Unit trusts: some practical insights

by Peter Slegers, CTA, Director, Carlie Frantzis, ATI, Lawyer, and Amy Lancaster, ATI, Lawyer, Tax & Revenue Group, Cowell Clarke

Unit trusts have a wide application in commerce, particularly in the property sector, offering the flexibility of a trust structure but with the certainty more often found in corporate structures. This article will revisit the fundamental legal nature of a unit trust and the concept of units. It will then review the merits of the modern unit trust structure, comparing it with other typical business and asset holding structures such as private companies and partnerships of discretionary trusts. It will also take a closer look at some of the common but nonetheless challenging tax issues that arise when advisers are dealing with unit trust structures. The authors' review is limited to private unit trusts and does not address public or listed unit trusts. It is hoped that this article will provide advisers with greater insight into this commonly used but sometimes misunderstood business and investment vehicle.

For many decades, unit trusts have been a mainstay of commercial and tax structuring activity in Australia, particularly, but not exclusively, in the property sector.

Unit trusts are unique, providing for the derivation of pre-tax income and substantial flexibility,[1] while also providing the certainty more typically found with corporate structures.

This article will revisit the fundamentals of unit trusts before delving into some of the critical but often overlooked tax issues. In so doing, it will highlight many of the advantages and disadvantages of unit trust structures, planning opportunities and potential pitfalls.

While unit trusts have a wide commercial application and commonly feature as public or even listed entities, the focus of this article will be on private unit trusts.

What precisely is a unit trust?

Background

References to "unit trusts" and "units in a unit trust" are to be found throughout the income tax legislation.[2] Yet, for the most part, a helpful definition of a "unit trust" remains elusive.

Under the general law, a "unit trust" in common with a "discretionary trust" does not have any constant, fixed normative meaning.[3] It therefore largely remains a term of commercial convenience.

In many ways, the state and territory tax laws possibly come the closest to describing, rather than defining, what your everyday tax adviser would regard as a fair, albeit crude, description of a unit trust when they typically make reference to trust schemes in which persons hold units.[4] In other words, a unit trust may simply be regarded as a trust in which the equity interests are expressed as units.

The first unit trust was reputedly launched in the United Kingdom in 1931, inspired by the comparative durability of United States mutual funds through the Wall Street crash of 1929.[5] Australian law followed suit in 1935, with the unit trust becoming an important segment of the Australian public investment market.[6]

The popularity of a unit trust as a private investment vehicle, however, did not gain traction until the 1960s, at which point such structures became increasingly used due to their significant tax advantages over corporate structures at the time.[7]

Nature of units

The starting point for gaining a better understanding of the nature of a unit trust is the High Court decision in *Charles v FCT*[8] (*Charles*). In that decision, the Commissioner of Taxation sought to tax distributions to unitholders that partly comprised of capital receipts in the hands of the trustee. The High Court found for the taxpayer and viewed the capital receipts as maintaining the same character in the hands of the unitholders as they had in the hands of the trustee.

The case is significant in that the High Court made some seminal observations in relation to the nature of a unit in a unit trust. The following passage from the judgment is particularly instructive:

> "11. At first sight it may seem that a person who invests in units under a trust deed such as that which is here in question does so with a view to obtaining the half-yearly distributions for which the deed provides, just as he might have bought shares in an investment company with a view to deriving half-yearly dividends from them; and that the periodical distributions received should be regarded as income in the one case just as they would be in the other … But [this] view is untenable, for a unit held under this trust deed is fundamentally different from a share in a company. A share confers upon the holder no legal or equitable interest in the assets of the company; it is a separate piece of property; and if a portion of the company's assets is distributed amongst the shareholders the question whether it comes to them as income or as capital depends on whether the corpus of their property (their shares) remains intact despite the distribution … But a unit under the trust deed before

us confers a proprietary interest in all of the property which for the time being is subject to the trust of the deed …; so that question whether monies distributed to unitholders under the trust form part of the income or their capital must be answered by considering the character of those monies in the hands of the trustee before the distribution is made."

Thus, a unit in a unit trust, or at least a unit trust of the kind that was considered in *Charles* case, is to be treated as a proprietary interest in the underlying trust property itself.

The far more recent High Court decision in *CPT Custodian* maintained this view but emphasised that any analysis of units in a unit trust will significantly depend on the provisions of the trust deed. In that case, the High Court rejected the Commissioner of State Revenue's argument that a unitholder in a land-owning unit trust owned an interest in the land itself.

At first glance, it may be difficult to reconcile these two High Court decisions. However, it is clear that much reliance was placed on the specific provisions of the trust deed of the unit trust in both cases, a point that the High Court emphasised in *CPT Custodian*:

> "36. The deed considered in *Charles* divided the beneficial interest in the trust fund into units … and the trustees were bound to make half-yearly distributions to unit holders, in proportion to their respective numbers of units, of the 'cash produce' which had been received by the trustees … [The taxpayers in this case] rightly stress that the deeds with which this litigation is concerned were differently cast and in terms which do not support any direct or simple conclusion respecting proprietary interests of unit holders such as that reached in *Charles*."

Thus, a thorough examination of the nature of the interests under the trust deed is critical to determining the legal nature of the unitholder's interests.

This may often impact on the outcomes of various statutory provisions, particularly under state and territory duty and land tax laws. The fundamental nature of a unit in a unit trust may, however, be less significant when it comes to federal income tax legislation, where the overall design of the CGT regime in particular often treats units, for all intents and purposes, as discrete property (rather than a proprietary interest in the underlying trust property). Thus, in many ways under the CGT regime, units in a unit trust are treated in the same or a similar manner to shares in a company.[9]

Tax features of modern unit trusts

The utility of the modern private unit trust as a structuring vehicle for investments and business is best demonstrated by considering some of the salient tax attributes of unit trust structures. There are endless comparisons that can be made between the tax features of unit trusts and other vehicles such as companies and discretionary trusts (including partnerships of discretionary trusts). The authors' comments are limited to the following five major points.

