Taxation of Discretionary Trusts

A Report to the Treasurer

And

the Minister for Revenue and Assistant Treasurer

The Board of Taxation

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Contents

Executive summary

The Board of Taxation considers that any proposal for fundamental change to the taxation treatment of trusts must be justified by compelling policy arguments before it could be supported. The Board is of the view that the efficiency and equity of the tax system would not necessarily be improved by aligning the tax treatment of trusts and companies. Structural differences would remain in the taxation of entity income, and in the taxation of income earned through an entity and income earned directly.

Recommendation 1

The Board of Taxation considers that there are no compelling arguments for broad based reform to more closely align the tax treatment of discretionary trusts and companies and that the Government should retain the current flow-through treatment of distributions of non-assessable amounts by discretionary trusts.

The Board notes that a number of amendments have been made to the taxation treatment of trusts in recent years to address specific tax planning opportunities. These amendments appear to have modified behaviour and the Board notes advice that non-compliance with these provisions is not considered to be a significant concern.

Recommendation 2

The Board of Taxation considers that, in light of the implementation of trust integrity measures over several years, concern about the use of trusts for tax planning does not of itself warrant fundamental change to the tax treatment of discretionary trusts.

While the Board considers the current tax treatment of trusts should be retained, two minor issues warrant consideration and clarification.

The first issue involves the operation of existing rules that prevent individuals accessing trust income that has only been taxed at the company tax rate.

Recommendation 3

The Board of Taxation recommends that the Government consider options for amending the income tax law to improve the effectiveness and fairness of provisions intended to prevent individuals who are trust beneficiaries with high marginal tax rates accessing, without further tax liability, funds that have been taxed only at the company tax rate.

The second issue concerns the interpretation of the law regarding the deductibility of interest payable on loans used by trustees to finance distributions of non-assessable amounts to beneficiaries. Clarification of the intent of the current law will address concerns that trusts are inappropriately claiming interest deductions.

However, the Board acknowledges the difficulties in tracing borrowings to distributions of unrealised capital gains in complex structures. If inappropriate taxation outcomes in the area of interest deductibility for trusts continue after the Commissioner of Taxation's view of the law is clarified then the Government should consider a legislative solution.

Recommendation 4

The Board of Taxation recommends that the Commissioner of Taxation clarify and publish his views about the deductibility of interest on borrowings used to finance non-assessable distributions to beneficiaries of discretionary trusts.

1. Introduction

1 The Australian income tax system taxes not only income that individuals earn directly, but also income earned through entities such as partnerships, trusts and companies. Current income tax laws apply various approaches to taxing different kinds of entity income in different circumstances.

Prior Government statements

2 In its August 1998 statement *A New Tax System* (***ANTS***), the Government outlined a proposal to tax all trusts like companies. The proposal was later narrowed down to cover only discretionary trusts, and the Government released exposure draft legislation in October 2000. However, in February 2001, after advice from the Board of Taxation and the identification of technical and practical problems through the consultation process (see Attachment A), the legislation was withdrawn by the Treasurer (see Attachment B).

3 The Treasurer's press release read, in part:

> As a consequence the Government is withdrawing the draft legislation and will not be legislating it. It will begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area. The Board [of Taxation] will be part of consultation.

4 The Board has prepared this report in that context.

Issues considered by the Board

5 The Board has focused its enquiry on identifying 'tax abuse in the discretionary trust area'. The Board decided to focus on this area, because this was the subject-matter of the withdrawn entities legislation and the use of discretionary trusts seems to be the main issue of community concern about trusts. Because the Board's conclusion is that no significant change is required to the status quo, the next step of identifying 'principles which can protect legitimate small business and farming arrangements' became unnecessary.

6 The issues considered by the Board can be summarised as follows:

A. Should discretionary trusts be taxed like companies:

(a) because discretionary trusts are close substitutes for companies?

(b) as a matter of principle?

(c) as a method of reducing tax abuse?

B. If there is no need to tax discretionary trusts like companies, are there nevertheless any other changes that should be made to the tax treatment of discretionary trusts?

7 In considering the issues set out in paragraph 6 above, the Board has considered the operation of current tax laws, and possible alternative approaches, against the traditional objectives of equity, efficiency and simplicity.

8 The concept of equity has two dimensions, horizontal equity and vertical equity. Horizontal equity reflects the view that it is fair that persons who are in similar circumstances should be treated equally by the tax system. In contrast, vertical equity refers to the objective that persons with a greater capacity to pay tax should be subject to higher taxation relative to taxpayers with a lower capacity to pay.

9 Efficiency refers to the objective of maximising the efficiency with which national resources are used with taxpayer compliance costs and tax administration costs reduced to the maximum extent possible.

