

Partnerships of trusts: Legal and taxation issues

AN ANALYSIS OF THE LEGAL AND PRACTICAL ISSUES FACING PRACTITIONERS AND CLIENTS IN ADMINISTERING A PARTNERSHIP OF TRUSTS WITH CORPORATE MANAGER.



INTRODUCTION

A partnership of discretionary trusts with a company as manager (**representative**) is a useful business structure for the following reasons:

1. the use of a trust¹ (when compared with a company) enables flexible income distributions and potential access to the capital gains tax concessions determined by reference to the circumstances of each individual trust;
2. as each trust is a discretionary trust it may be controlled by one family group (contrast with a business owned by multiple families in a hybrid or unit trust) enabling the trustee to make a family trust election (**FTE**) which is important in relation to various taxation purposes such as obtaining a deduction for tax losses or accessing franking credits; and
3. it has the commercial advantage of only one person being the public face of the partnership to customers and suppliers (namely, the representative instead of the business owners).

It is recommended for reasons of asset protection that each trust has a corporate trustee² not only because each partner trust has joint and several liability for the debts of the partnership but also to attempt to ensure that each partner is not exposed to any other business or personal liabilities which may expose the assets of the partnership.

A partnership of trusts is also a useful structure for professionals such as lawyers who, by reason of regulations governing their practice, may be restricted as to the structure they may use and how they share their business income with their families.

The structure also obviates any need for the business owners to have a separate service entity (eg to provide administrative services to the practice) in order to obtain the benefits of income streaming.

A partnership of trusts provides each business owner with control over the tax treatment of their share of the business' profits (eg streaming of distributions) and capital (eg access to the general discount and perhaps, small business concessions on any capital gain on disposal of an interest in business assets) and potentially enables revenue losses made by entities in the family group to be deducted from business income subject to the making of a FTE.

Of course, it is not necessary for a partnership of trusts to appoint a representative. However, the appointment of a representative by the partnership may make it less cumbersome for the business in its dealings with third parties as all client and customer contracts and leases of equipment or premises may be entered into by the representative, tax invoices may be issued in the name of the representative only and under the ABN of the representative, and all stationery may bear the name of the representative.

If it is intended the representative be the public face then it should be a company because an entity acting as agent only (that is, not carrying on an enterprise in its own right) is only entitled to apply for an ABN if it is a company.³

The representative may also employ staff in its own right as employer. Indeed, under some legislation affecting the incorporation of legal practices, a company which provides legal services (ie the

representative) must employ the business' lawyers in its own right. It is still not clear, however, whether an incorporated tax agent may act as representative for a partnership of trusts. Regulated partnerships of trusts will be considered in a future "A Matter of Trusts" article.

The representative may also hold assets of the business (the business, business name or premises) as bare trustee.

That is, the representative may act in various capacities. For example:

- as bare trustee for the partnership in respect of the ownership of assets;
- in its own capacity to employ staff; and
- as agent for the partnership in relation to issuing tax invoices.

From a legal perspective whether a representative acts in its own capacity or as agent or bare trustee for a partnership will depend upon the documentation (eg a partnership agreement) and the facts (ie the intentions of the parties and what actually occurs).

Unfortunately, the legal position of the representative in the context of its relationship to the partner trusts is often misunderstood. As this misunderstanding may affect the tax liabilities of each of the representative and the partner trusts, this article examines legal concepts of bare trustee and agency as well as the tax treatment of the partnership, partner trusts and the representative.

BARE TRUSTEE

A bare trust arises where one person (**the bare trustee**) holds the legal title to property on trust as nominee for

another (**the beneficial owner**) and the bare trustee has no discretionary powers in relation to that property nor any other “*active duties*” to perform⁴ in relation to that property other than to transfer that property to the beneficial owner or at their direction. That is, as Meagher JA observed, a person carrying on a business beneficially owned by another (ie as agent or trustee) could not be said to be a bare trustee.⁵ The bare trustee has limited rights of reimbursement and indemnity and a may have lien on the property for the costs of holding the property (for example, payment of rates in respect of real estate).

The term “bare trustee” is often used in statutes where its meaning depends upon the context.⁶

The Commissioner of Taxation has recognised the legal relationship of a bare trust (it also uses the expression, “Transparent Trust”) in PS LA 20002 and TR 2004/D25.

