TRUSTS ARE NOT THE ONLY WAY

HOW TO CHOOSE THE RIGHT INVESTMENT VEHICLE

by RICHARD STOKES

Investment promoters could find advantages in different corporate structures. Even when a unit trust seems the right way to go, a better alternative may exist.

The use of the unit trust structure to acquire investments which will provide income and/or capital growth for unitholders is well known. Apart from the tax advantages of the unit trust structure, the key to the success and popularity of such a vehicle among investment promoters is its great flexibility.

While Australian investors have been quick to take advantage of the taxation advantages of unit trusts – to such an extent that a number of changes to the Taxation Act have been made to halt abuses of those advantages, particularly by corporate investors – this has tended to obscure what may arguably be the most valuable feature of a unit trust from a promoter's point of view. This feature is, of course, the ease with which the unit trust can be expanded or contracted by an alteration in the number of units to cope with the inflow of new funds or the redemption of units by investors liquidating their investments.

The purpose of this article is to remind those concerned with the development of investment products that other legal forms exist, which may have characteristics that, in certain situations, could be particularly valuable. In some circumstances, a unit trust structure can prove to be completely unsuitable as an investment vehicle.

The company

Under the Companies Act 1981, and unaltered by the Corporations Act 1989, several classes of company are recognised:

- a company limited by shares;
- a company limited by guarantee;
- a company limited both by shares and guarantee; and
- an unlimited company.

Further, a mining company may be registered as a no-liability company.

In comparison with a unit trust, the company structure, of whichever class, has several distinguishing features of interest to the promoter. The directors of a company have total responsibility to the members of the company for the management of the company and control of its assets.

A company therefore has no requirement to appoint a trustee or custodian. There is no detailed document equivalent to the trust deed and hence the directors of the company have a much greater degree of flexibility in investment policy and internal administration. Directors, for example, may declare dividends at a level which retains funds for reinvestment within the company.

Particularly in the case of investment vehicles aimed at the retail end of the market, a company structure considerably simplifies the taxation treatment of dividends and capital gains in the hands of the member compared with that of distributions to a unitholder in a trust.

Similarly, the stamp duty regulations

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which apply to the transfer of shares in a company are simpler and less open to interpretation than those governing the transfer of units in a unit trust. The directors of a company may issue several classes of shares with different rights and entitlements; under a unit trust structure this would be much more difficult. A company also allows for perpetual succession which is not now possible for a unit trust.

A company limited by shares has the advantage that the liability of its members is limited to the amount of the issued share capital of the company. The position of unitholders in a trust will, at some future stage, regrettably have to be decided by the courts.

While the trust deed may limit the liability of unitholders to the amount invested in the trust, the NCSC *Prospectus Procedures Handbook* relating to the offer of units under such deeds warns that "the operation of law in this area is uncertain". This uncertainty may cause promoters some difficulty with both the trustee and lenders where the trust's manager wishes to obtain borrowing facilities or make speculative investments.

A member of **a company limited by guarantee** is not required to pay-in any capital unless it is wound up and its liabilities are found to exceed the value of its assets, in which case a member will be required to pay the guarantee amount specified in the memorandum of association.

Such a company can earn profits and distribute them, although moneys to form the investment pool would also be required by way of loan from members and/or external borrowings.

A company limited both by shares and guarantee may solve the problem of raising moneys for investment from members, as well as guaranteeing further funds in the event of winding-up. In practical terms, though, there is little difference between this class of company and a company limited by shares.

While the classes of company described so far offer the certain advantage over the unit-trust structure of limited liability, **an unlimited company** at least makes it categorically clear that the liability of members is unlimited! The unlimited company, however, has the significant feature that "nothing in (the Act) precludes an unlimited company from redeeming in any way its share capital, including any amount in its share premium account" (s123(12) of the Companies Act, repeated as s195(12) of the Corporations Act). Thus the issued share capital of an unlimited company may be increased or decreased as demand dictates; in this, it could be regarded as comparable with the unit trust.

A company limited by shares would have to obtain the approval of the Supreme Court before reducing its issued share capital; frequent changes caused by the redemption of shares would make this impracticable. Similar practical difficulties may apply to the frequent issue of shares by a company limited by shares. Recent changes to the Act allowing companies to buy back their own shares would also be too restrictive to be of practical use.