First and foremost, unit trusts are not taxed as entities. That is to say, either the trustee or, more typically, the unitholders (as presently entitled beneficiaries under Div 6 ITAA36) are subject to tax on the unit trust's net income.

On the basis that a present entitlement generally arises each income year under the trust deed as a matter of practice (see further below), unit trusts are often viewed as "flow-through" vehicles in which the unitholders derive pre-tax receipts that are only subject to assessment at the unitholder level. In this respect, they share a common attribute with partnerships.

This "flow-through" nature of a unit trust has two distinct advantages, namely:

1. it allows the identity of the unitholder to determine the tax treatment of the assessable income which may allow for greater flexibility where the unitholders are discretionary trusts or significant tax concessions where the unitholders are self-managed superannuation funds (SMSFs); and
2. the pre-tax nature of the income derived by a unit trust may mean that unitholders with tax losses from other activities are able to offset those tax losses against the income they derive from the unit trust as a presently entitled beneficiary.[10]

A second useful feature of a unit trust for tax purposes is that (in common with companies) it is possible to raise equity without a CGT event. That is to say, the issue of units in a unit trust (as with the issue of shares in a company) is an acquisition and not a disposal/CGT event.[11] The units of course need to be issued at their market value to prevent the general value shifting measures from arising, but otherwise no adverse tax issues should ordinarily arise from the issue of units.[12]

A third, possibly less common, advantage of a unit trust is in circumstances where the unit trust itself derives tax losses. In the authors' experience, it is often possible to effectively inject income from discretionary trusts to a loss unit trust in order to absorb those losses. Critically, the discretionary trusts must have fixed entitlements in the unit trust's income *or* capital for the purposes of the trust loss measures.[13] By comparison, injecting income into a loss company raises a number of challenges, including compliance with the sometimes ponderous company loss provisions.[14]

A fourth advantage of a unit trust (in this case, over a company) is that it is not subject to Div 7A ITAA36. That is not to say that Div 7A does not apply to unit trusts that are part of a group, but normally a private company needs to exist elsewhere in the group for Div 7A to have any application. If you are only dealing with a unit trust and other trust structures (with the only companies in the group being trustee companies), then no Div 7A issues should arise.

Finally, it might be said that, while accessing tax-sheltered amounts from unit trusts poses its challenges (see the commentary on CGT event E4 below), it is possibly less challenging than accessing such amounts from companies. Indeed, returning value to shareholders, whether on an interim basis or on a winding-up of a company, is generally a more challenging exercise than returning value to unitholders. Where s 104-70 ITAA97 (CGT event E4) applies, it is generally not as detrimental as where a tax-sheltered amount is treated as a dividend and, on account of the balance not having been subject to tax, as an unfranked dividend.[15]

While the advantages set out above need to be weighed against some of the problems that arise in the case of unit trust structures, unit trusts are certainly worth bearing in mind in any structuring exercise.

Use in the property sector

Possibly the greatest industry use of unit trusts is in the property sector. That is to say, in many ways, unit trusts may make for the best vehicle to hold real property between arm's length parties. This is for the reasons that follow.

First, unlike companies, unit trusts (with non-corporate unitholders) will generally qualify for the general CGT discount of 50% for discretionary trust unitholders or 33.33% for SMSF unitholders. This is particularly significant for capital-appreciating assets, particularly where the small business CGT concessions may be inaccessible due to the property being leased or the net asset values or turnover of the business using the property exceeding the small business thresholds. Even where the CGT discount is not available on the basis that property development is being undertaken (which will generate revenue rather than capital gains), the pre-tax nature of the profits allows for the often-generated tax losses (not only from unsuccessful developments, but also from start-up losses) to be used tax effectively.

Second, the syndicated nature of investments in the property sector often means that the ability to raise capital is much preferred through a unit trust structure. If one compares a number of arm's length discretionary trusts investing in a property (which will generally amount to a general law partnership) as opposed to the same discretionary trusts investing in a unit trust, the obvious advantage is the ability to introduce new investors without a CGT event, as well as the ease of administration dealing with units rather than the disposal and acquisition of fractional interests.[16]

Last, the ability to borrow at the level of the trustee of a unit trust also makes it far preferable to any direct investment of entities, for instance, where a syndicate of SMSFs together invest in the acquisition of a commercial building.

Significant provisions of the trust deed

Distinct issues for unit trusts

Many of the issues to consider when reviewing the trust deed of a discretionary trust will have equal relevance when reviewing the trust deed of a unit trust.[17]

Some distinct issues when reviewing a unit trust deed include the following:

- reviewing the unitholder's entitlement to the trust property. This will be important when establishing whether the trust is a "fixed trust" for the various provisions of the income tax legislation dealing with this concept (see below);
- considering the manner in which units are issued, transferred and redeemed. This is critical to managing the entry, exit and variation of entitlements of equity holders in the unit trust. The provisions governing the issue and redemption of units, and whether this is carried out at market value, will also have relevance when determining the application of the trust loss measures;[18] and
- governance issues relating to management of the unit trust between the trustee and unitholders, including the removal and appointment of the trustee (normally, there is no concept of an appointor and the change of trustee is effected by an ordinary or special resolution of unitholders).

