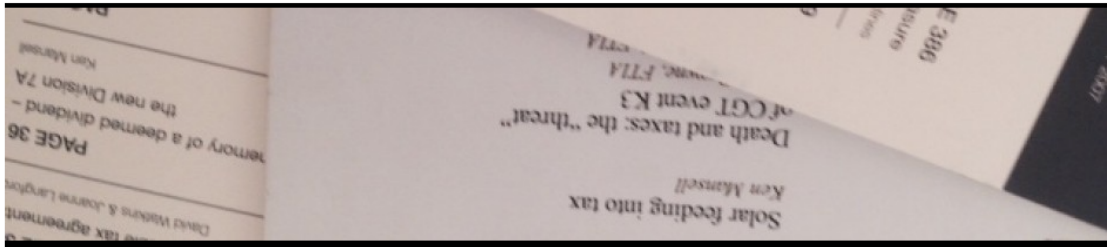


Tax Rambling

The rants of a tax nerd



Interest Deductions

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## 1. Interest is still a problem in common situations

### EXAMPLE 1...

From a case last month...

#### ***DiStefano and Commissioner of Taxation (Taxation) [2023] AATA 1697 (16 June 2023)***

Can a taxpayer claim a deduction for interest incurred in relation to uninhabitable property that has not been rented out for 4 years?

The taxpayer bought a property in 2006, let it out on short-term holiday agreements until 2010 and then a long term lease to 2013 when it fell into very poor conditions.

The taxpayer discussed renovation or redevelopment options and in late 2015 lodged a development application for a new residence getting approval in February 2016. Due to finance issues and mental health nothing happened by 30 June 2017.

*“When we have regard to all the circumstances, we are satisfied Mr DiStefano had done just enough to demonstrate he retained his commitment in the relevant year to the project that would ultimately yield assessable income (or, perhaps more accurately, his behaviour did not demonstrate he had at that point lost his commitment to that end). He made clear he originally acquired the property for rental purposes. While having limited success in attracting the sort of high-paying tenants he anticipated following the purchase, there is no reason to doubt he was making genuine efforts to market the property during that earlier period and he did have a long-term tenant at one stage.”*

### EXAMPLE 2...

The ATO Random Enquiry Program found that nine out of ten tax returns that reported rental income and deductions contain at least one error, even though most of those property owners were assisted by a registered tax agent.

The four big problems the Commissioner found were capital works treated as repairs, not apportioning deductions for private use, having no records, and the one that led to some of the biggest adjustments under this program, incorrectly claiming deductions for interest.

The Commissioner gives two very simple examples of this issue that he finds all the time.

**Example:****Interest incurred on funds redrawn from the loan**

Tyler has an investment loan for his rental property with a redraw facility. He is ahead on his repayments by \$9,500 which he can redraw. On the 1 July, Tyler decides to redraw the available amount of \$9,500 and buys himself a new TV and a lounge suite.

The outstanding balance of the loan at that time is \$365,000 and total interest expense incurred is \$19,000.

Tyler can only claim the interest expense on the portion of the loan relating to the rental property.

**Total loan balance – redraw amount = rental property loan portion**

That is:

$$\text{\$365,000} - \text{\$9,500} = \text{\$355,500}$$

To work out how much interest he can claim, he does the following calculation.

**Total interest expenses x (rental property loan portion ÷ loan balance) = deductible interest**

That is:

$$\text{\$19,000} \times (\text{\$355,500} \div \text{\$365,000}) = \text{\$18,505}$$

**Example:****Interest incurred on a mortgage for a new home**

Zac and Lucy take out a \$400,000 loan secured against their existing home to purchase a new home.

Rather than sell their existing home they decide to rent it out.

They have a mortgage of \$25,000 remaining on their existing home which is added to the \$400,000 loan under a loan facility with sub-accounts, that is, the two loans are managed separately but are secured by the one property.

Zac and Lucy can claim an interest deduction against the \$25,000 loan for their original home, as it is now rented out.

