

# Fixed trusts and unit trusts: one and the same?

by Tara Lucke, FTI, Senior Associate, Matthew Burgess, CTA, Partner,  
Liam Polkinghorne, Lawyer, McCullough Robertson

**Abstract:** There is some uncertainty about what a fixed trust is for taxation purposes. Following the Federal Court decision in *Colonial First State Investments Ltd v FCT* in 2011, it seems that, for taxation purposes, very few traditional unit trusts will satisfy the strict definition of a “fixed trust”. This article considers the specific requirements for a trust qualifying as a fixed trust and the relevance of the fixed trust concept for taxation purposes. Specifically, this article examines whether fixed trusts and unit trusts are the same, unit trusts and franked dividends, the status of distributions that are not fixed, borrowing by unit trusts, unit trusts as investment vehicles, risks posed by trust loss rules, the tax implications of converting a non-fixed trust into a fixed trust, and the consequences of CGT event E4 for unit trusts.

## Introduction

Recent years have been a turbulent time for the controllers of trusts and their advisers. While the taxation regime for discretionary trusts has been the focus of much attention, there have also been significant changes for unit trusts, particularly following the 2011 Federal Court decision *Colonial First State Investments Ltd v FCT (Colonial)*.<sup>1</sup>

As set out in the Australian Taxation Office’s (ATO) decision impact statement for *Colonial*, it now seems that, for taxation purposes, very few traditional unit trusts will satisfy the strict definition of a “fixed trust”.

The former government’s discussion paper, *A more workable approach for fixed trusts*,<sup>2</sup> released following the *Colonial* decision, succinctly summarises the current uncertainty about the meaning of a fixed trust for taxation purposes and in turn the impact on taxpayers:

“In practice, very few trusts will qualify as a fixed trust unless the Commissioner of Taxation exercises the limited discretion to treat a trust as a fixed trust. This creates uncertainty and complexity for taxpayers and means that taxpayers and the Australian Taxation Office incur compliance and administrative costs in preparing and responding to applications to treat a trust as a fixed trust.”

This article considers the specific requirements for a trust qualifying as a fixed trust and the relevance of the fixed trust concept for taxation purposes.

Generally speaking, there are two types of fixed trusts, being “ordinary fixed trusts” and “widely held unit trusts”. An ordinary

fixed trust is a general term used to describe all trusts which are not “widely held unit trusts”. As set out above, this article will focus on the rules relating to ordinary fixed trusts and will not consider widely held unit trusts.

For completeness, the following topics, among others, are all potentially relevant in the context of fixed trusts (however, detailed consideration of them is outside the scope of this article):

- (1) stamp duty;
- (2) land tax;
- (3) small business concessions;
- (4) Div 7A;
- (5) tax consolidations;
- (6) the value shifting provisions;
- (7) the closely held trust rules; and
- (8) corporate unit trusts and widely held public trusts.

## What is a fixed trust?

As set out above, the definition of a fixed trust for taxation purposes is currently under review by the government following *Colonial*, which concluded that the meaning of a fixed trust is narrower than commonly thought by taxpayers and their advisers.

## The Colonial case

The decision in the *Colonial* case has created widespread uncertainty about the meaning of “fixed trust” for taxation purposes.

Colonial First State Investments Ltd (Colonial First State) was the responsible

entity for a retail managed fund, which invested in the units of a wholesale fund, also run by Colonial First State. It proposed to amend the terms of the constitution (ie trust deed) of the wholesale fund to give the trustee discretion to stream different types of income to certain redeeming unitholders. Colonial First State applied for a private ruling from the Commissioner as to the tax consequences of the proposed amendment.

A key objective of the amendments was to alleviate the perceived unfairness for some unitholders when streaming capital gains out of the fund. In particular, the amendments were intended to enable the streaming of non-discounted capital gains to unitholders who had held their units for less than 12 months, and in turn to ensure that long-term unitholders could receive the capital gains entitled to the general 50% discount.

One of the questions posed by the private ruling was whether the wholesale fund would be a fixed trust for tax purposes if the proposed amendments were made.

The court considered the definition of “fixed trust” in the *Income Tax Assessment Act 1997* (Cth) (ITAA97) which states that, at least for trust loss purposes, a fixed trust is a trust where the beneficiaries have fixed entitlements to the income and capital of the trust, and the definition of “fixed entitlement” in s 272-5, Sch 2F of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) which provides that:

“If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of

income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a fixed entitlement to that share of the income or capital.”

The court confirmed that a trust will be a fixed trust if the beneficiaries have a vested and indefeasible interest in all of the income and capital of the trust fund under the trust instrument. As the legislation does not define “indefeasible”, the court confirmed that its ordinary meaning should be applied, ie “that interest cannot be terminated, invalidated or annulled”.

The court found that the wholesale fund would not be a fixed trust as the unitholders’ interests in the income and capital of the trust were defeasible. This was primarily because of the operation of the provisions of the *Corporations Act 2001* (Cth) which allowed the unitholders to modify, replace or repeal the constitution by special resolution.

Ultimately, the court decided that if a unitholder’s interest could be reduced or detrimentally affected as a result of a special resolution of unitholders or other actions of the trustee, the unitholder could not have a “vested and indefeasible interest”, as required by Sch 2F ITAA36.

