

Unit Trusts – Fixed & Hybrid

Fixed entitlements

- Ungearred fixed unit trust (real estate & cash only) – a controlling SMSF can be a unitholder
- Other ungearred or geared fixed unit trusts

Flexible entitlements

- Hybrid trust – voting units only
- Hybrid – income units
- Hybrid – capital growth units
- Non-fixed unit trust

Management of the reduction of capital issue (CGT Event E4) can be a major issue for trusts with any unitisation

Unit Trusts – Fixed and Hybrid – 6 Australian Variations

1. **(Ungearred) fixed unit trusts holding real estate** with some or all of the units held by a “controlling” SMSF trustee (non-SMSF unitholders may be fully geared if they hold ordinary units – income tax deductions for interest may be limited if they hold preference or income only units).
 2. **(Geared or ungearred) fixed unit trusts** holding real estate, listed and private securities, businesses and non-real estate business assets with **no units held by controlling SMSF** trustees (the trust itself and the units may be geared).
 3. **Fully discretionary hybrid trusts with voting unitholders only** holding real estate, businesses unlikely to have annual income tax losses, eg most professional practices, and non-real estate business assets (unitholders may lend or on-lend to the trust at market or other interest rates).
 4. **Hybrid trusts with fixed income (and voting) unitholders** holding real estate and possibly businesses and non-real estate business assets (unitholders holding fixed income units have limited access to income tax deductions for the interest paid; distributions of capital are at the discretion of the trustee).
 5. **Hybrid trusts with fixed capital (and voting) unitholders** holding real estate and possibly businesses and non-real estate business assets. Most trusts of this type were established in the 20th century.
 6. **Non-fixed unit trusts with default fixed units** holding real estate and possibly businesses and non-real estate business assets. Most trusts of this type were established in the 20th century.
- Investments that would cause the need for a family trust election for income tax purposes, eg shares, should be avoided in hybrid or non-fixed unit trusts unless the unitholders and beneficiaries are all within the same family group.

Asset & Trust Type

Asset	Impact on Choice of Unit Trust
Real estate (must be ungeared if trust has SMSF unitholder)	Non-SMSF unitholders can only gear purchase of units if they have a fixed interest in trust income & capital or (gearing may be limited) income only
Listed or private securities	Family trust elections likely to be needed (a problem if unitholders are not related); SMSFs cannot be an investor
Business or non-real estate business assets	Family trust elections can be needed if there are income losses; SMSF cannot be an investor

Fixed Private Unit Trusts

While the beneficiary entitlements are expressed in units rather than absolute or proportional terms, a fixed private unit trust has no trustee discretion or flexibility as to benefit and the entitlements of the unitholders are very close to those of the beneficiaries of an absolute trust.

This fixed attribute makes an ungeared fixed private unit trust a potential investment vehicle for commercial and residential real estate for a trustee of an SMSF, as the trust falls within the type of private trust that is excluded from the penal "non-arm's length income" taxation provisions. The trustee of such a unit trust is able to buy "business real property", as defined in section 66 of the *Superannuation Industry (Supervision) Act 1993* ("the *SIS Act*"), from unitholders, SMSF unitholder members and associates, but must acquire residential property from 3rd parties. (Other forms of non-cash investments in a fixed such as listed and private securities and business assets place the trustee of an SMSF in breach of the investment rules in the Superannuation Industry (Supervision) Regulations 1994.)

The fixed attribute also applies to a 2nd type of private fixed unit trust, ie one that is able to have gearing over its assets, but is also able to offer its non-SMSF unitholders the ability to claim an income tax deduction for interest paid to acquire units in the geared fixed unit trust. Since August 1999, the trustees of SMSFs have not been permitted by the *SIS Act* to invest in a geared private unit trust.

While the operation of the 2 types of fixed unit trusts is quite different, the governing trust Deed will be very similar for both types.

