How hybrid trusts work

Last month we explained what a hybrid trust is. This month we look at how hybrid trusts work. **Dale Gatherum-Goss**

NOT all hybrid trusts are the same. How each trust actually works is determined by the wording in that particular trust deed and by each accountant's interpretation of the rules and laws pertaining to the trust; and so I'll use a generic context for the sake of this article.

Let's assume you've already established a hybrid trust, had the trust deed stamped by the State Revenue Office and are ready to go.

Buying the investment property

You find a property for, say, $400,000 that will make an excellent investment and you decide to buy it. How do you sign the contracts?

In most states and territories, just using the trustee name is fine.

So, if your trust is known as Cloudbusting Pty Ltd as trustee for The Silver Lining Trust then you would merely have one or more of the directors of the trustee company sign the contract with the purchaser noted on the contract as: Cloudbusting Pty Ltd.

The minutes the trust keeps, along with the official accounting records of the trust, will note that the company is only acting in its capacity as trustee of the trust and not in its own right when buying the property.

However, it's a good idea for you to check this suggestion for the wording on the contract with your solicitor or conveyancer.

Sometimes the different states or territories can have differing rules that can cause potential problems for the unwary hybrid trust holder.

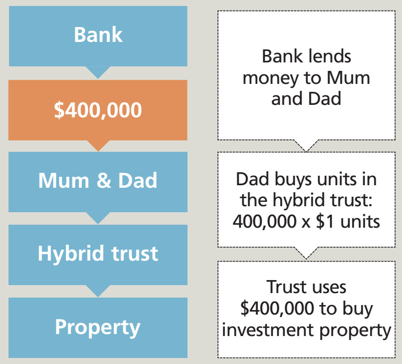
Financing the purchase

Although the trust is the legal owner of the property, it's important for the individuals who control the trust (mums and dads, in most cases) to borrow the money from the bank in their own names rather than under the name of the trust or the trustee company.

This is a potential trap for the unwary because if the loans are taken out by the trust or trustee company, then the trust must claim the interest and not the individuals. This means the negative gearing benefits associated with the use of a hybrid trust will be lost, despite the ludicrous claims made to the contrary by some ill-informed, yet high-profile mortgage brokers and accountants.

> *The Manager*
> *(insert name of lender)*
> *(insert address details)*
>
> *Dear Sir/Madam*
>
> *Further to our discussions, we now wish to apply for a loan of $400,000 as detailed below:*
>
> ***Name of Borrower:***
> *Mum and Dad*
> *1 Jones Street*
> *Jonestown Vic 3333*
>
> ***Purpose of Loan:***
> *To buy 400,000 x $1 units in The Silver Lining Trust. This trust will then use that money towards the purchase of a property at 2 Smith Ave, Smithtown without borrowings.*
>
> ***Security offered:***
> *A registered first mortgage over the property at 2 Smith Ave, Smithtown which has been valued at $400,000*
>
> *Thank you for your help and we look forward to hearing from you soon.*
>
> *Mum & Dad*

Diagram A: Purchase



I suggest you approach your lender and let them know that you're borrowing money in your own name to acquire the "special income units" in the trust which will then enable the trust to buy the investment property without the trust borrowing money at all.

Diagram A provides an outline of how this transaction would look.

The letter to the bank might look something like the example shown at left. Obviously, you can include more information about additional security offered and attach copies of deposits paid, contracts and other relevant documentation that the lender may need to process your application.

Accounting for it all

In your record keeping for the trust, you will show the trust buying the new property for $400,000 without any debt or borrowings at all. The other side to the accounting entry will show the trust issuing units to you for $400,000 in its equity section. All the normal transactions for an investment property remain pretty much the same (except for the interest and borrowing costs – which the individual claims in their own personal records), with the trust banking the rental income and paying the normal outgoings for an investment property from its own bank account.

It's also the trust that claims the depreciation allowances identified by a quantity surveyor as tax deductions.

As a simple example, this scenario might look like:

- Mum and Dad have borrowed $400,000 from a bank for Dad to buy the special income units in their hybrid trust at a rate of say 7.5 per cent.
- The trust has bought an investment property for $400,000 that receives $380 per week rent.

The trust might show the following result for a full year:

Rental income	$19,760
Less	
Agent's fees	$1,520
Council rates	$1,100
Depreciation	$4,500
Insurance	$420
Special building write-off allowance	$3,000
Water rates	$360
Total deductions	$10,900
Net profit	**$8,860**

This profit *must* then be distributed to Dad because he owns the units in the trust, entitling him to all of the net income of the trust in relation to this investment.

So, Dad's personal income tax return would look like this:

Income from hybrid trust	$8,860
Less, bank interest paid	$30,000
Less, bank fees paid	$120
Less, borrowing costs apportioned for the year	$550
Net loss	**$21,810**

And, as a result of this situation, Dad could expect to get a tax refund of about $6870 if he has an average salary and other income of between $25,001 and $75,000 for the 2007 financial year, taxed at 31.5 per cent.

Variation

If Dad wants, he's able to lodge a 15-15 variation each year to improve and better manage his cash flow shortfall from this investment.

It's this ability to refinance the investment loans that provides some of the greatest flexibility and advantages for the hybrid trust over other forms of structures.

A 15-15 variation is an application to the Tax Office to reduce the amount of tax deducted from your wages each week, allowing you to have your tax refund weekly rather than at the end of the year.

In later years

In future years the net profit of the trust will increase as the rental income increases with time and the depreciation claims reduce.

This will see more and more income distributed to Dad for him to declare in his own income tax return and the negative gearing tax advantages reduce, just as they would if the property were acquired in Dad's own name.

When this happens, it's common for people to buy another property within the hybrid trust, repeating the various steps noted earlier and using the increased equity in the trust's investment property to borrow against.

However, we also see people use one of the benefits of the hybrid trust in that they consider refinancing the loan.

Refinancing

At any point in time it's possible for the hybrid trust to go to a bank and borrow money against the security of this investment property to buy back the units it's issued to Dad, who in turn will repay his loan with the bank.

In taking out the new loan the hybrid trust will buy back its units and cancel them and when this happens:

- the trust will effectively revert to a traditional discretionary trust with all the usual flexibility of being able to distribute income to whomever it likes;
- the trust claims all future interest on the new loan, not Dad.

Diagram B: Refinancing

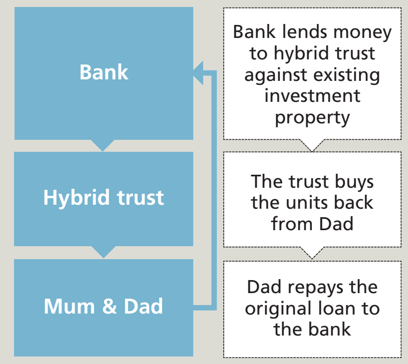


Diagram B provides an outline of how this refinancing transaction would work. In many ways, it's this ability to refinance the investment loans that provides some of the greatest flexibility and advantages for the hybrid trust over other forms of structures.

Doing it all again

Alternatively, Mum and Dad can always repeat this process of personally borrowing money from the bank to buy more units in the hybrid trust, for the trust to then go ahead and acquire further properties.

This allows Mum and Dad to continue to gain negative gearing tax advantages while the trust buys more investment properties and increases their overall wealth. ■

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