Investors wishing to liquidate their investments in limited liability companies therefore have to look to a secondary market, and the link to "net asset value" offered by the unit trust and available under the memorandum and articles of an unlimited company is usually lost.

The advantages to a promoter of earning fees from the investment of a "closed" pool of funds must be balanced by the problems caused when the market price of shares of limited companies falls to a discount to net asset value. As the investments made by a company are owned by it, as distinct from its members, no disposal of investments need occur on a change of members through a secondary market. The unlimited company, therefore, would seem to combine the advantages that a company structure has over a unit trust with the ability to readily increase or decrease in size as investors wish to buy and sell shares.

At one stage, unlimited companies, known by their popular name of "mutual funds", proved quite common structures for investment offerings. Of course, their weakness is the risk to investors of unlimited liability in the event of the company's collapse. Mutual funds in fact lost favour as a result of a corporate failure caused by the collapse in value of mining shares purchased by a geared unlimited company. However, a mutual fund whose constitution prohibited it from borrowing would reduce the risk to investors to a negligible level. Given the uncertainty about the liability of unitholders in a unit trust, there may be little practical difference between such a mutual fund and a unit trust.

A company may, subject to its articles, issue redeemable preference shares. Redemption must be either from the proceeds of a new issue of shares, or out of profits available for dividend, in which case an amount equal to the nominal value of the shares redeemed must be transferred from those profits to a "capital redemption reserve". Many overseas investment structures operate quite satisfactorily on the basis of redeemable preference shares.

The limited partnership

The traditional partnership suffers as an investment vehicle from the absence of limited liability and the fact that, except in certain professional practices, there is a limit of 20 to the number of partners. The limited partnership provides for two classes of partner – general partners, who have the same rights and unlimited obligations as partners in a traditional partnership and act as the investment promoter, and limited partners, who provide the funds for investment and whose liability is limited to those amounts.

In contrast to the traditional partnership, the limited partners cannot be involved in the management of the partnership. Indeed, such involvement removes their limited liability.

Limited partnerships are available only under legislation enacted in Queensland, Tasmania and Western Australia. In Queensland, there is no limit to the number of partners and limited

Continued Page 31

Mutual funds lost favour as a result of a corporate failure caused by the collapse in value of mining shares purchased by a geared unlimited company.

main interests – outside finance – could be helpful to the career he has targeted. He is undertaking an officer-training course with the Army Reserve. Given the demands of helping with the raising of his two-year-old daughter, that is a demanding task. But, he says, when he completes the officer-training course this year, he will have gained valuable management skills.

– John Hoffmann

Following is a full list of national Diploma and Certificate awards:

DIPLOMA COURSE

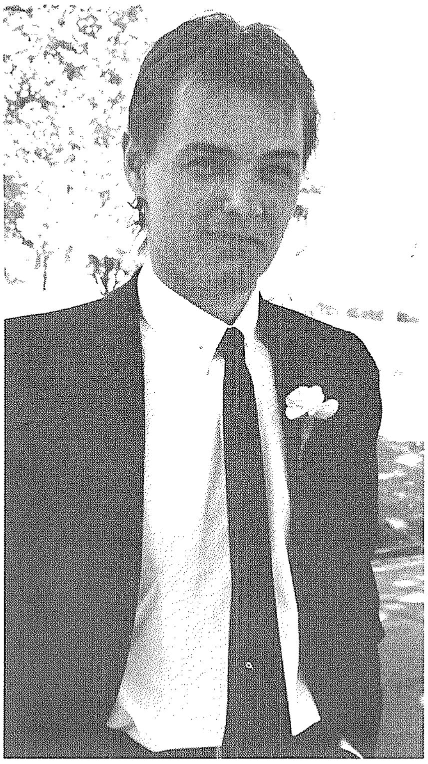
The President's Prize (Diploma course dux): Susan Campbell, Chambers McNab Tully & Wilson (Queensland Division).

The Australian Financial Review Prize – *The Securities Industry (Subject 51C):* Timothy O'Connell, Elders Finance Group Limited (NSW Division).