Given that the vast majority of unit trusts have variation provisions analogous to the one in *Colonial*, it is likely that, based on the decision, very few trusts in fact create a “vested and indefeasible” interest in a share of the income or capital of the trust estate.

As set out above, the former government released a discussion paper in July 2012 about the meaning of a fixed trust, and submissions on that discussion paper closed in September 2012. No announcement has since been made concerning proposed changes to the definition of fixed trust. Consequently, there is no formal guidance on what is meant by a fixed trust for tax purposes, and there remains significant uncertainty about how the ATO and the courts will apply the definition.

Further, the ATO’s decision impact statement for *Colonial* confirms that the ATO will offer no further guidance on the meaning of a fixed trust while the government is undertaking its review.

This article does not analyse the merits of the various reform options proposed by the government’s discussion paper.

### Fixed trusts and unit trusts – not necessarily the same

A unit trust is often an attractive investment vehicle for taxpayers, as it can offer many similar benefits to a corporate structure, with the following additional benefits:

- (1) access to the general capital gains tax (CGT) 50% discount;
- (2) the ability to issue units with different rights to income and capital;
- (3) no requirements for formal disclosure to ASIC and other regulatory bodies; and
- (4) no requirements for a formal audit.

Unit trusts are often viewed as the preferred structure for holding capital appreciating assets where there are unrelated third party investors.

Traditional unit trusts provide that the beneficial interest in the trust property is held in proportion to the units held by each unitholder. In *CPT Custodian Pty Ltd v Commissioner of State Revenue (CPT Custodian)*,<sup>3</sup> the High Court confirmed that there is no rigid meaning of a unit trust.

The ATO has confirmed in ID 2010/57 that a trust will be considered a unit trust for the purposes of Div 6C ITAA36 (which relates to the taxation of public trading trusts) where:

- (1) beneficiaries are made entitled to a share of a beneficial interest under a trust, such as an interest in either or both of the income and capital; and
- (2) the entitlement is measured by reference to a fixed standard of measurement,

irrespective of whether the trust deed labels the interests as “units”.

It also confirms that where the trust deed uses the phrase “pro-rata” to specify the relative interests of beneficiaries, then in most occasions of this nature, the holder of the beneficial interest will be a unitholder and the trust will be a unit trust.

As set out above, following the *Colonial* decision, whether a unit trust is a fixed trust for tax purposes is less than certain.

The test for qualifying as a fixed trust turns on whether the beneficiaries have a vested and indefeasible interest in the trust property. This must be ascertained from the terms of the trust deed, and in light of the guidance offered by *Colonial*, the following factors will be relevant to supporting that a trust is a fixed trust:

- (1) the trustee cannot create different rights or different classes of units;

(2) all units on issue must have the same rights to receive income and capital of the trust;

(3) units must be allotted for market value;

(4) all income and capital of the trust must be distributed in proportion to the unitholdings, ie there is no discretion held by the trustee;

(5) partly paid units cannot be issued;

(6) the trust deed requires all unitholders to agree on the redemption of units and any redemption must be at market value;

(7) all valuations of the trust fund, and in turn the determination of unit values, must be conducted by a valuer in accordance with “applicable Australian accounting principles”;

(8) the trustee cannot make gifts; and

(9) the unanimous consent of all unitholders is required to vary the trust deed and the variation power should prohibit amendments to any of the above provisions.

A power within the trust deed permitting the trustee to accumulate the income as corpus should not disqualify a trust from being a fixed trust, provided that the beneficiaries have a vested and indefeasible interest to the accumulated amounts.

Section 272-5 ITAA36 further confirms that the mere fact that units are redeemable, or that further units can be issued, does not mean that a unitholder’s interest is defeasible, provided the redemption or issue occurs for market value.

As confirmed in *Colonial*, having a vested and indefeasible interest is critical to the meaning of “absolute entitlement” for the purposes of the tax legislation.

“Absolute entitlement” is also a term clouded by uncertainty following the issue of TR 2004/D25 in draft in 2004 by the ATO (which remains unfinalised), and subsequent decisions confirming that it may never be possible to create absolute entitlement where the trustee has a right of indemnity from trust assets (eg in *Oswal v FCT (Oswal)*,<sup>4</sup> discussed in more detail below).

However, TR 2004/D25 confirms (notwithstanding that it remains in draft form) that the meaning of absolute entitlement is not relevant for a unit trust, on the basis that the CGT provisions in the ITAA97 treat the units in a unit trust as the relevant asset, rather than the unitholders’ interest in the underlying trust property.

It is important to understand the distinction between unitholders having a vested and indefeasible interest in the trust, as opposed to a proprietary interest in the underlying assets of the trust.

In *CPT Custodian*, the High Court stated that, as was later confirmed in *Colonial*, the nature of the interest of a unitholder will depend on the terms of the relevant trust deed. In particular, it was held that a sole unitholder was not the equivalent owner of the trust assets due to the trustee's right of indemnity. Under the trustee's right of indemnity, it could sell the assets held by the trust to satisfy that right of indemnity and, as such, a sole unitholder did not have a proprietary interest in the underlying assets of the trust.

### Unit trusts in multi-owner investment structures

Unit trusts are often seen as an ideal vehicle for investment activities between unrelated third parties in capital appreciating assets.

When determining an appropriate structure for a new investment venture, many factors are normally taken into consideration. These include, but are certainly not limited to, issues such as:

- (1) protecting the assets;
- (2) minimising tax payable on profits, both from an income and capital gains perspective;
- (3) flexibility of distributing income;
- (4) the ease of adding new investors; and
- (5) the ease of an investor's exit.