They cannot claim an interest deduction against the \$400,000 loan used to purchase their new home as it is not being used to produce income even though the loan is secured against their rental property.

How many times have you had these conversations with friends, family and clients? It does not matter what you used to secure the loan, but rather what you use the funds for. If you redraw we need to assess what you used the redraw for.

**Offset never redraw:** Of course the answer to these issues is to never make additional repayments that you can redraw, rather have an offset account. If Tyler had have put his repayments in an offset account that reduced the interest payable on his loan, when he took the money from the offset account, all the interest on the loan, which has just increased, remains deductible.

In this paper, we are going to consider the main mistakes that are made regarding interest. This paper considers:

- General principles governing deductibility of interest;
- Roberts and Smith and borrowing to repay capital;
- Deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries;

- Deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities
- Deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee

## 2. General principles governing deductibility of interest

**Australian  
Taxation  
Office**

Taxation Ruling

**TR 95/25**

FOI status: may be released

page 1 of 16

### **Taxation Ruling**

**Income tax: deductions for interest under section 8-1 of the *Income Tax Assessment Act 1997* following *FC of T v. Roberts*; *FC of T v. Smith***

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Taxation Ruling TR 95/25 summarises the deductibility of interest like this...

*The deductibility of a loss or outgoing comprising interest under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) (formerly subsection 51(1) of the Income Tax Assessment Act 1936) depends upon satisfying the words of the section, that is, being able to show that the loss or outgoing (or the part of the loss or outgoing in an appropriate case of apportionment) is:*

- a) incurred by the taxpayer in gaining or producing assessable income of the taxpayer and the loss or outgoing is not capital, or of a capital, private or domestic nature ('first limb'); or*
- b) necessarily incurred by the taxpayer in carrying on a business for the purpose of gaining or producing assessable income of the taxpayer and the loss or outgoing is not capital, or of a capital, private or domestic nature ('second limb').*

*The cases clearly indicate that whether or not a loss or outgoing incurred by a taxpayer satisfies the requirements of section 8-1 is dependent on all the facts and matters relating to the loss or outgoing incurred by the taxpayer in question. However, the following general principles are relevant to the question whether interest is deductible under section 8-1:*

- a. *The interest expense must have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income and not be of a capital, private or domestic nature. The test is one of characterisation and the essential character of an expense is a question fact to be determined by reference to all the circumstances.*
- b. *The character of interest on money borrowed is generally ascertained by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower. However, regard must be had to all the circumstances, including the character of the taxpayer's undertaking or business, the objective purpose of the borrowing, and the nature of the transaction or series of transactions of which the borrowing of funds is an element. In some cases, the taxpayer's subjective purpose, intention or motive may be relevant in deciding the deductibility of interest.*
- c. *A tracing of the borrowed money which establishes that it has been applied to an income producing use may demonstrate the relevant connection between the interest and the income producing activity. Normally this would be the case for non-business taxpayers. It might also be the case where a business makes a specific borrowing which goes to the structure of the business - for example, where a business makes a large borrowing to fund an offshore acquisition.*
- d. *A rigid tracing of the borrowed money will not always be necessary or appropriate (e.g., where the borrowing finances the replacement of funds withdrawn from the business by a person entitled to be paid those funds). In such cases the relevant question is whether borrowed funds are being used to replace another source of funding for business purposes.*
- e. *Interest on borrowed funds will not be deductible simply because it can be said to preserve assessable income producing assets.*
- f. *Interest on borrowings will not continue to be deductible if the borrowed funds cease to be employed in the borrower's business or income producing activity.*
- g. *The interest will not be deductible, to the extent to which it is private or domestic in nature, or is incurred in relation to the gaining or production of exempt income.*

But this Ruling also covers the famous refinancing principal of Roberts and Smith...

### 3. Borrowing to fund repayment of moneys originally advanced by a partner and used as partnership capital

This Ruling states that interest on 'a borrowing to fund repayment 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.

However, interest on borrowings to replace partnership capital which is represented by internally generated goodwill or an unrealised revaluation of assets will not be deductible.