Comparison – Unit Trusts

Fixed

- SMSF investment vehicle for real estate (*see notes*)
- Family trust elections are less of an issue
- May qualify for more favourable land tax treatment
- Major CGT problem – s104-70 (see notes)

Hybrid

- Greater flexibility as to income and/or capital
- S104-70 problem manageable
- Greater need for unitholders' agreement
- Risk of resettlement when voting unitholders change
- Family trust election problems limit their use

Requirements for SMSFs to be Able to Invest in Private Trusts

The trustee of an SMSF can only invest in a private trust (similar rules apply to private companies, with an additional need to secure the exercise of the ATO's discretionary approval) if in relation to the private trust and its investments:

- There are no outstanding borrowings or charges (that commenced after 11 August 1999).
- There are no investments in (or loans to) individuals or to entities other than financial institutions (this effectively blocks investments in listed securities).
- No business is being conducted.
- All transactions are being conducted on an arm's length rate basis (including the purchase and lease of business real property).
- Leases of business real property to a related party are legally binding.

The trustee of an Australian superannuation fund will be subject to maximum "non-arm's length" income tax rates (currently 45%) on income received from private trusts, unless the fund's interest in the trust is fixed and not able to be enhanced or diluted by non-arm's length transactions, eg the issue of further units at par, rather than at market value.

Section 104-70 – Reduction of Capital

A major problem for unitholders directly receiving trust income and capital is the operation of CGT Event E4. This is triggered whenever the trust's "accounting" income exceeds taxable income, but does not provide any compensation for the trust whenever the "taxable" income is greater. The section operates to reduce the cost base of the trust or (if there is no cost base or no remaining cost base) triggers an immediate taxable capital gain for the unitholders.

CGT & State Duty

Unitholder (Fixed/Non-Fixed)

- Reduction of capital provisions (CGT event E4 for unitholder)
- S115 discount not taxed; 152-C taxed on distribution
- Issue of income/capital units not a CGT event
- Distribution of trust capital dutiable in NSW, but not Vic

Hybrid (Non-unitholder)

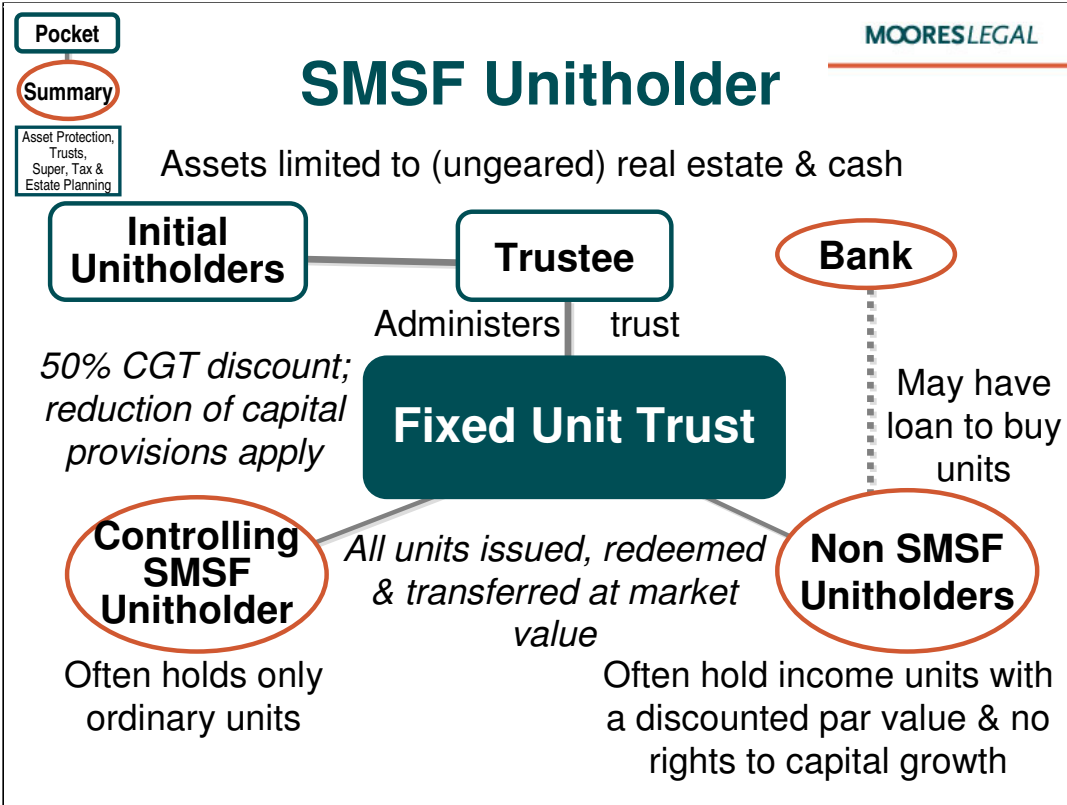
- Absolute entitlement provisions (CGT event E5 for beneficiary)
- S115 & 152-C discounts both tax free on distribution
- ATO may view transfer of voting units as a CGT event
- Distribution of trust capital dutiable in NSW, but not Vic