One particularly critical issue for unit trust deeds is to ensure that the trust deed provides an express provision to exempt the trust from the *Broomhead* principle. In *JW Broomhead (Vic) Pty Ltd (in liq) v JW Broomhead Pty Ltd*,[19] the Victorian Supreme Court determined that the beneficiaries of a fixed trust were impliedly required to indemnify the trustee against all losses incurred in carrying on the activities of the trust. This exposes the personal assets of each unitholder to a claim by the trustee of the unit trust should the unit trust have insufficient assets to indemnify the trustee against its losses. However, the court's decision made it clear that the implied indemnity is subject to the terms of the trust deed and can be ousted by an express provision.[20] Most unit trust deeds will contain such an express provision to exclude this right of indemnity. However, in the authors' view, it is always worthwhile reviewing the trust deed for this provision, especially given the consequences of the *Broomhead* principle applying.

Present entitlement and part-year distributions

A hallmark of the conventional unit trust is that the unitholders are given a fixed right to income and capital based on the unitholder's proportion of the total issued units (of the same class) in the trust at the end of each income year.

A significant issue arises, therefore, where units in a unit trust are sold and purchased part-way through an income year. This is on the basis that:

- the former unitholder will not, as a matter of course, obtain the benefit of having owned the units for part of the income year;
- the new unitholder will obtain the benefit of having owned the units for a full income year even though the new unitholder only owned the units for part of the income year; and

- the new unitholder may be assessed to tax for the whole of the income year even though they only owned the units for part of that income year.

One way that this issue can be addressed is by drafting the sale and purchase of units agreement such that the purchase price is adjusted to account for part of the year-end distribution. The adjustment might ensure that the former unitholder receives an increase in the purchase price for their units up to that part of the income year in which they were still a unitholder less an estimate of the tax liability that will arise to the new unitholder for the tax arising on that part of the income year in which they were not a unitholder. Of course, a similar proportionate adjustment would be made if the vendor and purchaser are not selling and buying all of their units but only selling and buying a proportion of units.

An alternative approach to making adjustments under the sale and purchase of units agreement would be for the trustee to rely on a power under the trust deed to make an interim distribution of income to unitholders in proportion with their unitholding at the time of sale and then to make a further part-distribution on 30 June. One downside with this approach is that all of the unitholders (of the same class) would need to receive the interim distribution and not just the unitholders selling or purchasing units. Another downside with this approach is that any income tax liability factored into an interim distribution made by a trustee of a unit trust is necessarily based on an estimate of the income which the trust will have derived at year-end, which may not correspond with the actual income tax liability of the unitholder at year-end.

> "Care needs to be taken in the manner in which the tax-sheltered amount arising from the general CGT discount is accessed."

The approach of adjusting the purchase price for the units under the sale and purchase of units agreement will have slightly different tax and duty outcomes for the vendor and purchaser. To this end, increasing the purchase price to account for part of the year-end distribution that the unitholder is entitled to receive will benefit vendors that are individuals or discretionary trusts as they will be able to apply the 50% discount to the whole of the capital gain and not pay income tax on part of the year-end distribution.

However, increasing the purchase price will disadvantage the purchaser as the purchaser will need to source further funds to acquire the units and may also have a greater duty impost, particularly where the increased purchase price exceeds the market value of the units. Of course, one benefit to the purchaser in paying a higher purchase price is that the units will have a higher cost base.

The income tax benefits to the vendor on an increase of the purchase price under the sale and purchase of units agreement may be managed by reducing the increase to the purchase price by the amount of income tax which the vendor would have paid on the year-end distribution on the relevant units.

The above complexities can be overcome if the sale and purchase transaction settles on 1 July of the relevant income year as there would be no need for the trustee of the unit trust to make an interim distribution, and any adjustments to the purchase price would be minimal.

Fixed versus non-fixed trusts

General observations

The tax implications of a transaction involving a unit trust vary considerably depending on whether the unit trust is treated as a "fixed trust" or a "non-fixed trust". Similarly, different tax outcomes will arise depending on whether or not unitholders have fixed entitlements in the trust.

It may be desirable to structure a unit trust as a fixed trust (or a trust with fixed entitlements) for a number of reasons. These include:

- satisfying the relevant tests for unit trusts that qualify as fixed trusts when applying tax losses under the trust loss measures of Sch 2F ITAA36;
- for the purposes of the holding period rules for franking credits on franked dividends derived by a unit trust;[21] and
- so that the income derived by an SMSF that holds units in a unit trust is not deemed to be non-arm's length income (NALI) and therefore subject to a penal tax rate of 45%.[22]

For completeness, a summary of the provisions of the income tax legislation that directly or indirectly rely on a trust being a fixed trust or a unitholder having a fixed entitlement is set out in the Appendix to this article.

Trust loss measures

A trust will be a "fixed trust" for the purposes of Sch 2F ITAA36 if persons have fixed entitlements to all of the income and capital of the trust.[23]

Section 272-5(1), Sch 2F ITAA36 in turn provides as follows in relation to "fixed entitlements":

> "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 terms "vested and indefeasible" are not defined in the tax legislation and, accordingly, bear their ordinary meaning.[24] This is subject to the "savings rule" in s 272-5(2) (see further below).

The Federal Court in *Walsh Bay Developments Pty Ltd v FCT*[25] (*Walsh Bay*) commented that a vested interest is one where the holder has an "immediate fixed right to present or future enjoyment". That is, the holder is in an unfettered position to demand payment of the share of the income.

This can be contrasted to what is properly described as a contingent interest, where the holder's right to demand payment depends on the occurrence of an event which may or may not take place. It is important to note that a condition of possession will not constitute a contingency.[26] For example, where the right to a portion of the trust income is unconditional but the holder's right to gain actual possession of that income is conditional on that amount first being properly determined, the holder's interest will still be a vested interest.