**Example 2: General law partnership**

*46. D borrows \$25,000 which is contributed as capital to a partnership.*

*47. Two years later, the partnership borrows \$25,000 to return D's initial capital contribution. The use of the repaid funds in D's hands will not be determinative of the deductibility of the interest to the partnership. At the time of the borrowing by the partnership, the \$25,000 previously contributed by D was being employed in the partnership's assessable income producing business. On these facts the interest expense will be deductible to the partnership as the borrowed funds can be seen to replace the partnership capital (see Roberts and Smith).*

*48. The funds borrowed by D are no longer invested in the partnership (an income producing asset). Whether or not D will continue to get a deduction for the interest expense on the original borrowings will depend on the use to which the funds returned to him by the partnership are put. If D uses those funds for a private purpose, then no further interest will be allowed.*

*49. If the amount borrowed by the partnership exceeds the partnership capital (e.g., if at the time of the second borrowing the partnership had repaid most of the capital) interest would only be deductible to the extent of the partnership capital attributable to the taxpayer.*

**Example 5: Company**

*54. A company runs a business to produce assessable income and it wants to reduce the entitlement of its shareholders to the real assets of the company (either by way of an agreement to buy back shares or otherwise reduce paid up capital, or by way of dividends from profits that arose from the company's income producing activities). It is short of liquid assets so it borrows funds which are intended to take the place of funds to be paid to the shareholders. In these circumstances the company has in effect replaced capital with debt. On the basis of the principles in Roberts and Smith the interest on the borrowing would be deductible to the extent that it replaced capital or realised gains which were used in the business to produce assessable income.*

4. Deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries

In Taxation Ruling TR 2005/12 the Commissioner considers the deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries. In it he states that the incurring of interest expenses by a trustee of a trust estate in respect of borrowed funds used by the trustee to discharge an obligation to pay a monetary distribution to a beneficiary will not, of itself, result in the interest expense being deductible. This is the case regardless of whether the borrowing of funds by the trustee allows income producing assets to remain part of the trust estate.

In order to be deductible, the interest expenses incurred by a trustee must be sufficiently connected with the assessable income earning activity, or business, carried on by the trustee as trustee of a particular trust estate. The interest expenses will be sufficiently connected if the purpose of the trustee in borrowing funds, when viewed objectively, is to refinance a 'returnable amount'.

Two examples of a returnable amount include;

- a beneficiary has an unpaid present entitlement to some or all of the capital of a trust estate, or some or all of the net income of the trust estate, and the amount to which the beneficiary is entitled has been retained by the trustee and used in the gaining or producing of assessable income of the trust; and
- a beneficiary lends an amount to the trustee who uses the money for income producing purposes (for example, by depositing it at interest in a bank).

Have a look at these examples:

***Example 3 - objective purpose of refinancing (discretionary trust)***

*39. In his capacity of trustee of the trust, the trustee of a trust with a discretionary power to advance moneys to objects of the trust runs a small business of importing handbags. A nominal amount was settled on the trust at the time of its creation. The trustee borrowed \$10,000 for use as working capital in the business. Under the trust deed, the trustee has a discretionary power to distribute some or all of the capital and/or the income of the trust estate to Mr or Mrs Zinc. On an annual basis, as a result of an exercise by the trustee of his discretionary power to distribute, Mr and Mrs Zinc each become presently entitled to 50% of the net income of the trust.*

*40. In previous years, Mr and Mrs Zinc each became entitled to a total of \$10,000 of undistributed income. Evidence shows that while Mr and Mrs Zinc are aware that they are presently entitled to a total of \$10,000, neither party has required payment of the amounts to which their present entitlements relate. The amounts have accordingly been retained by the trustee for use in the assessable income earning activities of the trust. The accounts of the trust, drawn up in accordance with generally accepted accounting principles, provide prima facie evidence that the unpaid amounts have been used for this purpose.*

41. In the 2002 income year, Mr and Mrs Zinc each call for payment of \$5,000 of their unpaid present entitlement. After reviewing the financial affairs of the trust, the trustee decides to refinance the amounts contributed by Mr and Mrs Zinc by borrowing \$10,000 from a bank rather than reducing the working capital of the business. The trustee's decision in this regard is reflected in relevant trust documents, including trust resolutions and the trust accounts.