CGT Event E4

One key consideration in choosing between a fixed unit trust and a fully hybrid trust and in deciding whether to issue preference income units in a fully hybrid trust should be issued is the operation of CGT Event E4. This CGT event is quite different from the other CGT events that apply to the different forms of trust. The CGT event covering discretionary trusts with no unitisation (or no unitholders directly receiving income) is CGT Event E5, the terms of which are set out in section 104-75 of *ITAA 1997*. CGT Event E5 applies when a beneficiary (other than a unitholder or the holder of a fixed interest) acquires absolute entitlement in a trust asset. As the beneficiary has no cost base in the trust, the governing provisions in section 104-75 make no reference to what happens to the beneficiary's cost base.

In CGT Event E4 by contrast, the governing provisions in section 104-70 provide that a CGT Event E4 occurs whenever a non-assessable part of the trust ("accounting") income is allocated to the unitholder. If this occurs, the non-assessable part of the trust income is first applied against the unitholder's cost base or remaining cost base. If, or to the extent that, there is no cost base or remaining cost base, the unitholder is subject to capital gains tax on the allocation of the non-assessable part of the income. Like CGT Event E5, CGT Event E4 does not apply to the Division 115 CGT 50% discount on distribution to a unitholder, but (unlike CGT Event E5) CGT Event E4 does apply to what would otherwise be other "income tax free" distributions, eg the Subdivision 152-C small business 50% CGT reduction.

In practice, CGT Event E4 (but not CGT Event E5) can pose major problems for trusts with year by year discrepancies between accounting income and taxable income. The provision is a taxation "black hole" in that every year in which there is an excess of taxable income over accounting income there is no restoration of the lost cost base.



Major Reasons for a Fixed Unit Trust with a Controlling SMSF Unitholder

Private fixed unit trusts are often established to directly hold real estate that is to be beneficially owned in part by the trustee(s) of one or more self managed superannuation funds ("SMSFs") and, initially at least, partly by individuals or other related parties. The SMSF unitholder(s) usually acquire their units by issue rather than by transfer. They receive income and capital gains at their normal income tax rates, rather than the penalty "non-arm's length income" rates that apply to income from non-fixed companies, family/hybrid trusts and geared or shareholding unit trusts.

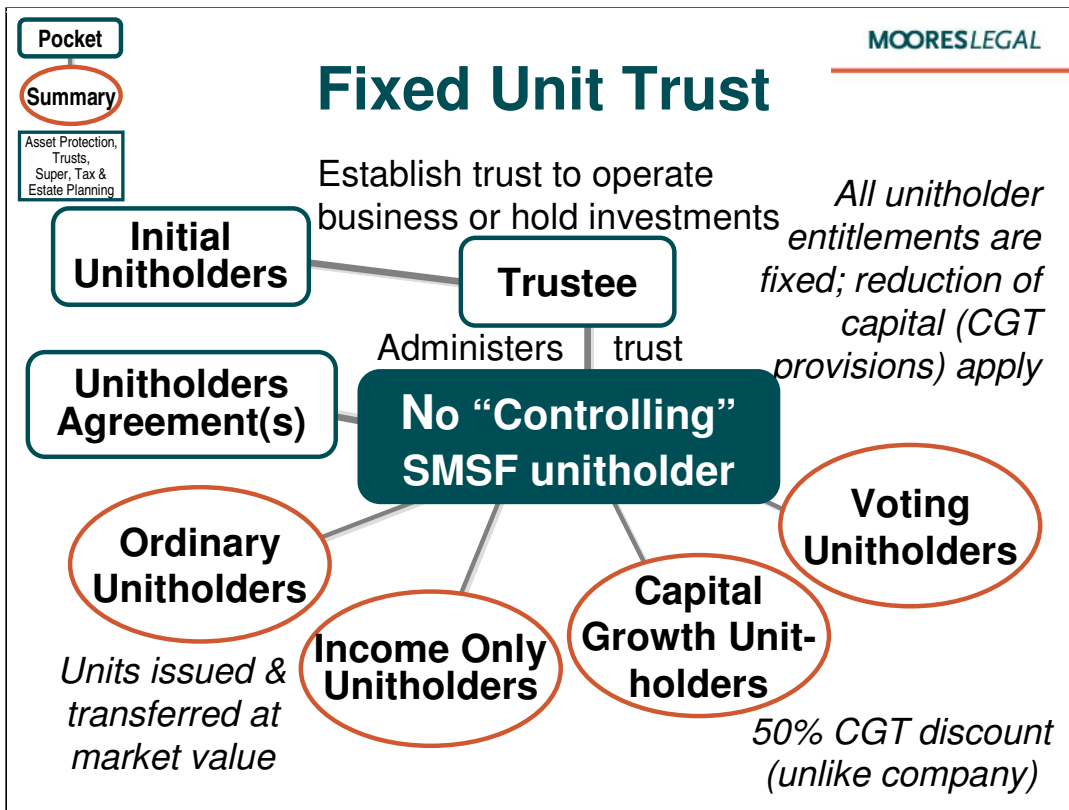
The non-SMSF unitholders, if borrowing to finance the purchase of their units, are usually able to claim an income tax deduction for interest paid on loans to purchase their units (usually holding no rights to capital growth) if, or to the extent that, they can show the prospect of a positive return on the units. In addition, they usually can redeem those units free of a significant taxable capital gain. Fixed unit trusts are eligible for the general 50% CGT discount. Under transitional rules, gearing is permitted in unit trusts with a controlling SMSF unitholder if the geared property was acquired prior to 11 August 1999.