10 To achieve the goal of simplicity a tax system must minimise to the maximum extent possible complexity in the tax law and associated administrative arrangements.

Issues not considered by the Board

11 This paper does not address matters specifically affecting other kinds of trusts such as superannuation funds, public trading trusts or corporate unit trusts.

12 As well, the Board has not concerned itself with the non-tax aspects of the use of discretionary trusts. In particular, since income-splitting can be achieved through various kinds of entities (of which trusts are only one kind), the Board has not examined or commented on the tax aspects of income-splitting. The Board notes that in A New Tax System, the Government indicated that it did not intend to prevent trusts from being able to split income among beneficiaries.[1]

Structure of paper

13 Section 2 of this paper provides background information about discretionary trusts and the taxation of entities. Section 3 considers arguments about taxing discretionary trusts like companies. Section 4 considers options for changing the current tax regime for discretionary trusts.

1 *A New Tax System*, August 1998, page 113.

2. Background — Discretionary trusts and the taxation of entities

Kinds of entities

14 Entities such as partnerships, trusts and companies are relationships, recognised in law, which allow individuals to cooperate to achieve objectives that they might not be able to achieve were they to act separately. Each entity broadly represents a group of individuals acting collectively under a legal structure.

15 Common entity forms include partnerships, companies and trusts:

- **partnerships** arise when two or more people carry on a business in common with a view to profit;
- a **company** relationship is an association of people with a common object registered under the corporations law;
- a **trust** relationship arises where a person (the trustee) is obliged to hold property for the benefit of one or more other people (the beneficiaries).

16 Differences in partnership law, corporations law and trust law allow individuals to choose between a variety of legal structures, facilitating their attainment of a wider range of objectives.

17 Various considerations influence the choice of entity through which to conduct a business or hold an asset. These considerations include:

- the commercial objectives of the parties involved;
- the time and cost involved in establishing a particular entity (see paragraph 20);
- the degree of complexity of a particular arrangement (see paragraphs 21 and 22);
- the reporting and disclosure requirements;
- the ability to raise finance (see paragraph 23);
- liability for the debts of the business (see paragraph 24);
- degree of flexibility afforded; and
- tax considerations.

Trusts

18 In a trust relationship, one person (the trustee) is obliged to hold property for the benefit of one or more other people (the beneficiaries). The powers and functions of the

trustee are usually set out in, and governed by, the terms of the trust deed that establishes the trust. Although the trustee has legal title to the trust property, there is an overriding obligation to deal with the trust property for the benefit of the beneficiaries.[2] This separation of legal and beneficial ownership is the key feature of a trust relationship.

19 Trusts may be classified in many different ways, but usually fixed and discretionary trusts are distinguished.

- In fixed trusts, the interests of the beneficiaries in the income and/or capital of the trust estate are fixed in the trust deed or document establishing the trust.

- In contrast, in discretionary trusts trustees choose which beneficiaries will receive distributions of income or capital, and how much each will receive.

Significant differences between discretionary trusts and other entities

Ease of establishment

20 Discretionary trusts can be relatively inexpensive to establish and simpler to administer than companies. However, adopting the trust structure can introduce trust law formalities that are not always well understood or complied with.

Complexity of arrangements

21 A range of legal issues can arise when the trust is not administered strictly in accordance with trust law or the trust deed. The operation of tax measures introduced to address tax abuse by trusts, such as the trust loss provisions, can further increase the complexities involved in using trusts.

22 Complexity and administrative costs of discretionary trusts are increased when a corporate trustee and/or corporate beneficiary is introduced. In such instances, not only does a trust deed have to be established, but company constitutions may be required as well. These companies also will have to comply with obligations under the corporations law, for example, relating to disclosure requirements.

Ability to raise finance

23 Borrowing can be complex and expensive in the case of discretionary trusts, as lenders may require their solicitors to examine and report on both the constitution of the trustee company (if there is one) and the trust deed. Furthermore, unlike companies, discretionary trusts cannot raise investor equity.

Liability for debts

24 Discretionary trusts afford beneficiaries a degree of asset protection, as trustees are personally liable for business debts, subject to a right to be indemnified out of the trust

2 People belonging to the class of beneficiaries to whom a trustee of a discretionary trust can distribute have no interest in the trust property until the trustee chooses to exercise the discretion in their favour and, as such, are more correctly known as the 'objects' of the trust. However, this paper uses the more common terminology and refers to these people as beneficiaries of the discretionary trust.

property for all liabilities incurred in the course of conducting trust business. Companies also provide asset protection because companies are separate legal entities. Unlike companies and discretionary trusts, partners have unlimited joint and several liability for the debts of the partnership.