42. The objective purpose of the trustee in borrowing \$10,000 was to replace amounts that previously had been provided by Mr and Mrs Zinc, and were used in the assessable income earning activities of the trust. Accordingly, the interest payable by the trustee on the loan is fully deductible.

**Example 4 - objective purpose of discharging an obligation to make a distribution (discretionary trust)**

43. In his capacity as trustee of a trust, a trustee runs a small business of supplying the equipment for the breeding of tropical fish. Under the trust deed, the business is to be carried on by the trustee for the benefit of Mr Tin and his family. Mr Tin is listed as the sole primary beneficiary of the trust in a Schedule to the trust deed. The listed secondary beneficiaries include Ms Tin, a cousin of Mr Tin. The trust deed gives the trustee a discretionary power to distribute some or all of the capital and/or the income of the trust estate to the primary and/or secondary beneficiaries of the trust.

44. A nominal amount was settled on the trust at the time of its creation. Subsequently Mr Tin, the driving force behind the business, settled \$100,000 on the trust for use as working capital in the business.

45. On 30 June 2002, the trustee exercises his power to distribute capital to Ms Tin making her presently entitled to \$5,000 of the capital of the trust. On the same day, the trustee borrows \$5,000 and distributes the amount to Ms Tin.

46. The trustee has not previously exercised his power to distribute in favour of Ms Tin, nor has Ms Tin provided any amount for use by the trustee in the assessable income earning activities of the trust<sup>[20]</sup> (for example, Ms Tin had never lent an amount to the trustee for use in the trust's assessable income earning activities).

47. Based on these facts, it is reasonable to conclude that the objective purpose of the trustee in borrowing \$5,000 was merely to discharge an obligation to make a distribution. The position of Ms Tin is conceptually no different to the position of the son considered in Hayden's case. Accordingly, the interest payable by the trustee on the loan is not deductible.

**Example 5 - objective purpose of refinancing (discretionary trust)**



48. *The corporate trustee of a trust with a discretionary power to advance moneys to discretionary objects of the trust runs a business of constructing and installing kitchens. In March 2000, the trustee sold a number of pre-CGT assets held by the trust, realising \$20,000. On 30 June 2000, the trustee exercised its discretionary power to make a distribution in favour of Mr Iron, making Mr Iron presently entitled to \$10,000 of the amount realised from the sale.*

49. *On the basis of an agreement reached with the trustee, Mr Iron leaves the amount to which he has become presently entitled in the hands of the trustee. On the basis of the trust's books of account (which have been drawn up in accordance with generally accepted accounting principles), the trustee can demonstrate that the unpaid amount was used to purchase specifically identified income producing assets.*

50. *In the 2002 income year, Mr Iron calls for payment of the \$10,000 amount to which he is presently entitled. Mr Iron intends to use the money to pay for an overseas holiday.*

51. *Rather than reducing the funds available to the business, the trustee decides to borrow to refinance the amount contributed by Mr Iron. This decision is reflected in the minutes of a meeting of the directors of the trustee. Following this decision, the trustee takes out a loan of \$10,000 and pays Mr Iron the \$10,000. The trust accounts show that Mr Iron's trust entitlements are reduced by \$10,000 and the lender is owed \$10,000.*

52. *The objective purpose of the trustee in borrowing the \$10,000 is to replace an amount (a returnable amount within the meaning of paragraph 5 above) that had previously both been provided by Mr Iron and used in the assessable income earning activities of the trust. Accordingly, the interest payable by the trustee on the loan is fully deductible. In these circumstances it is irrelevant that Mr Iron uses the payment for private purposes.*

53. *By way of contrast, if Mr Iron called for payment of the \$10,000 amount to which he is presently entitled on 5 July 2000, and the trustee borrowed that amount and discharged the present entitlement on 7 July 2000, the outcome would be different. In these circumstances the objective purpose of the trustee in borrowing the \$10,000 appears to be the discharge of the present entitlement rather than the replacement of an amount that had previously been provided by Mr Iron and used in the assessable income earning activities of the trust. As a result, the interest incurred would not be deductible in these circumstances.*

## 5. Deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities

In Taxation Ruling TR 2004/4 the Commissioner considers deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities.