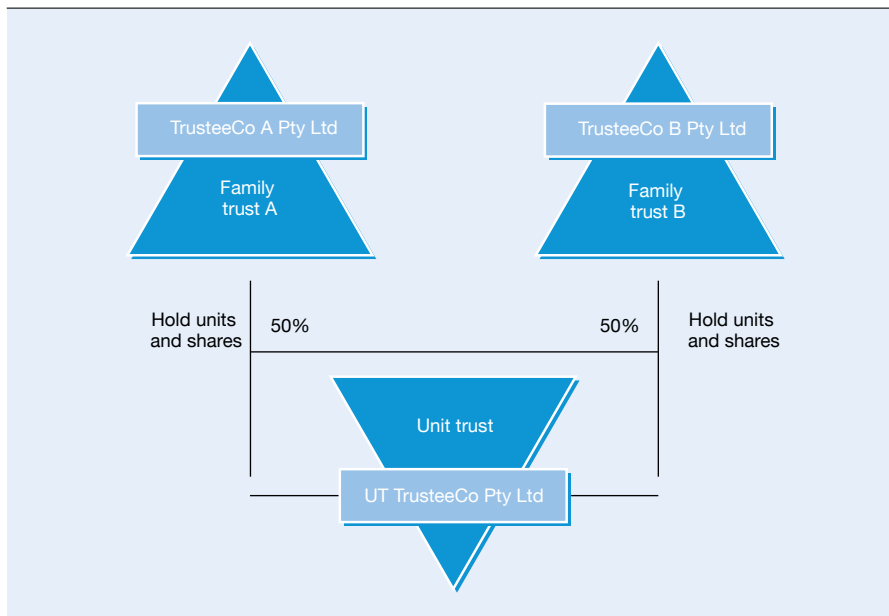
While a discretionary trust is often the ideal structure for making property investments where only one family group is involved, it is generally not an appropriate vehicle for investments between unrelated third parties.

While a unit trust or company both offer certainty for an investor's interest, given that each investor has a proportionate entitlement to both the income and capital returns of the underlying investment, a unit trust is often the preferred investment structure as it enables access to the general 50% CGT discount.

### Common structure

To maximise the combined benefits of discretionary and unit trusts, the investment structure summarised in Diagram 1 is often used for investments between unrelated third parties.

Diagram 1



In Diagram 1, the units in the unit trust are owned equally by two passive discretionary trusts. The shareholders of the corporate trustee of the unit trust are the same entities as the unitholders of the unit trust. Each unitholder would likely have a representative director on the board of the unit trust's corporate trustee.

The unitholders will often sign a shareholders' and unitholders' agreement governing the terms of their relationships, in addition to the provisions outlined in the trust deed for the unit trust and the constitution for the corporate trustee.

The unitholders themselves can borrow to finance the acquisition of units in the trust. The borrowed funds are used to subscribe for units in the unit trust, and the unit trust then uses the subscription funds to acquire the underlying assets. Alternatively, the unit trust itself can undertake the borrowings.

Obviously, if the unitholders borrow to subscribe for units, the deductibility of any interest expense on the borrowings is with each unitholder, rather than the unit trust.

### Related issues

When establishing a unit trust structure, it is important to ensure the deed is properly crafted to limit liability of the unitholders for debts of the trust. Unlike in a corporate structure, where shareholders are not liable for the debts of the company, there is a general principle that unless specifically excluded by the trust deed, the trustee will have a right of indemnity for the liabilities of

the trust against both the trust assets and the unitholders.

Failing to exclude this right of indemnity against the unitholders can therefore significantly undermine the asset protection advantages offered by structuring the investment through a unit trust.

Unitholders can generally access the small business concessions on the disposal of units in a unit trust, provided the usual requirements are met. The 50% general CGT discount should also be available if the units have been held for at least 12 months. It will be important, however, to consider the operation of CGT event E4, discussed in more detail below.

ID 2012/74 considers whether Div 7A ITAA36 applies where unitholders agree to retain their unpaid present entitlements within the trust in order to retire external debt incurred by the unit trust. ID 2012/74 confirms that in the factual scenario considered, because the unitholders agreed to defer receiving their proportionate share of the trust's profits and would continue to benefit in the trust assets proportionately to their unitholding, the unitholders were not providing financial accommodation to the trustee or any other taxpayer. Division 7A would therefore not apply.

### The relevance of qualifying as a fixed trust

Classification as a fixed trust is relevant across a number of areas of the taxation legislation, including:

- (1) the ability to pass on franking credits to unitholders;
- (2) the ability for a trust to carry forward tax losses;
- (3) ease of deductibility of borrowings; and
- (4) the application of CGT event E4 to distributions by fixed trusts.

Set out below are specific comments on a number of areas where the classification of a unit trust as a fixed trust is potentially relevant.

### Unit trusts and franked dividends

Unless a unit trust qualifies as a fixed trust, it is generally not a tax effective structure to hold shares in a company that is expected to pay franked dividends. In particular, the ITAA36 imposes strict requirements on when a franked distribution can “flow through an entity”. An entity which receives a franked distribution can potentially gross up its assessable income for the franking credit and obtain a tax offset equal to the franking credits received.

