

Supersized professional practice unit trusts

A PROFESSIONAL PRACTICE UNIT TRUST STRUCTURE MAY INADVERTENTLY BE A MANAGED INVESTMENT SCHEME AND/OR A PUBLIC TRADING TRUST WITH UNINTENDED CORPORATIONS LAW COMPLIANCE OBLIGATIONS AND UNINTENDED INCOME TAX TREATMENT.



A professional practice unit trust structure with more than 20 unitholders may be a managed investment scheme (MIS) and subject to specific regulation by corporations law. If the professional practice unit trust has at least 50 unitholders¹ it may be a public trading trust for taxation law purposes. These regulation issues will require consideration and may require management. A failure to manage and monitor such unit trusts may expose the trustee and the unitholders to criminal and civil offences and adverse unintended taxation consequences.

This article discusses selected regulatory issues under the *Corporations Act 2001* (CA 2001) and the *Corporations Regulations 2001* (CR 2001), the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) affecting large private unit trusts with a particular emphasis on large professional practice unit trusts.

OUTSIZED UNINCORPORATED ASSOCIATIONS

Prohibition on outsized unincorporated associations

It is an offence under s 115 CA 2001 to participate in the formation of an association that has an object of gain for itself or its members and has more than 20 members, unless incorporated or formed under the CA 2001 or an Associations Incorporation Act.² A smaller unincorporated association that subsequently exceeds 20 members arguably becomes subject to the prohibition.³

The criminal penalty is \$500 for individual and \$2,500 for company members.⁴ Although the fine is relatively modest, it

may impact upon professional registrations, particularly where the member must be a fit and proper person to qualify for registration. Section 115 CA 2001 is not a civil penalty provision so civil penalty orders (including compensation orders) do not apply.

Dealings with or by the unincorporated association are not void or unenforceable.⁵ The CA 2001 reverses the common law position.

The policy reason for the prohibition is to prevent the public having to deal with the uncertainty and the expense of not being able to identify the members of a large unincorporated association.⁶

Mutual contractual rights and obligations required

A unit trust that does not create mutual rights and obligations between unitholders cannot be a prohibited unincorporated association.⁷ Usually a unit trust with more than 20 unitholders is not a prohibited unincorporated association because there is no contract to which all unitholders are parties that create mutual rights and obligations between the parties.⁸

However, a unit trust with more than 20 members may breach the prohibition where the unit trust instrument or a unitholders' agreement grant the unitholders' meeting general power or extensive powers to give directions to the trustee as to how the unit trust is to be administered. If the unitholders are given powers as extensive and akin to the shareholders of a company, the unit trust may factually be an unincorporated joint stock company.

Accordingly, the terms of the trust instrument or unitholders' deed will need to be carefully considered and drafted.

Object of gain for the association or members

The outsized unit trust must have an object of gain for the outsized unit trust or its unitholders. The venture is not limited to carrying on business, but includes profit making schemes and passive investments.⁹

Professional practices

Professional unit trusts with more than 20 unitholders are susceptible to breach of the prohibition, particularly where statute prohibits or prohibited incorporation. To mitigate this restriction, Regulation 2A.1.01 CR 2001 increases the number of unitholders to:

- 50 for actuaries, medical practitioners, patent attorneys, share brokers, stock brokers, or trademark attorneys;
- 100 for architects, pharmaceutical chemists or veterinary surgeons;
- 400 for legal practitioners; and
- 1,000 for accountants.

Accordingly, large professional practice unit trusts of financial planners, engineers and allied health professions (to name a few) are restricted in membership size to not more than 20 unitholders. Further, growth of professional practices such as share brokers and stockbrokers that exceed the increased 50 unitholder limit may inadvertently breach the prohibition.

CA 2001

Applicable provisions

If trust interests are offered to the public or constitute a MIS, a unit trust structure may be required to comply with:

- the managed investment scheme provisions in Chapter 5C CA 2001;
- the fundraising supervision provisions in Chapter 6D CA 2001;
- the debenture issue requirements in Chapter 2L CA 2001; or
- financial reporting and continuous disclosure requirements in Chapter 2M CA 2001 for unlisted unit trusts that have issued a prospectus.