A “Transparent Trust” is a trust in which the beneficiary has an absolute, indefeasible entitlement to the capital and income of the trust.⁷

Accordingly, a bare trustee is exempt from lodging a tax return in respect of bare trust property. Instead, the beneficiary will be taxed in respect of income and will be liable for any CGT in respect of the property and must file a tax return.

The Commissioner cites with approval the definition of bare trust given by Gummow J in *Herdegen v Federal Commissioner of Taxation*:⁸

“Today the usually accepted meaning of ‘bare’ trust is a trust under which the trustee or trustees hold property without any interest therein, other than that existing by reason of the office and the legal title as trustee, and without any duty or further duty to perform, except to convey it upon demand to the beneficiary or beneficiaries or as directed by them, for example, on sale to a third party”.

The difference between the beneficial owner of property held under a bare trust and a beneficiary of a discretionary trust is that the beneficial owner under a bare trust is *sui juris*⁹ and absolutely entitled to all of the benefit of the property (eg to call for the transfer of that property) and for that reason the beneficial owner is personally bound to indemnify the bare trustee for liabilities properly incurred.¹⁰ On the other hand, (except in the unusual

circumstances where the principle in *Saunders v Vautier*¹¹ applies or where there is an unpaid beneficiary entitlement in favour of the beneficiary) a beneficiary of a discretionary trust does not have a vested and indefeasible or absolute entitlement to specific or any of the assets of the discretionary trust.

However, in TR 2004/D25 the ATO says:

“the existence of a bare trust does not lead automatically to the conclusion that a beneficiary of the trust is absolutely entitled”.¹²

This statement is misconceived. The fact that the rule in *Saunders v Vautier* **extends** the principle of absolute entitlement to a beneficiary of a will trust or a discretionary trust who is *sui juris* does not detract from the law that a beneficiary of a bare trust is absolutely entitled. The ATO has incorrectly focused on the different duties of a bare trustee and the trustee of a discretionary trust rather than the legal relationship between the trustee and beneficiary.¹³

It is noted on the cover sheet for TR 2004/D25 that the ruling is not finalised pending the outcome of consultation with Treasury in relation to absolute entitlement and “problem areas” of joint and multiple beneficiaries and trustee’s indemnity. This article proceeds on the basis that the legal principles applicable to a bare trust should apply irrespective of whether there is a sole beneficiary or joint beneficiaries or multiple beneficiaries as tenants in common.

AGENT

Entity acting solely as agent

The essential feature of agency is the ability of the agent to enter into contracts with third parties on behalf of the principal.¹⁴ Even if the principal is not disclosed by the agent to the third party, the agent is legally able to bind the principal to contracts with the third party. Consequently, the partner trusts would be liable for the acts of the representative and any claims against it.

At law a principal is legally responsible for the acts of the agent.

The agency relationship is created by the appointment (preferably under a written partnership agreement to which the representative is a party) of the representative as agent by the partnership.

Entity – agent and in its own right

The structure does not involve the representative acting as both agent and in its own right in matters unrelated to the partnership business. Consequently, it is not envisaged that any fee would be payable to the representative for its services other than full reimbursement by the partnership of all costs incurred by the agent.

Trust and Agency

Although both trustees and agents owe a fiduciary duty to another (the beneficiaries or principal) and must act in the interests of that other and not in their own interests in respect of the other’s property, “there is lacking in agency the essential element of a trust that the trust property must be vested in the trustee. An agent usually only has the possession of property on behalf of the principal, not title to that property”¹⁵ (whereas a bare trustee holds the title).

“The importance of distinguishing between trust and agency may be illustrated by considering the respective liabilities of trustees and agents to third parties. An agent will only rarely be personally liable to third parties...A trustee, on the other hand, will always be personally liable to third parties”¹⁶ (subject to any right of indemnity from trust assets).

MANAGER

The role of the representative is to operate the business on a day to day basis.

But ultimate control of the business (eg whether to dispose of the business) remains with the partners.

The relevance of the capacity in which the representative operates affects many matters related to the business such as whether the ABN to be shown on tax invoices should be that of the partnership, the bank accounts required, the flow of money, what tax returns are required and whether a reimbursement agreement is required for the purposes of GST and even the types of securities which should be given in respect of any borrowings by partner trusts to fund their capital contributions to the business. Many of these matters should be determined at the time the partnership is established.

There should be a written agreement between the parties specifying the

rights and liabilities of each and in the agreement the partners should indemnify the representative in respect of all tax liabilities, costs and claims made against the representative by third parties.

