Guide to a 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.

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 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.

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 Corporate's Unit Trust Deed

The following are some of the features of Australian Business Structures Pty Ltd's Unit Trust Deed, most 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 may not be a "fixed unit trust" or "fixed trust" for income tax or 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 *not* a requirement of this trust deed.

Resolution of disputes

Clause 16 of the deed outlines how the unitholders can make decisions regarding the unit trust, including by holding meetings or by unanimously signing written resolutions.

In the event that there is an equal number of votes on an issue to be decided at a unitholders' meeting (meaning there is a deadlock), subclause 16.10 **either** provides that the chairperson of the unitholders' meeting has a second or casting vote, to resolve the deadlock, **or** that the matter can be referred for decision by arbitration by an independent arbitrator pursuant to the law of the Governing State (if a unitholder so requests).

Giving the chairperson a casting vote allows for deadlocks to be resolved relatively easily, but also gives the chairperson the power to sway the vote on matters should there be an equal number of unitholders both for and against a particular issue.

Therefore, if subclause 16.10 does **not** give the chairperson a casting vote, this avoids one person possibly wielding a disproportionate amount of power at meetings, but also means that resolving deadlocks may not be so easy (and could potentially be protracted and quite costly).

TIP – SMSF unitholders

Not giving the chairperson a casting vote may be a strategy to be considered by trustees of self-managed superannuation funds (SMSFs) wanting to invest in 50% or less of the units in a unit trust, to ensure that the trust should not be a 'related trust' under section 70E of the *Superannuation Industry (Supervision) Act 1993* (SIS Act). This should allow the investment (i.e., the units) to be excluded from being an 'in-house asset'.

According to section 70E of the SIS Act, a unit trust will generally be a 'related trust' if the SMSF (together with its own related parties, or 'Part 8 associates') holds more than 50% of the units in the unit trust, or it has a majority voting interest, or exercises 'sufficient influence' or 'control' in relation to the trustee of the trust.

Therefore, if an SMSF invests in the unit trust, in order to ensure the units are not in-house assets, it is important that at all times any SMSF unitholder and related parties collectively:

- do not 'control' the trust (i.e., do not have entitlements to more than 50% of the capital or income of a trust, cannot appoint or remove the trustee, and ensure that the trustee is not accustomed or under an obligation, or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the SMSF, its members and related parties);
- do not hold a majority voting interest in the trustee company (e.g., do not hold more than 50% of the voting rights in that company); and
- do not hold 'sufficient influence' over the trustee company (e.g., do not represent more than 50% of the directors of the trustee company).

If the deed for the unit trust does not include provision for a casting vote by the chairperson in the event of a deadlock at a unitholders' meeting, and the SMSF unitholder (and its related parties) hold 50% or less of the units, then the SMSF unitholder (or related party) should not be able to exercise effective control over the trust at any time (i.e., in a situation where there is a deadlock in a meeting, and a trustee of the SMSF, or a related party, holds the position of chairperson at that time). In addition, it is important that any SMSF investment in the unit trust continues at all times to meet the requirements under Part 8 of the SIS Act for it to be excluded as an 'in-house asset' (e.g., the parties should ensure that an SMSF unitholder (and/or related parties) do not obtain an entitlement to more than 50% of the income, capital or voting rights in relation to the trust, such as when new units are issued).

Note that, even if the trust deed **does** give the chairperson a casting vote, an SMSF could still invest the trust and, depending on the circumstances, the trust still may not be a "related trust" (e.g., even if the SMSF owned 50% of the units, as long as no-one associated with the SMSF becomes the chairperson (getting a casting vote), the SMSF could still argue it does not 'control' the trust).

Also note that, if the trustee of the trust is a corporate entity, any SMSF unitholder with a 50% or less unitholding should also be careful when considering the shareholders and directors of the trustee company. For example, if members of the SMSF are appointed as directors, it is important that the requirements under section 70E of the SIS Act continue to be met and the members do not have a 'majority voting interest' or hold 'sufficient influence' over the **trustee company**. They should also be careful when issuing shares of different classes, and transferring and redeeming shares in the company, and consider whether the constitution of the corporate trustee provides a casting vote to a chairperson that can give rise to a related party relationship.

Expert advice should be obtained on any issue associated with the investment restrictions that apply to SMSFs under the SIS Act.