As to whether a vested interest is defeasible, the Federal Court in *Walsh Bay* went on to comment that a defeasible interest is an interest where the holder's right to demand payment is subject to be defeated by the operation of a subsequent condition or supervening event.[27] The Federal Court in *Walsh Bay* noted that the distinction between a contingent interest and a defeasible interest is not always easy to apply.[28] The distinction can be drawn as follows: a contingent interest is an interest which only arises on the occurrence of an event, whereas a defeasible interest is an interest which has already arisen but is subject to be withdrawn on the occurrence of an event. An indefeasible interest, as opposed to a defeasible interest, is one that is not subject to any such condition or event.

By way of further guidance, the Federal Court in *Colonial First State* held that an interest will be indefeasible in the context of Sch 2F if it cannot be terminated, invalidated or annulled. This requires an analysis of whether there is any circumstance in which the trustee (or any other person) could terminate, invalidate or annul a beneficiary's entitlement to their share of the income or capital of the trust.

In *Colonial First State*, the Federal Court held that a power to modify, replace or repeal the constitution (effectively the trust deed in that case) of a wholesale fund meant that the interests of the unitholders in the fund were defeasible for the purposes of Sch 2F. In PCG 2016/16, the Commissioner cites *Colonial First State* as authority for the assertion that "broad" powers of amendment will cause unitholders' interests under a trust deed to be defeasible (and therefore render the trust a non-fixed trust).

In PCG 2016/16, the Commissioner also provides a number of examples of common powers in modern trust instruments that the Commissioner considers will cause a beneficiary's interest to be defeasible, namely:

- a power to issue new units after the trust is settled or to redeem existing units (subject to the "savings rule" (see below));
- a power to reclassify existing units so that they do not all have equal rights to receive the income and capital of the trust;
- a power to reclassify receipts as being on income or capital account where the units that have been issued do not all have the same rights to receive the income and capital of the trust;
- a power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;
- a power to settle or appoint any part of the corpus of the trust fund to a new trust with different beneficiaries; and
- a power to enforce the forfeiture or cancellation of partly paid units due to the non-payment of a call, except where such partly paid units would be void ab initio.[29]

The "savings rule" in s 272-5(2), Sch 2F ITAA36 provides relevantly that, if units in an unlisted unit trust are redeemable (or further units are able to be issued) for a price that is determined on the basis of the net asset value according to Australian accounting principles, the mere fact that the units are redeemable (or that further units may be issued) does not result in the interests of the unitholders being defeasible. The implication generally to be drawn from this provision is that, if units are able to be issued or redeemed (other than at their net asset value according to Australian accounting principles), the interests of the unitholders *will* be defeasible and therefore will not amount to fixed interests in the capital of the trust.

In light of the above, it can be seen that it is often difficult for many conventional unit trusts to satisfy the definition of a "fixed trust" within the meaning of the trust loss provisions.

NALI provisions

SMSFs are often used as unitholders in unit trusts. Therefore, it is necessary to consider the trust deed and other surrounding circumstances to ensure that the income of the SMSF is not treated as NALI and taxed at the top marginal rate.

Section 295-550(4) ITAA97 broadly provides that income derived by a complying superannuation fund as a beneficiary of a trust, other than because of holding a fixed entitlement to income, is NALI.

The Commissioner adopts the view that, in the context of the NALI provisions, the concept of "fixed entitlement" is designed to test whether the amount of trust income was included in the income of the superannuation fund because the fund has an interest in the income that was vested immediately before the income was derived by the trustee.[30]

As described above, the legal concept of a "vested interest" relies on the holder having an immediate fixed right of present or future enjoyment, which in turn requires that:

- the identity of the beneficiary is established; and
- that beneficiary's right to the interest (as distinguished from their right to possession) must not depend on the occurrence of some event.[31]

That is to say, a vested interest is one that is bound to take effect in possession at some time and which is not contingent on any event occurring. This is to be contrasted with a contingent interest, which gives no right at all unless or until some future event happens (such as the exercise of a discretion by the trustee).[32]

Therefore, in circumstances where the unitholder of a unit trust has a right to income of the trust that is susceptible to measurement and which is not contingent on any event occurring (such as the exercise of a discretion by the trustee), there should be a basis for characterising that interest as a fixed entitlement to income.

This is consistent with the Commissioner's comments in TR 2006/7 regarding the policy for the introduction of the NALI provisions (insofar as they apply to trust distributions). In particular, the Commissioner states that these provisions are intended to distinguish between investment returns on fixed entitlements in unit trusts and distributions made to persons as beneficiaries of discretionary trusts resulting from the exercise of discretions.

Commissioner's discretion and safe harbour

Under the trust loss provisions, the Commissioner is provided with a discretion to treat a beneficiary's interest in a trust that would not otherwise be fixed as constituting a fixed entitlement.[33]

The Commissioner's PCG 2016/16 also outlines a "safe harbour" compliance approach. The safe harbour allows trustees of certain trusts to manage the trust's tax affairs as if the Commissioner has exercised the discretion, without the trustee having to apply to the Commissioner for the exercise of that discretion.[34] If absolute certainty is required, however, an application can be made to the Commissioner for the exercise of the discretion in any given case (rather than self-assessing on the safe harbour).

For completeness, it should be noted that the safe harbour compliance approach under PCG 2016/16 only applies in the context of the trust loss provisions in Sch 2F ITAA36. It does not apply to other measures that might rely on a unitholder having fixed entitlements in the trust.

Practical observations: how to structure a fixed trust

Care is clearly required when seeking to establish a fixed trust or when amending a trust deed to ensure that it meets the requirements of a fixed trust.

