Hybrids are being Spruiked Again!

A trust is either discretionary or fixed in the ATO's eyes anything in between is a charade. A chook on stilts is not a flamingo.

The cycle has come full circle, must be enough new players in the property market to make it worth promoting hybrid trusts again. I guess there is a whole new generation of property investors since hybrid trusts were squashed by the ATO over a decade ago. It has all been done before and soundly put to rest. There is no clever fix, no patented way. It is very clear.

There are basically two types of trusts. Those where the right to income and capital gains is fixed, where the beneficiaries are unit holders or specifically named such as bare trusts. Discretionary trusts on the other hand give the trustee a right, to decide how the profits or capital gain is distributed, typically referred to as family trusts.

The Trap

A hybrid attempts to take the good points of both but in truth they are very very dangerous and can end up with a property owned in what the ATO considers a discretionary trust so the interest on the bank loan to buy the units in the trust is not tax deductible. Generally, the trust uses the money paid for the units to buy a property. If you get caught out this way the interest on the whole loan for the property will not be deductible at all. Neither in the trust or your personal tax return.

Starting off as fixed and changing to discretionary won't work either. That can trigger a capital gains tax event to the unit holder at the market value of the underlying property.

It is pretty straight forward really, the ATO considers that if a trust deed has any discretionary powers, then it is a discretionary trust. The only time a trust is considered a fixed trust is when the rights of the beneficiaries are clearly fixed. Once those rights are clearly fixed, changing them is a CGT event. If those fixed rights are only to the income from the asset bought with the money contributed for the units and someone else is entitled to the capital gain then not all of the interest on the loan to buy the units is tax deductible

Interest on money borrowed to buy units in a trust is only tax deductible if there is a fixed right to the income from the trust that represents your contribution. For example, if you are the only unit holder, the only funds contributor, then you must be entitled to all the profits of the trust. This will make the interest tax deductible because it is a cost of earning income. There is no splitting this right between capital and revenue.

You cannot have an arrangement where the unit holders only receive the income and then offset it against the interest hoping to negatively gear. Then when the capital growth is realised on sale this goes to someone else other than the unit holder. TR 95/33 clearly sets out that your investment, under these circumstances, is intended for the benefit of someone other than you so you will only be entitled to claim enough interest to cover the profit distribution you have received. This, by the way is the best case scenario. Anything else and the ATO will find that there is some discretion in the deed for the trustee to mess with distributions so it is really a discretionary trust meaning the interest is not tax deductible at all as it is settled on the trust not loaned to the trust.

If the prompter tries to point out finer points of difference, it is all smoke and mirrors, a way of confusing the issue. The bottom line is they are claiming the trust has the ability to give you a loss in your tax return but not the capital growth. For this to be the case there either has to be some discretion by the trustee so a discretionary trust, no interest deduction. Or the borrowed money is used in part for some other purpose than producing income so the interest is not fully tax deductible. Or a CGT event, at market value, happens to transfer the asset before the capital gain is made.

Spruikers may tell you, no, we have got around that by the unit holder rights coming to an end or transferring the units. Any attempt to dissolve the rights of the unit holders is a capital gains tax event with the deemed gain being the market value of the underlying assets. So this old switcheroo is just going to trigger all the capital growth on the property anyway, taxable in the unit holder's hands.

The spruikers may tell you that they have a patent, big deal. What you need is an ATO ruling saying that your really can do what they claim. If they produce this ruling and some have a ruling. Read the fine print, you will find the ruling does not actually describe what you think you are getting. Or it does actually state that there is a CGT event when the rights attached to the units alter, they are just hoping you don't understand what that means.

Another issue to consider is if the property is owned in the name of the trust how can it be security for the loan to buy the units in your name? This means that you would need to secure the loan elsewhere which is certainly going to reduce your borrowing capacity.

Flexibility and Asset Protection

If you catch the spruiker out on all this, they will still say something along the lines of well at least it gives you maximum flexibility and asset protection etc.

Flexibility as explained above is a discretion so no deduction for interest on money borrowed outside the trust unless on lent to the trust at a higher interest rate, therefore no negative gear.

