A matter of trust

Purchasing property through a trust can provide generous tax benefits, but it's not for everyone. *Michael Quinn*, lawyer, accountant and director of The Quinn Group, explains

Many people think that purchasing an investment property through a trust can yield substantial tax savings. While this may be true in some circumstances, it's important to note that there are various types of trusts available, each with its own conditions, tax obligations and concessions. On top of this, every trust is further defined by the particulars contained in the trust's deed.

Types of trust structures

Of all trust structures, those most commonly used for property purchase are the unit trust, family discretionary trust and hybrid trust.

Even between these relatively similar structures, there can be diverse taxation and other factors that need to be considered. As the details will differ for each individual situation, it's extremely important that you seek advice from both legal and accounting professionals. Your lawyer and accountant can explain the long-term intentions for the trust, not just the short-term benefits, if in fact a trust is the right decision for your situation at all.

Making the wrong choice could cause problems down the track, with perhaps the most notable being loss of tax concessions and deductions, as well as potential liability for other costs.

Unit trusts

A unit trust structure exists where the assets owned by the trust are divided into defined portions known as 'units'. Unit ownership by the trust's beneficiaries (or unit holders) can be likened to the way in which shareholders hold shares in a company. Each beneficiary's share of the trust's income, and consequently the taxation liabilities and related expenses, is proportional to the number of 'units' that they hold.

Advantages

- **Asset protection**
  Should any beneficiary become bankrupt or financially troubled, such as being sued, for example, any assets that are owned by the trust aren't able to be touched by the creditors. This protection exists provided that the assets were transferred into the trust a number of years before the bankruptcy or similar proceedings commenced. In the case of bankruptcy, only assets that are personally owned by the beneficiary are able to be repossessed.

- **50% capital gains tax discount**
  As long as the asset has been held for more than 12 months, most trust structures – including unit trusts – are eligible for a 50% capital gains tax (CGT) discount on all capital gains that are produced.

- **Flexibility on distribution of income and capital**
  Unit trusts allow some flexibility in the distribution of the income and capital generated by the entity. Generally, trust units can be allocated to beneficiaries as either 'capital' or 'income' units. This allows for unit holders who are on a lower marginal income tax rate to receive the income generated by income units, as they'll be taxed at a lower rate.
  Those unit holders who are on a higher marginal income tax rate are more likely to be allocated capital units. For example, capital unit holders may choose to sell the asset when they retire. They'll then be liable for less tax on this income amount as they currently have no other forms of income.

- **Cheaper and easier than a company structure**
  A unit trust is cheaper to establish and maintain than a company. It's also generally an easier procedure to wind up a trust than a company.

- **Less regulation**
  There are fewer regulations governing trusts than there are governing companies, and units can generally be transferred and re-acquired without any legal problems.

Disadvantages

- **Not easy to vary the distribution conditions**
  While there's some flexibility in relation to the distribution of income in a unit trust, the implementation and allocation of capital and income units is restricted by the conditions set out in the trust's deed.
  The only way these distribution and allocation conditions can be varied is by formally amending the deed.

- **Transferring property into trust triggers stamp duty and CGT**
  The act of transferring a property from individual ownership to trust ownership will see the trust liable for stamp duty on acquisition of the asset. Additionally, the individual selling the asset will be liable for CGT on the disposal of the asset.

> Should any beneficiary become bankrupt or financially troubled, such as being sued, for example, any assets that are owned by the trust aren't able to be touched by the creditors

- **Rental loss quarantined**
  For investment properties that are owned by trusts, it isn't possible to offset any rental loss amounts against other investment income. The loss must remain quarantined in the trust until such time that a rental gain is made and the previous loss can be offset against it.

- **Capital loss quarantined**
  As with a rental loss, if a trust makes a capital loss on its assets, the amount is quarantined until there's a capital gain that it can be offset against. Beneficiaries or unit holders aren't able to apportion this loss to offset their own individual income.

- **Other considerations**
  Individuals aren't able to claim a deduction for any interest paid on monies that are borrowed and then injected into the trust for the purpose of allowing the trust to purchase assets, such as investment properties. However, the trust entity itself is able to claim a deduction for the interest paid on any monies borrowed.
  On the other hand, individuals are generally able to claim a deduction when acquiring units in a trust structure, as this is deemed to be a similar action to purchasing shares in a company. The individual is using the funds to obtain or increase the amount of units that they hold in a trust entity. As such, this is treated as a loan for personal investment and eligible costs can be deducted.
  It should also be noted that under a unit trust structure, each unit holder, or beneficiary, has complete discretion as to the transferring of their units on their passing, as dictated by their last will and testament. This means that essentially a beneficiary's units can pass to whomever they choose. This may be seen as either an advantage or a disadvantage, depending on each individual situation.

Family discretionary trusts

Generally speaking, a family discretionary trust is controlled by a husband and wife and doesn't include anyone who is outside of the family. The trustee of this type of trust has complete discretion when it comes to the distribution of income and capital among the beneficiaries, unlike the unit trust, where income is distributed in proportion to the amount of units held by each beneficiary and as dictated by the deed.

Advantages

These are similar to the benefits of a unit trust.