Division 207 ITAA97 confirms that franking credits cannot flow through a trust to the beneficiaries unless:

- (1) the trust is a fixed trust;
- (2) the trust is a family trust, ie it has made a family trust election; or
- (3) the beneficiary receiving the franking credits is a natural person whose tax offset entitlement does not exceed \$5,000 for the relevant income year.

Unless a unit trust is a fixed trust, the trust will need to make a family trust election in order to tax effectively stream dividends to beneficiaries.

A trust is only eligible to make a family trust election if it passes the family control test at the end of the specified income year. Family trust elections are made in respect of a family group, and must nominate an individual as the test individual whose family group is to be taken into account in relation to the election.

Once an election is made, it is generally irrevocable, subject to some specific exceptions. If a family trust makes a distribution to someone outside the family group, it will be subject to family trust distribution penalty tax.

Where units in a unit trust are held by unrelated third parties, it will usually be impossible for the unit trust to pass the family control test and therefore it will

be prevented from making a family trust election.

Even in circumstances where a unit trust is eligible to make a family trust election, the making of the election can significantly restrict the ability to make tax effective distributions in the future.

Practically, a unit trust will generally need to qualify as a fixed trust in order to enable unitholders to access franking credits.

### Status of distributions that are not fixed

#### Hybrid trusts

A key feature of a unit trust is that distributions are made by the trustee among the unitholders in proportion to the number of units held by each unitholder. A distribution of ordinary income is therefore assessable income to the unitholders. However, a distribution of capital is only taxable in the hands of the unitholder to the extent that it represents assessable income.

A hybrid trust is a general term without certain legal meaning, and is most commonly used to describe a trust where there are both fixed and discretionary entitlements to income and capital of the trust.

As set out above, a critical element of a fixed trust is that the unitholders have a vested and indefeasible interest in the trust property, ie that the trustee has no discretion as to each beneficiary’s entitlement to income and capital. Therefore, it follows that a hybrid trust will never satisfy the definition of a fixed trust due to the existence of the trustee’s discretion.

Where negative gearing is an objective, hybrid trusts have historically been a popular vehicle as they can be structured to give a unitholder fixed rights to income, with a broad range of beneficiaries being entitled to the capital of the trust at the trustee’s discretion.

In 2009, the Commissioner released TD 2009/17, which outlined the ATO’s view on the deductibility of interest incurred on borrowing funds to acquire an interest in a hybrid trust. In TD 2009/17, the ATO confirms its view that if the trustee has the ability to make discretionary distributions, a deduction for the full amount of interest incurred to fund the acquisition of units in the trust is not available.

In particular, the Commissioner states:

“Where the terms of the trust indicate that the borrowed moneys have been used to benefit

both the taxpayer and others, an apportionment calculation will be required to determine the taxpayer’s interest deduction.”

Decisions following the release of TD 2009/17 indicate that the ability for a taxpayer to deduct their interest expenses for an investment in a hybrid trust will depend heavily on the specific facts and circumstances in each case, particularly with reference to the construction of the trust deed.

#### Forrest

Following the release of TD 2009/17, the Full Court of the Federal Court considered the principle in *Forrest v FCT*.<sup>5</sup> In that case, Mr Forrest borrowed \$4.5m to acquire units in the Minderoo Trust. The Minderoo Trust had both discretionary beneficiaries (Mr Forrest’s family members) and Mr Forrest personally as the sole unitholder, and was what would be considered a “typical” hybrid trust.

The Commissioner argued that due to the discretion held by the trustee in making distributions, there was no certainty that the income of the trust would be distributed to Mr Forrest, and therefore there was not a sufficient nexus between the interest incurred and Mr Forrest gaining or producing assessable income. The Commissioner relied heavily on a provision in the trust deed which allowed the trustee to classify amounts received or disbursed by the trust as income or capital.

Mr Forrest argued that as he was the sole unitholder, he was fully and solely entitled to the ordinary income produced by the Minderoo Trust and could consequently claim a deduction for the full amount of the interest incurred on the \$4.5m he borrowed to acquire units in the Minderoo Trust. The operation of the relevant clause, he argued, was a power to classify amounts as being on capital account or income account, and did not affect his entitlement to all of the ordinary income of the Minderoo Trust.

The court concluded that the relevant clause was merely a discretionary power to be used by the trustee in administering the trust and it did not amount to a power to classify a receipt of income incorrectly as a capital gain. Therefore, the full amount of the interest expense incurred was deductible to Mr Forrest.

Somewhat unhelpfully, the court did not consider the Commissioner’s view set out in TD 2009/17 that the interest should be apportioned. Consequently,

the Commissioner chose not to alter his position outlined in TD 2009/17.

### Lambert

In the decision of *Lambert and FCT*,<sup>6</sup> the Administrative Appeals Tribunal (AAT) denied the taxpayer a deduction for interest incurred on borrowings obtained to fund the purchase of investment properties by a discretionary trust, of which the taxpayer was the trustee. While the documentation indicated that the borrowings were made by the taxpayer in his capacity as trustee of the trust, he argued that the intention was to make the borrowings in his personal name and on-lend the funds under an interest-free loan to the trust.

Although the properties were held by the discretionary trust, the taxpayer in his capacity as trustee signed a deed of variation which purported to ensure that the taxpayer was to receive the entire income from the trust until further notice. That is, the variation sought to create a fixed entitlement to the income of the trust for the taxpayer.