Trustee and Unitholder Control

The trustee is either a company (for limited liability, State duty and administrative reasons) or (less commonly) one or more individuals such as the unitholders. Control is held by the voting unitholders in proportion to their entitlements. Special market value rules relate to the acquisition, transfer and redemption of units; new units must also be issued at market value.

Income, Losses, Loans, Benefits and Capital Profits

As for any fixed unit trust, eg capital profits are taxed as under CGT Event E4.



Major Reasons for a Fixed Unit Trust (no controlling SMSF Unitholder)

Private fixed unit trusts that do not have a "controlling" SMSF unitholder are free to invest in listed and unlisted securities and in businesses and business assets (as well as real estate) and to borrow to fund trust investments. Difficulties with family trust elections for income tax purposes mean that unitholders in private fixed unit trusts holding shares are usually confined to individuals (in which case a family trust election will often not be an issue), "non-controlling" SMSFs or trustees of non-fixed trusts that have each made a family trust election. The ordinary unitholders, if borrowing to finance the purchase of units, are usually able to claim an income tax deduction for interest paid on loans to purchase their units. Fixed unit trusts are eligible for the general 50% CGT discount.

Trustee

Either a company (for limited liability, State duty and administrative reasons) or (less commonly) one or more individuals such as the unitholders.

Ultimate Control

