is the ability to convert equity to debt, and claim the interest payments on the debt as a tax deduction; this is known as the 'refinancing principle'. Following the decision in *FCT v. Roberts; Smith* 92 ATC 4380 and the issue of Taxation Ruling TR 95/25, however, a careful review is required of how the refinancing of capital is structured.

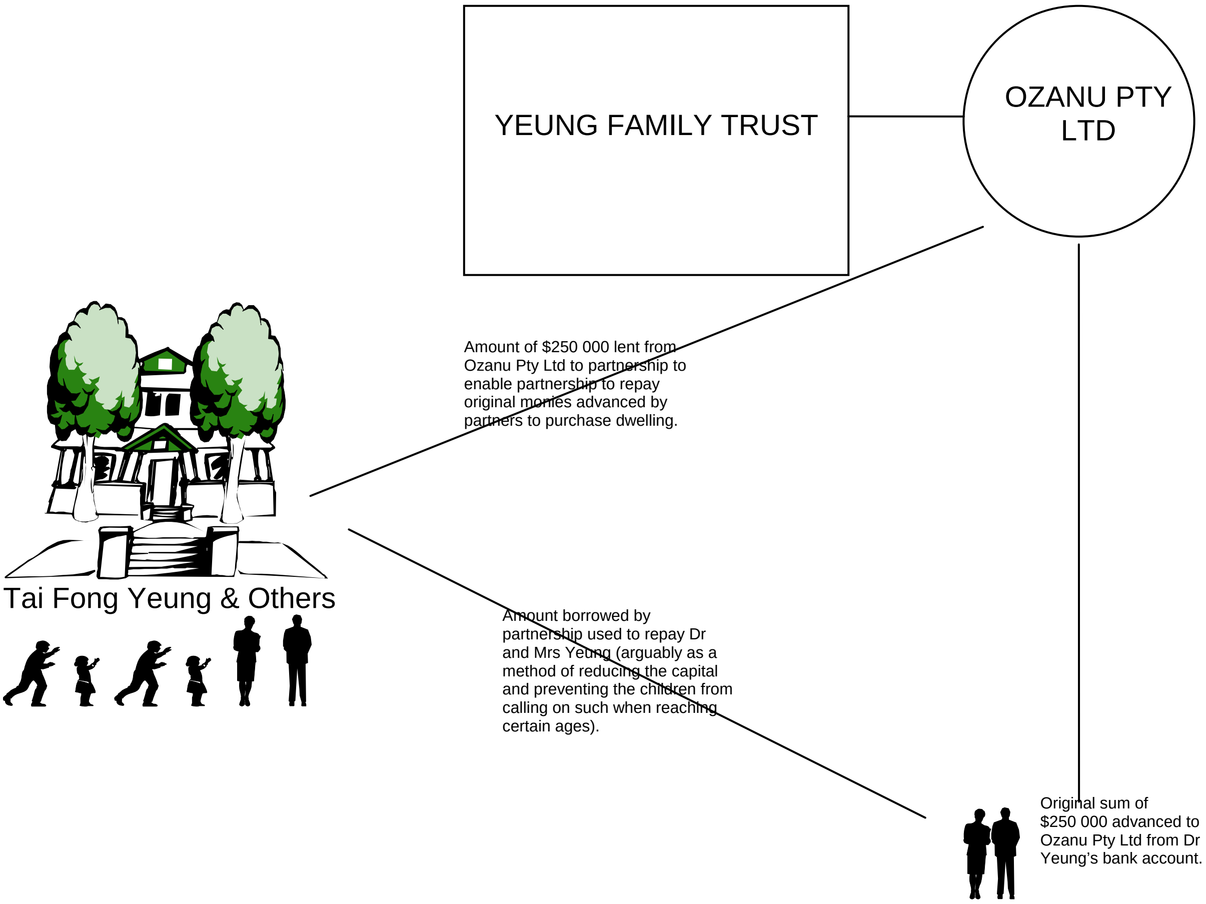
There have been a great deal of cases involving the general purpose, apportionment and deductibility of interest payments, and it may be appropriate to commence discussion of the deductibility of interest with the case of *Yeung & Anor v FCT* 88 ATC 4193.

