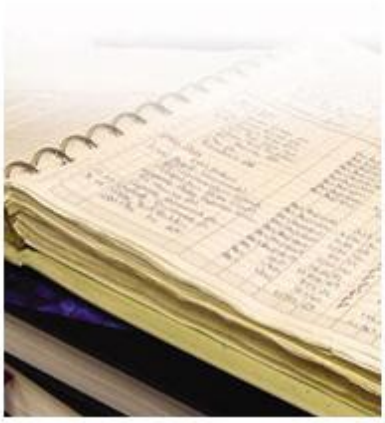
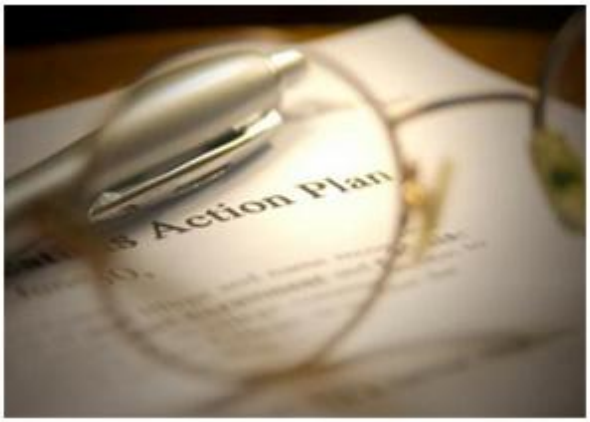
The Practice Managers' Guide to Hybrid Trusts

McMasters' Medical Practice Management





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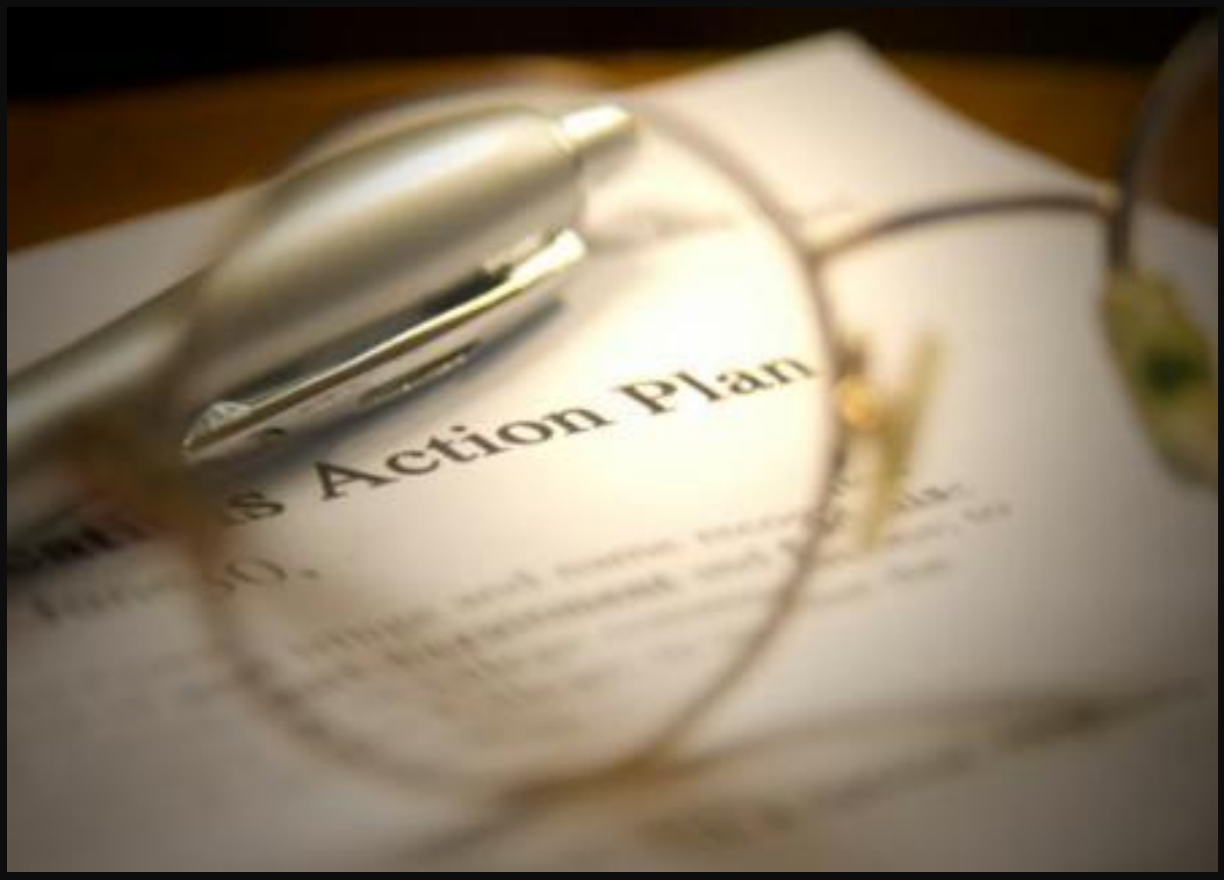