The arrangement (if successful) would have largely achieved a similar outcome as in *Forrest* in that the asset would have been owned by a trust, while the taxpayer would have been entitled to a tax deduction on the borrowing expense.

However, the AAT found that the variation was an ineffective exercise of the trustee's power of amendment under the trust deed because it was not executed validly. Also, the amendment was held to be void because it was inconsistent with the trustee's fiduciary duty to vary the deed for the benefit of the beneficiaries as a whole; the attempted amendment was in fact for the sole benefit of the taxpayer.

Furthermore, the AAT rejected that there was sufficient evidence to support an argument that the borrowings were made by the taxpayer in his personal name. Therefore, the interest liability arose to the taxpayer in his capacity as trustee of the trust, and the taxpayer's personal claim for the deductions were denied.

### Borrowing by unit trusts

#### Trustee's power to borrow and mortgage

As with any form of trust, the trustee of a unit trust or fixed trust must consider its fiduciary duty to maintain and protect the assets of the fund when undertaking

investments and in particular, when borrowing and offering trust property as security.

While the powers conferred on a trustee vary in each jurisdiction, the trustee has a statutory power to borrow and raise money by granting a mortgage where the trust deed contains a broad power to pay or apply the capital of the trust for any purpose. The trust deed should also contain an express power authorising the trustee to borrow and grant security over the trust property.

(3) units acquired in a unit trust before 12 August 1999.

### In-house assets

A superannuation fund may invest in a unit trust (subject to the application of the non-arms' length income provisions discussed below) provided that the unit trust is not a related party of the fund.

There is a prohibition in the SISA which restricts the amount of in-house assets that can be owned or invested by a superannuation fund to generally 5% of the market value of the fund's assets.

## “The test for qualifying as a fixed trust turns on whether the beneficiaries have a vested and indefeasible interest in the trust property.”

### Investments in unit trusts by self-managed superannuation funds

The meaning of a fixed trust appears frequently within the borrowing and investment framework for superannuation funds in the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA).

Borrowing by self-managed superannuation funds is predominantly structured through a form of fixed or bare trust, largely due to the general prohibition in the SISA against superannuation funds borrowing or maintaining a borrowing of money unless the borrowing is a “limited recourse borrowing arrangement”.

This arrangement allows a trustee of a superannuation fund to borrow money, or maintain a borrowing of money, under an arrangement where, among other requirements, the original asset or replacement asset is effectively held on a bare trust so that the trustee of the superannuation fund acquires a beneficial interest in the asset. In light of this requirement, the bare trust will generally satisfy the definition of a fixed trust.

Given the general restriction on direct borrowing by superannuation funds, a unit trust is often an appropriate vehicle for making investments through superannuation, and is generally structured through:

- (1) a jointly held unit trust, provided the unitholders are unrelated;
- (2) an ungeared unit trust; or

A unit trust that is controlled by a related party of the fund will be an in-house asset and caught by this prohibition, unless the trust satisfies the exemption in reg 13.22C of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (ie it is an ungeared unit trust).

The test for whether a trust is controlled by a related party of the fund requires consideration of the fixed entitlements of the unitholders. In particular, a related party of the fund will be deemed to control the trust if the fund or its associates have a fixed entitlement to more than 50% of the capital or income of the trust.

There is an exception to the in-house asset test in reg 13.22C for a unit trust that does not have any borrowings, notwithstanding that the trust may be a related party of the superannuation fund. This commonly arises where a superannuation fund wishes to make an investment through a unit trust with other (non-superannuation fund) unitholders who can borrow to invest in the trust, or if no borrowing is required to fund the investment.

To be eligible for the exemption, the following conditions need to be met:

- (1) the trust does not borrow;
- (2) the trust does not invest in or loan money to individuals or other entities (other than deposits with authorised deposit-taking institutions);
- (3) there is no charge over an asset of the trust;

- (4) the trust has not acquired an asset from a related party of the fund other than business real property;
- (5) the trust has not acquired an asset (apart from business real property) that had been owned by a related party of the fund in the previous three years;
- (6) the trust does not directly or indirectly lease assets to related parties other than business real property;
- (7) the trust does not conduct a business; and
- (8) the trust conducts all transactions on an arm's length basis.

Prior to 12 August 1999, an investment by a superannuation fund in a related unit trust was not an in-house asset. The transitional arrangements following the expansion of the definition of an "in-house asset" permit a fund to maintain an investment in a pre-12 August 1999 unit trust where the investment was not previously an in-house asset. However, it is relevant to also bear in mind that the sole purpose test and the non-arm's length income provisions may still apply to the investment. Following 30 June 2009, any further investments in a pre-1999 unit trust will be an in-house asset unless a specific exemption applies.

**Non-arm's length income**

Income derived by a superannuation fund as a beneficiary of a trust, other than because of holding a fixed entitlement to the income, is non-arm's length income of the entity and will be taxed at penalty rates under the non-arm's length income provisions of the ITAA97. It is therefore important to ensure that the unit trust is a fixed trust for taxation purposes if the unitholder is a superannuation fund.

Income derived by a superannuation fund as a beneficiary of a fixed trust will also be non-arm's length income if:

- (1) the fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arms' length; and
- (2) the amount of the income is more than the amount that the fund might have been expected to derive if those parties had been dealing with each other at arms' length.