Regarding interest incurred prior to assessable income the Commissioner states that interest incurred in a period prior to the derivation of relevant assessable income will be 'incurred in gaining or producing the assessable income' in the following circumstances:

- the interest is not incurred 'too soon', is not preliminary to the income earning activities, and is not a prelude to those activities;
- the interest is not private or domestic;
- the period of interest outgoings prior to the derivation of relevant assessable income is not so long, taking into account the kind of income earning activities involved, that the necessary connection between outgoings and assessable income is lost;
- the interest is incurred with one end in view, the gaining or producing of assessable income; and
- continuing efforts are undertaken in pursuit of that end.

Regarding interest incurred after assessable income the Commissioner states that where interest has been incurred over a period after the relevant borrowings (or assets representing those borrowings) have been lost to the taxpayer and relevant income earning activities (whether business or non-business) have ceased, it is apparent that the interest is not incurred in gaining or producing the assessable income of that period or any future period. However, the outgoing will still have been incurred in gaining or producing 'the assessable income' if the occasion of the outgoing is to be found in whatever was productive of assessable income of an earlier period.

Whether or not the occasion of the outgoing of interest is to be found in what was productive of assessable income of an earlier period requires a judgment about the nexus between the outgoing and the income earning activities.

An outgoing of interest in such circumstances will not fail to be deductible merely because the loan is not for a fixed term, the taxpayer has a legal entitlement to repay the principal before maturity, with or without penalty; or the original loan is refinanced, whether once or more than once.

However, if the taxpayer keeps the loan on foot for reasons unassociated with the former income earning activities; or makes a conscious decision to extend the loan in such a way that there is an ongoing commercial advantage to be derived from the extension which is unrelated to the attempts to earn assessable income in connection with which the debt was originally incurred, the nexus between the outgoings of interest and the relevant income earning activities will be broken.

And some examples

**Steele Case**

*The taxpayer owned a property on which she agisted horses and intended to construct and develop a motel facility. Ultimately the project fell through and the taxpayer sold the property and sought a deduction for interest costs of holding land. The Court held the interest was deductible even though the taxpayer did not derive assessable income from the operations for seven years that she held the property, absent some minimal agistment income.*

**Jones and Brown**

*The taxpayer was operator of a business that ceased trading two years ago. The business loan was taken out during the business. When the business ceased the owner sold all the assets and put them towards the outstanding loan but an amount still remained outstanding. The operator was not in a position to pay off the loan. The taxpayer continues to make interest repayments on this loan. The loan has not been extended or refinanced. In this case the interest will be deductible.*

**ATO ID 2002/1092**

*The taxpayer commenced a business through leased premises. After the business ceased the taxpayer defaulted on the rent and the lessor commenced legal action. After negotiation it was agreed that the taxpayer would pay the rent. To facilitate this payment the taxpayer took out a loan to pay the overdue rent and incurred interest. ATO ID 2002/1092 notes that no loan existed at the time of the business operation and therefore the interest expense has no direct relationship to the previous income earning activities and was not deductible.*

6. Is interest on a loan fully deductible when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others?

In Taxation Determination TD 2009/17 the Commissioner considers whether interest on a loan fully deductible under section 8-1 of the Income Tax Assessment Act 1997 when the borrowed moneys are settled by the borrower on trust to benefit the borrower and others? He states the answer is no as interest on a loan used to settle moneys on trust to benefit the borrower and others cannot be deducted.

