

Dangerous times ahead for the unwary

The Tax Office is taking an aggressive stance on hybrid trusts in a move that could spell trouble for some property investors. **Dale Gatherum-Goss**

OVER the past six months we've seen the Tax Office issue a number of Private Binding Rulings (PBRs) that have disallowed all, or most, of the interest an individual would like to claim for buying the income units in a hybrid trust. At face value, this is a concern to anyone using, or considering, a hybrid trust. However, a closer look reveals the Tax Office has four major concerns with hybrid trusts. They are:

- that the trust deed allows the trustee to distribute income to the unit holder, or a related beneficiary;
- that the trust is allowed to accumulate income instead of distributing the income to the unit holder;
- that the trust

deed allows the capital gains made by the trust to be distributed to any beneficiary; and

- that the trust deed allows for units to be redeemed by the trust with no apparent capital gains tax (CGT) consequences for the unit holder.

What is immediately obvious is that the hybrid trust deed is either a part of the problem or a part of the solution. So any discussion about hybrid trusts needs to have the trust deed kept clearly in mind, as an inferior trust deed will fail the Tax Office scrutiny and cause heartache and the loss of part, or all, of the negative gearing advantages claimed as a benefit of this structure.

Accordingly then, a well-written trust deed, used and interpreted properly, will see fewer problems and should maintain the ability to keep claiming the interest on a loan used to acquire income units in a hybrid trust as a legitimate tax deduction.

When we look at these issues in more detail and explain why they're a problem, we see that the Tax Office's concerns are quite reasonable.

Too much discretion

In tax law, it's important for a clear nexus, or relationship, to exist between incurring expenses and the right to income as a result of incurring those expenses.

This is why a normal family trust

doesn't allow the individual to claim negative gearing advantages when that individual borrows money to enable a family trust to acquire an income-producing asset. The trustee has the discretion to nominate which beneficiary will benefit from the trust's income simply because that's the very nature of a family, or discretionary, trust.

In doing so, it's clear that the person borrowing money and incurring interest expenses has no clear right, or entitlement, to the trust's income and accordingly, they can't prove a direct nexus between the interest costs they wish to claim and the trust's income.

Sadly, in a similar way, we now see some hybrid trust deeds provide for the income of the trust to be distributed to the income unit holder of the trust or another beneficiary of the trust, related to the unit holder, and at the discretion of the trustee.

Or, we see that some inferior trust deeds allow the trustee to accumulate the income and not distribute it to the unit holder who should be entitled to receive the income from the trust each year.

Obviously, this level of discretion removes the certainty of the relationship between the interest costs incurred by the individual on the loan taken out to buy the units and the income that the trust earns. Accordingly, the Tax Office would be right to disallow negative gearing advantages with this type of hybrid trust deed.

A well-written hybrid trust deed will ensure all of the income earned by the hybrid trust from the assets acquired from the trust issuing special income units must be distributed to the unit holder and no-one else.

Capital gains

Similar to the problem above, some hybrid trust deeds allow for capital gains made during the year by the hybrid trust on the sale of its investments or from its managed fund investments to be distributed at the



end of the year to a beneficiary other than the special income unit holder.

In fact, naively, and quite worryingly, some accountants even promote this point as a perceived benefit of their form of hybrid trust over others.

Again, the wording of the trust deed and the way the trust's accountant interprets the trust deed will have a significant bearing on whether this issue works for you, or against you, in a Tax Office review.

As a special income unit holder, you must be entitled to the income of the trust derived from the assets acquired from your subscription to the units of the trust. Without this entitlement, the nexus between the costs incurred by you in interest paid on your loan won't be tax deductible. And the problem is that for a long time now, "income" for tax purposes includes capital gains.

We've seen arguments put forward that say the units are "special income units" and accordingly the capital gains made by the hybrid trust aren't income and don't need to be distributed to the unit holder.

Sadly, this isn't the case when a closer look at the definitions within our tax law are considered. Section 95 of the *1997 Income Tax Assessment Act* says: "net income, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions..."

And assessable income will, and does, include capital gains. So, the Tax Office's approach of disallowing tax deductions for interest paid on a loan used to acquire income units in a hybrid trust where the trust allows the capital gains made by the trust to be distributed to *any* beneficiary seems right when considered in light of accepted tax law.

A well-written hybrid trust deed will ensure all income (even capital gains) in relation to an asset acquired by the trust as a result of the income units being issued are distributed to the unit holder at the end of the financial year.

Of course, if there are no unit holders at the end of the year (because no special income units have been issued; or the special income units have been redeemed), then the trustee is free to distribute its net income (including capital gains) to any

beneficiary of the trust in accordance with the rules and conditions of the trust deed.

Capital gains on redemption of units

Again, the wording of the particular trust deed and the interpretations involved will make a big difference here.

Logically, you wouldn't borrow money to buy assets that paid you a rate of return lower than the costs you incur. That is, you wouldn't buy assets that paid you 3 per cent per annum when you had to borrow money at 7 per cent per annum to buy those assets, as you'd be losing money, and that's not clever.

However, you may do so when the capital growth of those assets compensated you for the short-term income loss, and it's this principle that enables Australians to negatively gear their property and share investments. The growth in the asset values over time, along with rising incomes over time, makes the asset worth buying from

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an investment perspective.

So, if you borrow money to acquire special income units in a hybrid trust it's only reasonable to expect to receive both an income from those units and a capital gain over time from holding those units. Otherwise, questions could easily be raised as to why you would invest in a related trust that might never return a realistic and commercial income on those investments.

This is a problem with some of the hybrid trust deeds found on the market now and again. It's only reasonable that the Tax Office denies tax deductions to the individual where the investment makes no commercial sense at all other than to produce a tax benefit.

Redemption of the special income units in a hybrid trust, then, should logically mean the units are bought back at their market value for tax purposes, regardless of the price paid for those units initially. This redemption will then trigger a CGT event

for the individual who subscribed to those special income units.

Conclusion

The Tax Office's scrutiny of hybrid trusts, along with its disallowance of interest claims, is likely to continue as long as we have promoters who seem to disregard common sense and accepted tax law in selling their products. So, you'd be wise to discuss your hybrid trust with your accountant in light of these points and ensure your trust deed is well written and understood by your accountant.

You may well have to:

- seek a PBR of your own, or
- consider a strategy of how to deal with a Tax Office review of your situation; and
- perhaps even replace the existing trust deed with one that passes the Tax Office's scrutiny if this can be legally done without causing problems.

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pain of repaying tax benefits and fines aren't worth the hassle, in my opinion.

Hybrid trusts aren't dead, as some misinformed people have claimed, but the authors of trust deeds do have to be smarter and those trust deeds need to be used more in accordance with the laws and not how we might like them to be. ■

For more information about hybrid trusts – what they are and how they work – see the January and February 2007 issues of API.

Dale Gatherum-Goss is a CPA and founder of Gatherum-Goss & Associates. He is also the author of *Trust Magic*.

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