SUMMARY OF TAXATION ASPECTS

From a legal perspective there is no reason why a representative cannot act as agent or bare trustee or in a dual capacity as both agent and bare trustee.

A person can act in multiple legal capacities¹⁷ (eg as agent, bare trustee and in its own right or as executor of an estate and trustee of a unit trust).

The Commissioner has not taken a position nor issued any public pronouncements on whether a representative of a partnership of trusts should account as agent or bare trustee. However, the Australian Taxation Office

has recognised that a person can act in multiple legal capacities.¹⁸

If the representative were to hold property for the partnership (such as land or a business name) then that relationship would not be one of agency but of bare trustee and beneficial owner. However, the carrying on of a business by the representative for the partnership is an agency relationship.

Therefore, the tax treatment of income and capital gains and of GST, PAYG, FBT, payroll tax and superannuation guarantee contributions should be determined by reference to the legal relationship giving rise to the tax liability and the beneficial ownership of the relevant asset. For example, income derived from the carrying on of the business by the representative is income of the partner trusts. Similarly, capital gains made on the sale of business assets held by the

representative may be assessable in the hands of the partner trusts.

But from a capital gains tax perspective if it were not for the bare trust arrangement, the representative would be assessed on any capital gains.

That is, if a representative acting as agent is reimbursed all expenses but otherwise not remunerated for their services and all staff are employed by the representative as agent for the partnership of trusts then the taxation consequences (ie income tax, capital gains tax, PAYG, FBT and payroll tax) are the same as for a partnership of trusts with no representative but there is a difference for GST purposes.¹⁹

Diagram A sets out the respective tax liabilities of the partnership, partners and representative whilst Diagram B compares the tax liabilities under the structure with a company.

Diagram A:

Summary of the main advantages/disadvantages of a partnership of trusts versus corporate structure. Advantages are represented by a “✓” and disadvantages by a “✗”. This is not an exhaustive list of the advantages/disadvantages.

Event	Partnership of trusts	Corporate structure
Ease of administration	✗	✓
Capital gains tax 50% general discount	✓	✗
Capital gains tax small business concessions available to the partner/shareholder	✓	✓ (only available where there is a significant individual – in practice this limits the number of shareholders to 5)
Income tax – flow through taxation on entity profits	✓	✗
Flexibility of income distributions Note 1: Some flexibility is afforded to a shareholder but only if it is a trust but this is limited by the dividend imputation rules and special rules for dividends received through a trust and application of the small business participation percentage test for access to small business concessions.	✓	✗ (limited availability to a trust shareholder – see note 1)
Profits accumulated in entity taxed at 30%	✗	✓
Income taxed at source Note 2: Excess dividends and problems with timing differential.	✗ (provision for tax must be made)	✓ (see note 2)
Deduction for self employed contributions to superannuation – if no salary paid.	✓	✗
Cost of implementation – establishment of a new discretionary trust to hold interest	✗ (liability of partner makes it desirable to hold interest in a new trust with no assets)	✓ (shareholder may use existing trust)

Diagram B

Several of the taxation consequences which may apply for each entity:

	At partnership of trusts level	Discretionary trust partners	Partnership agent
50% CGT discount on sale of business	N/A	✓	N/A – no commission or other income paid to it and no assets owned beneficially.
Income tax liability	Nil	✓ marginal tax rates apply to income distributions to beneficiaries (for any undistributed income, effective tax rate up to 46.5%)	Nil
GST liability	✓	✗ (unless non-partnership business)	✗ (But yes, if a subdiv 153-B agreement is entered into under GST Act)
Business tax returns and TFN registration	✓	✓	Nil tax returns, TFN registration required
BAS tax returns and GST registration	✓	✗ (unless non-partnership business)	✗ (But yes where subdiv 153-B applies plus note PAYG requirements)
Tax invoices	✗ (But yes, if a subdiv 153-B agreement is entered into under GST Act)	✗ (unless non-partnership business)	✓
ABN	✓	✓	✓

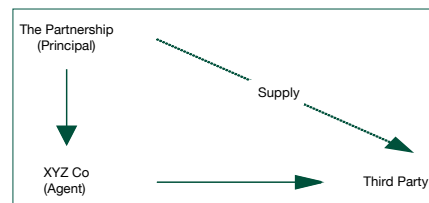
GST

There are two options for the issue of tax invoices under subdiv 153-A of the GST Act where the representative does not supply any services in its own right – (eg does not employ staff), namely the representative may invoice the GST under the partnership's name and ABN or under the representative's name and ABN.²⁰ Failure to comply with either option, for example by stating the representative's name and the partnership's ABN on the invoice means that it is not a valid tax invoice.²¹

Diagram C below deals with the situation where the representative (agent) issues a tax invoice under subdiv 153-A to the

customer (third party) but the goods are supplied to that customer as agent (ie as if the supply were direct to the customer from the principal (the partnership)).