Use of trusts in Australia

25 Statistical data about the use of trusts in Australia, taken from 1998-99 tax returns, is provided at Attachment C. In brief, the data indicates that:

(a) approximately 340,000 discretionary trust tax returns were lodged with the ATO in 1998-99, compared with about 600,000 companies, 500,000 partnerships and 90,000 fixed trusts;

(b) approximately 1.9 million individuals received a distribution from a partnership or trust in 1998-99, with net distributions from trusts to individuals totalling about $9 billion. About 40 per cent of trust profits allocated to individuals are received by individuals in the $35,000 to $100,000 income range, with partnerships distributing a higher proportion of profits to lower-income individuals and companies distributing a higher proportion of profits to higher-income individuals; and

(c) the rate of growth in the number of trusts has been similar to that of companies in recent years, with the number of partnerships growing at a much slower rate.

26 Statistical data about the use of trusts to earn business income, taken from 1998-99 tax returns, is provided at Attachment D. The data indicates that:

(a) a significant portion of discretionary trusts do not directly earn business income;

(b) most trusts reporting business income were discretionary trusts; and

(c) as business income increases, companies become increasingly dominant as the preferred entity form.

27 The data does not indicate the extent to which trusts are used as part of a business structure with other entities.

Entity tax models

Entities as conduits

28 Entities are simply relationships between individuals that are recognised in law. As such, entities can be characterised as conduits, which produce income that flows through to individuals. The conduit analogy applies regardless of the size of the entity, because

ultimately individuals own all entity profits irrespective of whether the profits are retained or distributed.

29 Put broadly, the Australian income tax system is based on the premise that the profits of entities should generally be taxed as income of the individuals for whom the entity acts. The regimes applying to trusts and partnerships are clear examples of this. Several reviews of the Australian entity taxation regime have applied this conduit approach. As the Asprey Review noted in the context of company tax, it is 'necessary to go behind the veil of separate legal personality which the company enjoys and translate the tax formally imposed on company income into a set of individual tax 'burdens''.[3]

Integration

30 One element of the conduit approach to taxing entities is that tax paid on income earned through an entity should receive the same tax treatment as income earned directly by an individual. This is often referred to as 'integration'.

31 Several reviews of the Australian tax system have concluded that the integration model of entity taxation is the 'theoretical ideal'. The Campbell Committee went further, and recommended the adoption of the integration model for company and personal income tax.[4]

32 However, a pure integration model may be difficult to administer in practice, because retained profits must be allocated among individuals for tax purposes. While many entities are able to do this, data management difficulties arise:

- where the ownership structure is complex;
- where the entity is widely held; or
- where interests are regularly traded.

33 In Australia, the tax treatment of partnerships is broadly consistent with the integration model. For tax purposes, there is no concept of unallocated partnership income. Rather, the whole of the 'net income' of the partnership must be allocated to individual partners and assessed in their hands. Tax preferences generally flow through to the partners. Individual partners may immediately access tax losses, as these are not trapped within the entity.

De facto integration

34 An alternative approach to entity taxation, which can be described as 'de facto integration', would tax profits that are allocated to individuals at the individuals' marginal rate and retained profits at a rate no less than the top marginal rate. This treatment of retained profits avoids the data management difficulties mentioned in paragraph 32, while ensuring there are no tax incentives for retention. If all profits are distributed to individuals, this approach has the same effect as (and delivers the efficiency and equity goals of) integration, because distributed profits are taxed as if directly earned by the beneficiary. If

3 Taxation Review Committee Full Report, 31 January 1975, page 224.
4 Committee of Inquiry into the Australian Financial System Final Report, September 1981, page 217.

profits are retained, lower-income taxpayers are effectively taxed at a higher rate compared to income they earn directly.

35 De facto integration might not be attractive to entities seeking international investors, where other countries tax entity profits at a lower rate than Australia's top marginal rate.

36 In Australia, the tax treatment of discretionary trusts can achieve results broadly consistent with the de facto integration model. Tax is levied on beneficiaries who are presently entitled[5] to a share of the net income of a trust as if they had earned that income directly. The trustee is taxed on the share of the net income of the trust to which no beneficiary is presently entitled, generally at the top personal rate of tax plus the Medicare levy.

37 Income generally retains its character in the hands of beneficiaries, and tax preferences[6] flow-through[7] to the beneficiaries of discretionary trusts. Beneficiaries of discretionary trusts are not taxed on capital distributions or distributions sourced from unrealised capital gains. These features are all consistent with an integrated tax approach, because individuals are not taxed on unrealised gains. However, losses cannot be distributed to the beneficiaries and instead must be offset against the future income of the trust.

