



Is your hybrid trust an appropriate property investment vehicle?

By Garry Pammer, CA, BEc, LLB

Even ignoring all the structuring considerations of companies, superannuation funds and associateships, you can easily feel overwhelmed with the remaining choices recommended by your advisor within trust law i.e. standard discretionary, class discretionary, hybrid, fixed non-unit, income unit and fixed unit trusts to name a few!

Back in the January/February 2005 edition of *Australian Dental Practice*, Alison Lacey (nee Wagschall), an Associate within our firm, wrote an informative article concerning the particular use of hybrid trusts in holding real estate investments.

Recent Tax Office stance

At the outset of that 2005 article, Alison wrote that a common question asked by practitioners at the time was "what structure should an asset be purchased in to protect it from business or other legal risks?" Now in 2007, given the unfavorable views recently expressed by the Tax Office in a number of private binding rulings (PBRs), a common question being asked of us at present is "are hybrid trusts still a viable property investment structure?"

Our considered short answer is yes, hybrid trusts are still an appropriate structuring choice in certain scenarios. It is difficult to be exhaustive but in our own experience, provided you establish, manage and use a hybrid trust, working closely with both your legal and accounting advisors in tandem, then the end result should be an effective property investment structure that sits in close accordance with the tax laws and principles that the Tax Office has espoused in its recent PBRs.

So what is a hybrid trust?

Effectively, a "hybrid trust" is a combination of both a discretionary trust and a unit trust. For example, a hybrid trust may be non-discretionary for certain distributions of income and capital and discretionary for other income and capital distributions. Given the possible variations in the rights and restrictions between beneficiaries, hybrid trusts are therefore one of the most flexible investment vehicles in circumstances where borrowing is used to acquire an asset.

Given the ability to leverage real estate investments by borrowing between 80-105% of the value of the property, the use of hybrid trusts has become prevalent among property investors. Structured correctly, they can offer a beneficiary negative gearing benefits while also offering a greater level of asset protection than if the property was acquired directly by the beneficiary. Of course, negative gearing should first be determined to be an appropriate financial planning strategy for an investor.

How negative gearing works

Notwithstanding what the Tax Office position is, commonsense dictates that you would only borrow money to buy assets if the rate of return is higher than the costs you incur. In relation to real estate for example, you borrow money at 7-8% per annum (depending on how well you have borrowed) to buy a rental property that may yield you between 3-6% per annum (depending on how well you have bought). The money you are losing is the deductible negative gearing loss. On the face of it this is not a great short term investment strategy, notwithstanding that the tax deduction you derive could be as high as 46.5%.

So why does the Tax Office effectively partner you in this loss making venture by bearing up to 46.5% of your negative gearing loss? Essentially the Tax Office has no choice under existing legislation and interpretive case law. You, the taxpayer, are entitled to claim interest as a tax deduction to the extent it is incurred in gaining or producing assessable rental income even if the expenses exceed the income received in the early years of your property investment.

However, the deduction is available in the short term because there is an expectation that the negative gearing loss will diminish as the investment runs its natural course and positive income eventually emerges. Note that positive gearing is something that normally does emerge over time as rental yields increase while interest expense remains relatively constant. If interest only loans are used, positive gearing may take a little longer to emerge (unless you have bought very well) but it does still emerge in due course. In any event, the natural course of this gearing strategy also includes the capital gain that eventually crystallizes on the ultimate disposal of the property. Long term capital growth in excess of 8% per annum compensates for the period that rental yields have been outstripped by interest rates.

So rising positive net income and/or growth in asset values, over time, makes for a great long term investment strategy which sits well with both investors and the ATO.

How a hybrid trust works

The above investment and tax analysis should hold true whether the short term negative gearing loss is achieved through direct ownership of real estate or indirect ownership by investing in a hybrid trust.

For example, you own a dental practice and have a 46.5% marginal tax rate. You are a sole trader and have a level of business risk. You identify a \$1 million investment property with excellent rental yield and capital growth prospects.