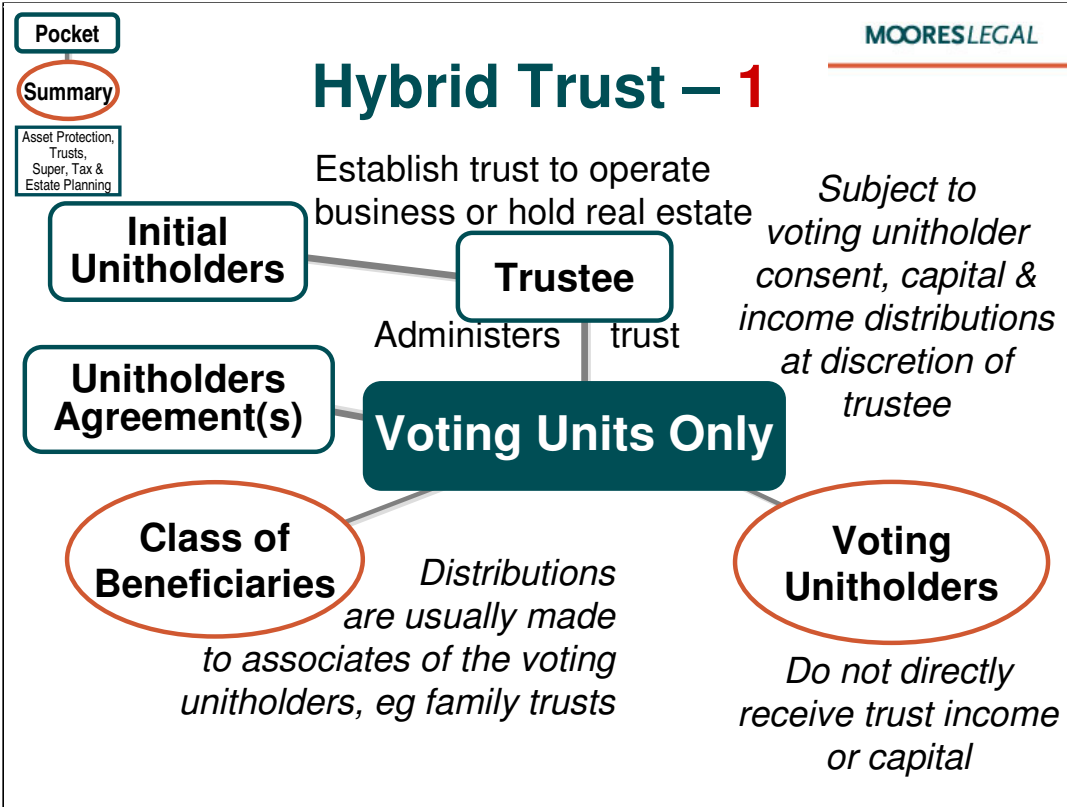
Held by the voting unitholders in proportion to their entitlements. Exercise of that control usually requires the approval of a simple majority or a 75% or 100% majority. Special rules relate to the transfer of units; new units must be issued at market value.

Income, Losses, Loans and Benefits

The income of the trust is taxed on allocation in the hands of the beneficiaries. The trustee withholds and pays tax for them if they are under a legal disability, eg under 18, or are non-residents. Losses cannot be distributed, but usually can be carried forward. Loans and benefits subject to some restrictions.

Capital Profits

Taxed as a capital gain under CGT Event E4.



Major Reasons for a Hybrid Trust with Voting Units Only

Protection against the trustee's right of indemnity from fixed unitholders. # Ability to vary from year to year the benefits beneficiaries receive from trust income and capital (the latter potentially qualifying for the 50% CGT discount). # Ability to distribute tax exempt amounts and retain their tax free status in the hands of beneficiaries (in contrast to capital payments from companies and fixed unit trusts).

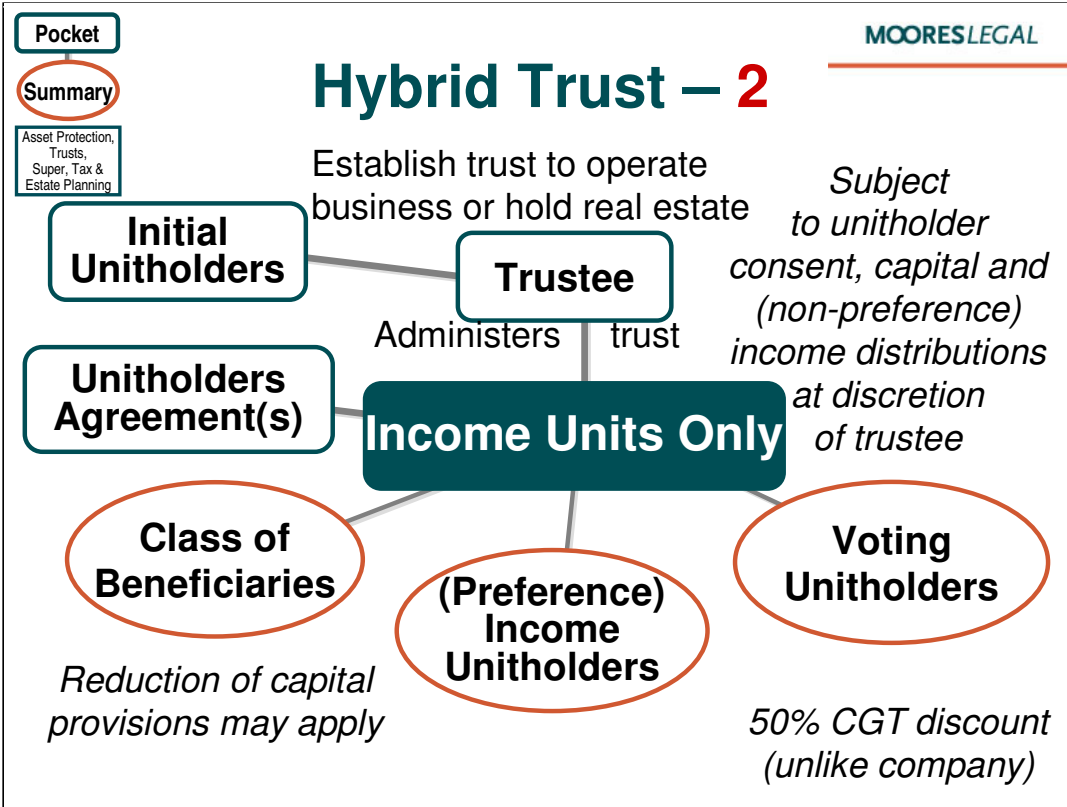
Note: With family trust elections rules having particular significance for non-fixed trusts, hybrid/non-fixed unit trusts not confined to a single family usually should only be established if receipt of dividend franking credits and annual income losses are unlikely. SMSFs should not invest in hybrid unit trusts, because of the non-arm's length income penalties in section 295-550 of *ITAA 1997*.

