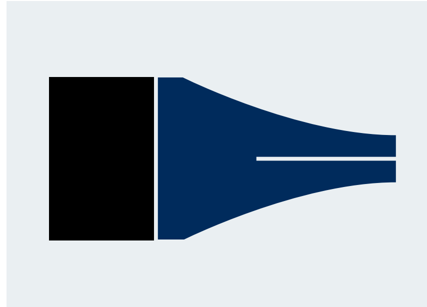
Superannuation funds and public trading trusts

by Philip Broderick, CTA, Sladen Legal

This article considers when a superannuation fund's investment in a unit trust will cause it to be a public trading trust and the corresponding consequences.



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Introduction

When superannuation funds[1] consider structuring through, or investing in, another private entity, the choice is generally between a company and a unit trust. More often than not, when the decision is made to invest in a unit trust, rather than a company, the decision is primarily made in order to take advantage of a unit trust's "flow-through" nature under the current tax laws. However, what is arguably not considered enough is that a unit trust may become a "public trading trust" where a superannuation fund(s) holds a right to 20% or more of the income or capital of a unit trust, with the result that the unit trust will be taxed as a company and the flow-through nature of the unit trust will be lost.

The purpose of this article is to examine how a superannuation fund's investment in a unit trust can cause it to be a public trading trust and the resulting consequences. This article will not examine the application of the in-house asset rules to an investment in a unit trust (it is assumed that the units meet one of the exemptions to the in-house asset rules or the trust is not a "related trust") or any of the other superannuation rules and tax rules (including the non-arm's length income rules) that should be considered when a superannuation fund invests in a unit trust. This article is also confined to examining the public trading trust rules where their application is caused by a superannuation fund(s) holding units in a unit trust (rather than other factors that may cause a unit trust to be a public trading trust[2]).

What is a public trading trust?

In order for a trust to be a public trading trust the following five tests must be satisfied.[3]

Test 1: is it a unit trust?

The public trading trust definition and each of the tests outlined below are premised on the basis that the trust is a unit trust.[4] Although in most cases it will be pretty clear whether the trust is a unit trust or not, this is not always be the case. For example, is a "hybrid trust", where the trustee has discretion to distribute income and/or capital to a class of discretionary beneficiaries and, in the default of such a distribution, the income is held for the unitholders in proportion of their units, a unit trust?

Another interesting issue is whether the public trading trust rules can be avoided by using a "fixed trust" rather than a unit trust. The Australia Taxation Office, in three PBR,[5] has conceded that certain fixed trusts will not be a unit trust (and therefore will not be a public trading trust). The ATO made these determinations that the fixed trusts in question did not allow for the purchase, repurchase or redemption of the beneficiaries' beneficial entitlement in the trust.

However, in PBR 21572, the ATO was at pains to stress that you cannot avoid the trust from being a unit trust merely by the absence of the creation of any "units" under the trust deed. Rather, in the ATO's view, the key characteristic of a unit trust is the ability to purchase, repurchase or redeem a beneficiary's beneficial interest in the trust (whether that interest is described through the use of units or beneficial entitlements or some other terminology).

Test 2: is it a public unit trust?

The second test is to determine whether the trust is a public unit trust. There are a number of circumstances when the investment by a superannuation fund(s) will cause a unit trust to be a public unit trust for a particular income year, including:

- if, at any time during that income year, one or more superannuation funds[6] hold, or have the right to acquire, or become the holder of units in the unit trust which entitle the holder to 20% or more of the property, or income, of the trust;[7]
- if, at any time during that income year, 20% or more of the money paid or credited by the unit trust during a year of income was paid or credited to a superannuation fund(s);[8] or
- if there is a provision in the unit trust's trust deed, another agreement or under a person's power, under which the rights attaching to the units are capable of being varied or abrogated to allow a superannuation fund(s) to be entitled to 20% or more of the income or property of the unit trust or 20% or of the money paid or credited by the trust.[9]

A public unit trust will most commonly arise where a superannuation fund(s) holds 20% or more of the units in a unit trust on the basis that the units entitle the superannuation fund(s) to 20% or more of the income and capital of the unit trust (although an examination of income and capital rights under the unit trust deed would need to be undertaken to confirm this). Under the second category listed above, a unit trust can also be a public unit trust if a superannuation fund(s) has less than 20% of the units but where the superannuation fund(s) has the right to hold more than 20% of the units (eg via options) or where the superannuation fund's units grant it rights to 20% or more of the income, or the property, of the unit trust.