Dr Tai Fong Yeung, his wife and their four children acquired a residential property as tenants-in-common in equal shares. A lease document was prepared, and the property was leased to the family. As they were 'in receipt of income jointly', the family members were a partnership as defined in s.6(1) *ITAA 1936*. On 1 July 1980, Dr and Mrs Yeung served notice on the partnership requiring repayment of sums originally advanced for the purchase of various properties, and in February 1982 there was an exchange of cheques from Dr Yeung's bank account. Firstly an amount was advanced to Ozanu Pty Ltd (the corporate trustee of the Yeung Family Trust) and then a cheque was drawn from Ozanu Pty Ltd and paid to Dr Yeung's bank account. The cheque from Ozanu Pty Ltd was treated as a loan from the company to the partnership, to enable the partnership to repay the original monies advanced to purchase the properties. The partnership then claimed the interest on the loan from Ozanu Pty Ltd, which the Commissioner disallowed in the 1981 to 1983 income years. The taxpayers appealed against the Commissioner's disallowance of their objections, and the Federal Court held in favour of the taxpayers that the interest on the loan was deductible. The *Yeung* case has been reproduced diagrammatically below in diagram 1.

Yeung's case provided some insight into the deductibility of interest and, in particular, I refer to comments made by Davies J. at 4203:

> '*So far as the taxpayers were concerned, the giving of notice on 1 July 1980 and the exchange of cheques which occurred on 4 February 1982, were not directed to the gaining of assessable income.*
>
> *What the partnership achieved by the borrowing from Ozanu Pty Ltd was the maintenance of the income earning properties. Funds were withdrawn, but were replaced by loan funds and the income-earning properties remained held by the six members of the family.*
>
> *It follows that the partnership is entitled to the deductions sought of the interest incurred on the $250 000 borrowed from Ozanu Pty Ltd.*'

Diagram 1



Therefore, it is important to determine the taxpayer's purpose when reviewing the deductibility of interest on a loan and, as advised by Davies J. in *Ure v FCT* 81 ATC 4100 at 4104:

> '*In an income-producing enterprise, both income and equity may be invested in assets directed to the earning of income. In such an event, if equity capital is repaid and loan capital replaces it, interest payable on the loan capital will ordinarily be an allowable deduction from the income derived from the assets. This is because the assets held represent the equity and the loan capital, and if the assets are directed to the earning of income, then both the loan capital and the equity capital which they represent are devoted to the earning of assessable income.'*

Unfortunately, the decision in *Yeung* carries little weight today, as both the decision in *FCT v Roberts; Smith* 92 ATC 4380 and also Taxation Ruling TR 95/25 establish that only the genuine refinancing of capital in *common law* partnerships, and not partnerships that exist merely by definition of s.6(1) *ITAA 1936*, will give an entitlement to a deduction on interest used to repay capital accounts. Below are paragraphs 8 and 11 of TR 95/25:

> *8. The 'refinancing principle' in Roberts and Smith has no application to joint owners of investment property which are not common law partnerships.*
>
> *11. Accordingly, it is inappropriate to describe a borrowing by the joint owners of investment property, which does not constitute a business, as a refinancing of funds employed in a business.*

As a consequence, many practitioners have suggested that *Roberts & Smith* means the end of refinancing capital amounts, except in the case of genuine common law partnerships. I would argue that there is a need to change the structures used, so that s.6(1) partnerships are no longer used for investment or business, and are replaced with a structure that enables the refinancing of capital and also a deduction on the interest paid. In his judgement in *Roberts & Smith*, Hill J. gave examples of circumstances where the tracing of borrowed money was not necessary, or crucial, in order to characterise the interest. In those examples Hill J. identified a subsidiary principle or purpose which would enable a deduction on borrowed monies. He said that interest is deductible to an entity, if the borrower replaces funds employed in the entity's business by financing a payment by the entity in discharge or reduction of an obligation to a person who is entitled to be paid those funds.