Income, Losses, Loans and Benefits

The income of the trust is taxed on allocation in the hands of the beneficiaries. The trustee withholds and pays tax for them if they are under a legal disability, eg under 18, or who are non-residents. Losses cannot be distributed, but usually can be carried forward. Loans and benefits subject to some restrictions.

Capital Profits

Taxed as a capital gain for the default unitholder/beneficiary (less any personal capital losses) allocated or receiving the gain (but usually subject to a 50% discount). Small business CGT exemptions/concessions can apply and can be distributed to beneficiaries – the reduction of capital rules in s104-70 of *ITAA 1997* do not apply if the trustee distributes to non-unitholder beneficiaries – the more favourable s104-75 applies instead.



Major Reasons for Hybrid Trust with Income and Voting Units

Protection against the trustee's right of indemnity from fixed unitholders. # Ability to vary from year to year the benefits beneficiaries receive from trust income and capital (the latter potentially qualifying for the 50% CGT discount). # Ability to distribute tax exempt amounts and retain their tax free status in the hands of beneficiaries (in contrast to capital payments from companies and fixed unit trusts).

Unitholders, if borrowing to finance the purchase of their units, are usually able to claim an income tax deduction for interest paid on loans to purchase their income only, non-capital or preference units if, or to the extent that, they can show the medium term prospect of a positive return on their investment.

Note: With family trust elections rules having particular significance for non-fixed trusts, hybrid/non-fixed unit trusts not confined to a single family usually should only be established if receipt of dividend franking credits and income losses are unlikely. SMSFs should not invest in hybrid unit trusts, because of the non-arm's length income penalties in section 295-550 of *ITAA 1997*.