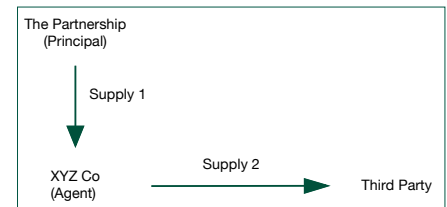
Diagram C



Alternatively subdiv 153-B of the GST Act enables an agent to act as a principal for the purposes of accounting for GST only

so that in respect of supplies made by the representative to third parties, the supplies are treated each as an independent supply by the representative to the third party and a corresponding separate supply between the partnership and the representative with the representative and the partnership treated as acting between a principal and another principal. In these circumstances the supply between the partnership and the representative is also a taxable supply²² (see Diagram D below). The purpose of this general agency is to simplify the GST treatment of rendering accounts in accordance with GSTR 2000/37. In order for this principal to principal arrangement to apply, the manger and partnership must agree in writing to apply subdiv 153-B.

Diagram D



However, there must be a written agreement under subdiv 153-B, if a representative acts as agent for a partnership and in its own capacity but on behalf of the partnership (eg employs staff). In that case, the representative should account for GST, PAYG, FBT and payroll tax and should lodge BAS statements and, if it is not paid any remuneration, a nil tax return. The representative could then invoice the partnership for the cost of all supplies made by it on behalf of the partnership and be reimbursed all these amounts by the partnership.

A representative will only be liable for income tax if it retains any income (ie is paid a fee for acting as agent by a partnership) or receives income from other sources. In that case, the representative must lodge a tax return in respect of its own tax liability.

In a previous, "A Matter of Trusts" article in this journal,²³ the GST treatment of partnerships of trusts with representative appointed was discussed in detail.

Family Trust Elections

In 2007 there were a number of amendments made to the family trust regime in Schedule 2F of the *Income Tax Assessment Act 1936 (ITAA36)*.

Amendments were made to both the procedural mechanisms associated with the making of a family trust election and the substantive provisions of the family trust regime. In a previous, "A Matter of Trusts" article,²⁴ these amendments and how to make a family trust election were discussed in detail.

A FTE may be made in order to claim tax losses or certain debt deductions or to enable access to franking credit benefits associated with a dividend received by a trust or to enable income to be distributed to other entities in the family group in respect of which a FTE has been made.

Under the trust loss provisions of Schedule 2F of ITAA36 there are fewer tests for a family trust to satisfy in order to claim tax losses and certain debt deductions.

In order for a trust to be considered to be "a family trust" within the meaning of Schedule 2F it must make and be able to make a FTE.

RESTRUCTURING

Before restructuring a business into a partnership of trusts it is important to consider what capital gain, if any will be derived by the original business owners as a result of the restructure (that is, on the disposal or transfer of the business by the existing business owners to the new business owners). The determination of the capital gain and how the business owners may be able to manage any tax liability in respect of that gain may be an impediment to restructuring depending upon the owners' respective circumstances and the importance to them of the advantages of any restructuring.

*The Trust Structures Guide*²⁵ contains a detailed discussion and analysis of the establishment of a partnership of trusts with representative, the operation of the structure, liability issues of partner trusts, GST and ABN registration requirements for the structure (which depend upon how the structure operates – see above discussion headed "GST"), the capital gains tax consequences of admitting new investors, use of revenue losses, access to family trust elections, application of the small business concessions to reduce capital gains and benefits compared with a hybrid trust.

The most significant disadvantage of the structure is that the introduction of new partners would necessarily involve a disposal of an interest in the partnership by each existing partner unless new investors were to acquire an exiting partner's interest or it is not intended to admit new partners.

CONCLUSION

A partnership of trusts with representative is recommended where the ability of each partner to access the small business CGT concessions or to make its own FTE is important. Consequently, it is a useful structure not only to own and operate a business but also for two or more families to hold shares or land.