Imputation

38 A third approach to entity taxation is to impose a separate tax on entity profits while providing dividend relief through an imputation regime. Under this approach, a credit is provided for tax paid at the entity level when profits are distributed to individuals.

39 The imputation approach avoids many of the practical difficulties that arise under either of the integration models. However, it only directly reflects tax paid at the individual shareholder level when profits are distributed in the same fiscal period as they are earned. Retained profits receive a different tax treatment in that they are subject only to the lower company tax rate.

40 Where the entity tax rate is lower than the top marginal rate for individuals (whether because of international tax competition or otherwise), the differential tax treatment provides an incentive for funds to be retained at the entity level.

41 In Australia, company profits are taxed at both the entity and shareholder levels. Tax is levied at the company level at a rate of 30 per cent, and a tax credit is allowed to resident shareholders for Australian tax paid at this level under the imputation rules. This approach has both benefits and disadvantages to taxpayers.

42 Companies can retain after-tax profits within the entity indefinitely. As the company tax rate is 18.5 percentage points below the prevailing top marginal tax rate plus Medicare

5 Present entitlement is a critical concept in the trust provisions, it refers to the legal right of a beneficiary to benefit from the net income of a trust once a trustee has exercised a discretion to pay or apply trust income to them.

6 Tax preferences are concessions that provide a benefit to a specified activity or class of taxpayer. Tax preferences can result in the net income of the trust being less than the trust's accounting income.

7 Flow-through taxation concerning a trust occurs where income is not taxed at the trustee level, but flows through to beneficiaries retaining its character and is then subject to taxation (unless non-assessable) at the beneficiary level.

levy, retaining the profits so that only the company tax rate is paid can provide tax benefits, in the form of deferral of tax payments, to taxpayers with a personal tax rate higher than the company tax rate.

43 On the other hand, tax losses are trapped within the company and cannot be distributed to members. In addition, although companies are allowed a wide range of tax preferences, the benefit of the tax preferences received by a company generally is lost when distributed to shareholders.[8]

44 Where a company is a beneficiary of a trust, it can be made presently entitled to the income of the trust. As company income is taxed at 30 per cent until distribution, there can be a tax incentive for trustees to distribute to a corporate beneficiary rather than an individual beneficiary (thus enabling the individual beneficiaries to defer tax liability).

8 In the context of companies, tax preferences that are available at the company level do not generally flow-through at the individual shareholder level because under the company model dividends received are generally included in shareholder's assessable income.

3. Should discretionary trusts be taxed like companies?

45 As mentioned in paragraph 2 above, draft legislation providing for discretionary trusts to be taxed like companies was exposed for public consultation in October 2000, and withdrawn in February 2001.

46 The arguments in favour of taxing discretionary trusts like companies fall into three broad categories:

(a) discretionary trusts are close substitutes for companies;

(b) as a matter of principle discretionary trusts should be accorded the same tax treatment as companies;

(c) taxing discretionary trusts like companies would reduce tax abuse.

Should discretionary trusts be taxed like companies because they are substitutes for companies?

Are discretionary trusts used as substitutes for companies?

47 The argument in favour of taxing discretionary trusts like companies is that because the 2 kinds of entities share certain common characteristics such as limited liability (if the trustee is a company), trusts are often used as substitutes for companies.

48 The Board does not find this argument convincing, for several reasons.

49 While trusts and companies have some similarities, they also have important differences. For instance, discretionary trusts have much more limited access to equity finance than do companies. This suggests that, at least for larger businesses, discretionary trusts may not provide the same advantages as companies, and are therefore unlikely to be used as substitutes for companies.

50 In the case of small businesses, limited liability may not be a particularly important factor in the choice of a business entity (because assets and liabilities are typically of a lower value and individuals may in any case have to guarantee entity liabilities personally). The Board noted that a number of factors determine the choice of entity structure, and limited liability is not necessarily the most important. For instance, estate planning and intergenerational transfer of assets are often the prime drivers of choice.

Should discretionary trusts be taxed like companies as a matter of principle?

51 Australian tax laws apply to a wide range of different entities, and there are many similarities, and many differences, among the various entities.

52 The Board considers that the appropriateness of the various tax outcomes resulting from the use of discretionary trusts should be assessed by policy-makers not by comparison with the tax outcomes available from the use of other entities but by reference to the traditional tax policy measures of equity, efficiency and simplicity.

53 Applying this approach, the Board concluded that taxing discretionary trusts like companies would not necessarily improve equity or efficiency, for the following reasons:

- according the same tax treatment to income earned through discretionary trusts and through companies could improve equity and efficiency in some respects, but it would also potentially introduce offsetting inequities and distortions because it would exacerbate current differences in the tax treatment of income earned through discretionary trusts and income earned through other entities (such as partnerships) that retain a flow-through tax treatment.

