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Hybrid trusts

What is a hybrid trust? Why are they becoming more popular? And is it a structure that's right for you? **Dale Gatherum-Goss**

WHILE the basic concept of a hybrid trust has been around for some time, it's only over the past 10 to 15 years that they've become more widely known and used. Hopefully, this article will give you more of an insight into hybrid trusts. However, I apologise in advance for my bias, as I use a hybrid trust for my own investing and am comfortable recommending them in the right circumstances.

A hybrid trust is a cross between a discretionary trust (often known as a family trust) and a unit trust. Hybrid trusts have features of both trusts and are sometimes known as class trusts, among other names. To make matters a little more confusing, we have hybrid discretionary trusts and hybrid unit trusts but for the sake of this article, my mention of a hybrid trust refers to a hybrid discretionary trust, as it's my view that this type of trust provides better flexibility and assurance of tax benefits.

A hybrid trust is principally designed as an entity used to own wealth creation assets, such as property, while allowing the individuals to benefit from negative gearing on their income tax return.

A family trust is a good entity to own investment assets because of:

- its asset protection features,
- its flexibility to reduce income tax through being able to claim more expenses than an individual can, and,
- its ability to distribute the net income of the trust between family members at the lowest rates of tax possible.

However, a family trust doesn't allow an individual to benefit from negative gearing because of the discretion the trust has to distribute its profit to any beneficiary of the trust. This is why trusts are considered not as attractive as holding assets in your own name to some investors and advisors.

This discretion as to who can benefit from the income of the trust is a problem in tax law. It means an individual can't borrow money on behalf of the trust and claim a tax deduction for the interest because that individual isn't *absolutely entitled* to the income of the trust.

You see, for an expense to be tax deductible it must be incurred in earning your income – not earning a potential income at the discretion of someone else.

However, with a hybrid trust, the individuals borrow money to buy the "special income units" in the trust which entitle the individual to the income that the trust earns. This entitlement to the income is sufficient to enable the individual to claim the interest on the loan used to buy the units in much the same way as they could if they bought shares on the stock exchange to benefit from the dividends paid on those shares.

A hybrid trust can also be used as either a hybrid trust (when it issues special income units) or as a family trust (when it has no units issued at all). Therefore, at a later stage in your investing life, when the assets of the trust produce positive cash flow, it's possible for the trust to buy the units back from you at their market value and revert to a family trust where it can distribute the income to any of the beneficiaries instead of just to the unit holder. This provides added flexibility.

> **Typically, you can expect to pay between $2000 and $3000 for a hybrid trust to be created...**

Should everyone use this structure?

Absolutely not! To start with, a trust (any type of trust) isn't necessary for owning properties.

It's merely an option that some people consider when their intention is to build a good sized portfolio of wealth-producing assets and they're conscious of the need for asset protection and flexibility.

After all, the value of the properties in your portfolio in 10, 20 or 30 years from now will be significantly different from what it is now and, accordingly, the income these assets produce for you will also change significantly over time. So the more flexibility you have to manage your portfolio, the better you'll be able to reduce your tax.

As a rule of thumb, I'd suggest that if you only intend on owning a small portfolio for the tax benefits of negatively gearing your investments then a hybrid trust may be unsuitable for you, given the extra costs and obligations they impose on the investor.

However, if you intend on buying a large portfolio of investments and still wish to benefit from negative gearing then a hybrid trust is something you may wish to consider after careful investigation and due diligence.

Pros and cons

The major benefits of a hybrid trust have already been stated earlier: asset protection, flexibility, and the ability to claim negative gearing advantages individually while owning the investments inside a trust structure.

The downsides to using a hybrid trust are also worth considering. They are:

COSTS. The costs involved in establishing and maintaining such a structure. Typically, you can expect to pay between $2000 and $3000 for a hybrid trust to be created for you, inclusive of a trustee company and stamp duty on the creation of the trust. Ongoing costs include ASIC (Australian Securities and Investments Commission) fees of about $212 per annum and increased accounting fees to prepare and lodge financial statements and income tax returns on behalf of the trust.

INCREASED LAND TAX. This applies in some states and territories. While a trust, or even multiple trusts, used to be attractive in avoiding land tax by having ownership of multiple properties split between the trusts with each trust taking advantage of the land tax free thresholds, this is no longer the case in Victoria and New South Wales, in particular. It's also quite conceivable that other states will follow suit in a bid to increase their revenue, if for no other reason.

TAX OFFICE DISAGREEMENT. The potential for the Tax Office to disagree and not allow tax deductions for an individual due to: changes in tax law; disagreeing with how tax law should be interpreted; and a poorly worded trust deed being used that provides the trust with discretion to distribute income to beneficiaries other than the special income unit holders.

To explain this further, you should understand that not every accountant or solicitor would agree that an individual can benefit from negative gearing using a hybrid trust, as they have interpreted the law differently and operate on a more conservative basis than others.

So, it's clear a hybrid trust isn't a perfect structure for everyone, but if you wanted to investigate the idea further where would you go?

I would suggest a good start would be with your accountant or solicitor because they'll be able to set up the hybrid trust if you decide to go ahead with it. Just be careful with the wording of the trust deeds and ask the accountant or solicitor setting one up for you to ensure that you should be entitled to a tax deduction for the interest on the loans used to buy the units in the hybrid trust.

In my experience, the wording of some hybrid trust deeds provides too much discretion and could therefore fail in a review or audit by the Tax Office, thus causing much grief and financial stress.

The following are questions I would encourage you to ask of yourself and your advisors if you're contemplating using a hybrid trust for your investing portfolio:

- How would a hybrid trust help me as an investor?
- What do you know of the Tax Office's thoughts on hybrid trusts?
- What about your trust deed makes it good to use and are you comfortable that it would pass scrutiny by the Tax Office? Why do you believe this?

I hope this article has helped to explain a little more about what a hybrid trust is and how it's used by property investors.

Next month I'll explain in more detail how a hybrid trust works, along with examples to make it easier to follow and understand. ■

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FAQs

Q Can I transfer my existing properties into a hybrid trust?

A Unfortunately, while the answer is yes you can, the practicalities are that such a transfer would trigger both stamp duty and capital gains tax issues, and so the costs of doing so would be too prohibitive for most people. I suggest you leave them where they are and consider a trust only for future property investments if you still intend on buying quite a few more properties.

Q Has the Tax Office looked at hybrid trusts?

A Yes, it has. An accountant in Sydney, Nick Moustacas of Strategic Wealth Management, was good enough to share with me a copy of a private binding ruling issued by the Tax Office to one of his clients confirming that it was comfortable with the individual claiming the interest as a tax deduction. I'm also aware of other reviews performed by the Tax Office on hybrid trusts that have led to no action being taken.

Q If the hybrid trust entitles me to the income of the trust and not the capital, can I distribute the capital gains made by the trust to any beneficiary?

A No. When a trust deed refers to the capital of a trust it actually means the assets and equity in the trust and not the capital gains. For tax purposes, the capital gains made by a hybrid trust are actually defined as income and so must be distributed to the unit holder along with ordinary income.