In the authors' experience, the preferred approach is to draft the trust deed (or deed amendment) on the basis that the trust is structured as a fixed trust as far as is possible under the law, but at the same time recognising the potential uncertainties in this area. For example, the following factors should be considered when drafting or amending a trust deed for fixed trust purposes:

- ensuring that the trustee does not have a discretion to make differential distributions of trust income or capital between the unitholders, and instead requiring the net income and capital to be distributed in proportion to the units held by the respective unitholders;
- ensuring that there is no power to issue or redeem units in the trust other than for a price based on the net asset value according to Australian accounting principles;
- ensuring that the deed provides that all new units are of the same classes, carry identical rights, and are issued in the same proportions as the existing units already on issue from time to time;
- ensuring that there is no power to reclassify existing units in the trust or to designate new units into classes;
- ensuring that there is no power to reclassify receipts as being on income or capital account (ie that there is no "income recharacterisation" power);
- ensuring that there is no power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;
- ensuring that there is no power to settle or appoint any part of the corpus of the trust to a new trust with different beneficiaries (for example, it may be appropriate to restrict a clause allowing for a new settlement to having the same beneficiaries in the same proportions as the existing trust); and
- ensuring that the power to amend the trust deed is drafted narrowly to ensure that an amendment that would otherwise purport to remove a beneficiary's fixed entitlement in the income or capital of the trust is impermissible and ineffectual.

Naturally, the drafting of a trust deed or deed amendment will depend on the specific taxing regime regarding fixed trusts or fixed entitlements.

Background to CGT event E4

The law

From time to time, a unit trust will derive various forms of income and other receipts that are not assessable. These amounts may be referred to as tax-sheltered amounts. One of the major disadvantages of unit trusts is that the payment of such tax-sheltered amounts will often trigger CGT event E4.[35]

CGT event E4 happens where:[36]

- the trustee of a trust makes a payment to a unitholder in respect of their unitholding or interest in the trust; and
- some or all of the payment is non-assessable.

Where CGT event E4 happens, the cost base of the units owned by the unitholder is reduced by the non-assessable amount.[37] Moreover, a capital gain arises to the unitholder where the non-assessable amount exceeds the cost base of their units for the amount of the excess.[38] Invariably, where unit trusts have not been capitalised but instead funded by borrowings or credit loans, the unitholders will only have a nominal cost base and therefore the whole of the non-assessable amount may amount to a CGT event E4 capital gain.

Tax shelters

The effect of CGT event E4 is to trigger CGT consequences on the payment of a variety of tax-sheltered amounts to unitholders (by reducing the cost base of units and potentially triggering a capital gain). In this regard, it may be said that certain tax-sheltered amounts derived by a unit trust are "trapped" in that structure.

There are numerous tax-sheltered amounts that may be subject to CGT event E4. Some of the typical amounts regularly encountered in practice include:

- amounts arising from the unit trust holding depreciating assets (especially where accelerated depreciation is allowed under the capital allowance provisions);[39]
- amounts arising from a unit trust that owns buildings or structures that qualify for deductions under the capital works provisions;[40]
- pre-CGT capital gains;[41]
- capital gains disregarded by the small business 50% reduction;[42] and
- income distributions received by a unit trust that are sheltered by the unit trust having available current year or carry-forward tax losses to apply against that income.

The tax legislation expressly excludes tax-sheltered amounts arising from the general 50% discount from CGT event E4.[43] However, for this concession to be available, care needs to be taken in the manner in which the tax-sheltered amount is accessed (see further below).

Payments versus loans

In the authors' view, CGT event E4 should not apply where the trustee of a unit trust makes a loan to a unitholder (even where such amount may be wholly or partly funded by a tax-sheltered amount). Arguably, CGT event E4 is only intended to target the payment of tax-sheltered amounts from a unit trust structure where such a payment represents a reduction in the capital value of the unit trust and not the advancing of funds to a unitholder as a genuine loan (that must be repaid). Of course, once the loan is repaid and such amounts are then distributed to the unitholder, CGT event E4 would apply. The loan only represents a deferral in this regard.

In the authors' opinion, it is highly likely that CGT event E4 would apply where the trustee makes a loan to a unitholder (funded by non-assessable amounts) and subsequently forgives the loan. In this case, the loan and forgiveness may be viewed as a device to distribute tax-sheltered amounts to the unitholder by "dressing up" the transaction as something that, as a matter of substance, amounts to a payment in the context of the use of that term in s 104-70 ITAA97.

Payments to associates

As stated above, the conventional unit trust gives its unitholder a defined right to income and capital each income year based on their proportionate unitholding in the unit trust.

Some unit trusts, however, have a hybrid function and can provide the trustee with a discretion to distribute income not only to unitholders, but also to associates (typically, relatives and related entities) of the existing unitholders. While this may have commercial utility for the unitholders, it may also provide greater flexibility in tax planning.

To this end, and as stated above, CGT event E4 will only apply where the person or entity receiving a payment of a non-assessable part has a unit or an interest in the trust that extends beyond the interest that a beneficiary may have in a discretionary trust. In the authors' view, a payment to an associate of a unitholder would not fall within the ambit of CGT event E4 on the basis that an associate's interest in the unit trust is akin to that of a beneficiary in a discretionary trust and is wholly dependent on the trustee exercising its discretion.[44]

Provided the trustee has had the discretion to distribute to associates of a unitholder from the unit trust's establishment, the authors consider that the subsequent exercise of such a discretion should not attract the anti-avoidance provisions under Pt IVA ITAA36. An issue may arise, however, where the unit trust deed is later amended to facilitate the trustee making payments of non-assessable amounts out of the unit trust on a tax-free basis.

Unit redemptions and advances of capital

Background

Unitholders in a unit trust may wish to extract value from the unit trust following the derivation of a substantial capital gain or where the trust has been used as a vehicle to accumulate value over time.

Capital in a unit trust can be extracted from the trust and accessed by the unitholders through the following means:

- the advancement of capital to the unitholders by the trustee; or
- the redemption of units in the unit trust.

Which approach is taken may depend on a range of commercial issues for the trustee and unitholders, particularly whether the parties wish for the unit trust to continue in existence or be wound up. The different approaches will, however, give rise to significantly different tax outcomes for the unitholders.