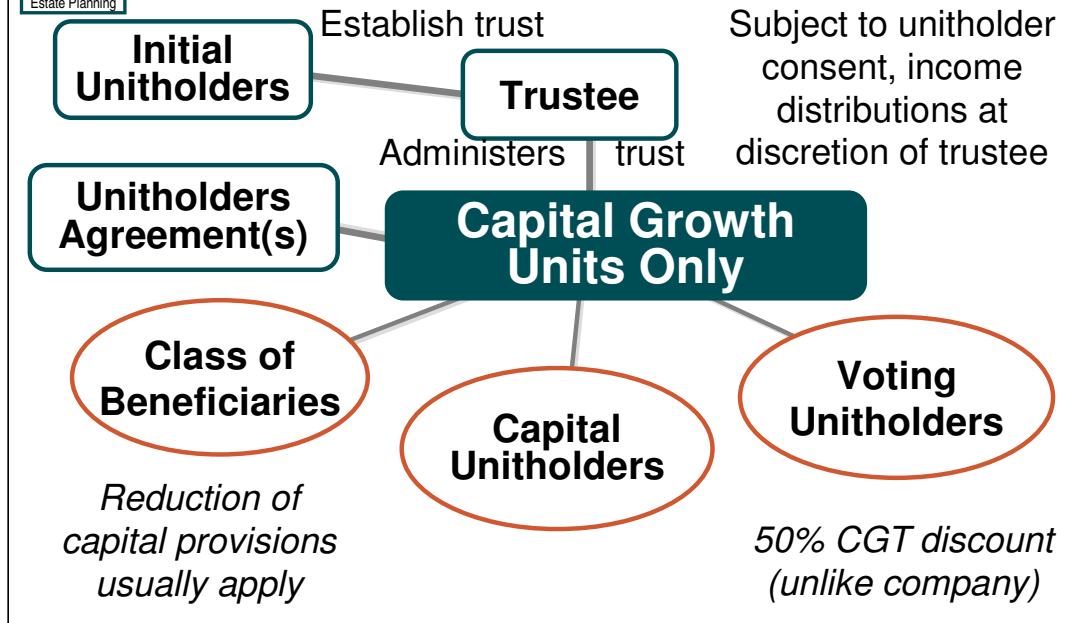
Income, Losses, Loans and Benefits

As for any hybrid unit trust.

Capital Profits

Taxed as a capital gain for the default unitholder/beneficiary (less any personal capital losses) allocated or receiving the gain (but usually subject to a 50% discount). Small business CGT exemptions/concessions can apply and can be distributed to beneficiaries – the reduction of capital rules in s104-70 of *ITAA 1997* do not apply if the trustee distributes to non-unitholder beneficiaries – the more favourable s104-75 applies instead.

Hybrid Trust – 3



Major Reasons for Hybrid Trust with Capital Growth and Voting Units

Most trusts of this type of trust (holding real estate and possibly businesses and non-real estate business assets – unitholders may lend or on-lend to the trust at market interest rates) were established in the 20th century.

Trustee

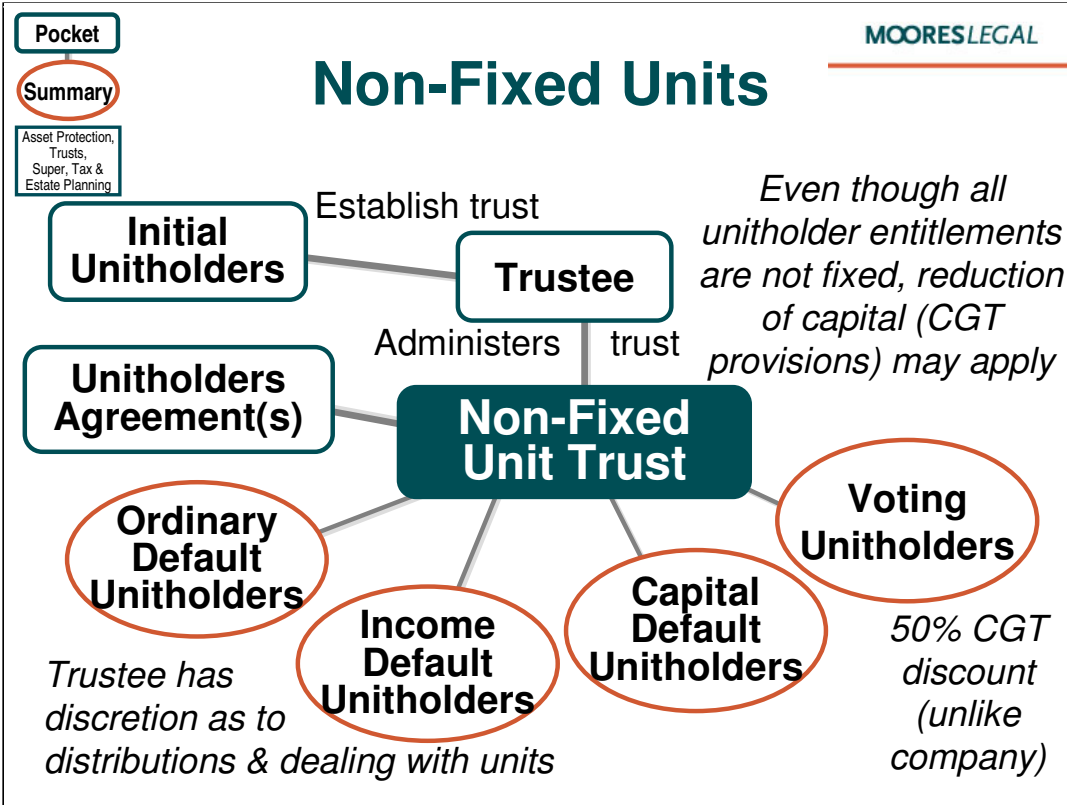
The trustee is either a company (for limited liability, State duty and administrative reasons) or (less commonly) one or more individuals such as the unitholders.