The third category of public unit trust listed above also has the potential to catch unit trusts where the unitholding of the superannuation fund(s) (and its rights to income and capital) is below 20%. This third category has been drafted very broadly and has the potential to catch many (if not most) unit trusts. This is because many "standard" unit trust deeds grant the trustee of the trust wide powers to vary the rights of the units, to vary the trust deed and to issue units with special rights. Given the breadth of the drafting of the third category, it could be argued that, where these powers exist, there is an ability to increase the superannuation fund's interests in the income or property of the trust in excess of 20%. Given that this last category was presumably drafted as a form of anti-avoidance, it is hoped that the ATO would only seek to enforce this test where there has been some attempt to avoid the application of the other two public unit trust categories.

Test 3: is it a trading trust?

The third test to consider is whether the unit trust is a trading trust. A unit trust will be a trading trust if, at any time during an income year, either of the following two categories apply:

- its trustee carried on a trading business; or
- its trustee controlled, or was able to control, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business.

Test 3.1: is the unit trust carrying on a trading business?

According to the ATO, the test for determining whether a unit trust is carrying on a trading business under the first category (or whether another person is under the second category) is determined under ordinary principles. The ATO refers to TR 97/11 as setting out factors which, in the ATO's view, indicate the carrying on of a business. These include:

- whether the activity has a significant commercial purpose or character (this indicator comprises many aspects of the other indicators);
- whether the taxpayer has more than just an intention to engage in business;
- whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity;
- whether there is repetition and regularity of the activity;
- whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;
- whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
- the size, scale and permanency of the activity; and
- whether the activity is better described as a hobby, a form of recreation or a sporting activity.[10]

It is important to note that this test is aimed at the activities of the trustee. So, if the trustee appoints another party to undertake services for the trustee and those services constitute a business, then prima facie the trustee will not be carrying on those business activities. However, in the ATO's view, based on the expanded definition of trustee under s 6(1) ITAA36, activities undertaken by other parties may cause those parties to be a "trustee" of the trust[11] and therefore result in the trust being a trading trust. For example, in PBR 1012138374360, the ATO found that, although the trustee did not carry on a business, a manager appointed by the trustee to undertake various activities for the trust was carrying on a business. Under the terms of the management agreement, the manager had become a fiduciary for the members of the trust and therefore was deemed to be a trustee. Consequently, the trust in question was a trading trust on the basis that its deeded trustee was carrying on a business.

Test 3.2: does the unit trust control the affairs or operations of another person carrying on a trading business?

The second category of the trading trust was inserted to prevent unit trusts from using interposed entities to avoid the application of the trading trust test. It is interesting that the test relies on whether the unit trust controls the "affairs or operations" of another person, rather than the more common "rights to income and capital" or the "acting in accordance with directions" type control tests.

In any event, the test is wide and, based on the explanatory memorandum that introduced the trading trust provisions, the ATO has indicated that it will give a broad interpretation of the provisions.[12]

The ATO has taken the view that the "affairs" of a person comprise "all its business affairs, interests or transactions, all its investment or other property interests, all its profits and losses, and its goodwill",[12] while the "operation" of an entity is said to be "(i) an action, or process or method of working or operating; (ii) an active process, a discharge of a function; and (iii) a piece of work, especially one in series".[12] When comparing the two phrases, the ATO has indicated that: "the word 'operations' has a narrower meaning than 'affairs' and would sit more comfortably as a reference to the day-to-day business of the company rather than its business structure. However, the concept of 'affairs' may include 'operations'."