As for asset protection, that is about keeping assets out of your name in case you are sued. But you still own the units that give you all rights to the property so your creditors will receive the units instead and still get the property. If a tenant in the property sues you then yes there is some protection if the property is owned in a trust rather than your name. This is the case whether the trust is fixed or discretionary and certainly does not require an expensive hybrid deed. It should be noted that your basic trust deed only costs a few hundred dollars.

Now to the Detail

Extract from TR 95/33 https://www.ato.gov.au/law/view/pdf/pbr/tr1995-033.pdf

4. However, if the outgoing produces no assessable income, or the amount of assessable income is less than the amount of the outgoing, it may be necessary to examine all the circumstances surrounding the expenditure to determine whether the outgoing is wholly deductible. This may, depending on the circumstances of the particular case, include an examination of the taxpayer's subjective purpose, motive or intention in making the outgoing.

6. If it is concluded that the disproportion between the outgoing and the relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective (e.g., to derive exempt income or the obtaining of a tax deduction), then the outgoing must be apportioned between the pursuit of assessable income and the other objective: see Fletcher at 91 ATC 4957-8; 22 ATR 621-3

In Case 2/2008 2008 ATC the AAT held that interest payments on loans taken to purchase units in a hybrid trust were not deductible. “Under the trust deed, the beneficial interest in the fund was divided into the unit component (held on trust for unit holders) and the discretionary component (held on trust for discretionary beneficiaries). The trustee could, in its absolute and uncontrolled discretion, determine the proportion of either component. The discretionary powers of the trustee applied to a wide range of amounts, including income, profits and capital gains or losses. The trustee could make decisions as to whether any such amounts were capital or income, and whether expenses were to be paid out of capital or income.”

Imagine that, no interest deduction for the whole time you owned the property yet the rent was assessable.

TD 2009/17

https://www.ato.gov.au/law/view/document?Docid=TXD/TD200917/NAT/ATO/00001

32. (f) The taxpayer's units do not give the taxpayer an entitlement to all of the benefits which may reasonably be expected to be produced by the asset(s)

TD 2009/17 is the ATO's ruling on hybrid trust deeds. As expected the ATO have basically said that the unit holders must receive all the benefits from the investment of the borrowed money to be able to claim all the interest as a tax deduction. Further, it is not just a matter of what is received it is a matter of what the trust deed says. So, if for example the deed says that the units can be redeemed by the trustee for the original price paid then the trust is caught ie interest not deductible, even if the units are never actually redeemed.

This means if you have already bought a property in a hybrid trust that has a plan to redirect the capital gains further down the line you will not be entitled to a deduction for the interest just because the deed gives you that option even if you never use it. Something to be very concerned about if you are buying even a standard unit trust deed from a solicitor who uses a one size fits all approach.

Clauses to watch out for

- The units carry no entitlement to capital gains
- The units only carry an entitlement to part of the income produced by the money invested
- The units can be redeemed by the trustee for less than the market value of the underlying assets
- The units only carry an entitlement to the capital gain
- The units expire

Conclusion

To confuse the issue, there are all sorts of variations of Hybrid trust deeds. I have yet to find a deed that allows any more tax advantages that personal ownership, fixed trust or discretionary trust, depending on what your needs are. All of these options are cheaper than a hybrid anyway. Further, you take the risk of an ATO attack. All trust tax returns have to answer a question as to whether they are a hybrid trust, so you won't slip under the radar.

I once rang a solicitor whose trust deed I was reviewing. I said this looks to be exactly the same as the deed in a recent ATO ruling saying it was not effective for tax purposes. The response was, yes that is our deed we made that application. So, I asked, why are you still selling these deeds? The response was, we put a disclaimer on our advice that the client should seek the advice of an Accountant before using the deed!

If I have still not convinced you please seek the advice of an Accountant who is aware of TD 2009/17 but of course they will need to read the deed so you are going to have to pay for it anyway before you can get said advice. Its an arrangement Telstra would be proud of.