The History of Hybrid Discretionary Trusts.

The History of Hybrid Discretionary Trusts takes a look at the evolution of the entity and why the ATO took such an aggressive stance towards the interest expense of Unitholders.

Hybrid discretionary trusts first started to be marketed in the early to mid 1990's. The deeds then were largely discretionary trusts that had the ability to issue units. Sometimes those units were called Special Units, Special Income Units or various other names. The basic premise was that an individual would borrow from a bank an amount of money and subscribe for units in the hybrid discretionary trust. The trust would use the funds to acquire an income producing asset, usually a rental property. The property would be leased out and the net income of the fund would be distributed to the Unitholder. The Unitholder would claim the interest on the borrowed funds against the net income received from the trust.

The Property Investor Trust™

The Australian Taxation Office was aware of the trusts and didn't appear to have an issue with their use or administrative operation. Macquarie Group Services had provided their hybrid discretionary trust to the Australian Taxation Office on many occasions starting around 1998 and no issues or concerns were raised in relation to any clauses or features. Then Chan and Naylor, who had been using Macquarie Group Services deeds, developed a new hybrid discretionary trust with a whole range of features that were always going to upset the Australian Taxation Office. The trust was called a Property Investor Trust™. It was heavily marketed with features that appeared too good to be true. Some of the features of the Property Investor Trust™ included:

- Separating ordinary income and statutory income so that units may be issued that gave rights to only ordinary income and not statutory income (i.e. capital gains),

  [clauses – "Revenue Income" means that part of the income of the Trust Fund that does not represent Non-Revenue Income and "Non Revenue Income" means that part of income of the Trust Fund that is assessable in accordance with the provisions of Part 3-1 of the Income Tax Assessment Act 1997.]

- Making the redemption amount received by the Unitholder an amount that could be less than what he paid for the units, and

  [clause – A Registered Holder may by notice in writing to the Trustee request redemption of the Units specified in such request at its market value or request the return of the capital or part thereof, paid on the Units specified in such request.]

- Make Unitholders entitled to a diminishing amount of income by virtue of an entitlement to revenue income clause that diminished a Unitholders right to income as the value of the trust fund

increased.

[clause - The Registered Holder of 'A' Class Units shall be entitled to that part of the income of the Trust Fund as is represented by the following formula:

$$\frac{A}{B} \times C$$

where:

A = the amount of capital contributed on an 'A' Class Unit.

B = the greater of the market value as determined by the Trustee of the Class A Unit Asset as at the end of the financial year or the amount of capital contributed on an 'A' Class Unit.

C = Revenue Income derived by the Trust in respect of the Class 'A' Unit Asset.]

It is most likely the last feature above of the Property Investor Trust™ that caused the most concern in terms of interest deductibility for an 'A' Class Unitholder. In relation to the income entitlement of an 'A' Class Unit the greater the increase in the market value of the trust's assets the proportion of income received by the unitholder decreased. For example if the unitholder had contributed 100% of the funds for the purchase by the trust of an asset, and the asset doubled in value then the unitholder would be entitled to 50% of the revenue income and none of the capital gain. Not even the advisors to Andrew Forrest went that far. In Forrest v Commissioner of Taxation [2010] FCAFC 6 (5 February 2010), Mr Forrest was entitled to all the revenue income from the Minderoo Trust.

Taxpayer Alert TA 2008/3

On 26 March 2008 the Australian Taxation Office issued Taxpayer Alert TA 2008/3. In that document the ATO questioned whether interest was deductible on a borrowing to acquire units in a hybrid trust as the income generated could be used to benefit discretionary beneficiaries (i.e. diminishing income entitlement of 'A' Class Units for example). At the time the ATO issued TA 2008/3, 26 March 2008, the case against Andrew 'Twiggy' Forrest was being heard in the Administrative Appeals Tribunal (AAT). It is without doubt that the ATO were expecting the AAT to deny Mr Forrest his interest deductions to confirm their view in TA 2008/3.

