Guide to a Non-Geared Unit Trust

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Law

The law is as stated 1 July 2016.

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What is a Trust?

A trust is a relationship where a person (the trustee) is under an obligation to hold property for the benefit of other persons (the beneficiaries). If the beneficiary and the trustee are the same person, then this will not be a valid trust.

EXAMPLE

Rob provides in his will that if he dies, his children are to benefit. His will also provides that if his children are not yet 18 when he dies, Rob's brother Jake is to look after the property on behalf of Rob's children. Jake will not benefit at all.

This is a trust relationship where, upon Rob's death, Jake (as ***trustee***) is under an obligation to invest the assets of Rob's Estate on behalf of Rob's children (the ***beneficiaries***).

A trust is not a separate legal entity, even though, for tax law purposes, a trust return is required to be lodged. The trustee is the legal owner of the property and the beneficiaries (in some circumstances) effectively hold a 'beneficial interest' in the trust property.

A trust cannot exist forever. The trust comes to an end on the "Vesting Day", and for most trusts (except those in South Australia) this day must generally occur within 80 years of the establishment date.

What is a unit trust?

A unit trust is a trust in which the trust property is divided into a number of defined shares called units. The beneficiaries subscribe for the units in much the same way as shareholders in a company subscribe for shares.

The assets of the trust, being the trust fund, are held by the trustee on trust for the unitholders, who generally are entitled to the capital and income of the trust fund in proportion to their holding of units.

EXAMPLE – Unit trust

The Smith Trust has four beneficiaries as follows:

	Units held
Jenny	10
Jane	20
Jeremy	5
John	15

The Smith Trust derives $100,000 during a year of income. Therefore the beneficiaries will be entitled to receive the following amounts:

	Income
Jenny	$20,000
Jane	$40,000
Jeremy	$10,000
John	$30,000

A unit in a unit trust is really just a means of describing the share in the trust fund to which the unitholder is entitled.

From an investor's point of view, owning units in a unit trust is seen to be the same as owning shares in a company. However, they are fundamentally different – a shareholder has no interest in the assets of the company, whereas a unitholder does have an interest in the underlying property of the unit trust.

What is a non-geared unit trust?

A non-geared unit trust is basically identical to an ordinary unit trust apart from certain limitations as set out below, and may be considered by trustees of self-managed superannuation funds (SMSFs) wanting to invest in a related unit trust.

When an SMSF invests in a related unit trust, that investment is ordinarily considered an 'in-house asset' of the fund. SMSFs are basically subject to a limitation so that the value of their in-house assets is not allowed to be any more than 5% of the value of their total assets.

However, certain investments in related unit trusts (i.e., units) can be excluded from this calculation, provided certain conditions are met (including the following, as set out in Regulation 13.22C of the *Superannuation Industry (Supervision) Regulations 1994*):

- the unit trust has no borrowings or loans;
- the unit trust does not have any investments in **any** other entity;
- the unit trust does not have a charge (e.g., mortgage) over any of its assets;
- the unit trust does not own any assets that were acquired from a related party, or were previously owned by a related party, of the fund (except business real property);
- the unit trust has not entered into a lease agreement with a related party of the fund (unless the lease is legally binding and relates to business real property); and
- the unit trust has not made a loan or provided any other form of financial assistance to a related party of the fund.

These entities are commonly known as 'non-geared' unit trusts, due to the requirement that such trusts are not permitted to have any borrowings or other charges on their assets (i.e., 'gearing') if the related SMSF is to continue to enjoy the benefit of having the investment excluded from being an in-house asset.

The investment in such a related unit trust must **continue** to meet these requirements to continue to be excluded from being an in-house asset. Consequently, regulation 13.22D further provides that, if an 'event' set out in that regulation happens, the investment **may no longer be excluded** from being an in-house asset. Apart from the above conditions, these 'events' also include the unit trust conducting a business or conducting a transaction otherwise than on an arm's length basis.

