

# Using a Hybrid Discretionary Trust to acquire income-producing assets

Following two recent Taxpayers Alerts issued by the Commissioner, a great deal of caution needs to be exercised in establishing and operating Hybrid Discretionary Trusts.

## What is a Hybrid Discretionary Trust?

A Hybrid Discretionary Trust may take many forms and there is no standard definition. Nevertheless, the most common form of this type of vehicle is a discretionary trust, the trustee of which has the power to issue units that encompass various rights. Those units, normally described as “income units”, give their holders an entitlement to certain proportions of the net income (ordinary and statutory income including capital gains) of the trust. If the units are redeemed, the trust reverts to being a discretionary trust.

Although numerous variations exist, the Hybrid Discretionary Trust described above is the most common and is the version dealt with here.

## Common uses of Hybrid Discretionary Trusts.

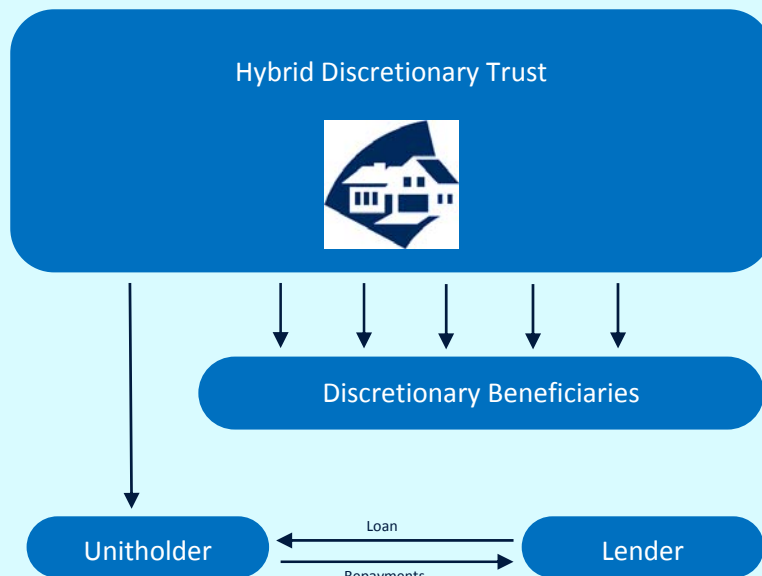
Hybrid Discretionary Trusts are predominantly used for the acquisition, holding and protection of income-producing assets. The most common reason for doing so is to enable an individual to utilise borrowed funds to acquire units in the trust, and to consequently receive a portion of the trust income and claim deductions for the interest expenses incurred.

Although companies and superannuation funds also acquire units in Hybrid Discretionary Trusts for investment purposes, this document only addresses arrangements whereby individuals do so by undertaking borrowings.

### Important Issues

In order to be entitled to deductions for interest expenses they incur, geared income unitholders must:

- be in the same position they'd be in if they held the underlying asset directly;
- be entitled to both the ordinary income of the trust and its capital gains; and
- have their units redeemed at amounts reflecting the market value of the underlying asset.



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### Alternative uses for Hybrid Discretionary Trusts

Hybrid Discretionary Trusts have many uses, in addition to allowing individuals to reap the tax and asset-protection benefits of making negatively-gearred asset acquisitions. For example, it may be that a trustee wishes to raise additional funds from a company, individual or another trust that does not undertake a borrowing itself. In that instance, the new unitholder's entitlements may include distributions of the ordinary income of the trust plus an amount for inflation, or to the capital gains of the trust and not any of its ordinary income. Hybrid Discretionary Trusts have various uses, and professional advice should be sought before any transactions are entered into.

### The MGS Hybrid Discretionary Trust

The provisions of MGS Hybrid Discretionary Trusts do not contain any of the features that the Commissioner has described as offensive in taxpayer Alerts. In particular, the income unitholder is entitled to that proportion of the net income of the trust (ordinary and statutory income including capital gains) which is reasonably attributable to their investment. This right cannot be defeated, including by way of accumulation. Importantly, units should always be acquired and redeemed at amounts that reflect the market value of the underlying asset - if they aren't, the CGT "market value substitution rules" will apply in calculating any tax liability.

### Problems with Hybrid Discretionary Trusts

Realistically, Hybrid Discretionary Trusts are not without their shortcomings, in the same way that all other types of vehicles, entities and structures have one form of problem or pitfall or another. However, knowing these issues allows for planning to avoid what is sometimes unintended consequence. As with all types of unitised trusts, there is a potential double incidence of CGT with a Hybrid Discretionary Trust, which occurs when units are redeemed prior to the disposal of the underlying asset – CGT events occur when the units are redeemed as well as when the underlying asset is disposed of. To avoid this problem, seek assistance from a professional advisor.