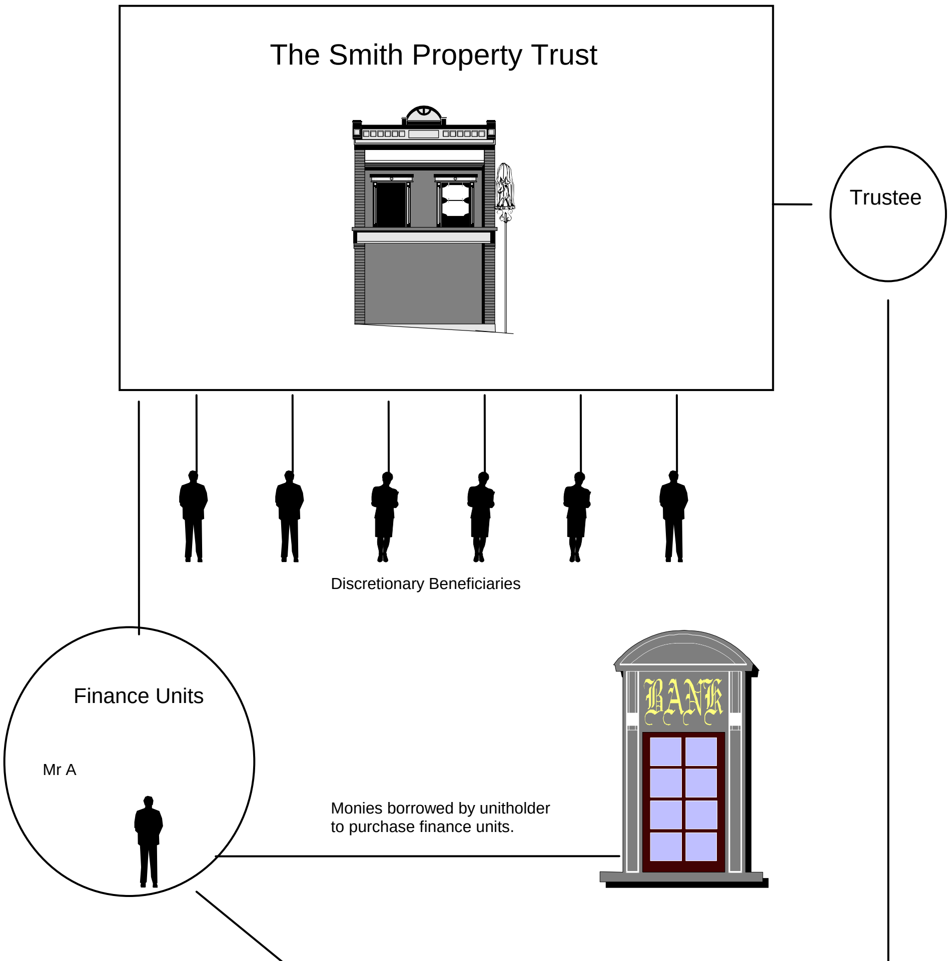
Following from these comments, I refer to Draft Taxation Ruling TR 93/D38 and advise that, even though it has been replaced by TR 95/25 in which there is no mention of trusts, at paragraph 9 it stated that:

> *9. Interest on borrowings by a trustee is deductible if the borrowings finance the discharge or reduction of any of the following obligations, again subject to the restriction mentioned in paragraph 6:*
>
> *(a) a liability to a lender of money which, at the time of the replacement borrowings, is being applied to the assessable income-producing purposes of the trust estate;*
>
> *(b) a liability to a trade creditor;*
>
> *(c) an obligation to make a payment to a beneficiary of the trust estate, under the terms of the trust or by agreement between the beneficiaries, in reduction or extinguishment of the beneficiary's interest in the corpus of the trust estate; and*
>
> *(d) a liability to pay a beneficiary a share of the net income of the trust estate.'*

I draw attention to paragraph (d) above, which entitles a trustee to a deduction if the borrowings finance the discharge or reduction of a liability to pay a beneficiary a share of the net income of the trust estate. Remembering that a unit in a unit trust is a chose in action represented by a bundle of rights, one of which may be to a share of net trust income, then a borrowing by a trustee to redeem income units would be deductible to the trustee, as in diagram 2. I would advise that capital gains be considered in this regard; if the unit entitlement is to income only and not capital growth or distribution, however, then capital gains may be minimal.

It should also be noted, however, that the Commissioner does not consider himself to be bound in any way by his opinions expressed in withdrawn draft rulings.