- practitioners assisting the Board cautioned that any move to tax discretionary trusts like companies would reduce the degree of integration that the current law can potentially achieve for trust beneficiaries. Taxing trusts like companies would prevent the flow-through of tax preferences and the retention of the character of income distributed and could potentially have equity impacts (see paragraphs 30 to 33).

54 For these reasons, the Board concluded that the efficiency and equity of the tax system would not necessarily be improved by aligning the tax treatment of discretionary trusts and companies.

55 The Board also noted that any proposal to tax discretionary trusts like companies could impose significant transitional costs on the economy and on those individuals who have structured their affairs under existing rules (see Attachment A). The Board was particularly concerned that the burden of these transitional costs would fall most heavily on small businesses and farmers.

56 A key difference between the taxation of companies on the one hand and trusts (or partnerships and individuals) on the other is that amounts that are non-assessable in the hands of the trustee (tax-preferred income) are not taxed on distribution to beneficiaries whereas such amounts are assessable dividends in the hands of company shareholders. If this tax-preferred income were to become taxable on distribution, income earned through a trust would be taxed differently to income earned by an individual directly; this would be a departure from the integration objective which leads to potential equity and efficiency concerns as mentioned above. The Board therefore considers that to the extent that flow-through taxation has the potential to further integration, it has the potential to deliver superior outcomes in terms of equity and efficiency.

Recommendation 1

The Board of Taxation considers that there are no compelling arguments for broad-based reform to more closely align the tax treatment of discretionary trusts and companies and that the Government should retain the current flow-through treatment of distributions of non-assessable amounts by discretionary trusts.

Should discretionary trusts be taxed like companies to reduce tax abuse?

Would the company tax model reduce tax abuse?

57 Under the current tax treatment of discretionary trusts, assessable income earned through a trust and distributed to beneficiaries is taxed as if beneficiaries had earned the income directly. Any undistributed income of the trust is taxed in the hands of the trustee at the top marginal tax rate. Consistent with the law, amounts that are non-assessable in the hands of the trustee may be distributed to beneficiaries tax-free.

58 Critics of this tax model argue that flow-through tax treatment allows for the tax-free distribution of amounts that are untaxed due to tax abuse. For example, if the trustee fails to include an amount of income in the trust's tax return, the amount would remain untaxed if distributed to a beneficiary, presuming the beneficiary also fails to include it in a tax return. Consequently, critics suggest that trusts allow for the benefit of such tax abuse to be passed on to individual beneficiaries.

59 Critics of flow-through tax treatment have claimed that the imputation regime that applies to companies provides additional integrity compared with trusts if tax is not assessed at the entity level. For instance, if a company fails to include an amount of income in its annual tax return, that untaxed amount could be distributed as an unfranked dividend and, as such, would be assessable income of the shareholder, taxable at the shareholder's marginal tax rate.

60 However, unless and until amounts not shown in the company or trust tax return are distributed, and reported in an individual's return, the company model does not provide any greater integrity under a self-assessment tax system than the flow-through taxation model applicable to trusts. Moreover, funds retained in a company may be used to advance the personal interests of shareholders (for example, through the purchase of personal use assets), in the same way that such funds retained by a trust may be used.[9]

61 The Board is not convinced that the company model provides enough additional integrity such as to justify a move to tax trusts like companies. The Board considers that the potential equity and efficiency gains associated with integration of trust taxation and individual taxation should not be abandoned due to concerns about tax abuse. The Board

9 The deemed dividend rules (Division 7A), which treat certain amounts paid by a private company as dividends, may apply to tax certain disguised distributions.

considers that, as a general rule, tax abuse should be addressed at its source through better enforcement action to limit tax abuse opportunities.

Are there other forms of tax abuse available through the use of trusts which treating trusts like companies would reduce?

62 Since the 1990s, a number of amendments have been made to the taxation treatment of trusts, to address specific tax planning opportunities (see Attachment E). The ATO has indicated:

- that the legislation appears to have modified behaviour; and
- that non-compliance with the new provisions is not a significant concern (although extensive compliance reviews have not been completed on some measures).

63 The ATO has also advised that targeted anti-abuse rules are difficult to apply in some circumstances where taxpayers have very complex arrangements. In these cases, it can be almost impossible to trace the ultimate source of funds; consequently, it can be very difficult to identify tax abuse techniques and enforce the rules.

64 The Board notes that the ATO is continuing to monitor closely such complex arrangements.

65 The Board has also considered examples of practices which, while within the law, lead to tax advantages. These examples revolve around the distribution of unrealised gains on revaluation of trust assets.

