

Hybrid Discretionary Trusts **2011 Update**

What the ATO will accept

The ATO has finally issued a Private Binding Ruling stating that a full deduction will be allowed for interest on borrowed funds to acquire special income units in a Hybrid Trust.

What is a Hybrid Discretionary Trust

A Hybrid Discretionary Trust may take many forms and there is no standard definition. Nevertheless, the most common form of this type of vehicle is a discretionary trust, the trustee of which has the power to issue units that encompass various rights. Those units, normally described as “special income units”, give their holders an entitlement to certain proportions of the net income (ordinary statutory income including capital gains) of the trust. If the units are redeemed, the trust reverts to being a discretionary trust.

Although numerous variations exist, the Hybrid Discretionary Trust described above is the most common and is the version dealt with here.

The Private Binding Ruling

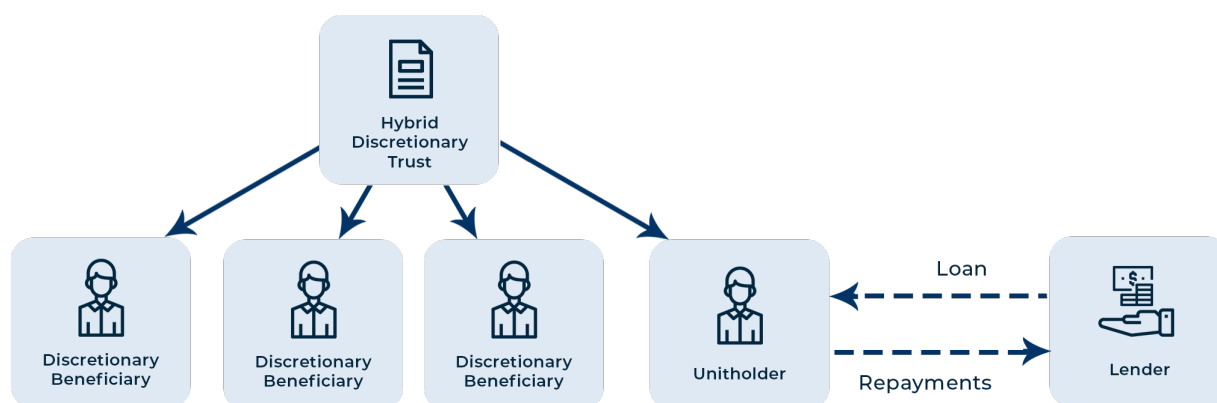
The Private Binding Ruling has been issued to one particular taxpayer and it is only that taxpayer that may bind the Commissioner to what is said in the PBR. The PBR states:

Question

Are you entitled to a full deduction for interest expenses incurred on borrowed money used to acquire Special Income Units in the Macquarie Group Services Trust (the Trust) under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997)?

Answer

Yes. A full deduction is available for the interest expense incurred in the circumstances described in this ruling.



Important Issues

In order to be entitled to deductions for interest expenses they incur, geared income unitholders must:

- be in the same position they'd be in if they held the underlying asset directly
- be entitled to both the ordinary income of the trust and its capital gains
- have their units redeemed at amounts reflecting the market value of the underlying asset

What the Private Binding Ruling says

The PBR 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
- 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 Unitholders entitlements should they hold Special Income Units on the vesting date

The ruling also assumes certain other factors including that no further amounts will be settled on the trust, the real estate will be leased to an arms-length third party, apart from the initial issue no further units will be issued to the unitholder. These issues are all relevant in maintaining the deductibility of the interest.

Problems with Hybrid Discretionary Trusts

Realistically, Hybrid Discretionary Trusts are not without their shortcomings, in the same way that all other types of vehicles, entities and structures have one form of problem or

pitfall. However, knowing these issues allows for planning to avoid what is sometimes unintended consequence. As with all types of unlisted trusts, there is a potential double incidence of CGT with a Hybrid Discretionary Trust, which occurs when units are redeemed prior to the disposal of the underlying asset - CGT events occur when the units are redeemed as well as when the underlying asset is disposed of. To avoid this problem, seek assistance from a professional advisor.

I have an MGS Hybrid Trust - What should I do?

If you established the MGS Hybrid Discretionary Trust prior to 2011 then you should have the deed amended so that it is in line with what is accepted by the ATO. Some features which formed part of the deed to which the ruling relates were only settled in 2011.

I have a Property Investor Trust - What should I do?

The Property Investor Trust is a particular hybrid discretionary trust developed by Chan & Naylor. Many of the clauses and features would not be acceptable to the ATO and therefore a full deduction in relation to any borrowing would not be allowed. Contact MGS for an amendment to bring the deed in line with what is accepted by the ATO.

I have another hybrid discretionary trust - What should I do?

The hybrid discretionary trust you have established should be checked and if necessary amended to bring it in line with what is acceptable to the ATO. The trust deed, application for units and unit certificates should be reviewed and where necessary amended.

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