And some examples:

**Example 1**

*Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

*Paul borrows \$1 million from a bank, in his own name, and settles it on the trust. The trustee issues 500,000 units to Paul and 500,000 units to Paul's wife. The trustee uses the \$1 million to purchase a rental property.*

*The trust deed provides that unit holders are entitled to a proportionate share of the income of the trust based on their unit holdings.*

*The units Paul and his wife acquire are redeemable at the trustee's discretion. The units are redeemable for an amount equal to each unit holder's proportionate share of the trust fund, calculated by reference to the net asset value of the fund as at the date of redemption.*

*Only 50% of Paul's interest expense is deductible (see paragraph 44 of this Determination). The terms of the trust indicate that Paul has used the borrowed money, in part, to benefit his wife and, in part, to acquire an interest in the trust which is likely to be productive of assessable income.*

### **Example 2**

*Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.*

*Paul borrows \$1 million from a bank, in his own name, and settles it on the trust. The trustee issues 1 million units to Paul. Paul's wife and children are also beneficiaries of the trust. The trustee uses the \$1 million to purchase a rental property.*

*The trust deed provides that the trustee holds the income of the trust for the benefit of the unit holders at the end of the accounting period. The deed also provides the trustee with a discretion to appoint realised capital gains amongst Paul, his wife and his children.*

*The units Paul acquires are redeemable at the trustee's discretion. The units are redeemable for an amount equal to the sum Paul settled on the trust. Any remaining trust capital is held for the benefit of the other beneficiaries.*

*Paul's interest expense is not deductible in full. The terms of the trust indicate that Paul has used the borrowed money, in part, to create a fund for the benefit of his family. Accordingly, some of Paul's interest expense will not be incurred in gaining or producing his assessable income.*

*Because Paul has also used the borrowed money to acquire income producing units for himself, part of the interest expense will be deductible. An apportionment calculation is therefore required (see paragraph 45 of this Determination).*

## **7. Deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities**

In Taxation Ruling TR 2000/2 the Commissioner considers the deductibility of interest on moneys drawn down under line of credit facilities and redraw facilities.

**Regarding lines of credit**, where interest accrues periodically on the outstanding balance of a mixed purpose line of credit sub-account, the deductibility of accrued interest is determined by considering the application of the borrowed funds for income producing and non-income producing purposes. The original application of the borrowed funds will not determine deductibility where funds borrowed under a line of credit facility have been recouped or withdrawn from the original use and are reapplied to a new use, e.g., upon sale of an asset purchased with borrowed funds.

Where borrowed money applied to a particular use is recouped and redirected to another use, it is necessary to examine that new application of those borrowed funds in considering the deductibility of interest. Where there are changes in the use of money borrowed under a line of credit facility, or in the amount of borrowed money used for a particular purpose, the deductibility of the interest accrued on that part of the outstanding debt will be determined by considering the advantages sought from that new application of those funds. Interest will be deductible under section 8-1 to the extent that it is incurred on that part of the outstanding borrowed money used at that time for an income producing purpose.

**Regarding redraw facilities**, the deductibility of interest on a further borrowing of money under a redraw facility depends upon the use to which the redrawn funds are put.

Where the original borrowing is for non-income producing purposes and the taxpayer uses the redrawn funds wholly or partly for income producing purposes, that part of the accrued interest attributable to the redrawn funds used for income producing purposes is deductible.

Similarly, where the original borrowing is for income producing purposes and the taxpayer uses the redrawn funds wholly or partly for non-income producing purposes, that part of the accrued interest attributable to the redrawn funds used for non-income producing purposes is not deductible.

Where a taxpayer uses redrawn funds for a different purpose to the original borrowing in circumstances, the loan account becomes a mixed purpose account and the same principles discussed above in relation to mixed purpose line of credit sub-accounts will apply to the mixed purpose loan account. There is an ongoing need to apportion interest on a mixed purpose loan account. That apportionment needs to be made on a fair and reasonable basis. Subsequent repayments are apportioned between the outstanding debt used at that time for income producing and non-income producing purposes.