The Practice Manager's Guide to Hybrid Trusts

Introduction

The Practice Managers' Guide to Hybrid Trusts has been developed to helps explain the commercial advantages and disadvantages of conducting an investment or a business through a hybrid trust, particularly for unrelated third parties in business and property ventures.. It contains numerous practical tips and advice, and identifies the various planning opportunities and pitfalls giving consideration to how trusts may be used to create and protect wealth. It has been identified as an area where practice managers and doctors alike have a keen interest, and a lot of important information is contained in the guide.

Hybrid trusts are typically seen as taking the 'best' features of a discretionary trust and the 'best' features of a unit trust to blend them into the one entity. This can create a flexible and powerful tax planning solution.

Hybrid trusts allow the respective rights and entitlements of unrelated third parties to be respected, while still allowing flexible income and capital distributions between those parties. Once

distributions have occurred between the unrelated parties, hybrid trusts also allow flexible income and capital distributions among all related persons (e.g. spouses, children, related family trusts etc).

This guide explains how hybrid trusts operate, discusses the advantages and disadvantages of hybrid trusts compared to other trusts, and explains ownership of assets and distribution of income.

Topics included in this guide include:

- The flexibility of hybrid trusts;
- Hybrids explained;
- Advantages and disadvantages of hybrid trusts;

Further reading on this topic is encouraged and will be identified throughout the guide.

8.1 THE FLEXIBILITY OF HYBRID TRUSTS

By blending the features of discretionary trusts and unit trusts, flexibility is created allowing for tax planning solutions. However, different solicitors will have different approaches.

One approach is to allocate units to unit holders. As for most unit trusts the units entitle the unit holder to a fixed proportion of the net income of the trust as at 30 June each year. They also entitle the unit holder to a fixed proportion of any capital distributions. However, the income and capital distribution rules also allow the trustee to:

- by written resolution before 30 June, allocate net income between the unit holders other than in proportion to each unit holder's issued units as a percentage of total issued units;
- by written resolution before a capital distribution, whether on the vesting of the trust or beforehand, allocate capital amounts including net capital gains between the unit holders other than in proportion to each unit holder's issued units as a percentage of total issued units;
- by written resolution before 30 June, allocate net income allocated to a unit holder to persons included in a class of discretionary beneficiaries connected to that unit holder (typically family members and related companies and trusts); and
- by written resolution before a capital distribution, whether on the vesting of the trust or beforehand, allocate capital amounts including net capital gains allocated to a unit holder to persons included in a class of discretionary beneficiaries connected to that unit holder.

The 'attribution principle' applies to hybrid trusts. This means specific taxation credits and rebates, and particular types of assessable income, including net capital gains, can be allocated between unit holders and, once so allocated, between individual discretionary beneficiaries connected to that unit holder.