66 The Board considered these to be limited examples that do not question its general conclusion in Recommendation 1. The Board was also concerned that any attempt to remove these tax advantages for classes of trusts delineated either by size, type or complexity, carries risks of being arbitrary and unfair.

67 The Board noted that the Commissioner of Taxation is continuing to monitor this area and that he will report directly to the Government on any need to improve integrity.

Recommendation 2

The Board of Taxation considers that, in light of the implementation of trust integrity measures over several years, concern about the use of trusts for tax planning does not of itself warrant fundamental change to the tax treatment of discretionary trusts.

4. Can the current tax treatment of discretionary trusts be improved?

68 Having concluded that fundamental change in the current taxation treatment of discretionary trusts is not warranted, the Board then considered whether the current tax treatment of such trusts could be changed to improve equity and efficiency outcomes.

69 The Board identified 2 minor issues as warranting consideration and clarification.

- Should the existing rules preventing the use of corporate beneficiaries to allow individuals access to the lower company tax rate be made more effective?
- Is there a need to clarify the rules on the deductibility of interest on loans used to finance distributions of non-assessable amounts by trusts?

Distributions to corporate beneficiaries

70 The income tax law currently includes rules intended to prevent individuals using discretionary trusts to access income tax at the company tax rate without paying 'top-up' tax equal to the difference between the company tax rate and their personal marginal rate. The Board found that the current rules:

- on the one hand, do not achieve the intended effect in all circumstances; and
- on the other hand, may operate so as to disadvantage trust beneficiaries in certain situations where loans arise for reasons unrelated to tax planning.

How are the rules intended to operate?

71 A private company's flexibility in distributing funds to shareholders is limited by the deemed dividend rules (Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936)). These rules are intended to ensure that profits taxed at the company tax rate cannot be effectively distributed to shareholders (or associates), through means other than dividends, without a 'top-up' tax being paid. The deemed dividend rules operate by deeming certain advances, loans and other benefits provided by private companies to shareholders (or associates) to be assessable dividends, to the extent that the company has a distributable surplus.

72 The ambit of the deemed dividend rules is extended to trusts by section 109UB of the ITAA 1936, which applies to a private company that is a beneficiary of a trust estate. A trustee can make a company presently entitled to trust income without distributing cash to the company. This allows a trust to effectively accumulate income that has been taxed only at the company tax rate. Section 109UB deals with the case in which a trustee:

- makes a company presently entitled to trust income (so as to access the company tax rate), and

- then distributes the underlying cash to individual beneficiaries through loans (so that the beneficiaries avoid paying any 'top-up' tax that would be imposed on a distribution if the beneficiaries have a higher marginal tax rate).

73 Section 109UB deems the loan to have been made by the company, thus attracting the operation of the deemed dividend rules.

Cases in which section 109UB is ineffective

74 Section 109UB, however, does not cover a case in which:

- the trustee makes a private company presently entitled to trust income, but does not pay the income to the company; and

- the trustee then distributes the underlying cash to trust beneficiaries, but not as a loan.

75 In such circumstances, the individuals are able to access, without further tax liability, trust income that has been taxed only at the company tax rate.

76 One way of distributing the underlying cash other than as a loan is for the trustee to re-value assets of the trust and then to use the cash to make a (tax free) distribution of the corpus to a beneficiary. The beneficiary then lends the corpus distribution back to the trust, thus setting up a loan account reflecting the trustee's indebtedness to the beneficiary. When the trust then repays that loan to the beneficiary, section 109UB does not operate to deem the repayment to be a loan made by the company, and so the deemed dividend rules do not apply.

Cases in which section 109UB operates unfairly

77 The Board received advice from practitioners to the effect that the motivation for establishing the accounts as described in paragraph 76 is often not tax minimisation, but rather a desire to avoid the perceived inflexibility and unfairness of section 109UB. The effect of section 109UB is to treat certain transactions as creating loans that are then affected by the deemed dividend rules. Once the section operates to deem a loan to exist, there is no scope for reversing the operation of the section, such as by repaying the loan (opportunities that are available under similar provisions in other parts of the tax laws.[10]) That is, section 109UB has a finality not found in other provisions of the deemed dividend rules.

78 The inability to avoid the operation of section 109UB by regularising the arrangements that created the deemed loan may have particularly adverse or unintended consequences in cases where a trust operates a small or medium-sized business. The Board has been advised that arrangements that are caught by section 109UB are, typically, temporary accounting balances that would usually be extinguished at year end through trust distributions. In other cases, the 'loans' arise where the operators of the business, in the course of running the business, inadvertently fail to distinguish between the trust's cash and their own cash. In other words, these are 'accidental loans', but section 109UB has no mechanism for reversing the initial deeming of the loans to be dividends.