The deed for this Non-Geared Unit Trust contains specific provisions ensuring that the trustee of the unit trust cannot exercise any powers that would cause one of the events in Regulation 13.22D to occur *without the consent of any SMSF unitholder* – refer subclause 8.42. However, although the intention of this deed is to make it clear to the trustee that it needs to seek the consent of the SMSF unitholder in such situations, if it inadvertently causes an event in Regulation 13.22D to occur (e.g., it lends money to another unitholder, without seeking the consent of the SMSF), subclause 8.43 also provides that an "exercise of a power in contravention of subclause 8.42 is not invalid by reason only of the Trustee not having the written consent of a Unitholder", and also provides that the trustee will not be liable to the SMSF for any consequent loss.

Consequently, simply investing in a trust called a "non-geared unit trust" will not automatically mean the investment is not an in-house asset of any superannuation fund unitholders. Therefore, trustees of non-geared unit trusts and their SMSF unitholders still need to be careful of the in-house asset (and other) restrictions applying to SMSFs.

TAX TIP – Trust is also a ‘fixed unit trust’

In addition, this trust is also a “fixed unit trust” for income tax purposes, because the issue and redemption of units in the trust are required to be made effectively at market value, which should ensure that any SMSF’s investment in the unit trust cannot be inadvertently eroded by subsequent issuing or redemption of units to or for other unitholders.

Another aspect of a Fixed Unit Trust is that it is easier for such a trust to carry forward its tax losses (as well as other tax advantages if a trust is a ‘fixed trust’).

A trust is a ‘fixed trust’ for tax purposes if persons (i.e., individuals, companies, trusts, etc.) have fixed entitlements to all of the income and capital of the trust, but this does not necessarily mean that all unit trusts will be fixed trusts.

For a unitholder to have a fixed entitlement to a share of income or capital of the trust, they will need to have a vested and indefeasible interest in a share of income or capital of the trust under the trust deed. The tax law states that a unitholder’s interest will not be held to be “defeasible” merely by reason of the fact that their units are redeemable, or further units are able to be issued, *provided* the trust deed contains a clause that states that units can only be redeemed or issued for a price determined on the basis of the net asset value (according to Australian accounting principles) of the unit trust at the time of redemption or issue. Our Fixed Unit Trust Deed (and Non-Geared Unit Trust Deed) contains clauses to this effect – refer subclauses 4.5 and 12.2.

If the trust deed allows for other methods of valuing new units or the redemption of units then the trust may be a ‘non-fixed trust’.

Generally, a fixed trust can utilise carry forward losses, to be offset against future income, if it satisfies the ‘50% stake test’. Basically, this test requires that the same individuals must have had, at all relevant times, more than a 50% stake in the fixed trust (i.e., more than a 50% stake in the income and capital of the trust between them, which is usually evidenced by the relevant unitholdings). A fixed trust must also satisfy the ‘income injection test’.

For a non-fixed trust to be able to utilise its carry forward losses, it may not only need to satisfy the 50% stake test, but *also* the ‘pattern of distributions test’, the ‘control test’ and the ‘income injection test’. Although this is more difficult, it is important to note that a non-fixed trust can still utilise carry forward losses provided it satisfies the relevant tests.

Please see your accountant for further advice regarding this complex area.

TAX WARNING – Recent changes affecting fixed trusts

The recent case of *Colonial First State Investments Limited v Commissioner of Taxation [2011] FCA 16* has confirmed that the definition of ‘fixed trust’ in the income tax laws is perhaps narrower than originally understood, because the requirement that the rights of beneficiaries be ‘indefeasible’ (i.e., cannot be defeated) is very difficult to meet. Consequently, the Government has recently stated that, in practice, very few trusts will qualify as a fixed trust unless the Commissioner of Taxation exercises his limited discretion to treat a trust as a fixed trust (even if they include a clause like that set out above (although having that clause may nonetheless assist if the Commissioner needs to exercise his discretion)). Due to the uncertainty and complexity this has created, the Government was looking at amending the law as it applies to fixed trusts, and issued a discussion paper for this purpose on 30 July 2012, but there have been no further changes to the relevant legislation since then.

However, the ATO released PCG 2016/D16 in October 2016, outlining the factors it will take into account when considering whether to exercise its discretion to treat a trust as being a fixed trust.