Why this is an advantage

The hybrid trust is a flexible commercial structure and is particularly suited to situations where two or more unrelated persons co-own a business or an investment, and there is a potential to distribute income and capital gains and tax credits and rebates to related persons. This may help lower the unit holders' overall income tax bill.

Because there is only one entity, i.e. the hybrid trust (and, in almost all cases, a trustee company), hybrid trusts are simple and cheap to put in place. Hybrid trusts can achieve the same commercial results as a partnership of discretionary trusts, but with fewer legal costs and less accounting and administrative costs. That said, often the unit holder will be the trustee of a discretionary trust or other entity, and will not always be a natural person.

More particularly, the advantages of a hybrid trust are:

- unit holders can claim a deduction for the interest incurred on the cost of their units. A beneficiary of a discretionary trust is not able to do this. This has an intrinsic tax planning value, but also means it is less likely for a trust to have quarantined interest losses that are locked up and cannot be readily accessed by related persons. This can happen, for example, if a trust borrows money to buy an investment property, or if a trading trust incurs business

losses;

- it is comparatively easy for new owners to join and for old owners to leave the structure. Because the class of discretionary beneficiaries are defined by reference to their relationship with the unit holder, a transfer of a unit or an issue of a unit to a new unit holder automatically introduces a new class of beneficiaries without the need to amend documents or, for example, end one partnership and start a new one, with the attendant tax consequences and extra costs;
- the interests of each owner are protected, and are not subject to a discretionary power on the part of the trustee. The resolutions to distribute net income other than proportionately must be signed by each unit holder to be effective and this protects each unit holder from unfair treatment. This means the units' capital value is preserved and the units have a market value and can be bought and sold. This compares to the position of a beneficiary of a discretionary trust who only has a mere expectancy that the trustee may exercise a discretion in its favour. Such a beneficiary does not have a separate asset or assets recognised at law; and
- the difficulties experienced with section 160ZM of the Income Tax Assessment Act 1936 ("the Act"), where non-assessable income received in connection with units effectively erodes indexed cost base or even triggers a deemed capital gain, can be avoided by allocating this income to a discretionary beneficiary. This means, for example, problems with (under-capitalised) unit trusts realising tax exempt capital gains on the sale of business goodwill can be avoided.

All the other tax laws applying generally to trusts, including the loss trust rules and the restrictions on channelling franking credits apply.

Converting an ordinary unit trust to a hybrid trust

It is possible to convert an ordinary unit trust to a hybrid trust. An amending deed is prepared to delete the old income and capital distribution clauses and introduce new flexible income and capital distribution clauses. This deed should be approved by the directors of the trustee company and by a meeting of unit holders, and should be sealed and stamped as required under the law.

The capital gains and stamp duty impact of a conversion should always be considered before adopting the amending deed. It is quite possible the conversion comprises a resettlement, and this can be problematic if the trust owns significant assets, particularly land.

Practitioners should proceed with a conservative caution. Hybrid trusts are excellent structures and can achieve significant commercial and taxation benefits for clients. As always, the particular circumstances of each client should be carefully considered before putting a structure in place.

Unit holders' agreements

Because hybrid trusts are typically used by un-related parties to co-own assets, it is likely that a unit holders' agreement will also be required. A unit holders' agreement sets out the rights and obligations of each unit holder in respect of each other. This is distinct from the trust deed, which sets out the relationship between the unit holders and the trustee. The unit holder's agreement

typically includes issues like what happens if someone wants to sell their unit, or someone wants to sell the underlying assets of the unit trust and wind the hybrid trust up.

A unit holders' agreement is a form of co-ownership agreement and is like a partnership agreement.

8.2 HYBRID TRUSTS

The definition of trusts and the evolution of the relationship of one person's ability to legally own an asset for the benefit of another person, or set of persons, is discussed in The Practice Managers' Guide to Family Trusts and Unit Trusts. The person who legally owns the asset is called the trustee, and the person or persons for whose benefit from the asset is called a "beneficiary".