10 See section 109D ITAA 1936.

What should be done about section 109UB?

79 The Board considers that changes should be made to the tax law:

- to improve the effectiveness of the deemed dividend rules so as to more effectively prevent beneficiaries accessing trust income that has borne tax only at the company tax rate; and
- to remove the unfairness in the operation of section 109UB that is currently inducing some small and medium-sized business operators to establish arrangements that enable them to avoid the operation of the section completely.

80 The Board identified 2 possible forms that those changes could take. One involves amendments of section 109UB, while the other involves repealing section 109UB and replacing it with a different kind of provision.

Amending section 109UB

81 Section 109UB could be amended:

- to improve the effectiveness of the section, to provide that a repayment to an individual beneficiary of a loan made to a trustee in the kind of circumstances described in paragraphs 74 to 76 will be deemed to be a loan made by the company to the individual beneficiary; and
- to remove the unfairness of the section, to provide that a 'loan' that is repaid within 12 months after it is made is not caught by the section.

Repeal and replacement of section 109UB

82 Alternatively, section 109UB could be repealed, and replaced with a section setting out the consequences where a trustee makes a company presently entitled to the income of a trust, but does not pay the funds to the company within a reasonable period. The consequences could be either that the trustee would be assessed on the amount of the income as if there had been no distribution, or that the company would have to pay a top-up tax (which could create franking credits in the company).

Need for further consideration of options

83 The Board notes that there is a need to further consider the practical, accounting and legal implications of these 2 possible approaches to section 109UB. Further consideration and consultation should be carried out before any action is taken to amend or repeal the section.

Recommendation 3

The Board of Taxation recommends that the Government consider options for amending the income tax law to improve the effectiveness and fairness of provisions intended to prevent individuals who are trust beneficiaries with high marginal tax rates accessing, without further tax liability, funds that have been taxed only at the company tax rate.

Deductibility of interest on loans used to fund certain payments

84 A trustee proposing a corpus distribution, especially if the distribution effectively comes from a revaluation reserve, may need to borrow the money to fund the distribution. The Board received advice from practitioners that the principles of interest deductibility applying to such borrowings are not clear, because of the absence of ATO guidance. Taxation Ruling TR95/25 clarified the principles applying to partnerships, individuals and companies, but the ruling did not consider trusts.

85 Consequently, taxpayers and their advisers may be uncertain about whether a trust can claim a deduction of interest expenses where amounts are borrowed then distributed to beneficiaries.

86 This confusion may have led to inappropriate taxation outcomes, if trusts have claimed deductions of interest costs that are not sufficiently connected to the income-producing activities of the trust. The Board considers that the Commissioner of Taxation's position on the deductibility of interest for trusts should be clarified.

87 The Board's view is that a deduction should not be allowed for interest on borrowings used to finance a non-assessable distribution to a beneficiary of a discretionary trust, irrespective of whether the borrowing is direct, or indirect via another entity. Thus, in particular, a deduction would not be available for interest on a loan to fund the distribution of unrealised capital gains to a beneficiary of a discretionary trust.

88 The Board noted ATO advice that rulings on interest deductibility, however clear, may be difficult to enforce if taxpayers arrange their affairs through complex structures (whether the structures involve individuals, companies, trusts, partnerships or any other entities), because of the fungibility of funds. The Board considers that if, after the Commissioner's view of the law is clarified, it appears that some trusts are continuing to claim deductions for interest costs that are not sufficiently connected to the income-producing activities of the trust, then the Government should consider a legislative solution.

Recommendation 4

The Board of Taxation recommends that the Commissioner of Taxation clarify and publish his views about the deductibility of interest on borrowings used to finance non-assessable distributions to beneficiaries of discretionary trusts.

Attachment A: Taxpayer concerns with the consistent entity tax regime

89 In October 2000, the Government released exposure draft legislation for a consistent entity tax regime, proposing to tax non-fixed trusts like companies. Unlike the initial proposal to tax entities on a consistent basis, the proposal was modified to maintain the current tax treatment of companies and maintain flow-through taxation for fixed trusts, not just collective investment vehicles and excluded trusts. Submissions on the measure raised a number of technical and practical problems in addition to concerns about the policy to tax trusts like companies.

90 Concern was expressed that potentially all trusts with a trust deed that provided even a limited discretion for the trustee to allocate trust income or capital could be subject to the new regime and many trusts would incur costs reviewing trust deeds to determine their status.

91 Practical problems about determining the contributed capital of the trust in the transition to the new regime included identification of prior taxed amounts and lack of documentation to determine the tax status of trust assets.

