

Unit trusts and fixed trusts ... reading the deed is only the start

- by Matthew Burgess, Director, View Legal

As reported at 2017 WTB 28 [956], one area that seems to be receiving an increasing amount of interest from the ATO in recent times concerns the distinction between a unit trust and a fixed trust.

Often, the differences between these 2 types of trusts can be quite subtle.

As with most trust interpretation issues, the interpretation of the trust deed will be critical in this regard. In other words, as regularly explained in this *Bulletin*, the starting point in any trust related matter is to read the trust deed.

Draft ATO Guideline

Where a trust deed is reviewed and the instrument does not reflect the intention of the parties, it is generally possible to convert what would otherwise be a unit trust into a fixed trust for tax purposes (and vice versa) without any adverse tax or stamp duty consequences.

Whether a unit trust is in fact a fixed trust is an area that has been the subject of significant uncertainty.

In October 2016, the ATO did release draft Practical Compliance Guideline 2016/D16 on its view of what is a fixed trust – see 2016 WTB 45 [1558] (the draft is expected to be finalised soon).

Unfortunately, the release by the ATO is problematic for at least 3 reasons, namely:

- it only considered the meaning of "fixed trust" for the purpose of the trust loss provisions under the ITAA;
- the drafting approach of the ATO is non-definitive; in other words, the ATO confirms it will retain the discretion to deem a trust not to be fixed despite what it sets out in the guidelines;
- furthermore, the guidelines are not themselves binding on the ATO.

Subject to the above comments, broadly, it seems to be accepted that the following factors will be relevant to supporting that a trust is a fixed trust:

- the trustee cannot create different rights or different classes of units;
- all units on issue must have the same rights to receive income and capital of the trust;
- units must be allotted for market value;
- all income and capital of the trust must be distributed in proportion to the unitholdings, ie there is no discretion held by the trustee;
- partly paid units cannot be issued;
- the trust deed requires all unitholders to agree on the redemption of units and any redemption must be at market value;
- 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";
- the trustee cannot make gifts;

- 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.

When is a trust not a unit trust?

As many will recall, late in 2016, the High Court confirmed its view of "unit trust" within Div 6C of Pt III of the ITAA 1936 in the decision in *ElecNet (Aust) Pty Ltd (as trustee for the Electrical Industry Severance Scheme) v FCT* [2016] HCA 51 (reported at 2017 WTB 1 [43]).

In that case, the issue of whether a trust was a unit trust was critical as unless the structure was a unit trust, it would not be able to be treated as a company for tax purposes under the public trading trust regime.

The High Court relevantly held that because the relevant interests in the scheme did not create "discrete parcels of rights", they could in turn not be characterised as "units".

In particular, the taxpayer's argument that the statutory definition of "unit" in s 102M of the ITAA 1936 only requires an interested party to have "a beneficial interest in any property" of the trust estate was held to not have wider application.

Indeed, the High Court held the relevant interests in the trust under review were in fact "discretionary" in nature which reinforced that the trust could not satisfy the concept of a "unit" interest, which essentially needs to be analogous to shares in a company.

Converting water into wine (or family trusts into fixed trusts)

For a myriad of structuring issues, one other related issue that appears to be raised more regularly is whether it is possible to convert a family discretionary trust into a fixed trust.

This issue has been considered by the ATO in Private Ruling Authorisation Number 1012991136582.

Broadly, the factual matrix was as follows:

- a "standard" family trust held an asset;
- the trust had a widely crafted power of variation;
- the trustee resolved to make a capital distribution of the balance in the unrealised capital profits account to certain beneficiaries, with this amount left unpaid (ie meaning it was a debt owed by the trust to the beneficiaries);
- by agreement, there was then a conversion of the debts (and some other outstanding loans) to equity such that each of the relevant beneficiaries had a certain percentage of "equity" in the trust;
- relying on the power to vary, the trustee then amended the terms of the trust deed to convert it into a fixed unit trust.

After analysing the provisions of its Tax Determination in relation to resettlements (namely TD 2012/21), the ATO confirmed that so long as the amendments are within the powers of the trust deed, the continuity of the trust will be maintained for trust law purposes.

This is because the ultimate beneficiaries of the trust after the proposed amendments would be the individuals who were the objects of the trust before the variation. The fact that the extent of the interests of the beneficiaries in the trust change as a result of the variation was seen as irrelevant.

Therefore, the amendments to the terms of the trust did not trigger CGT event E1 or CGT event E2, being the "resettlement" CGT events.

CGT event E1 happens if a trust is created over a CGT asset by declaration or settlement.

CGT event E2 happens if a CGT asset is transferred to an existing trust.

The ATO further confirmed that CGT event E5 was not triggered by the conversion of a family trust to a fixed trust.

CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust as against the trustee despite any legal disability of the beneficiary.

CGT event E5 does not however happen if the trust is a unit trust and thus this exemption was held to apply here.

The ATO also confirmed that there are no other CGT events that happened when the family trust was converted into a unit trust. This is because the amendments were within the trustee's powers contained in the trust instrument. This in turn meant that the continuity of the trust was maintained for trust law purposes.

Conclusion (as is always the case with trusts) – read the deed

As regularly highlighted in this *Bulletin*, ***it is critical to "read the deed"*** before purporting to take any steps in relation to a trust.

The difficulties that arise in relation to unclear definition of a "fixed trust" are yet another example of this.

Furthermore, as is the case with so many other trust related areas however, the need for the Government to prioritise legislative clarity is paramount.

Given so many issues turn on whether a trust is fixed for tax purposes, it is a terrible reflection on our tax laws that this question continues to be so unnecessarily complex.