A trust is defined in Underhill's Law Relating to Trusts and Trustees as follows:

> *"A trust is an equitable obligation, binding on a person ("trustee") to deal with property over which he has control ("trust property") either for the benefit of persons ("beneficiaries") of whom he may be one, and any one of whom may enforce the obligation, or for the advancement of certain purposes."*

Another definition is found in Osborn's Concise Legal Dictionary:

> *"A relation or an association between one person (or persons) on the one hand and another person (or persons) on the other, based on confidence, by which property is vested in or held by the one person on behalf of or for the benefit of another."*

For a trust to exist four elements must be present. These are:

(i) a trustee;
(ii) a beneficiary, (called in the case of a hybrid trust, a "unit holder");
(iii) trust property; and
(iv) an equitable obligation on the part of the trustee to hold the property for the benefit of the beneficiary.

Most Australian businesses are carried on in trusts. Trusts can be quite small. For example, a family trust may own a small parcel of shares with a cost of less than $100,000, or they can be very large: some of the managed investment trusts have more than 20,000 unit holders or beneficiaries.

Virtually all modern trusts are evidenced by a deed. This is a legal document prepared by a solicitor which sets out the purpose of the trust, the rights and obligations of the beneficiaries, the powers of the trustee, and the identity of the beneficiaries, the trustee and the appointor. A formal trust deed is, at least for practical purposes, necessary to create a workable hybrid trust.

Unit Trusts

A hybrid trust takes the best elements of both a unit and a discretionary trust. However, to understand this, it helps to understand unit trusts.

A unit trust is a trust where the rights of the beneficiaries to income and capital are fixed. This is in the sense that they are not subject to any discretion on the part of a trustee, and are hybridised, in the sense that those rights are divided amongst the beneficiaries based on how many units have been issued to them.

The beneficiaries are therefore usually referred to as "unit holders". Each unit holder's interest in the trust is fixed. Different unit holders or different classes of unit holders may have different rights to income and capital distributions and voting rights. These rights will be determined at the time the units are issued or as otherwise agreed by the unit holders and the trustee.

Unlike the beneficiaries of a discretionary trust, unit holders do have rights to the underlying assets of the trust (adjusted for liabilities). These rights are recognised at law as a form of property, can be bought and sold and do have a value. These rights have a value because the unit holder is entitled to future payments of income and capital, and this means other people may be prepared to pay to acquire the unit from the unit holder.

Units

A unit is a piece of property that entitles the unit holder to a specified proportion of the income and capital of the trust. The nature of a unit was considered by the High Court in Charles v FCT where it was said:

> *"A unit held under this trust is fundamentally different from a share in a company. A share confers on the holder no legal or equitable interest in the assets of the company; it is a separate piece of property; and if a portion of the company's assets is distributed amongst the shareholders the question of whether it comes to them as income or capital depends on whether the corpus of their property (i.e. the shares) remains intact despite the distribution. Units under the trust deed before us confer a proprietary interest in all the property which for the time being is subject to the trusts of a deed; Baker v Archer Shee [1927] AC 844; so that the question were the monies distributed to the unit holders under the trust form part of their income or their capital must be answered by considering the character of those monies in the hands of the trustees before the distribution is made."*

In other words, a unit in a unit trust confers on the unit holder an equitable interest in both the underlying capital and the income of the trust. Where an amount is distributed to a unit holder under a trust deed its character as capital or income, and even as different types of capital or income, in the hands of the unit holders will depend on its character in the hands of the trustee. The character will, of course, be the same.

Hybrid trusts and asset protection advantages

Hybrid trusts do not have the asset protection advantages for unit holders that discretionary trusts have for beneficiaries. This is because of the nature of the units, as explained above. Unit holders seeking to protect assets actually own units that are of equal value to the net assets of the trust. Were a unit holder to be sued, for example, their units could be compulsorily acquired.

However, asset protection can be achieved by arranging for a unit to be held by a discretionary trust or perhaps some other related person. In this way, the target of the suit does not have an identifiable and transferable right to the trust assets.