Therefore, it should be noted that we have taken reasonable steps to ensure that our Fixed Unit Trust Deed is a 'fixed trust' for income tax purposes, as far as practicable within the confines of the existing legislation, but that recent developments mean that this is now less certain. Future legislative changes may also necessitate amendments to the deed to ensure that it becomes, or remains, a 'fixed trust'.

TAX TIP – Consider only issuing 'ordinary' units

To maximise the potential for the trust to be a 'fixed trust', particularly if the Commissioner's discretion is required, the trustee should only issue 'ordinary' units to the unitholders (i.e., where each unit gives the unitholder an equal right to trust income, trust capital and voting rights).

How is a unit trust established?

Most unit trusts are established by subscription; that is, the initial unitholders (the "subscribers") subscribe for units in the unit trust, paying a set amount for each unit to the trustee and, in return, the trustee issues those subscribers with the requisite number of units, much like shareholders applying for shares in a company. Again, like shares in a company, the units can (if the trust deed so allows) be partly or fully paid and can also be divided into different classes with different rights (such as different voting, income or capital rights). However, most units are issued fully paid and generally have equal rights. Our Non-geared unit trust deed allows for there to be different classes of units, although it in effect requires units to be fully paid.

The parties to the trust deed of a unit trust by subscription will be the trustee and the subscribers or initial unitholders.

EXAMPLE

Jack and Jill pay $100,000 each to Ron Pty Ltd as trustee of the Property Unit Trust to subscribe for units in the trust. Jack and Jill are the ***subscribers***, and Ron Pty Ltd is the ***trustee***.

Note that it is possible to establish a unit trust by settlement, as with a discretionary trust, or even by unilateral declaration, but this is less common.

What are the benefits of a unit trust?

The main advantage of the unit trust over other types of trusts is that the parties involved are issued with units which (like shares):

- Define that party's interest in the assets and income of the trust;
- Can be easily transferred; and
- Can be re-acquired by the trustee.

Other benefits of a unit trust include the following:

- Less regulation than a company;
- Taxation advantages over a company (in some cases);

- The trust deed can be tailored to the needs of principals and beneficiaries;
- No legal problems with redeeming units from the unitholder; and
- Easier to wind up than a company.

What are the disadvantages of a unit trust?

As the units themselves are an asset, a unit trust does not offer the same sort of asset protection as a discretionary trust does. If a person is made bankrupt, then the person's units will be treated like any other asset and could be sold to raise funds to pay their creditors.

Another disadvantage of a unit trust is that tax-free distributions cannot be made as easily from a unit trust as from a discretionary trust.

EXAMPLE – Disadvantages of a unit trust

The Flying Unit Trust has 2 unit holders who each hold one unit with a $1 cost base. The Trust makes a capital gain of $200,000, which is then reduced to $50,000 on applying the CGT 50% discount and then the small business 50% active asset reduction.

When distributed, the tax-free amount of $50,000 relating to the small business 50% reduction will trigger a capital gain to the unitholders (although the $100,000 reduction relating to the 50% discount can flow through tax free).

One other disadvantage of a unit trust (which may also be seen as an advantage) is that a unitholder's interest in the assets and the right to receive income is based on their unitholding. The flexibility and the advantage of being able to distribute on a discretionary basis is not usually present (especially with a 'fixed trust').

When does a unit trust start?

A unit trust by subscription is created when the unitholders subscribe for units in the trust.

EXAMPLE – Starting date of a Unit Trust

John and Jerry subscribe for units in the River Unit Trust. The unit trust is created at this time.

A trust deed may be subject to stamp duty. The stamp duty (if any) can vary from one State (or Territory) to another.

Elements of a unit trust

There are a number of elements of a unit trust, including:

1. The trustee(s);
2. The trust fund (i.e., the trust property); and
3. The unitholders.

In addition, for a trust to exist, there must be a personal obligation on behalf of the trustee in respect of the trust property.

The trustee(s)

The trustee is the legal owner of the trust property (although not necessarily a beneficial owner), and is responsible for managing the trust fund. Being the legal owner, all of the transactions of the trust are carried out in the name of the trustee. The trustee signs all documents for and on behalf of the trust, i.e., in its capacity as trustee of the trust.