Advances of capital and redemption of units

An advancement of capital involves the trustee resolving to appoint and pay capital amounts in the unit trust to the unitholders without disturbing the ownership of the units. An advancement of capital will trigger CGT event E4 on the basis that the trustee will have paid tax-sheltered amounts to the unitholders (see above).

A redemption of units involves the trustee cancelling some or all of the unitholder's units in exchange for the trustee paying capital proceeds to the unitholder. A redemption of units will trigger CGT event C2 on the basis that there will have been an extinguishment of an intangible CGT asset (ie units).[45]

There are some important differences in the tax outcomes arising from the occurrence of CGT events E4 and C2, namely:

- only the capital gain arising from CGT event C2 will take account of and include any amount that has been sheltered from tax by application of the 50% discount;[46] and
- a capital loss can only arise under CGT event C2 and not CGT event E4.[47]

The above differences and their application in practice are illustrated in the case study below.

Comparison of capital extraction methods

Case study

The Avengers Trust is a unit trust of which there are several arm's length unitholders.

The unitholders are controlled by superheroes who have pooled funds together to acquire warehouses owned by the Avengers Trust that are used to store and manufacture body armour and other protective suits worn by each of the superheroes.

All of the unitholders are the trustees of discretionary trusts.

In the 2025 income year, one of the larger warehouses is sold for $6m, giving rise to a gross capital gain in the Avengers Trust of $4m. The Avengers Trust and the unitholders qualify for the 50% discount but no other concessions.

After the payment of bank debt and transaction costs, there is $5m available for distribution to the unitholders.

The unitholders have varying percentages of units in the Avengers Trust and different cost bases.

Two unitholders of note are as follows:

1. the Captain America Trust, one of the original unitholders of the unit trust, owns 20% of all units in the Avengers Trust. The total cost base of these units is $50,000; and
2. the Black Widow Trust, which bought into the unit trust at a later date, owns 10% of all units in the Avengers Trust. The total cost base of these units is $400,000.

The unitholders are desirous of accessing the net proceeds from the sale of the warehouse on a tax-effective basis.

On the basis that the gross capital gain made by the trustee of the Avengers Trust will be reduced by the 50% discount, $2m will be included in the taxable net income of the Avengers Trust. The unitholders will be assessed on this amount based on the amount attributed to each of them under Subdiv 115-C ITAA97 and their specific entitlement to the net financial benefit referable to the capital gain.

On the basis that the $2m net capital gain has been assessed as assessable income to the unitholders,[48] this will leave $3m[49] to be distributed as capital of the Avengers Trust. As the trustee of the Avengers Trust has applied the 50% discount, $2m of this amount will be tax-sheltered. This tax-sheltered amount is expressly excluded from the operation of s 104-70 by item 1 of the table in s 104-71(4) ITAA97.

Assuming that the unitholders wish for the Avengers Trust to continue in existence, the trustee would need to resolve to distribute the proceeds remaining in the Avengers Trust by way of an advancement of capital (which would trigger CGT event E4 in relation to the tax-sheltered amount). This would have a number of tax consequences for the Captain America Trust and Black Widow Trust (see Table 1).

On the basis that the Captain America Trust qualifies for the 50% discount, its net capital gain on CGT event E4 would be $75,000.

Assuming instead that the unitholders wish for the Avengers Trust to be wound up and to go their separate ways, the trustee would need to effect a redemption of all of the units held in the trust (which would trigger CGT event C2 in relation to capital proceeds received by the unitholders for the redemption of their units). This would have a number of tax consequences for the Captain America Trust and Black Widow Trust (see Table 2).

On the basis that the Captain America Trust qualifies for the 50% discount, its net capital gain on CGT event C2 would be $275,000.

Table 1. Advancement of capital: tax consequences

Unitholder	Capital distribution	Less tax-sheltered amount[50]	Non-assessable part	Cost base of units	Adjusted cost base	CGT event E4 gain
Captain America Trust (20% of units)	$600,000	$400,000	$200,000[51]	$50,000	Nil[52]	$150,000
Black Widow Trust (10% of units)	$300,000	$200,000	$100,000[53]	$400,000	$300,000[54]	Nil

Table 2. Unit redemption: tax consequences

Unitholder	Capital proceeds	Less cost base of units	CGT event C2 gain/(loss)
Captain America Trust (20% of units)	$600,000	$50,000	$550,000
Black Widow Trust (10% of units)	$300,000	$400,000	($100,000)

The following observations can be made from the above comparisons:

- the amount comprising the capital proceeds on a CGT event C2 will include the amount that has been sheltered by the 50% discount. Therefore, a higher capital gain will arise to those unitholders which do not have a substantial cost base (for example, the Captain America Trust) when compared to CGT event E4; and
- capital losses are only available on the occurrence of CGT event C2 but not on CGT event E4 (only a cost base reduction will arise on the latter event). For the Black Widow Trust, if this capital loss is triggered in the same income year as the CGT event from the sale of the warehouse by the Avengers Trust, the Black Widow Trust can apply the capital loss against its share of the capital gain attributed to it. However, a capital loss is only available against the grossed-up capital gain and not the capital gain arising after applying the 50% discount. Therefore, the $100,000 loss would be applied against the Black Widow Trust's grossed-up capital gain of $400,000, reducing it to $300,000 before applying the 50% discount to further reduce the gain to $150,000.

It can be seen from Table 3 that CGT event E4 would favour the Captain America Trust, whereas CGT event C2 would favour the Black Widow Trust.

Ultimately, when deciding whether capital should be extracted from a unit trust by way of an advance of capital or a unit redemption, consideration should be had not only to what is commercially viable, but also to the tax attributes of each unitholder's unitholding in the trust.