The trustee

The trustee is a shelf company owned by the client and set up specifically to act as trustee of the trust. The shareholders and directors control the trustee. The trustee legally owns the trust property but does not beneficially own the trust property. Beneficial ownership of the trust property lies with the unit holders.

The trustee can also be any competent natural person over the age of 18 who is not bankrupt or under some other legal disability.

The advantages of using a company as a trustee are that:

(i) having legal ownership of the trust's assets in the name of the company makes it clear that they do not belong to the individuals who control the company;

(ii) the company may stay in existence virtually forever, and will not die or become unable to manage its own affairs. This means things are simpler and there is less bother with changing trustees and re-registering ownership with authorities such as the various state Titles Offices; and

(iii) the directors or other persons who control the company can exercise defacto control without being personally involved in the trust.

If units are owned via family trusts the various income tax, asset protection and estate planning advantages connected to family trusts are also available to the client.

The disadvantages of using a company as trustee, are the extra cost of setting up and running a company each year. As the cost of establishing a company is now quite low, and the extra annual cost is also quite low, this disadvantage is not typically seen as substantial.

Stamp duty savings on property transfers

Where a hybrid trust owns real estate it can pay to transfer units in the trust rather than the underlying real estate. This is because stamp duty will be based on marketable security rates, typically about 0.5% of the value of the property, rather than land rates, typically about 5% of the value of the property (rates vary state to state).

This is particularly the case if it is likely that the underlying property may be transferred to related persons or to persons who are known to you, and enjoy a mutual good faith. It may not be practical in the case of a transfer to a stranger because the stranger may be concerned that the trust has borrowed money or incurred some other liability. This may not manifest itself until after the transfer is completed. This has obvious problems it is understandable that the stranger would be happier to pay full stamp duty and be assured of full and unencumbered title.

In some cases such a transfer can trigger the so-called "land rich entity" rules. Where this happens the transfer is treated as being a property transfer and stamp duty is assessed at land rates. The rules differ from state to state and therefore cannot be more than noted here.

You should examine your state's situation and speak to your adviser before transferring units in the trust, whether or not it owns property.

The procedure for transferring units should be set out in the trust's deed.

Control of hybrid trusts

Typically, the unit holders as a group control the trust. This is because the trust deed typically gives them the power to direct the trustee and, if necessary, to terminate the trustee's appointment and appoint another legal person to act as the trustee instead.

The deed typically specifies the percentage vote required for a resolution of a meeting of unit holders to be effective. Usually it is 50% unless decided otherwise as the trust deed is being prepared.

Corporate unit holders: 30% tax rate

Hybrid trusts can be combined with private companies to get the benefit of the 30% tax rate currently applying to private companies. Arranging for the units to be held by the private company does this. This means that some or all of the trust's net income is taxed in the hands of the company each year.

The main rule here is that the cash must be actually paid over to the corporate beneficiary, and then retained in the corporate unit holder. If this does not happen there is a risk that the special anti-avoidance rules applying to private company loans, outlined in Division 7A, may apply.

Specific advice should always be sought before deciding to distribute net income to a corporate unit holder.

Other advantages of hybrid trusts

The other advantages of hybrid trusts include:

(i) confidentiality of information, particularly regarding the financial affairs of the trust. There are no statutory disclosure requirements for trusts in the way that there are for companies under the ASIC database. There is also no requirement for a trustee dealing with other persons to disclose that it is acting as a trustee of a trust and not in its own right. Thus bank accounts can be opened, leases signed, investments made etc for the benefit of the trust without other people needing to know this. In most cases we suggest that they should not know that the trustee is acting for a trust;

    In many ways there is an expedience at work here. Bank officers, for example, tend not to understand the trust structure. Therefore, it is usually simplest to establish bank accounts in the name of the trustee only;

(ii) there are no formal audit requirements. Accounts have to be prepared but this is only to

facilitate the preparation of an annual income tax return;

(iii) the absence of any formal legislative framework, such as the Corporations Law, to control the activities of the trustee. Trusts are of course subject to the various Trustee Acts and all other relevant law for example, the Trade Practices legislation and the Income Tax Assessment Act. This makes trusts very flexible entities to use for your business activities;

(iv) the easy entry and exit of owners, i.e. unit holders;

(v) trusts are quite cheap to establish and run each year; and

(vi) trusts are relatively simple to wind up.