The CA 2001 distinguishes between a “body corporate” and a “body”. A body corporate includes an unincorporated association such as a unit trust. The above provisions potentially apply to unit trusts because the provisions use the term “body” rather than “body corporate”.

Compliance with these requirements are onerous, and unit trusts that are potentially liable for compliance with the provisions may need to seek dispensation through a class order or specific Australian Securities and Investments Commission (ASIC) exemption order.

Managed investment schemes

Broadly, Chapter 5C CA 2001 requires registration of a MIS if the scheme has more than 20 members or has been promoted by a person in the business of promoting MIS unless offers under the scheme are exempt from disclosure under Chapter 6D CA 2001.

If a unit trust structure is a MIS it must be operated by a qualified and licensed responsible entity and the responsible entity is subject to prescriptive constituent document provisions, statutory duties, holding of assets, internal management structures and preparation of compliance plans.

A MIS is subject to the product disclosure statement (PDS) requirements in Part 7.9 CA 2001, unless excluded such as small-scale offerings (20 issues in 12 months not exceeding \$2,000,000).¹⁰

A professional practice unit trust with more than 20 unitholders may be a MIS.

Consequences of breach

Operating an unregistered and/or non-complying MIS may constitute various offences and ASIC may wind up the MIS.¹¹

Breach by the trustee of the MIS provisions may expose the trustee to civil penalty orders (including compensation orders)¹² and the issue of units may be voidable.¹³

Accordingly, inadvertently operating an unregistered and/or non-complying unit trust MIS may create a quagmire of legal consequences.

Professional practice

Relevantly, an excluded offer includes offers to senior management, certain close relatives and any body corporate they control.¹⁴ Accordingly, a professional practice unit trust that makes offers only for the issue of units to senior management and their close relatives and controlled entities as part of the admission and retirement of the professional principals will not be subject to several of the CA 2001 requirements.

However, this is piecemeal and it will still be desirable for the unit trust to obtain the following specific exemptions from ASIC:

- exemption from registration as a MIS under s 601ED CA 2001;¹⁵
- exemption from the trustee having to hold an Australian financial services licence;¹⁶
- exemption from the PDS requirements under Part 7.9 CA 2001;¹⁷
- exemption from the MIS hawking prohibition under s 992AA CA 2001.¹⁸

To obtain ASIC’s exemptions in respect of a professional practice unit trust, it will likely be necessary to limit offers and issues of units to senior management principals and their close relatives and their controlled companies and trusts and for the unit trust to provide a reduced degree of disclosure by way of information memorandum.

PUBLIC TRADING TRUSTS

Introduction

A public trading trust is treated similarly to a company for certain income taxation purposes under Div 6C ITAA 1936. The trust provisions in Div 6 ITAA 1936 do not apply.

Broadly, a public trading trust may retain profits, have those profits taxed at 30

per cent and pay franked distributions to unitholders.

A unit trust that is inadvertently a public trading trust will have drastically different taxation consequences for the trustee and the unitholders and will be significantly more complex to administer for tax purposes.

A unit trust will be a public trading trust if:¹⁹

- it is a public unit trust and is a trading trust in relation to the relevant income year; and
- it is either an Australian resident trust for the relevant income year or was a public trading trust in a preceding income year; and
- it is not a corporate unit trust regulated by Div 6B ITAA 1936.²⁰

Public unit trust and trading trust

A unit trust will be a public unit trust if the units are listed on a stock exchange, were offered to the public or were held directly or indirectly by at least 50 persons. Associated unitholders such as relatives and nominees may be aggregated in counting the 50 unitholders and beneficial ownership of units can be traced through any interposed entities to ultimate beneficiaries.²¹ Arguably, beneficial ownership cannot be traced through superannuation funds or discretionary trusts.²²

A unit trust that is otherwise a public unit trust is not a public unit trust where it is closely held (20 person/75 per cent exception) meaning:

- 75 per cent or more of the distributions are appointed to 20 or fewer unitholders;
- 20 or fewer unitholders have formal or informal rights, powers or control to receive 75 per cent or more of the distributions that are appointed;
- if no distributions are appointed, assuming distributions were appointed, 75 per cent or more of the distributions would be appointed to 20 or fewer unitholders.