Small business CGT concessions: accessing tax-sheltered amounts

15-year exemption and retirement exemption

Where a capital gain is disregarded by a trust under the 15-year exemption (Subdiv 152-B ITAA97), the trust accessing the exemption may make a payment of an exempt amount within two years of the CGT event to an individual who is a CGT concession stakeholder of the trust just before the event.[55]

The retirement exemption (Subdiv 152-D ITAA97) also requires a payment of an exempt amount to an individual who is a CGT concession stakeholder where a capital gain is disregarded by a trust, unless the CGT concession stakeholder is under 55 before the choice is made to apply the retirement exemption.[57] This payment must be made within seven days after the trust makes the choice to apply the retirement exemption (which must be lodged with the trust's tax return for the year in which the CGT event has happened).

On the basis that the payment is made to an individual (directly or indirectly) who qualifies as a CGT concession stakeholder within the above time periods for the 15-year exemption and retirement exemption, the amount will be non-assessable non-exempt income.[58] This will overcome CGT event E4 which, as noted above, occurs where a trustee makes a payment to a unitholder and some or all of the payment is non-assessable.

Character of payment

The income tax legislation does not describe the nature or character of the payment made by the trustee of the unit trust to the unitholder/beneficiary qualifying as a CGT concession stakeholder under the 15-year exemption or retirement exemption. In the authors' view, as noted above, the correct characterisation of the payment may be a capital distribution. However, such a characterisation would necessitate payments being made equally to all unitholders of the same class, including those unitholders that may not qualify as CGT concession stakeholders, for instance, because their unit holding is less than 20%. It remains to be seen in these circumstances whether the payment of amounts to CGT concession stakeholders may be characterised in some other manner.

As noted above, the legislation does not speak to the character in which the sheltered amount arising from the 15-year exemption and retirement exemption must be paid from a trust to its unitholders/beneficiaries. Although the position is uncertain, the payments to unitholders may arguably be recorded as non-deductible expenses of the trust that arise as a consequence of the trustee choosing to apply the 15-year exemption or retirement exemption. The validity of the approach may be further supported if the trust deed expressly allows for such payments to the unitholders. This may require a deed amendment to be effected to grant the trustee such a specific power.

Table 3. Advancement of capital versus unit redemption

Unitholder	Warehouse disposal – share of net capital gain	Net capital gain/(loss) from CGT event E4	Total assessable amount
Captain America Trust (20% of units)	$400,000	$75,000	**$475,000**
Black Widow Trust (10% of units)	$200,000	Nil	**$200,000**
Unitholder	**Warehouse disposal – share of net capital gain**	**Net capital gain/(loss) from CGT event C2**	**Total assessable amount**
Captain America Trust (20% of units)	$400,000	$275,000	**$675,000**
Black Widow Trust (10% of units)	$200,000	($100,000)	**$150,000**[56]

There are some commercial issues with this approach, in that the amount remaining in the trust will be capital owing to all of the unitholders rather than amounts owing exclusively to the unitholders that do not comprise CGT concession stakeholders. However, such issues may not be overly significant if the unitholders are members of the same family group.

Concluding remarks

Whatever the disadvantages in unit trusts as business and investment vehicles, their overall utility is likely to ensure that they remain a popular structure for years to come.

The flow-through nature of the vehicle, coupled with its obvious commercial uses as a trust with defined equity interests, guarantees the unit trust a place in the repertoire of effective structures called on by tax advisers when appraising their clients of the various options available.

Peter Slegers, CTA
Director, Tax & Revenue Group
Cowell Clarke

Carlie Frantzis, ATI
Lawyer, Tax & Revenue Group
Cowell Clarke

Amy Lancaster, ATI
Lawyer, Tax & Revenue Group
Cowell Clarke

Acknowledgment

The authors would like to thank Michael Croft, Law Clerk in Cowell Clarke's Tax & Revenue Group, for his assistance with the research in this article.

References

1 Particularly where the units are held by discretionary trusts.

2 For instance, "unit trust" is defined in s 202A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) but only for the purposes of dealing with tax file numbers. "Public traded unit trust" has the meaning given by s 149-50 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) but "unit trust" remains undefined. A "widely held unit trust" is defined in s 272-105, Sch 2F ITAA36 but, again, "unit trust" remains undefined. "Units" and "unit trusts" are also frequently referred to in the CGT provisions, for example, see s 108-5 ITAA97, item 3 of the table in s 109-10 ITAA97, and the exceptions to CGT event D1 in s 104-35(5) ITAA97.

3 *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53 at [15] per Gleeson CJ and McHugh, Gummow, Callinan and Heydon JJ (*CPT Custodian*).

4 See the definition of "unit" in s 2 of the *Land Tax Act 1936* (SA) and s 2 of the *Stamp Duties Act 1923* (SA); see the definition of "unit trust" in s 3 of the *Land Tax Management Act 1956* (NSW); see the definition of "unit" and "unit trust scheme" in the Dictionary to the *Duties Act 1997* (NSW); and see the definition of "unit" and "unit trust scheme" in s 3(1) of the *Land Tax Act 2005* (Vic) and s 3(1) of the *Duties Act 2000* (Vic).

5 NE Morecroft, *The origins of asset management from 1700 to 1960*, Palgrave Macmillan, 2017, pp 221–257.

6 B Mees, M Wehner and P Hanrahan, *Fifty years of managed funds in Australia*, preliminary research report, Investment and Financial Services Association Ltd, 2011, pp 9–10; GC Spavold, "The unit trust – a comparison with the corporation", (1991) 3(2) *Bond Law Review* 249.

7 In particular, the prevention of double taxation that applied to companies prior to the introduction of the dividend imputation system, as well as receipts of the trustee maintaining their (tax-free) character in the hands of the unitholder.

8 [1954] HCA 16.