To avoid the impact of the non-arm's length income rules, it is therefore vital for taxpayers and their advisers to ensure that:

- (1) no distributions are made to a superannuation fund from a discretionary trust; and
- (2) where a superannuation fund owns units in a unit trust, that the unit trust is a fixed trust for tax purposes.

The ATO has expressed the view in TR 2006/7 that the meaning of a "fixed trust" must be ascertained from the terms of the relevant trust deed.

It is also relevant to note that the non-arms' length income rules may apply where a self-managed superannuation fund allows its fixed entitlement to remain as an unpaid present entitlement, as this does generally not reflect an arms' length arrangement.

When allowing unpaid present trust entitlements in favour of a superannuation fund, it is therefore necessary to ensure that interest on those unpaid distributions is paid by the trust at market rates as would be the case if the superannuation fund and trust were dealing with each other at arm's length.

**Are there risks with unit trusts in trust loss rules?**

Schedule 2F ITAA36 contains a number of measures intended to restrict recoupment of losses and to prevent the transfer of the tax benefit of losses to an entity that did not bear the economic loss at the time it was originally incurred by the trustee.

As the application of the trust loss rules varies depending on the type of trust in question, the classification of a trust as fixed trust is critical when considering the ability to access trust losses.

Schedule 2F defines "fixed entitlement" for the purposes of identifying a fixed trust for trust loss purposes. However, as set out above, this definition specifically requires the beneficiaries to have a "vested and indefeasible" interest in the trust property, the meaning of which is unclear following *Colonial*.

If a trust is considered a fixed trust, it will only need to pass the 50% stake test and income injection test to access the losses within the trust. An excepted trust, which is defined as a fixed trust where all the entitlements to capital and income are held by tax-exempt entities, is entirely exempt from satisfying the trust loss tests.

Table 1 provides a diagrammatic summary of the relevant tests for each type of trust.

**50% stake test**

The 50% stake test operates to ensure that there has been no significant change in the ownership of a trust. A fixed trust will satisfy the 50% stake test if there are individuals who have fixed entitlements, either directly or indirectly, to more than 50% of the income or capital of the trust estate for the entire relevant period.

If no individual has a stake of more than 50% in the income or capital of the trust for the entire relevant period, the test will not be satisfied.

For example, assuming a trust otherwise satisfies the fixed trust definition, and the following facts apply:

- (1) John and Mary have a 70% fixed entitlement to the income and capital of the Smith Family Unit Trust;
- (2) Stephen and Jane hold the remaining 30% entitlement;
- (3) the Smith Family Unit Trust has a loss in 2010; and
- (4) during 2011, John and Mary sell their 70% interest to Nicholas.

In the above example, as the original unitholders owning more than 50% of the fixed entitlements have not held their interest for the entirety of the relevant period, the trust will fail the 50% stake test and the loss cannot be used in the 2011 financial year.

**Alternate test for fixed trusts**

The 50% stake test will be failed where the units are not held by individuals, for

**Table 1**

Fixed trust	Non-fixed trust	Family trust
50% stake test	50% stake test	Modified income injection test
Income injection test	Income injection test	
	Control test	
	Pattern of distributions test	

example, in circumstances where the units are held by discretionary trusts.

However, the alternate test for fixed trusts allows the 50% stake test to be passed if non-fixed trusts own more than 50% of the income and capital of the fixed trust, provided those unitholder trusts themselves satisfy the relevant trust loss provisions applying to non-fixed trusts.

Broadly, this means that a unitholder discretionary trust holding more than 50% of the income and capital of a fixed trust must also satisfy both the pattern of distributions test and the control test (summarised below), unless it has made a family trust election.

### Income injection test

The income injection test is intended to prevent an “outsider” of a trust “injecting” funds into the trust to take advantage of losses.

The income injection test applies where:

- (1) the trust has a deduction (including prior year losses) in the income year being examined;
- (2) there is a scheme under which the trust derives assessable income, an outsider provides a benefit and a return benefit is provided to the outsider; and
- (3) it is reasonable to conclude that the assessable income has been derived or the benefits have been provided, wholly or partly, because the deduction is allowable.

An “outsider” for the purposes of a fixed trust is any person who is not the trustee of the trust, or a person with a fixed entitlement to a share of the income or capital of the relevant trust.

### Deductibility of losses by non-fixed trusts

The trust loss measures applying to a non-fixed trust (ie any trust that is not a fixed trust) are significantly more onerous than the measures applying to a fixed trust.

If the trust is a family trust (ie a discretionary trust which has made a family trust election), only the income injection test will need to be satisfied. All other non-fixed trusts will have to pass not only the 50% stake test and income injection test (set out above), but also the:

- (1) pattern of distributions test; and
- (2) control test.

These tests must all be satisfied before a non-fixed trust is able to carry-forward losses.

### Pattern of distributions test

The pattern of distributions test considers whether distributions have consistently been made to the same individuals. In practice, this is normally the most difficult test to pass.

A trust passes the pattern of distributions test for an income year if the trust distributed at least 50% of the income and capital to the same individuals, directly or indirectly, in each test year. Although there is no requirement for the individuals who received the income and capital to be the same individuals, if the test is not satisfied for both income and capital, the test is failed.

The test must be satisfied for every year the trust makes distributions out of the preceding six income years. If separate percentages of distributions are made, the smallest distribution percentage during the period is applied to all income years. This is obviously more relevant where the trustee has discretion when determining the distributions from the trust in each income year.