### The Commissioner's concerns

The Commissioner of Taxation has issued Taxpayers Alert TA 2008/3, to voice a number of concerns he has in relation to certain features of some Hybrid Discretionary Trusts. The particular features which the ATO appears to have the most difficulty include:

- an ability to defeat a unitholder's entitlement to receive distributions of fixed proportions of trust income and capital gains;
- a unitholder not being entitled to receive distributions of trust capital gains at all;
- interests or entitlements being conferred upon associates of a unitholder for less-than-market-value consideration;
- a unitholders entitlement to receive distributions of the trust ordinary income being less than what it should be, meaning that they've borrowed to fund income to which other beneficiaries are entitled;
- a unitholder only being entitled to receive distributions of the trust capital gains;
- a unitholder's interest in the trust ending before the cost of their investment has been recouped;
- a unitholder redeeming their units at their purchase price or less than market-value; and
- units being purchased at an amount less than their market-value.

Many of the concerns of the Commissioner would not affect the majority of users of Hybrid Discretionary Trusts.

Interestingly, the Commissioner does not mention the "proportionate theory" in his Alert. The theory essentially provides that the distribution of a trust's capital gains will be in the same proportion as the distribution of its ordinary income. This is important, as it determines the entitlement of the unitholder to capital gains and the value of their units for redemption purposes.

The Commissioner has also raised a concern regarding distributions to complying superannuation funds, in Taxpayer Alert TA 2008/4. It is not the purpose of this document to discuss that particular Alert or the tax consequences of such distributions.

### Common misconceptions

There are many common misconceptions regarding Hybrid Discretionary Trusts. Some of these include that:

- a unitholder having an entitlement to trust income isn't entitled to trust capital gains. Quite simply, the net income of a trust includes both ordinary income and realised capital gains. Further, following judicial acceptance of the proportionate theory and the release of Practice Statement PS LA 2005/1 (GA), capital gains flow to beneficiaries in the same proportion as ordinary income;
- a unitholder not having an entitlement to trust capital doesn't have an entitlement to trust capital gains. Importantly, the capital (or corpus) of a trust is different to a capital gain. Corpus usually includes amounts settled on the trust, or amounts that don't form part of its net income (eg. depreciation). Restricting a unitholder's entitlement to capital or corpus doesn't restrict their entitlement to capital gains;
- where a deed provides that units are to be redeemed at value, they can be redeemed at the same price paid for their acquisition. As the majority of income units in Hybrid Discretionary Trusts provide for a proportionate distribution of trust income and capital gains, the value of the units must approximate the proportionate value of the underlying asset; and
- that, where a deed provides that the trustee may accumulate income, the unitholder may be defeated. Most deeds make such a provision, but also state that where units are on issue accumulation may only occur in respect of the remainder of the income.

### Hybrid Discretionary Trust/Unit Trust structure

Hybrid Discretionary Trusts are a good vehicle for investing in assets, where an individual is seeking to claim interest expense deductions and to simultaneously have the asset held in a trust. It is preferable to hold residential property in a unit trust, in order to enable an SMSF to become a unitholder at a later date. However, depending on its terms, a vehicle may be deemed to be a related trust and not of the type in which an SMSF can invest. Prior to acquiring any residential investment property, advice should be sought from a qualified accountant or lawyer.

### Abusive Hybrid Discretionary Trusts

Abusive Hybrid Discretionary Trusts may be those that purport to allow a geared unitholder to claim deductions for interest expenses incurred on loans to acquire units, but where the unitholder receives distributions of something less than what they would have if they'd invested in an asset directly.

Arrangements that cause offence usually have some common features, including that:

- units only give an entitlement to distributions of ordinary trust income and not capital gains;
- units can be transferred between associates, depending upon their tax circumstances, without any tax consequences;
- units can be redeemed prior to the disposal of the underlying trust asset without triggering a capital gain;
- a unitholder's entitlement to trust income reduces proportionally as the underlying trust asset's value increases; and
- that the trust has perpetual succession and is able to simultaneously deliver numerous tax efficiencies, including those relating to land tax and stamp duty.

Of course, these are only a few of the dangerous features identified to have the potential to jeopardise the ability of a geared unitholder to claim deductions for interest expenses incurred on loans to acquire units.

### References and Disclaimer

The following material should be read in conjunction with this document in relation to Hybrid Discretionary Trusts:

- Income Tax Ruling IT2684;
- Practice Statement PS LA2005/1 (GA);
- Taxpayer Alert TA2008/3;
- Taxpayer Alert TA2008/4;
- *Zeta Force Pty Ltd v. Federal Commissioner of Taxation* 98 ATC 4681; (1998) 31 ATR 277.

Disclaimer: Information contained in this document is of a general nature only and should not be relied upon in making a decision. Specific advice from a qualified professional should be sought.