9 Note 1 in s 108-5 ITAA97 expressly confirms the status of units as a CGT asset.

10 Subject, of course, to the tax loss rules that apply to the particular type of unitholder.

11 S 109-10 ITAA97. Also see the exception to CGT event D1 in s 104-35(5)(d) ITAA97.

12 S 104-35(5) ITAA97.

13 S 270-25, Sch 2F ITAA36.

14 Div 165 ITAA97.

15 Whether a taxable dividend under s 47(1) ITAA36 or the general definition.

16 See the CGT treatment of disposals and acquisitions of partnership interests in IT 2540.

17 For a discussion of these issues, see P Slegers, "Effective trust deeds and trust resolutions", (2012) 46(10) *Taxation in Australia* 443.

18 S 272-5(2)(d), Sch 2F ITAA36.

19 [1985] VicRp 88.

20 [1985] VicRp 88 at [395].

21 Former s 160APHL(14) ITAA36.

22 S 295-550(4) ITAA97 and s 26 of the *Income Tax Rates Act 1986* (Cth).

23 S 272-65, Sch 2F ITAA36.

24 Note that the meaning of "vested" has not been judicially considered in the context of Sch 2F ITAA36, save for some cursory discussion in *Colonial First State Investments Ltd v FCT* [2011] FCA 16 (*Colonial First State*).

25 *Walsh Bay Developments Pty Ltd v FCT* (1995) 130 ALR 415 at 427 (*Walsh Bay*).

26 (1995) 130 ALR 415 at 427–428.

27 (1995) 130 ALR 415 at 428.

28 Ibid.

29 Para 16 of PCG 2016/16.

30 Para 208 of TR 2006/7.

31 *Walsh Bay* at 427 and 428.

32 The Commissioner adopts this view in para 209 of TR 2006/7.

33 S 272-5(2), Sch 2F ITAA36.

34 See the criteria contained in category 6 in attachment B to PCG 2016/16.

35 This is distinct from beneficiaries of discretionary trusts, which the ATO has taken the view that CGT event E4 cannot apply to (see TD 2003/28).

36 S 104-70(1) ITAA97. Note that tax-sheltered amounts are more precisely defined in the legislation as non-assessable parts.

37 S 104-70(6) ITAA97.

38 S 104-70(4) ITAA97.

39 See Div 40 ITAA97 in relation to standard depreciation, and Subdiv 40-BB and s 328-180 of the *Income Tax (Transitional Provisions) Act 1997* (Cth) in relation to accelerated depreciation.

40 Div 43 ITAA97.

41 See the specific disregarding provisions for each CGT event under Div 104 ITAA97. This may not result in an adverse tax outcome if the relevant units in the unit trust were also acquired prior to 20 September 1985 (see s 104-70(7) ITAA97).

42 Subdiv 152-C ITAA97.

43 S 104-71(4) ITAA97. There is no equivalent exclusion in s 104-71(4). Also see TD 2006/71 on the small business 50% reduction.

44 This applies the reasoning adopted by the Commissioner in TD 2003/28.

45 S 104-25 ITAA97.

46 As stated above, tax-sheltered amounts arising from the application of the 50% discount are not captured by CGT event E4.

47 See s 104-25(3) and the note to s 104-70(4).

48 Including the Captain America Trust and the Black Widow Trust.

49 $5m refers to the net proceeds, less $2m.

50 Arising from the 50% discount (see item 1 of the table in s 104-71(4) ITAA97).

51 The total non-assessable part of $1m multiplied by 20%.

52 A CGT event E4 capital gain arises because the non-assessable part exceeds the cost base of the units. The cost base of the units is reduced to nil per s 104-70(5) ITAA97. No capital loss is available under CGT event E4.

53 The total non-assessable part of $1m multiplied by 10%.

54 The non-assessable part does not exceed the cost base. Therefore, no CGT event E4 capital gain arises.

55 S 152-125 ITAA97.

56 The gross capital gain arising from the sale of the warehouse attributed to the Black Widow Trust of $400,000 less the capital loss arising from the partial redemption of units of $100,000 and less the 50% discount.

57 S 152-325 ITAA97.

58 S 152-125(1)(a)(ii) ITAA97.

Appendix. Fixed trust provisions

	Income Tax Assessment Act 1936
Schedule 2F	Trust loss provisions
Section 102UC	Trustee beneficiary reporting
Sections 160APA and 160APHD	Franking of dividends
Section 160APHL(14)	Holding period for franking credits
	Income Tax Assessment Act 1997
Section 104-72	CGT event E4 and trusts
Section 115-50	Discount capital gains
Section 115-110	Foreign or temporary residents – individuals with trust gains
Section 116-35	Capital proceeds – market value substitution rule
Section 118-510	CGT and venture capital
Section 124-781	Capital gains and scrip-for-scrip roll-over
Subdivision 165-F	Company tax losses – ownership of a company by non-fixed trusts
Section 170-265	Company as a member of a linked group
Section 295-550	Non-arm's length income for complying superannuation funds
Section 328-440	Small business restructure roll-over – ultimate economic ownership of a non-fixed trust
Section 415-20	Designated infrastructure entity
Section 703-40	Consolidation: treating entities held through non-fixed trusts as wholly-owned subsidiaries
Section 707-325	Consolidation: modified market value of an entity becoming a member of a consolidated group
Section 713-50	Consolidation: determining destination of distribution by non-fixed trust
Section 719-35	Consolidation: treating entities held through non-fixed trusts as wholly owned subsidiaries
Section 725-65	Direct value shifting: cause of the value shift
Section 727-110	Indirect value shifting: common ownership nexus test
Sections 727-360, 727-365, 727-400 and 727-410	Indirect value shifting: control, common ownership and ultimate stake tests
Section 855-40	Capital gains or losses of foreign residents