A public unit trust will be a trading trust where it directly or indirectly controls the affairs or operation of a trading business²³ that is not an “eligible investment business” such as trading in land, securities, shares,

units futures, swap contracts or other passive investments.²⁴

Accordingly, a professional practice unit trust will constitute a public trading trust if the ultimate beneficial ownership of the unitholding exceeds 50 persons and the 20 person/75 per cent exception does not apply.

Other taxation issues

The comparative tax treatment of a public trading trust and a unit trust include:

- the trustee is taxed on the net income of the public trading trust at 30 per cent;²⁵
- the trust provisions in s 26(b) and Div 6, Part III ITAA 1936 do not apply;²⁶
- the unit trust dividends are included as assessable income in s 44(1) ITAA 1936;²⁷
- the imputation system in Part 3-6 ITAA 1997 applies;²⁸
- the foreign tax credit interaction is problematic in several respects;²⁹
- dividend withholding tax interaction is problematic;
- the 50 per cent CGT Discount applies³⁰ but it probably cannot be passed out to the beneficiary;³¹ and
- the trust loss provisions in Schedule 2F ITAA 1936 apply.

Accordingly, the taxation treatment for a public trading trust is drastically different and the administration for taxation purposes significantly more complex than a unit trust.

CONCLUSION

A professional practice unit trust structure with at least 20 members may constitute a MIS and will be subject to CA 2001 regulation unless ASIC provides an exemption order. If a professional practice unit trust exceeds 50 unitholders or underlying beneficiaries with unitholdings then the professional practice unit trust may be a public trading trust with drastically different and more complex taxation treatment.

Advisers should consider the possible application of the CA 2001 and public

trading trust rules generally and to a super sized professional practice unit trust and manage any consequential risks.

*Ron Jorgensen, Director
Accredited Specialist in Tax Law
HARWOOD ANDREWS LAWYERS*

Reference notes

- 1 Or underlying persons with the requisite beneficial interests in the unit trusts income and capital.
- 2 Associations Incorporations Act 1991 (ACT); Associations Incorporations Act 1984 (NSW); Associations Act 2003 (NT); Associations Incorporations Act 1981 (Qld); Associations Incorporations Act 1985 (SA); Associations Incorporations Act 1964 (Tas); Associations Incorporations Act 1981 (Vic); Associations Incorporations Act 1984 (WA).
- 3 *Re Thomas (1884) 14 QDR 379.*
- 4 5 penalty units of \$100 per penalty unit under section 1311(5) CA 2001 and 5 times the penalty for body a corporate under section 1312 CA 2001.
- 5 Section 103(2) CA 2001.
- 6 *Smith v Anderson (1880) 15 Ch D 247.*
- 7 *Playfair Development Corp Pty Ltd [1969] 2 NSWLR 661.*
- 8 *Perpetual Trustees WA Ltd (1989) 1 WAR 117 at 129.*
- 9 *Re Arthur Average Association (1875) 10 Ch D 546.*
- 10 Section 1012E CA 2001.
- 11 Section 601EE CA 2001.
- 12 Section 601MA CA 2001.
- 13 Section 601MB CA 2001.
- 14 Section 708 CA 2001.
- 15 Section 601QA CA 2001.
- 16 Section 911A(2)(f) CA 2001.
- 17 Section 1020F(1)(a) CA 2001.
- 18 Section 992B(1)(b) CA 2001.
- 19 Section 102R(b) ITAA 1936.
- 20 Division 6B ITAA 1936 was an anti avoidance provision to prevent companies from avoiding company tax by restructuring a company's assets into a unit trust and is of restricted application.
- 21 Section 102P ITAA 1936.
- 22 ATO ID 2001/66.
- 23 Section 102N ITAA 1936.
- 24 Section 102M ITAA 1936.
- 25 Section 102S ITAA 1936.
- 26 Section 102T(16) ITAA 1936.
- 27 Section 102T(11),(12),(14) & (19) ITAA 1936.
- 28 Sections 202-15, 202-40, 202-45 & 960-115 corporate tax entity.
- 29 IT 2556.
- 30 ATO ID 2003/652.
- 31 ATO ID 2003/798.