- **Asset protection**
  The asset protection advantages that a family discretionary trust structure provides are the same as for all other trust structures.
  The trust allows for an individual to have control over assets but not personally 'own' them. A trust is a separate legal entity and, as a result, if an individual is declared bankrupt

or is sued, creditors can't access assets held by the trust.

- **50% capital gains tax discount**
  As mentioned earlier, all trusts are eligible for a 50% discount on CGT, as long as the asset has been owned by the trust for more than 12 months. It should be noted that self-managed superannuation funds are also a form of trust structure, but they attract a reduced discount rate of 33.33%.

- **Maximum flexibility in the distribution of income**
  A family discretionary trust has complete flexibility when it comes to the distribution of income. The trustee determines how the income is allocated and this can be amended as seldom or as frequently as the trustee desires. This differs to the unit trust structure, where the deed dictates the allocation of income.

- **Cheaper and easier than a company**
  As with unit trusts, family discretionary trusts are cheaper to establish and maintain, and easier to wind up, than a company structure.

- **Less regulation**
  The same advantage as unit trusts.

Disadvantages

- **Transferring property into trust triggers stamp duty and CGT**
  As with unit trusts, the act of transferring the ownership of a property from an individual to a family discretionary trust will see the trust entity liable to pay stamp duty on acquisition of the asset. In addition, the individual who is disposing of the asset, that is, transferring ownership of the asset to the trust, will be liable to pay CGT.

- **Rental loss quarantined**
  Where family discretionary trusts make a rental loss on their investment property, they are not able to offset this amount against any other investment income. The loss must remain quarantined until such time that a rental gain is made and the previous loss can be offset against it.

- **Capital loss quarantined**
  If a family discretionary trust makes a capital loss on its assets, the beneficiaries aren't able to use this to offset their personal income. As with the rental loss amount, any capital loss must remain quarantined until such time that a capital gain occurs and the loss can be offset against it.

- **Other considerations**
  As with a unit trust, under a family discretionary trust structure, an individual isn't able to claim a deduction for any interest that's paid on any monies that are borrowed and injected into the trust. The trust entity is, however, eligible to claim a deduction for any interest that is paid on any monies borrowed by the trust.

  Unlike a unit trust, the family discretionary trust structure doesn't allow for beneficiaries to dictate the transfer of their portion of trust ownership on the event of their passing. Family discretionary trust deeds dictate that there's a distinct and defined flow of ownership rights.

  As a result of this, beneficiaries aren't able to use their will to leave their share to any person other than as set out by the trust deed. Generally speaking, the deed sets out that the beneficiaries of the trust are husband and wife, their children and children's spouses and their grandchildren. There are, of course, variations on this arrangement, but this is a general example of a common family trust agreement.

  Again, this can be seen as an advantage or disadvantage, depending on each situation.

Hybrid trusts

Hybrid trusts are a combination of both unit and family discretionary trusts. Beneficiaries hold a defined amount of units, as per a unit trust, but the trustee has the discretionary power to vary each beneficiary's entitlements and income.

As a hybrid trust has units, any interest that's paid on monies borrowed and used to purchase these units can be claimed as a deduction, as this process is likened to the purchasing of shares, as with a unit trust structure.

Perhaps the biggest disadvantage is that the costs of establishing a hybrid trust are notably higher than for other types of trusts.

From both a legal and accounting perspective, the establishment of a hybrid trust structure requires considerably more work than that of a unit or family discretionary trust, hence the associated costs are greater.

Purchasing in your own name

Using a trust to purchase property is, of course, not suitable for everyone. Acquiring an investment property in an individual's name can produce a number of benefits that aren't available through the trust structure. In saying that, these are balanced out by some disadvantages that are applied to individuals but not to trusts.

As always, each situation is different and needs to be considered on its individual merits.

Advantages

- **Rental loss offset against other income**
  Perhaps the biggest advantage of purchasing an investment property through an individual name is that any rental loss can be offset against the individual's other taxable income. This will result in a reduced taxable income amount for the individual.

- **Capital loss offset against capital gains**
  Similar to rental loss, any capital losses made by an individual on investment properties that are owned in their name can be offset against any capital gains that are made on other investments. The offset amount will reduce the individual's total taxable income for that financial year.

- **50% capital gains tax discount**
  Individual investors are eligible for the same 50% CGT discount as trusts. The provision that the investment must have been held for more that 12 months applies to both individuals and trusts. The discount will assist in reducing the individual's taxable income amount even further.

Disadvantages

- **No asset protection**
  Assets that are owned solely in an individual's name are liable to be repossessed should the individual become bankrupt or has a lawsuit filed against them.

- **Possible reduction of family tax benefit**
  In a situation where an individual's net loss from investments is greater than their net income, a negative taxable income is generated. In this instance, the Australian Taxation Office (ATO) looks at both amounts as being positive, and adds them together to produce a positive taxable amount, for the purposes of calculating eligibility of the family tax benefit. For example, you may have an income of $20,000 and a loss of $60,000, generating a negative taxable income of -$40,000, on which no income tax is payable. However, the ATO calculates your income as $80,000 ($20,000 + $60,000) solely to determine your eligibility for the family tax benefit. Hence, you may risk losing all or part of your allowance.

I can't stress enough how important it is to seek the advice of a professional lawyer and accountant before proceeding with the establishment of any trusts and related property purchases. Then you'll be provided with all the necessary information and can proceed to make the best decision for your situation. ■

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