As a trust is not a separate legal entity, the trustee bears the duties and responsibilities in relation to the trust. As such, the trustee is personally liable to creditors and accountable to beneficiaries.

TRUST TIP – Limitation of trustee's liability

The trustee can limit their personal liability by making it clear that any contract or promise is supported by the trust's assets only and not by the trustee's own personal assets. Special care should be taken when entering into finance arrangements, as many finance documents will have a clause stating that the trustee enters into the obligations in a personal capacity as well as their capacity as trustee.

The trustee should make it clear that they are contracting in their capacity as trustee and not on their own behalf and should consider inserting a specific clause in every contract to limit liability.

If this is not possible, the trustee should insert the following words after their name "as trustee only by not otherwise".

The above procedures are recommended but cannot be relied upon to fully protect the trustee. Also refer to the Trust Warning below.

The trustee's overriding duty is to obey the terms of the trust deed. The trustee also has a duty to act in the best interests of the beneficiaries. There are many other duties imposed on the trustee by law.

In summary, these are:

- A trustee must carry out the terms of the trust;
- A trustee must act in good faith;
- A trustee must preserve the trust assets;
- A trustee must exercise reasonable care in the administration of the trust;
- A trustee must not benefit from their position as trustee;
- Trustees must not put themselves in a position of conflict of compromise; and
- A trustee must keep proper accounts and records.

In addition to a trustee's duties, which the trustee must carry out, the trustee also has the choice to use "powers". Powers under many trust deeds include the power to buy assets, dispose of them at any time, mortgage assets for the purposes of undertaking borrowings, and so on.

Who should be the trustee?

As the trustee is personally liable for the debts and transactions they undertake on behalf of the trust, it is generally best that a company be the trustee for the following reasons:

- it is easier to effect changes of control;
- a company never dies – this saves the expense of transferring assets to new trustees on the death or retirement of the existing trustees; and
- the limited liability nature of a company means the personal liability of the trustee is limited.

TRUST WARNING – Directors may still be liable

A corporate trustee will not provide total protection. Even with a corporate trustee, there may be circumstances in which a director of a trustee company is personally liable, such as:

- taxation offences committed;
- unpaid taxes;
- taking on debts which the directors know the corporate trustee is unable to repay;
- taking on debts which are not permitted under the trust deed; or
- where the directors give a personal guarantee.

In addition, there is a risk in some circumstances that the "corporate veil" will not work before a court of law.

Although there are circumstances in which the corporate trustee can be personally liable, a corporate trustee still generally offers greater protection than an individual being the trustee. Therefore, it is recommended that, where possible, a company be the trustee.

Should different trusts have different trustees?

It is generally preferable to have separate trustees for the following reasons:

- It avoids the need to prove which assets belong to which trust. If two trusts have the same trustee and one gets into financial difficulty, it could be extremely costly for the trustee to prove which assets are beneficially owned under which trust; and
- There is a risk that a creditor could get access to the assets of all trusts for which the trustee acts, i.e., creditors of one trust may access assets of the others.

Trustee's right of indemnity

If a trustee's liability arose from the proper exercise of their powers and duties, the trustee can be indemnified out of the trust assets. Broadly, this means the trustee can pay expenses from trust funds, instead of their own (although, if the assets of the trust fund are insufficient to meet the expenses, the trustee may be personally required to pay for such expenses).

A trustee can lose their right of indemnity if, for example:

- they do not act within their powers;
- the expense or liability has not been properly incurred;
- the trustee has not acted with reasonably diligence; or
- the trustee has breached their duty.

Who can get rid of the trustee?

Generally speaking, the unitholders are able to remove the trustee through making a 'special resolution' (i.e., a resolution passed by unitholders holding at least 75% of the units).

The trust fund

The trust fund is all the property of the trust including the income accumulated and any other money and property held by the trustee pursuant to the terms of the trust.

The beneficiaries

The beneficiaries are the people (including entities) for whose benefit the trustee holds the property.