The Commercial Law Association Prize *Securities Industry Law (52C):* Christopher Taubman (NSW Division); James Boynton, Mallesons Stephen Jaques (Victorian Division).

The Australian Mining Council Prize – *Mining Investment Analysis (55):* Richard Facioni, Macquarie Bank Limited (NSW Division).

The Australian Merchant Bankers' Association Prize – *Applied Corporate Finance (56):* Tze Y. Masters, State Bank of Victoria (NSW Division).



Kurt Smyth, Certificate course dux.

The Council of Authorised Money Market Dealers Prize – *Money Market and Fixed Interest Investment (59):* Stephen C. O'Brien, IPAC Securities Limited (NSW Division).

The Sydney Futures Exchange Prize – *Australian Futures Trading (60):* Antony Carr, Edwards Dunlop & B. J. Ball (NSW Division).

The Australian Finance Conference Prize – *Options Markets and Trading (62):* David F. Dennis, Macquarie Bank Limited (NSW Division).

CERTIFICATE COURSE

President's Prize (Certificate course dux): Kurt F. Smyth, National Mutual Life Association of Australia Limited (Victorian Division).

The Commercial Law Association Prize – *Securities Industry Law (22C):* Duncan E. Graham (distance education, Tasmania).

The Australian Stock Exchange Limited Prize – *The Australian Stock Market (25):* Stephen A. Guy, Mercantile Mutual Life Insurance Co Limited (distance education, Queensland).

The Australian Futures Exchange Prize – *The Australian Futures Market (26):* Philip Lorensini, Commonwealth Bank of Australia (Victorian Division).

The Australian Stock Exchange Prize – *Stockbrokers' Administration Procedures (27):* Timothy Samway, Burrows Limited (NSW Division).

The Council of Authorised Money Market Dealers Prize – *Australian Money Markets (28):* Tony A. Cottam, Citicorp Australia Limited (NSW Division); Andrew Schwab, National Australia Bank Victorian Division).

The Personal Investment Monthly Prize – *Personal Investment Planning and Investment (31):* Alfred C. Wong, Capita Finance Group (NSW Division). □

TRUSTS AND OTHERS

From Page 29

partnerships may be formed for any business except banking and insurance. In Tasmania and Western Australia, the number of partners is limited to 20 except in banking partnerships where the limit is 10. The limited partnership structure has proved more popular in recent years since, like the unit trust that distributes its taxable income, the partnership itself is not subject to tax. The life of a limited partnership is restricted to seven years. Compared with a company, a partnership is simple to form and administer, although a partnership automatically dissolves if a partner dies or becomes bankrupt.

The close corporation

The Close Corporation Act 1989 allows for the formation of a completely new corporate structure which in some respects is similar to a limited partnership. A close corporation may have no more than 10 members who must be natural persons and who have limited liability. Its share capital must comprise a single class of fully paid shares which may not be offered to the public.

There are much reduced reporting requirements compared with other classes of company. Rather than a memorandum and articles, a close corporation has a "founding statement" – which must be signed by the initial subscribers and which states the name and address of the company and its share capital in addition to subscriber details – and an "activities statement" describing the actual or intended business activities of the company. Neither banking nor insurance activities are allowed and a close corporation cannot act as a trustee.

Subject to the limit on the number of members, a close corporation can make issues of shares at any time after incorporation (but not to the public) and the Act allows close corporations to purchase their own shares.

Further, subject to restrictions, the close corporation is able to finance the purchase of its own shares.

Dividends may be paid to members only if, after their payment, the value of the company's assets exceeds its liabilities and it is in the position of being able to pay its debts as they fall due. Taxation is under the same rules as those applicable to other forms of company.

The Close Corporation Act 1989 was assented to on July 14, 1989, but at the time of writing had not been proclaimed.

"Statutory" investment vehicles

A number of other structures may be used to offer investment products. The most significant of these are the life assurance company, friendly society, credit union and co-operative registered under the appropriate Acts. Since formation of these structures is considerably more complex than those discussed above, and involves many other issues, their review lies outside the scope of this article. They could nevertheless be worthy of some consideration by investment promoters. □