It is a question of fact as to whether a unit trust controls, or is able to control, the operations or affairs of another entity. Control could be found where the unit trust:

- holds directly, or through interposed entities, a majority voting interest in the trading business entity[13] or even 50% of the shares in a company;[14]
- has the right to remove and/or appoint directors to the board of an entity;
- has the right to compel the entity to perform business actions (eg through a shareholders/unitholders agreement); or
- has the right to veto the ability of the entity to perform business decisions.

The last category of control was considered in ID 2011/11, where the ATO determined, even though a superannuation fund held only 25% of the shares in a company, that the fund in question controlled the affairs and operations of that company (in a negative control sense). This was because, under a shareholders agreement, the company was prevented from undertaking certain actions (such as dealing with the company's capital structure, shareholders' rights, corporate governance, business scope and strategic direction) without 80% of the shareholders' approval. That is, effectively, the company could not make such decisions without the approval of the superannuation fund.

Given that these types of provisions are common in shareholders and unitholders agreements, it would be very easy for a unit trust to inadvertently control a trading entity through this type of an agreement, even where the unit trust has a minority interest. Therefore, it is important, if the unit trust does not wish to trigger this type of control over the affairs of a trading entity, that the unit trust carefully considers the structure of its (direct and indirect) participation in such trading entities.

Of course, this should be considered in light of what control the unit trust would like over the trading entity. For example, it might be more important for the unit trust to maintain a right of veto than the consequences of being a trading trust.

Where a unit trust invests offshore, the use of a foreign entity for such investments will not trigger the second trading trust category if the business of that foreign entity (or entities that the foreign entity controls) consists primarily of investing in land outside Australia for the purpose, or primary purpose, of deriving rent (the rent purpose requirement is discussed further below).

Test 3.3: does the trading business wholly consist of eligible investment businesses?

Certain business operations will not cause a unit trust to be considered a trading trust. This includes where the unit trust wholly carries on one or more of the following "eligible investment businesses":[15]

- investing in land for the purpose, or primarily for the purpose, of deriving rent; or
- investing or trading in various financial instruments (including loans, shares, units, futures, swaps, life insurance policies etc).

In relation to investing in land, the purpose of deriving rent need only be the primary purpose and does not need to be the sole purpose. Therefore, this leaves some scope for other purposes such as capital growth, property development or management fees. In the ATO's view,[16] primary means "principally" or "chief". In PBR 1011313102554, the ATO conceded that the primary purpose of the land investments for the trust in question was for deriving rent, even though there was a secondary purpose of deriving capital growth. This view appears to have primarily been made on the basis of the marketing material for the trust in question.

In regard to whether the primary purpose of rent can be satisfied, s 102MB(2) ITAA36 contains a safe harbour rule that provides that investments in land will be taken to be primarily for the purpose of deriving rent if:

- the purpose of each land investment of that entity includes a purpose of deriving rent (note that there is no primarily requirement for each parcel of land); and
- at least 75% of the gross revenue from the land investments consists of rent (note that the definition of rent excludes rent calculated by reference to profits, where such profit-based rent is designed to transfer all, or substantially all, of the profits from the tenant).

In relation to the requirement that an entity must "wholly" carry on "eligible investment businesses", there is another safe harbour test. This states that an entity will still be said to be wholly carrying on such businesses even if no more than 2% of the entity's gross revenue was from non-eligible investment businesses (provided that such other revenue is incidental and relevant to the carrying on of the eligible investment businesses).[17]

Test 4: is the trust a resident unit trust?

The fourth test that the unit trust must satisfy is that it is a resident unit trust for either the income year in question or the previous income year.

A trust will be a resident unit trust where, at any time during an income year, the following two requirements are satisfied:

- either of the following conditions are satisfied:
  - any of the property of the unit trust is situated in Australia; or
  - the trustee of the unit trust carried on business in Australia; and
- either of the following conditions are satisfied:
  - the central management and control of the unit trust was in Australia; or
  - Australian residents held more than 50% of the beneficial interests in the income or property of the unit trust.[18]

Test 5: the unit trust is not a corporate unit trust

The fifth test requires that the unit trust is not a corporate unit trust within the meaning of Div 6B ITAA36[19] in relation to the relevant year of income (which broadly applies where companies transfer assets to a public unit trust in exchange for units).