In choosing to invest via your hybrid trust you:

- Borrow \$1 million from the bank to buy units in the hybrid trust;
- The hybrid trust uses this \$1 million cash injection to buy the property;
- The bank secures its \$1 million loan to you by way of a mortgage over the hybrid trust's property.
- The trust receives rent and pays all landlord expenses. The net income is distributed to you, as unit holder, enabling you to service your loan. Insofar as the interest expense on your borrowings will exceed the net rental income received from the hybrid trust, a deductible negative gearing loss emerges.

During the course of the hybrid trust investment strategy, your interest expense will diminish and your overall taxable investment income stream will become positive. Ultimately, the hybrid trust may refinance the property, redeem your units and continue to hold the investment. Future income distributions thereafter may be discretionary amongst a number of beneficiaries. Alternatively the trust may sell the property, redeem your units and distribute the balance of the capital gains on a discretionary basis. Note that should future positive income streams and capital gains be available to be distributed on a discretionary basis among various family beneficiaries, overall you may well be paying tax at marginal rates lower than your 46.5% rate.

What not to do

Remember, negative gearing achieved through direct ownership of property or by investing via a hybrid trust should sit well with the ATO if your emerging investment strategy can objectively be seen to encapsulate rising net income and/or growth in asset values, over time. So why have there been adverse PBRs that disallow much, if not all, of the interest expense incurred in buying units in a hybrid trust?

It is hard to be exhaustive as every case depends on its own facts, but what follows are some practices that have emerged, if not aggressively promoted by some people, that you should not be doing nor your trust deed allow:

- Income should not be accumulated within the trust;
- Initial income distributions should not simply be spread across various beneficiaries (as in the case of a standard discretionary trust). The unit holder borrowing money must have some clear, overriding rights and entitlements to establish a nexus between trust income and interest incurred;
- Similarly capital gains should not simply be made to various beneficiaries irrespective of the unit holder. As outlined above, income as well as capital gains are integral to both the commercial and tax integrity of an investment strategy that involves negative gearing; and
- If units are to be redeemed (to enable income or capital gains to be distributed on a discretionary basis) they should not be redeemable in an ill-defined manner, at initial cost and/or at a critical time in the investment horizon (such as when positive gearing emerges).

What should you do now?

You should be revisiting both the wording of your existing trust deed and the manner in which you have used your trust with both your legal and accounting advisors.

Depending upon the outcome of this prudential review, you may consider seeking your own PBR. We are aware of a number of favourable PBRs in respect of a clear and concisely drafted hybrid trust deed used appropriately as a wealth accretion vehicle.

Alternatively, you may replace or amend your existing hybrid trust deed (subject to stamp duty considerations) and/or outline a reasonably arguable position establishing the objective intention and use of your trust in the event of Tax Office scrutiny in the future.

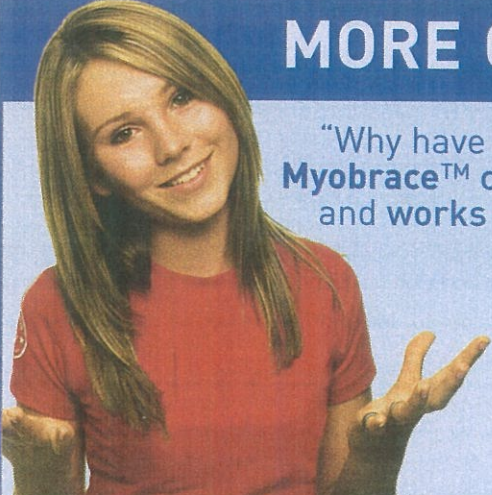
Hybrid trusts still do offer real benefits for certain people when appropriately structured and managed. However please do not be misinformed as to how "appropriate" your geared investment strategy really is in an objective sense.

About the author

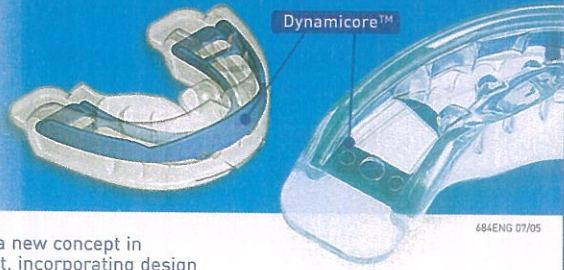
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