Income, Losses, Loans and Benefits

The income of the trust is taxed on allocation in the hands of the beneficiaries. The trustee withholds and pays tax for them if they are under a legal disability, eg under 18, or who are non-residents. Losses cannot be distributed, but usually can be carried forward. Loans and benefits subject to some restrictions.

Capital Profits

Taxed as a capital gain for the default unitholder/beneficiary (less any personal capital losses) allocated or receiving the gain (but usually subject to a 50% discount). Small business CGT exemptions/concessions can apply and can be distributed to beneficiaries – the reduction of capital rules in s104-70 of *ITAA 1997* do not apply if the trustee is exercising its discretion in favour of non-unitholder beneficiaries – the more favourable s104-75 applies instead. Trauma/critical illness insurance proceeds are not exempt from CGT when paid to a trust with non-absolute entitlements.



Non-fixed Unit Trusts

Most trusts of this type of trust (holding real estate and possibly businesses and non-real estate business assets – unitholders may lend or on-lend to the trust at market interest rates) were established in the 20th century. Often the reason for the unit trust being a non-fixed trust, rather than a fixed trust, for taxation purposes is the ability of the trustee to issue units at par (as well as or in addition to market value).

Trustee

The trustee is either a company (for limited liability, State duty and administrative reasons) or (less commonly) one or more individuals such as the unitholders.

Ultimate Control

Held by the voting unitholders in proportion to their entitlements. Exercise of that control usually requires the approval of a simple majority or a 75% or 100% majority. Special rules relate to the transfer of units; new units must be issued at market value.

Income, Losses, Loans and Benefits

The income of a fixed unit trust is taxed on allocation in the hands of the unitholders. The trustee withholds and pays tax for unitholders who are under a legal disability, eg under 18, or who are non-residents. Accumulations of income are taxed at the highest personal marginal income tax. Losses cannot be distributed, but usually can be carried forward. Loans and benefits are subject to some restrictions.

Capital Profits

Taxed as a capital gain under either CGT Event E4 or CGT Event E5.

Unit Trusts – Further Reading

**Australian Master Estate
Planning & Succession
Guide – Chapter 4**

**You Can't Take It
With You –
Chapter 10**

**The latest version of this Pocket Summary is at
www.mooreslegal.com.au/services/epss/pocket-summaries**

All of the Pocket Summaries are copyright. They are for training, educational and general information purposes only and should not be relied on as (or in substitution for) legal, accounting, financial or other professional advice.

Further Reading

- The 1st edition of the **Australian Master Estate Planning and Succession Guide** by Allan Swan is scheduled to be published by **CCH** in 2011.
- The 1st edition of **You Can't Take It With You** by Andrew Simpson was published by **Wrightbooks** in 2009.
- The 5th edition of **Tax Issues in Family Law Property Settlements** – The Difference Between Hacking and Carving by Peter Szabo was published by **MOORESLEGAL** in 2008.

About the Author of the Pocket Summaries – Allan Swan

In addition to his main role as a principal of the **MOORESLEGAL** estate planning team (working in the areas of **Asset Protection, Trusts, Superannuation, Tax and Estate Planning**) Allan is also the principal of **APTSTEP**, a provider of training and materials. Allan's current presentation topics are:

- Asset Protection Planning (includes pages 1 & 5-7 of this Pocket Summary)
- Blended Families
- Tax and Business Structures Overview (1)
- Estate Planning – Key Cases and Rulings
- Estate Planning – Practical Case Studies for 2010
- Estate Planning – Tax and Strategic Issues
- Funding Estate Planning
- Ruling from the Grave
- SMSFs – Planning Issues (5)
- Superannuation Death Benefits (5)
- Superannuation Overview (5)
- Testamentary Trusts
- Trusts – Income and Capital Distributions (5 & 7)
- Trusts – The A-Z (all).

Contact Allan 03 9843 2153 for further information regarding on the content of the topics, the fees charged and to schedule a presentation, workshop or seminar.