Even though use of a representative may require the partnership to lodge nil tax returns and BAS statements the costs of these compliance measures may be outweighed by the benefits of the representative being able to issue tax invoices under its own name and ABN to customers of the business.

An analysis of the legal principles of bare trustee and agency shows that if the representative remits all receipts to the partnership (whether derived by the representative as agent or bare trustee), flow-through taxation applies to the partners in respect of all revenue and capital generated by the business and the use or on disposal of its assets because at all material times the partners are the beneficial owners of the business and its assets.

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Reference notes

- 1 A trust only exists as a legal entity for tax law purposes. From an Australian perspective outside the tax law a trust is not a legal entity.
- 2 It is noted that statutory regulation in some States may not permit trusts in a professional partnership to have different corporate trustees.
- 3 Section 8, A New Tax System (Australian Business Number) Act 1999; Taxation Ruling MT 2006/1; Div 153 A New Tax System (Goods and Services Tax) Act 1999; GST Ruling 2000/37; Reg 29-70.01 of the GST Regulations.
- 4 Jacobs' *Law of Trusts in Australia*, 7th ed. [315] p 48.
- 5 *Corumo Holdings Pty Ltd v C Itoh Ltd* (1991) 24 NSWLR 370 at 398.
- 6 In *Corumo's* case p398 the term was held to mean "a trustee who was no more than a nominee or cypher in a common sense commercial view".

- 7 PSLA 2000/2 Para 3-11, para 10 – Consequently, the CGT provisions of the 1997 Act do not recognise a disposal of the legal title by the trustee. See subdvs 104-10(2).
- 8 (1988) 84 ALR 271 at 281 cited in TR 2004/D25 at para 35.
- 9 A person who is of full age and has full legal capacity.
- 10 Jacobs' [2105] p567; *Hardoon v Bellios* [1901] AC 118; *Balkin v Peck* (1998) 43 NSWLR 706.
- 11 If a beneficiary's interest in trust property is vested and indefeasible and they are of age then they can put an end to the trust by directing the trustees to transfer the trust property to them or at their direction, even though the trust deed may contain a contrary intention. The basis of the principle is that a beneficiary is entitled now to that which will be theirs eventually anyway: *Saunders v. Vautier* (1841) 4 BEAV 115; 49 ER 282.
- 12 PSLA 2000/2 para 33.
- 13 PSLA 2000/2 para 36.
- 14 See definition of "Agency" in *Butterworths Concise Australian Legal Dictionary* (3rd ed. P16); *International Harvester Co of Australia Pty Ltd v Carrigan's Hazeldene Pastoral Co* (1958) 100 CLR 644.
- 15 Jacobs' [210] p 11.
- 16 Jacobs' p 12.
- 17 (*Trustee Act 1958* (Vic) s35 (protection regarding notice when person is trustee of more than one estate or trust); regarding duty to keep and render separate accounts – *Freeman v Fairlie* (1817) 3 Mer 29, 36 ER 12 at 41 (Mer); *Skinner v Trustees and Executors Agency Co Ltd* (1902) 27 VL 218 (FC) per *Madden CJ* at 227)
- 18 GST Ruling GSTR 2008/3 says an agency relationship may arise between the trustee and beneficiary under a bare trust resulting in GST implications in connection with tax invoices, the margin scheme and the going concern provisions in real property transactions.
- 19 For completeness, it is noted that Div 153 applies to situations where a principal makes a supply or acquisition through an agent and does not apply where a person as agent merely pays invoices on behalf of a principal and does not make any acquisition on behalf of the principal – GSTA TPP 091 dated 26 October 2005.
- 20 Regulation 29-70.01 of the GST regulations; para 65 of GSTR 2000/37 (addendum to consolidated ruling dated 2 April 2008).
- 21 GSTA TPP 040 2 November 2005.
- 22 GSTR 2000/37 at [24] and [78].
- 23 *A Matter of Trusts* by *Harwood Andrews Lawyers* – GST, Agency and a Partnership of Discretionary Trusts published in *Taxation in Australia*, Issue 39, No.6 Dec 2004 – Jan 2005.
- 24 "Family trust elections – where are we today?" published in *Taxation in Australia*, Volume 43 No.9 April 2009.
- 25 Published by the Taxation Institute of Australia, author *Harwood Andrews Pty Ltd* 2009 ed. [27-100] p 148-161.