In the case of a unit trust, the beneficiaries are the unitholders. The unitholders have an underlying interest in the trust property.

Traps for the unwary

Listed below are some common traps which may be exposed on an ATO audit:

- No dated and stamped trust deed;
- The trust bank account was opened some months after the date shown on the trust deed (which then looks like the deed has been back-dated);
- No evidence of the subscription monies ever being paid;
- If the trustee is a company, no evidence that the board of directors resolved to accept the position of trustee in accordance with its constitution;
- The terms of the trust deed have not been followed;
- No written minutes showing distribution of income or capital; and
- Trustees or beneficiaries using the bank account as their own – which exposes them to tax or other consequences for breaches.

Features of the Non-Geared Unit Trust Deed

The following are some of the features of the Non-Geared Unit Trust Deed, many of which are common to many unit trusts. However, the deed should be read in full to fully ascertain the relationship between the trustee(s) and the subscriber(s).

- The trustee can issue units of different classes or reclassify existing units into different classes – refer subclauses 4.4 and 4.5. Trustees should obtain professional advice before taking any such action.
- New units must be first offered to existing unitholders on a pro rata basis, before they can be offered to others (unless the unitholders unanimously resolve otherwise) – refer clause 4.
- Similarly, transfers of existing units by unitholders (other than to family members, etc) must follow the same procedure as above – refer clause 6.
- The trustee can repurchase or redeem some or all of a unitholder's units if requested and the trustee exercises its discretion to do so. Such units will generally be repurchased at their market value (unless all of the unitholders allow them to be repurchased on a different basis) – refer clause 12.
- Unitholders can meet to make decisions about the unit trust, including regarding the removal and appointment of the trustee. The procedures for these meetings are governed by the trust deed. Generally, each unitholder is entitled to one vote for each unit they hold – refer clause 16.
- The trustee must keep a register of unitholders (much like a company keeps a register of its shareholders) – refer subclause 5.3.
- The trustee does not have an indemnity from unitholders for any debts – unitholders are protected to the largest extent possible – refer subclause 18.3.
- A unitholder cannot demand that a particular asset owned by the trust is distributed to it – refer subclause 4.2.
- The unit trust under this deed is a "Fixed Unit Trust" for income tax purposes, but may not be a "fixed trust" for other purposes (such as land tax). For income tax purposes, a unit trust may be a "Fixed Unit Trust" if the issue of new units or the redemption of existing units must be valued in accordance with Australian accounting principles, which **is** a requirement of this trust deed– refer subclauses 4.5 and 12.2.
- The deed for this Non-Geared Unit Trust contains specific provisions ensuring that the trustee of the unit trust cannot exercise any powers that would cause one of the events in Regulation

13.22D of the *SIS Regulations* to occur without the consent of any SMSF unitholder – refer subclause 8.42. However, although the intention of this deed is to make it clear to the trustee that it needs to seek the consent of the SMSF unitholder in such situations, if it inadvertently causes an event in Regulation 13.22D to occur (e.g., it lends money to another unitholder, without seeking the consent of the SMSF), subclause 8.43 also provides that an “exercise of a power in contravention of subclause 8.42 is not invalid by reason only of the Trustee not having the written consent of a Unitholder”, and also provides that the trustee will not be liable to the SMSF for any consequent loss.

TIP – SMSF unitholders

Where an SMSF owns 50% or less of the units in a unit trust, it may assist any argument that the trust is not a ‘related trust’ of the SMSF if the trust deed does not include provision for a casting vote by the chairperson in the event of a deadlock at a unitholders’ meeting.

However, it should be noted that the terms of *this* deed (i.e., for a ‘non-geared unit trust’) assume that the trust **will be** a related trust of any SMSF unitholder. Therefore, the existence or otherwise of a casting vote for the chairperson should not affect whether or not the trust is a related trust – it will only be relevant when working out how disputes between unitholders can be resolved.

Refer to section 70E of the *Superannuation Industry (Supervision) Act 1993* for the requirements to establish whether a unit trust will be a ‘related trust’ of an SMSF. Expert advice should be obtained on any issue associated with the investment restrictions that apply to SMSFs under the SIS Act.