The meaning of “distribution” is given a wide meaning and includes paying or crediting income or capital (this includes loans), transferring income or capital, reinvesting the income or capital on behalf of a person in accordance with their directions and applying the income or capital to a person’s benefit.

### Control test

The control test examines whether a different group commences to control the trust after the relevant loss year. A group includes a person and their associates, either alone or together.

A group controls a non-fixed trust if:

- (1) the group has the power by means of the exercise of a power of appointment or revocation or otherwise to obtain beneficial enjoyment of the capital or income of the trust;
- (2) the group is able, directly or indirectly, to control the application of the capital or income of the trust;
- (3) the group is capable, under a scheme, of gaining the beneficial enjoyment referred to in (1) or the control referred to in (2);
- (4) the trustee is accustomed, under an obligation or might reasonably be

expected to act in accordance with the directions, instructions or wishes of the group;

- (5) the group is able to remove or appoint the trustee; or
- (6) the group acquires more than a 50% stake in the income or capital of the trust.

The test deals with more practical notions of “control” rather than changes of trustees within the group. A new trustee or appointor from outside the original group, however, would cause the test to be failed.

### Converting a non-fixed trust into a fixed trust – tax implications

In some circumstances, it may be desirable or commercially necessary to convert a non-fixed or discretionary trust into a fixed trust. However, the CGT consequences of such an exercise need to be examined carefully and in particular, the risk of triggering a trust resettlement (ie the creation of a new trust giving rise to CGT event E1).

### Resettlement consequences

In 2011, the Full Court of the Federal Court in *FCT v Clark (Clark)*<sup>7</sup> considered the circumstances in which a resettlement would occur. In that case, the trust in question was a unit trust which had been substantially varied over several years by changing the trustee, the beneficiaries and the trust property.

In rejecting the Commissioner’s argument that these amendments had amounted to a resettlement of the trust, the court held that the three factors to consider when determining whether there has been a continuum of a trust are:

- (1) the terms of the trust deed;
- (2) the trust property; and
- (3) the membership of the trust.

Further, the court confirmed that where the changes are within the scope of the variation power in the relevant trust deed, changes over time to the trust property and beneficiaries should not trigger a resettlement, provided that they can be identified at all times and there has not been a severance which would lead to the termination of the trust.

Following *Clark*, the ATO accepted in TD 2012/21 that a valid amendment to a trust not resulting in a termination of the trust will not of itself result in the happening of CGT event E1.

TD 2012/21 confirms that the ATO's position, formerly set out in its statement of principles (SOP), was unsustainable following the court's decision in *Clark* and that:

"Neither CGT Event E1 nor CGT Event E2 ... happens unless:

- the change causes the existing trust to terminate and a new trust to arise for trust law purposes, or
- the effect of the change ... is such as to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust."

The ATO has also withdrawn the SOP which had set out the ATO's view on when it believed changes to a trust would give rise to a new trust (and therefore trigger CGT consequences).

The ATO has also confirmed in its decision impact statement released for *Clark*:

"To the extent that the High Court in *Commercial Nominees* left open the possibility that there might be a loss of continuity in circumstances short of the existence of the trust having come to an end, the Commissioner acknowledges that in *Clark* there were significant changes to the property, membership and operation of the [Trust] without any finding by the courts that there was a loss of continuity such as to deny the trust access to the losses being carried forward."

Although *Clark* and the ATO's withdrawal of the SOP have narrowed the ATO's previously wide interpretation of when a variation would amount to a resettlement, there remains some uncertainty about the scope of permissible variations.

The recent decision by the Federal Court in *Oswal* is one of the first decisions to consider CGT event E1 following *Clark*. In this case, the trustee of a discretionary trust resolved to hold shares that were a part of the corpus of the trust on sub-trust for the absolute benefit of certain beneficiaries of the trust.

The trustee, Mr *Oswal*, argued that the declaration did not create a new trust over the shares, but merely created a separate fund of the relevant assets within the trust. The court agreed with the ATO and held that the resolution by the trustee to make the beneficiaries absolutely entitled to the shares triggered CGT event E1.

This decision would appear to be consistent with one of the examples given by the Commissioner in TD 2012/21. It should be noted, however, that Mr *Oswal*

has appealed the decision to the Full Court of the Federal Court, and the appeal is expected to be heard in December 2013.

Importantly, as *Oswal* did not expressly discuss *Clark* or "resettlements", it offers limited guidance when considering the resettlement consequences of converting a discretionary or non-fixed trust into a fixed trust.

For completeness, *Clark* confirms the longstanding trust law principle that the variation must be within the scope of the variation power in the relevant trust deed.

### Converting a non-fixed unit trust into a fixed trust

In light of the guidance offered by *Colonial* about the meaning of a fixed trust, it may be appropriate to vary the trust deed for a unit trust to ensure that it qualifies as a fixed trust.

Given the narrow interpretation of the meaning of "resettlement" following *Clark*, variations to a trust deed to insert or remove the provisions summarised above should not create any risk of a resettlement, as there would remain continuity of the trust, applying the key indicia of continuity of trust terms, trust property and membership.

