

# Hybrid Discretionary Trusts

What the ATO will accept

October 2023

Subject	Hybrid Discretionary Trusts
Topic	Deductibility of interest on borrowings to acquire Special Income Units
Alert Status	<b>High</b>
Legislation/Cases	Section 8-1 of the Income Tax Assessment Act 1997 Taxpayer Alert TA 2008/3 Taxation Determination TD 2009/17 Income Tax Ruling IT 2386 FC of T v Munro (1926) 38 CLR 153 Ure v FC of T (1981) 11 ATR 484 Forrest v FC of T (2010) ATC 20-163
More info	<p>MGS has worked with the Australian Taxation Office getting an understanding of what clauses and features need to be in a Hybrid Discretionary Trust so that the Special Income Unitholder is allowed a full deduction for the interest. A few important issues have come out of our discussions with the ATO including:</p> <ul style="list-style-type: none"><li>- The ATO considers all Hybrid Discretionary Trusts require amendment</li><li>- Care needs to be taken when amending so as not to cause a resettlement</li><li>- Those taxpayers who don't amend in line with the ATO view will have their returns amended to apportion the interest</li><li>- The ATO does not issue Private Binding Rulings for past years</li><li>- Those taxpayers that do amend their Trust Deed who have not undertaken offensive behaviour will not have their returns amended</li></ul> <p>We are able to amend any provider's Hybrid Discretionary Trust Deed to bring it into line with the ATO view without causing a resettlement.</p>

## Background

Hybrid Discretionary Trusts were a popular vehicle for investing in real estate over the last 10 to 15 years. In 2008 the ATO indicated their concerns with the release of a Taxpayer Alert TA 2008/3 which outlined arrangements where the ATO considered the interest deduction would be denied. Eventually, the ATO issued Taxation Determination TD 2009/17 which provides that interest will be apportioned where the borrowed moneys have been used to benefit both the taxpayer and others. The ATO amended the assessments of Andrew (Twiggy) Forrest and denied his interest deduction in full. Mr Forrest owned units in a hybrid trust which entitled him to all the income other than capital gains. The Full Federal Court found in favour of Mr Forrest and allowed the interest deduction in full. The problem with the case and how it was run by the ATO was that the question of apportionment was not considered. It is believed that the decision would have been different had the ATO argued apportionment instead of trying to deny his claim in its entirety.

## The ATO's concerns

The Commissioner of taxation issued Taxpayers Alert TA2008/3 and Taxation Determination TD 2009/17, to voice a number of concerns he has in relation to certain features of some Hybrid

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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 a trust capital gains at all
- interests or entitlements not 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
- units being purchased at an amount less than their market-value

Not all of these features exist in the majority of Hybrid Discretionary Trusts however the Commissioner considers any one of the above features to result in a need to apportion the interest of the Unitholder.

## Amending Hybrid Discretionary Trusts

Any amendment to a trust needs to be done with great care and knowledge of trust and tax laws. The risk of triggering a resettlement is very high and many other income tax, and stamp duty provisions may apply. For example, converting a trust into a unit trust triggers a capital gain (section 104.65 of the ITAA97, CGT Event E3) and making a beneficiary absolutely entitled to a trust asset, even where it is not transferred to the beneficiary, will also trigger a capital gain (section 104.75 of the ITAA97 CGT Event E5). Other CGT provisions that need to be considered include:

- Disposal to beneficiary to end income rights (s.104.80 of the ITAA97, CGT Event E6)
- Disposal to beneficiary to end capital interests (s.104.85 of the ITAA97, CGT Event E7)
- Disposal to beneficiary of capital of capital interest (s.104.90 of the ITAA97, CGT Event E8)

There are many other provisions in terms of what could go wrong when amending a hybrid discretionary trust. It is obviously more difficult where the deed splits revenue income and non-revenue income. We have discussed this with the ATO and have a way of amending those deeds with the different definitions of ordinary income and statutory income.

## What the ATO expects after an amendment?

The ATO says that the Special Income Unitholder will be entitled to a full deduction on interest expenses incurred on borrowed money used to acquire the units. The requirements to be entitled to the full interest deduction are:

- The Special Income Unitholder must be presently and absolutely entitled to a portion of the trust income attributable to the trusts use of their subscription monies

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- The above entitlement cannot be defeated by way of accumulation or otherwise
- The entitlement to income includes part of a year where units are redeemed part way through the year
- Redemption of Special Income Units entitles the holder to an amount with reference to the market value of the assets of the trust
- The Special Income Unit Holder is absolutely entitled to redemption
- There is a method to calculate the Special Income Unit holders entitlement should they hold Special Income Units on the vesting date

The ATO is also concerned with other factors concerning the use and administration of hybrid discretionary trusts. Macquarie Group Services will discuss these further issues with practitioners during the amendment of their clients' deeds.

### What Hybrid Discretionary Trusts will MGS amend?

Macquarie Group Services will amend hybrid discretionary trusts sold by the following companies:

- Chan and Naylor (Property Investor Trust™)
- Lawcentral
- Cleardocs
- JMA Legal
- Patricia Holdings
- Thrifty
- NTAA Corporate
- Espreon
- Companiesonline
- Onlinelegal
- Trustdeeds.com.au
- Reckon
- ACIS
- NCS Corporate Support
- Topdocs
- Binettervale
- Any other hybrid discretionary Trust

### The Macquarie Group Services amendment solution

The MGS hybrid discretionary trust solution includes a unique set of documents to put your firm and clients on solid ground with the Australian Taxation Office. MGS provides the following kit with amending your clients' hybrid discretionary trust:

- Deed of Variation
- A full copy of the PBR issued to Christopher Batten
- A copy of the Reasons for Decision issued to Christopher Batten
- An outline of the history of hybrid discretionary trusts
- A guide to what the amendments mean
- A guide to using the trust after the amendments

MGS can also provide trust deeds branded for your firm. This allows your firm to offer clients specialised advice and products - you are the experts. And as ASIC agents we can also assist with rapid Company Formation if a trustee company is required. We even offer a discount for a company + trust package.

### Bamford Compliant?

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MGS Discretionary trusts permit streaming to the extent of current tax law and have always complied with the Bamford decision.

## **We are innovators:**

- We developed the NSW Land Tax Unit Trust and hold a Ruling that proves it works
- We offer THREE unit trust 'control' options – Trusts *always* have different issues
- We offer a CONTROLLER option in all Discretionary Trusts – the ultimate independent safeguard
- We warned Treasury about the CGT problem in old SMSF Borrowings under s67(4A)
- We alerted NSW Practitioners to the NSW Duties problem in SMSFs
- Our SMSF has NO comparison. 10 kits plus a member wallet for one low cost
- Hybrid Discretionary Trust (Negative Gearing option) – ATO compliant to avoid disputes
- We can amend many problems:
  - o Unit Trusts to Land Tax Unit Trusts
  - o Amend many Hybrid Discretionary Trusts to encompass the Negative Gearing option
  - o Update any SMSF – 1, 10, 100 or more

## **Jump on-board & put us to the test**

1. No account applications for practitioners, no payment up-front. We invoice on delivery
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4. Customise all documents with your practice details for free
5. Try our services. Self-register for free at [www.macquariegs.com.au](http://www.macquariegs.com.au)
6. Call for advice and assistance (02) 9231 5111

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