And one example:

*Barry has a line of credit with the XYZ Bank. His credit limit is \$100,000 and when that facility is established on 1 April he draws down \$80,000 to invest in income producing shares. Barry's net salary of \$4,000 per month is paid directly into the line of credit account on the last day of the month and interest and charges are debited*

on the same day. Barry redraws \$2,000 per month on the first day of the month for living expenses. On 30 April, Barry makes a lump sum repayment of \$20,000 from the proceeds of the sale of a private yacht, in addition to the \$4,000 repayment from his salary. On 1 June, Barry draws down a further \$20,000 for home renovations, in addition to the \$2,000 draw down for living expenses.

Date	Borrowings and Interest	Payments	Account Balance	Income Portion (see below)	Non-income Portion (see below)
1 Apr	80,000		80,000	80,000	NIL
30 Apr	400	24,000	56,400	56,400	NIL
1 May	2,000		58,400	56,400	2,000
31 May	292	4,000	54,692	52,819	1,873
1 Jun	22,000		76,692	52,819	23,873
30 Jun	383	4,000	73,075	50,328	22,747

The repayments of \$20,000 and \$4,000 made on 30 April first pay the accrued interest of \$400 and then reduce the outstanding principal used at that time for income producing purposes to \$56,400.

The interest of \$400 accrued in April is wholly attributable to borrowed funds used for income producing purposes and is therefore fully deductible.

The \$4,000 repayment on 31 May first pays the accrued interest of \$292 and then proportionately reduces the outstanding principal used at that time for income producing purposes and for non-income producing purposes. The proportionate reduction in the outstanding principal attributable to income producing purposes will be  $\$3,708 \times 56,400/58,400 = \$3,581$ , giving a balance of the outstanding principal used for income producing purposes at that time of \$52,819. The proportionate reduction of principal attributed to non-income producing purposes will be  $\$3,708 \times 2,000/58,400 = \$127$ . The balance of the outstanding principal used for non-income producing purposes at that time, therefore, will be reduced by \$127 to \$1,873.

The interest of \$292 accrued in May is related partly to the outstanding principal used that month for income producing purposes and partly to the outstanding principal used that month for non-income producing purposes. The amount of interest Barry can claim as a deduction for May is calculated as:

$$\begin{aligned}
 & 292 \times \text{deductible interest percentage} \\
 &= 292 \times ((56,400 + 52,819)/(56,400 + 54,692)) \times 100 \\
 &= 292 \times 98.3\% \\
 &= 287
 \end{aligned}$$

Barry can claim a deduction of \$287 for interest for the month of May.

The borrowings on 1 June of \$20,000 for home renovations and \$2,000 for living expenses were for non-income producing purposes. The outstanding principal used

*for non-income producing purposes at 1 June will, therefore, be \$1,873 (see paragraph 33 above) + \$22,000 = \$23,873.*

*The \$4,000 repayment on 30 June first pays the interest accrued that month of \$383 and then proportionately reduces the outstanding principal used at that time for income producing purposes and for non-income producing purposes. The proportionate reduction in the outstanding principal used at that time for income producing purposes will be  $\$3,617 \times 52,819/76,692 = \$2,491$ , giving a balance of the outstanding principal used at 30 June for income producing purposes of \$50,328. The balance of the outstanding principal used for non-income producing purposes at 30 June will, therefore, be reduced by \$1,126 to \$22,747.*

*The interest of \$383 accrued in June is related partly to the outstanding principal used that month for income producing purposes and partly to the outstanding principal used that month for non-income producing purposes. The amount of interest Barry can claim as a deduction for June is calculated as:*

$$\begin{aligned} & 383 \times \text{deductible interest percentage} \\ &= 383 \times ((52,819 + 50,328)/(54,692 + 73,075)) \times 100 \\ &= 383 \times 80.7\% \\ &= 309 \end{aligned}$$

*Barry can claim a deduction of \$309 for interest for the month of June.*

#### 8. Deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee

In Taxation Determination TD 2018/9 the Commissioner considers the deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee.

He states that 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.

It is only where:

- the beneficiary is presently entitled to income of the trust estate at the time the expense is incurred, and
- 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