The application of the five tests has been summarised in the flow chart set out in Diagram 1.

Consequences of being a public trading trust

Public trading trusts are taxed like companies

The primary consequence of a trust being classified as a public trading trust is that the trust's income (whether distributed or not) is taxed at the company tax rate.[20] Capital gains made by a public trading trust are also taxed at the corporate tax rate.

This has a number of consequences. For example, it effectively means that the capital gains discount on capital gains derived by the public trading trust will be lost so that, when the gain is distributed to unit holding superannuation funds in accumulation phase, those capital gains will be taxed at the rate of 15% rather than 10%.[21]Even where the superannuation fund(s) is in pension phase, the loss of the flow-through tax treatment for the public trading trust could have an adverse effect, for example, if there are co-unitholders that are trusts, or under the government's proposed changes to the pension phase exemption.[22]

Another consequence is the delay in receipt of income, even if the superannuation fund is in pension phase. While the tax paid by the unit trust is refundable via a franking credit, there will be a delay in receiving that franking credit until the superannuation fund lodges its tax return. For example, if the public trading trust declared a fully franked dividend on 30 June 2013, the superannuation fund will not receive the franking credit refund until it lodges after tax return on, say, 15 May 2014, whereas a unit trust distribution on 30 June 2013 could be paid in full soon after the resolution.

A further consequence is that the public trading trust may not have enough franking credits to fully frank its distributions. This could happen, for example, where the public trading trust is able to depreciate its assets, it receives foreign income or it receives non-taxable income. Such non-franked income will be taxed at the superannuation fund level (assuming that it is in accumulation phase), whereas it would not necessarily have been fully taxed if it had been directly received by the superannuation fund.[23]

Other tax consequences

It is important to note that a public trading trust is not deemed to be a company for tax purposes and that the "corporate tax rules" only apply to the extent that the tax provisions specifically provide that they apply to public trading trusts. Corporate tax rules that apply to public trading trust include:

- distributions from a public trading trust are treated as though they were

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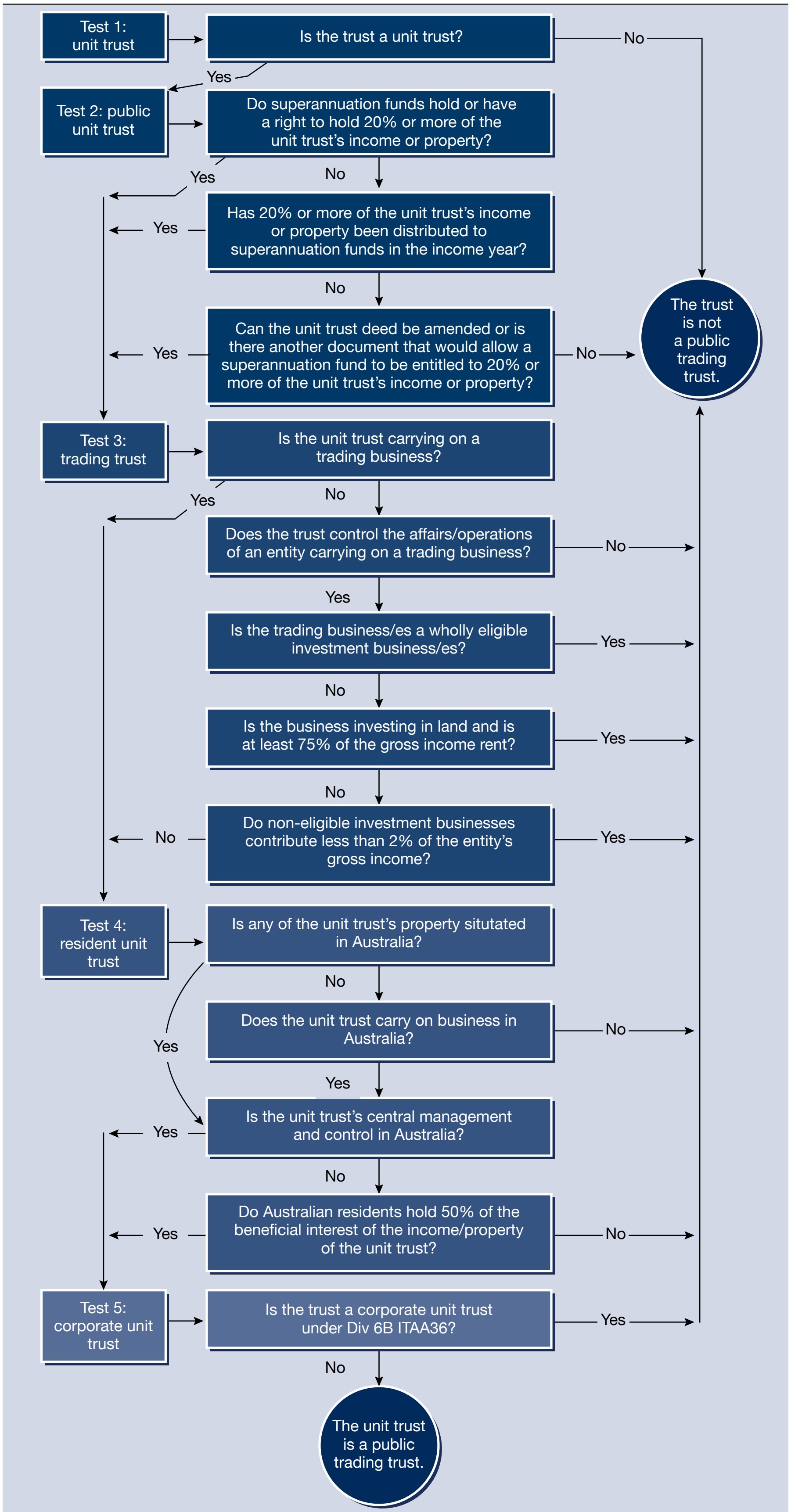
Diagram 1: Public trading trust tests



dividends from a company,[24] including that the franking credit rules apply to such distributions;

- the dividend stripping provisions in ss 46A and 46B ITAA36 apply in a modified form;[25]
- non-unit trust dividends are treated as non-share dividends;[26]
- a public trading trust is an R&D entity;[27]
- the public trading trust must administratively pay tax in the same manner as companies, including the liability to withholding tax on distributions paid;[28] and
- the debt/equity rules[29] and demerger relief[30] apply to public trading trusts as though they are companies.

Examples of where a public trading trust will not be treated as a company include the non-application of both Div 7A ITAA36[31] and the scrip-for-scrip roll-over relief.[32]

In relation to the public trading trust distributions being treated as frankable distributions, this only occurs if the distribution meets the definition of "unit trust dividend". Unit trust dividends are any distribution made, whether monetary or property, to a unitholder or an amount credited to a unitholder.[33] However, such distributions will not be a unit trust dividend if:

- it is money/property paid, credited or distributed to the extent that the money or property is attributable to profits arising at a time when the trust was not a public trading trust; or
- it is money/property paid, credited or distributed in respect of the cancellation, extinguishment or redemption of units, provided the money represents money/property transferred for the creation or issue of such units and the amount does not exceed the issue price of those units.

Practical consequences

In addition to the tax consequences, there are a number of practical consequences of becoming a public trading trust, including:

- the ATO has an administrative practice that, if a unit trust becomes a public trading trust, the public trading trust must apply for a new tax file number and ABN (a potentially lengthy process), with the consequential additional administration required to update records and notify suppliers and customers;

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- complications that arise in the interplay of trust law (including how distributions operate from a trust perspective), accounting purposes (which continues to treat the public trading trust as a trust) and being taxed like a company under tax law;
- complications in preparing trust distribution minutes in a manner that is compliant from a trust law perspective and the trust deed and is also appropriate from a tax perspective on the basis that the trust is taxed like a company;
- in the initial year, the public trading trust will not have any franking credits and therefore frankable distributions may have to be delayed until after the public trading trust pays tax;
- the public trading trust can accumulate income at the tax rate of 30% (with franking credits) rather than the normal trust accumulation rate of 45% (without a refundable credit); and
- public trading trusts can switch between being a "standard unit trust" and a public trading trust (for example, a unit trust could go above and below the safe harbour rules in different years).

