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AUSTRALIAN TAX ADVISER

2106: MARCH 2021

Tony Westhuysen

Principal, Solutions in Taxation

INFORMATION EXCHANGE CORPORATION

L17, 40 Mount Street,
North Sydney NSW, 2060

E: admin@ifx.com

T: 61 2 9956 7775

W: www.ifx.com.au

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IN THIS ISSUE

Continued

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IN THIS ISSUE

SECTION 1 — PROFESSIONAL DEVELOPMENTS

USE OF DISCRETIONARY TRUSTS — SOME CAUTIONARY ADVICE

Discretionary trusts remain the preferred vehicle for both asset protection and tax minimisation, however, when considering the use of these vehicles in tax effective structures, there are some issues to consider.

¶6.1 Discretionary trusts and borrowings

The recent AAT case of *Chadbourne and FCT*[1], highlighted the difficulty of securing a tax deduction for interest on money borrowed and on-lent to a discretionary trust. The Commissioner denied these interest deductions because s 8-1 says you cannot claim deductions unless they gain or produce assessable income. Where the income consists of discretionary trust distributions, the necessary 'nexus' between the loss or outgoing (interest expense) and the possibility of a discretionary trust distribution does not exist.

This case represents an all too common scenario where the taxpayer and his wife borrowed money to finance the purchase of income-producing investments. On the advice of an accountant and lawyer, the taxpayer purchased an property in the name of a discretionary trust, which he controlled. These loans were subsequently refinanced, but remained in the name of the taxpayer. Shares were also purchased and sold in the name of the trust, not the taxpayer.

The primary issue which formed the basis for the Commissioner's contentions was that there was no nexus between the interest expense incurred by the taxpayer and his wife, and the assessable income derived from the investment properties and the shares.

The taxpayer argued that the motive for purchasing the investment properties and shares was to generate income and profits, therefore deductions for interest, despite being incurred personally, should be allowed as they were associated with the income-producing assets of the trust.

The taxpayer thought that he could claim a deduction for the interest expense against the income derived by the trust, however in reality the interest expense was claimed against the distribution of income the taxpayer received from the trust, not income derived by the taxpayer.

The taxpayer had not derived the assessable income for the purposes of the Income Tax Assessment Act, he had merely been the recipient of a discretionary distribution of trust income. This was a subtle difference that was sufficient to sever the nexus between the income and the expense and ultimately deny the taxpayer a deduction he would have otherwise been able to claim. Had the interest expense been incurred by the trust, or had the income-producing assets been held in his name, a deduction may have been allowed.

The decision in this case highlights a common issue faced by advisers where a client fails to understand or acknowledge the distinction between entities they control and their personal funds. It is an extremely common scenario where the beneficiary of a discretionary trust which they control enters into a loan or establishes a

1 [2020] AATA 2441