### Converting a discretionary trust into a fixed trust

The SOP confirmed the ATO's historic view that converting a discretionary trust to a unit trust would trigger a resettlement. However, there is limited guidance following *Clark* and the withdrawal of the SOP about whether a discretionary trust being converted to a fixed trust, ie bestowing a fixed entitlement to income and capital on particular beneficiaries, would amount to a resettlement.

A variation to convert a discretionary trust into a unit trust would result in a material change to the range and entitlements of beneficiaries. However, it is unclear whether this change would be significant enough to trigger a resettlement, particularly in circumstances where the default beneficiaries remain unchanged (which may be a requirement for stamp duty purposes in some states if the trust owns dutiable property).

Importantly, the Commissioner acknowledged in TD 2012/21 that:

"... assuming there is *some continuity* of property and membership of the trust, an amendment made to the trust that is made in proper exercise of a power of amendment contained under the deed

will not have the result of terminating the trust, irrespective of the extent of the amendments so made so long as the amendments are properly supported by the power." (emphasis added)

The Commissioner's use of the words "some continuity" above suggest that, even where there is not absolute continuity of trust property and membership, the Commissioner is willing to accept that significant amendments will not cause the termination of the trust, provided the amendment is made pursuant to a sufficient power of variation.

In cases where there are changes to the beneficiaries of the trust but continuity of the trust property, there should generally be sufficient continuity of the trust, ie "some continuity" in the Commissioner's words. It is therefore arguable that the variations required to convert a discretionary trust to a fixed trust are not so significant as to indicate the continuity of the trust has not been maintained.

It is also relevant to consider the application of CGT events E3 and E5. CGT event E3 happens if a trust over a CGT asset is converted to a unit trust, and just before the conversion, a beneficiary of the trust was absolutely entitled to the asset. CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust to which Div 128 ITAA97 applies) as against the trustee (disregarding any legal disability the beneficiary is under).

If no beneficiary has absolute entitlement, CGT events E3 and E5 will not happen. Although a discussion about the meaning of absolute entitlement is outside the scope of this article, as set out above, the concept of absolute entitlement is largely unsettled, and following the recent *Oswal* decision, it may in fact be somewhat difficult to establish that CGT event E3 or E5 has been triggered.

### Tax issues for unit trusts and CGT event E4

While a unit trust is akin to a company in some respects, as the unitholders will have set entitlements to income and capital, a unit trust is a "flow-through" vehicle for tax purposes, meaning income and capital gains must be distributed to the beneficiaries in proportion to their unitholding, and any undistributed income in each financial year will be taxed at the highest marginal rate.

The consequences of CGT event E4 must be considered when distributing



non-assessable income from a unit trust that is a fixed trust for tax purposes. CGT event E4 is relatively complex in practice, and broadly happens if:

- (1) the trustee of a trust makes a payment to a taxpayer in respect of the unit or interest in the trust (except for CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and
- (2) some or all of the payment (the non-assessable part) is not included in the taxpayer's assessable income.

If the trust does not qualify as a fixed trust, CGT event E4 will not apply. The application of CGT event E4 is therefore a relevant consideration when determining whether to establish a unit trust as a fixed or non-fixed trust.

### When does CGT event E4 apply?

It is relatively common for non-assessable amounts to be included in a distribution, giving rise to a difference in "tax law income" and "trust law income". That is, the net income of the trust (calculated in accordance with s 95 ITAA36) exceeds the income of the trust available for distribution (calculated in accordance with the deed). This difference could arise for several reasons, including:

- (1) expenses chargeable against trust income for that income year but not deductible in that income year;
- (2) the small business 50% reduction; or
- (3) building allowances in accordance with Div 43 ITAA97.

Ultimately, the objective of CGT event E4 is to increase the tax payable by a unitholder in situations where non-assessable amounts would not otherwise be included in the unitholder's assessable income.

After amendments to the law in 2001, CGT event E4 no longer applies to a payment of the non-assessable general 50% CGT discount. Again, the rules in this regard are relatively complex. However, there are a number of concessionally treated amounts which are excluded when calculating the non-assessable component to ensure that CGT event E4 does not capture concessions which should otherwise be exempt.

There are calls for further reform requesting that timing differences be removed from the scope of CGT event E4, following the release of ID 2012/63, which confirms that CGT event E4 will apply where the trust income exceeds net income for the particular year.

If CGT event E4 is triggered, the cost base of the units is reduced by the

non-assessable amount (but not below nil). The taxpayer will make a capital gain if the non-assessable part of the distribution is more than their cost base. However, it is possible to apply the general 50% CGT discount to any capital gain, provided that the taxpayer is not a company and has held its units for longer than 12 months.

### Conclusion

Although the benefits of a trust being considered a fixed trust for tax purposes are clear, the definition of a "fixed trust" is anything but.

While *Colonial* provides some guidance about the requirements for a unit trust to qualify as a fixed trust, the government's proposed reform of the fixed trust definition and the ATO's response to the *Colonial* decision create significant uncertainty and complexity for taxpayers and their advisers. For some taxpayers, the lack of flexibility arising from seeking to satisfy the fixed trust criteria suggested by *Colonial* may in fact outweigh the taxation benefits of qualifying as a fixed trust.

*Tara Lucke, FTI*  
Senior Associate  
McCullough Robertson

*Matthew Burgess, CTA*  
Partner  
McCullough Robertson

*Liam Polkinghorne*  
Lawyer  
McCullough Robertson

### Disclaimer

This article covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. This article is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue.

### References

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