Conclusion

When a superannuation fund holds an interest in a unit trust, it is important that the public trading trust rules be examined to determine whether such investment will cause the unit trust to fall within the definition of a public trading trust. As shown in this article, determining whether a unit trust is a public trading trust is not always a straightforward process and will require an analysis of the rights of the superannuation fund's units, as well as the trading activities not only of the unit trust, but also other entities that the unit trust has an interest in.

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References

1 The references to superannuation funds and trusts in this article include a reference to their trustees in the role as trustee of the superannuation fund or trust (as the case may be).

2 S 102P of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). For example, the unit trust is listed or open to the public or units are held by other exempt entities.

3 S 102R ITAA36.

4 For example, see the opening of s 102R ITAA36.

5 PBR 21572, PBR 24174 and PBR 1011509794220.

6 Together with any other tax-exempt entities (such as charities and government agencies).

7 S 102P(2)(a) ITAA36. Public unit trusts also include trusts where any of the units are quoted on a stock exchange, if the units were offered to the public or 50 or more persons hold units.

8 S 102P(2)(b) ITAA36.

9 S 102P(2)(c) ITAA36.

10 TR 97/11 at para 13. See also PBR 1011464509350.

11 PBR 1012138374360.

12 See ID 2011/11.

13 See PBR 25044 where the trust owned 100% of the shares in a company that held 100% of the shares in a trading company and the trust was found to control the trading company.

14 See PBR 1012311760988 where two unit trusts each held 50% of the shares in a trading company and each of those unit trusts were found to control that trading company.

15 See the definition of "eligible investment business" in s 102M ITAA36.

16 PBR 1011313102554.

17 S 102MC ITAA36.

18 S 102Q ITAA36.

19 S 102R(1)(a)(v) ITAA36.

20 S 102S ITAA36 and s 25 of the *Income Tax Rates Act 1986* (Cth).

21 An example of the tax treatment to a superannuation fund that is not in pension phase is as follows: $100 of capital gain made by the public trading trust will be taxed at 30%. When the remaining gain of $70 is paid to the superannuation fund as a unit trust dividend, with a $30 franking credit, the unit trust dividend (ie the $70 cash plus $30 franking credit) will be taxed at 15% (ie $15) less the franking credit ($30), giving a net tax refund of $15. The cash result is that the superannuation fund receives $85 (ie $70 in cash plus a $15 tax refund), giving an effective tax rate of 15%. Whereas, if the superannuation fund had received the capital gain directly, it would have paid tax at the rate of 10% provided it held the CGT asset for greater than 12 months.

22 That is, superannuation funds will only be able to receive tax-exempt income in pension phase for the first $100,000 of income for each pension member.

23 For example, if a "flow-through" unit trust receives $100 in income and has $100 in depreciation expenses, the unit trust will have no net income but $100 in cash. If it pays that cash to the unit holding superannuation fund, CGT event E4 will cause the fund to reduce its cost base in the units by $100, and after the cost base is reduced to nil, any remaining distribution will be taxed to the superannuation fund as a capital gain (ie 10% if the superannuation fund has held the units for at least 12 months). Whereas, when $100 is paid by the public trading trust to the superannuation fund, it will be taxed as a non-franked dividend at 15%.

24 S 102T(11) and (14) ITAA36.

25 S 102T(3) ITAA36.

26 S 102T(23) ITAA36

27 S 102T(9) ITAA36.

28 S 102T(11) and (12) ITAA36.

29 Div 974 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

30 Div 125 ITAA97.

31 Although note that the ATO has included the use of public trading trusts to avoid Div 7A in its 2012-13 compliance program. Website at www.ato.gov.au/atp/content.aspx?menuid=52932&doc=/content/00326650.htm&page=50.

32 ID 2003/197.

33 S 102M ITAA36.