Diagram 2

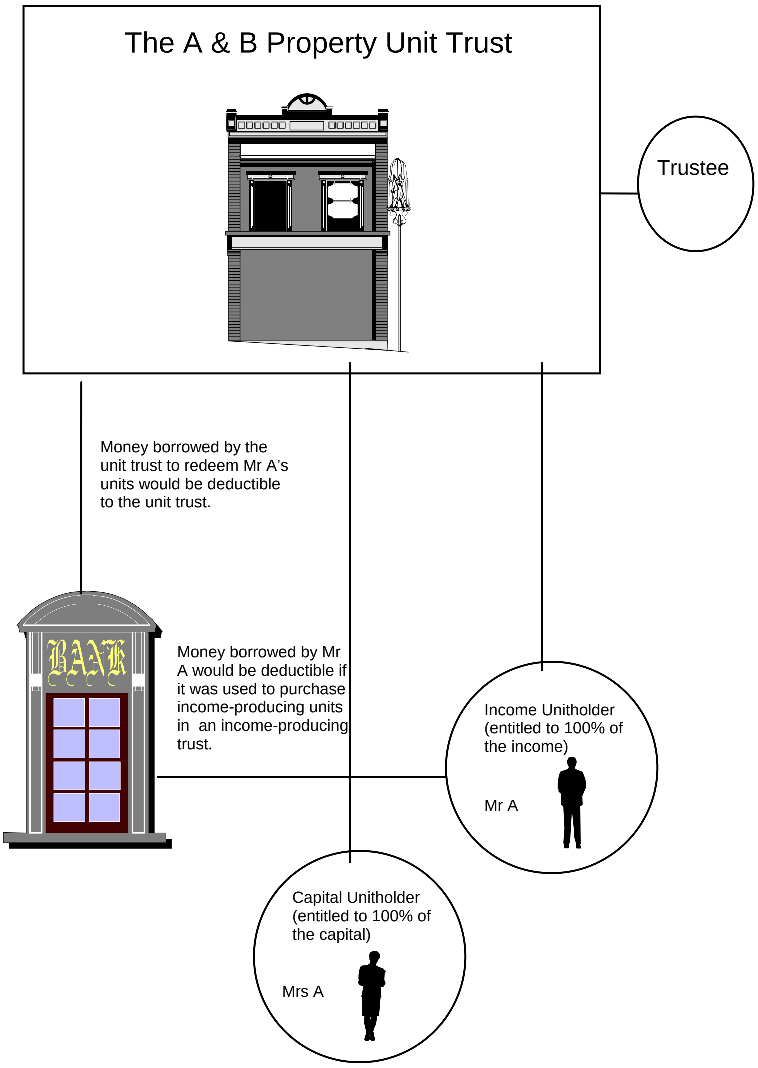


Interest on monies borrowed by the trustee to redeem Mr A's finance units (ie. reduce the trustee's liability to pay the beneficiary (Mr A) a share of net income) would be deductible to the trustee against assessable income of the trust.
Refer:
- TR 93/D38;
- Comments of Hill J. & examples in *FCT v Roberts & Smith* 92 ATC 4380; and
- Davies J. in *Ure v FCT* 81 ATC 4100.

NOTE: Refer TD 40 Capital Gains: What is the treatment where units in a unit trust are issued or redeemed by the trustee?

All of the above principles are demonstrated in the following example: Mr and Mrs A wish to purchase a rental property for investment purposes and to provide for the future of their children, using borrowed funds. A discretionary or unit trust is established, in which Mr A applies for and is issued income units. Mr A borrowed the funds to purchase those income units. Therefore, Mr A should be entitled to a deduction on the interest on the loan under s.8-1 *ITAA 1997*, and I refer to IT 2684 and IT 2512 in this regard. If the trustee, following an application to redeem the units being sent from the unitholder, redeemed the units using borrowed funds (as in diagram 3), then the interest on this loan would also be deductible.

Diagram 3



Ascertaining the purpose of the borrowing by the trustee is paramount in determining the deductibility of the interest on the loan. However, the application of the funds by Mr A is of no consequence and, therefore, has no bearing upon the trustee's entitlement to a deduction.