Taxation Determination TD 2009/17

On 18 April 2008 the AAT confirmed the Commissioners denial of Mr Forrests interest deductions and the ATO had a win on their hands. They issued Taxation Determination TD 2009/17 on 15 July 2009 which sought to apportion the interest. The ATO at this stage began to issue a small number of amended assessments to

various taxpayers denying their interest deduction in excess of the income they had received from the hybrid trust. Objections were lodged and eventually some time in 2010, post the Full Federal Court decision in Forrest the interest deductions were allowed in full. On 28 July 2010 Mr Christopher Batten, a director at Macquarie Group Services Pty Limited lodged an Application for Private Binding Ruling.

The Forrest Decision

Sometime in 2005 Mr Andrew 'Twiggy' Forrest was issued with an amended assessment in relation to interest he had claimed against units he had acquired in a hybrid discretionary trust. His interest was denied in full for the years ended 30 June 2000, 2001 and 2002. He lodged an objection on 20 October 2005 and the matter was heard in April 2008. On 18 April 2008 the AAT handed down its decision affirming the ATOs decision to deny the interest deductions. This was a significant win for the Australian Taxation Office and if it wasn't for the fact Mr Forrest lodged an appeal to the Full Federal Court of Australia the ATO would have commenced denying the deductions of people using hybrid trusts.

The Full Federal Court handed down its decision on 5 February 2010 reversing the AAT decision and allowing Mr Forrest a full deduction for the interest on his units in the Minderoo Trust. It should be pointed out that Mr Forrest held units that only entitled him to the ordinary income in the Trust. His units did not entitle him to any capital gain. They didn't have the diminishing 'A' Class Unit issue mentioned above. The Commissioner attempted to have the Full Federal Court return the question of deductibility of the interest to the AAT so that they may decide if the interest should have been apportioned as opposed to denied in full. The Commissioner failed and the Forrest decision had done little to clear up the deductibility of interest in relation to hybrid discretionary trusts. The apportionment question is critical in terms if the effectiveness of hybrid discretionary trusts.

The Batten Private Binding Ruling

The Private Binding Ruling issued to Christopher Batten on 11 April 2011 was the first time the ATO had acknowledged there could be terms of a hybrid discretionary trust which allowed a unitholder a full deduction for the interest expense. The ruling only binds the Commissioner to Christopher Batten, however the ruling and the many discussions and conferences leading up to the issue of the ruling give an insight into what the ATO will allow in terms of entitlements to income and capital gains that will result in the allowance of a full interest deduction.

The Current Position (Amend or lose the deduction)

The Property Investor Trust™ was not the only hybrid discretionary trust that exhibited features that were going to upset the ATO in terms of claiming the interest on borrowed monies by Unitholders; however the PIT didn't just push the boundaries of what is acceptable it took a running jump over the edge. The ATO argues today that no hybrid discretionary trust established prior to the final changes to the Macquarie Group Services Hybrid Discretionary Trust would meet with the ATO view of what is required in a hybrid discretionary trust so that a unitholder was allowed a full deduction for the interest incurred on borrowed funds to acquire units. The ATO argues TD 2009/17 still applies and in relation to a lot of deeds including the Property Investor Trust™ it still would. The diminishing entitlement to income in terms of 'A' Class Units will never be allowed by the ATO and it is more than likely it would never be allowed by the Courts.

The Macquarie Group Services Position

Macquarie Group Services Pty Limited does not agree with the ATO in relation to the need to amend the hybrid discretionary trust provided by Macquarie Group Services prior to July 2010. The deeds did not have any of the abusive features mentioned above and were more compliant than the trust deed in the Forrest case. However, the ATO has indicated they intend to deny interest deductions where taxpayers don't amend their hybrid discretionary trust deeds to comply with the ATO view. The cost of funding a case to the Full Federal or High Court is too expensive to warrant any action other than conforming to the ATO view.

The new MGS Hybrid Discretionary Trust

Macquarie Group Services now has a trust that conforms to the views of the Australian Taxation Office. A Special Income Unitholder who borrowed funds to acquire his or her units will be entitled to a full deduction for the interest incurred. Now that there is certainty in terms of the taxation treatment some meaningful discussion can occur as to when a hybrid discretionary trust is appropriate.