Disadvantages of hybrid trusts

The major potential disadvantage of a hybrid trust is that it cannot distribute capital or revenue *losses* to its unit holders. As a result, should a trust incur a net loss its beneficiaries will not be able to offset that loss against any other assessable income that they may derive.

Expert advice should be sought if it is expected that a trust may make a revenue loss or a capital loss for taxation purposes. For example, it may be wise to have debt held at the unit holder level, rather than the trust level, to avoid negative gearing type losses being locked up in the trust.

The taxation of trusts is discussed briefly below.

When does the trust start?

The trust is expressed to start on the Start Date, as specified in the trust's deed.

More technically, the Trust starts on the date that the Trustee first acquires property. This will probably be in the form of a small cash payment from the first unit holders to the trustee in return for the trustee issuing the first units. Something like 10 $1.00 ordinary units is quite common, and it is probable that your accountant has decided to stipulate this nominal amount (.

The $10.00 will usually be treated as being paid on the date specified as the Start Date in the trust deed. The Trustee will probably issue more units to the first unit holders and new unit holders as the trust gets up and running.

When does the trust finish?

The Trust finishes in 80 years from the Start Date unless the unit holders determine a shorter period or a longer period. 80 years is a conventional period: there is an old rule of equity called the 'rule against perpetuities' which in effect means it is not possible to set up a trust that runs forever. This reflects a policy desire that at some time property vest in a person who is capable of dealing with it absolutely, and that property is not controlled 'from the grave.'

Most modern trust deeds specify 80 years as the life of the trust. It appears 80 years is chosen because it is usually longer than the initial unit holders' (or the underlying individuals) expected life span. 80 years is also the period used in some related Acts of Parliament, for example, section 209 of the Queensland Property Law Act. 80 years is certainly the most common period. The lifestyle of a

typical trust can be found at appendix 1 of The Practice Managers' Guide to Family Trusts and Unit Trusts.

In whose name should assets be held?

The trustee is the legal owner of the trust's property. This means the trustee's name should appear on all ownership documents, such as shares in private companies, units in private trusts, or title deeds for land ownership.

Clients may add the tag "… as trustee for the (name) hybrid trust" if they wish. This has the advantage of reminding all concerned that the asset is held on trust and does not belong to the trustee personally. However, in some cases this will not be possible. For example, most land Title Offices will only register a title in the name of the trustee, i.e. the legal owner, and will not allow the tag "… as trustee for the (name) trust" to be used.

The taxation of hybrid trusts

Hybrid trusts are efficient tax planning vehicles. Usually hybrid trusts do not pay tax themselves. Instead the net income flows through them and is attributed to the unit holders. The amount of tax paid by the unit holders depends on their individual tax profiles. For example, a unit holder with $100,000 of carried forward tax losses will not pay tax on a distribution of $10,000. This is because the unit holder's taxable income will still be less than nil. Another unit holder in the top marginal tax bracket may pay up to $4,500 tax, plus Medicare levy on a distribution of $10,000.

The trust deed is drafted so franking credits, dividend rebates, and different classes of income, capital gains and other tax amounts having particular tax consequences flow through the trust to the appropriate unit holders.

The taxation of trusts is a very complex area and it is not possible to cover the field in a few short paragraphs, or even pages.

Distribution of net income

The distribution of net income should be documented in a minute of a meeting of the trustee of a hybrid trust each year.

This minute will need to be modified to suit the particular circumstances of the each hybrid trust each year. A sample of a minute can be found at appendix 3 of The Practice Managers' Guide to Family Trusts and Unit Trusts.