92 Entity taxation (of non-fixed trusts) aimed to provide the same substantive tax treatment of realised gains of concessionally-taxed trust assets and (pre-23 December 1999 capital gains tax assets) as would have been achieved if trusts had maintained the flow-through tax treatment. Before the sale of a trust's 'grandfathered assets', unrealised gains linked to those assets were potentially taxable as income through the operation of the profits first rule. The profits first rule was criticised for imposing higher compliance costs for trusts than companies as market valuations of assets could be required in order to determine the amount of available profits.

93 The National Farmers' Federation was concerned that family groups which hold property in a discretionary trust for inter-generational succession planning purposes, but who also want to distribute unrealised gains as part of a family settlement, would be subject to double taxation of unrealised capital gains tax assets held in the trust.

94 The operation of the entity regime raised other ongoing problems about its interaction with the imputation system and capital gains tax rules. Beneficiaries of non-fixed trusts do not have a membership interest that is viewed as being at risk, nor does their membership interest have a cost base. Consequently, beneficiaries who are not part of a family trust election could not use imputation credits attached to franked dividends; this would result in double taxation of that income. Also, capital distributions, including settled amounts, could be subject to capital gains tax when distributions were made by a trust that had not made a family trust election.

95 On 27 February 2001, the Treasurer announced that, in light of these technical problems and advice from the Board of Taxation, the Government would not proceed with draft legislation providing for the taxation of non-fixed trusts like companies.

Attachment B: Treasurer's press release — entity taxation

The text of the Treasurer's press release on entity taxation issued on 27 February 2001 is as follows,

'ENTITY TAXATION

In October 2000 the Government released exposure draft legislation providing for the taxation of trusts like companies.

Following the release of the exposure draft legislation, the Government received a great number of submissions which raised technical problems particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues that meant that the draft legislation is not workable.

The Government has also taken advice from the Board of Taxation which recommended that the Bill not proceed and suggested looking at alternative approaches.

As a consequence the Government is withdrawing the draft legislation and will not be legislating it. It will begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area. The Board will be part of consultation.

Claims that the cost to revenue of this decision amount to $1 billion are false. *A New Tax System* policy statement costed this measure in conjunction with revenue bring forward under PAYG which has already been introduced and on a 36 per cent tax rate. Stripping out PAYG which has been introduced and allowing for a reduced tax rate at 30 per cent (as will apply from 1 July 2001), the cost of this decision in the full financial year 2001-2002 is of the order of $110 million.

CANBERRA

27 February 2001'

Attachment C: The use of trusts in Australia

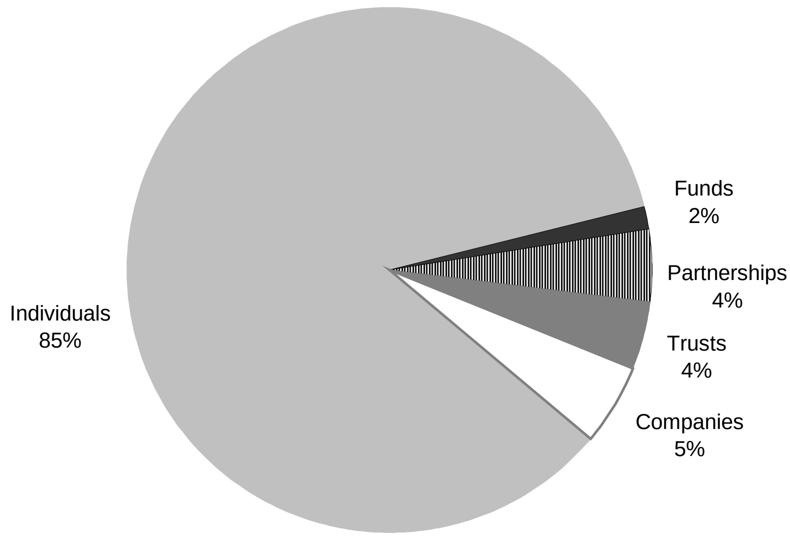
96 This attachment profiles companies, partnerships and trusts in the Australian economy, using information from 1998-99 income tax returns.

The number of taxpayers

97 In 1989-99, around 11.5 million taxpayers lodged tax returns. The overwhelming majority of returns were lodged by individual taxpayers.

98 Around 470,000 trusts lodged a return. By way of comparison, around 500,000 partnerships and 600,000 companies lodged returns.

Chart 1: Number of taxpayers



Total distributions by entities

99 About 1.9 million individual taxpayers (or about 20 per cent of the total number of individual taxpayers) received a distribution from a partnership or trust in 1998-99. By comparison, about 2.4 million individual taxpayers received a dividend.

100 Net trust distributions to individuals amounted to about $9 billion in 1998-99, or about 3 per cent of individual income. This was in line with the $9 billion received as gross dividends and imputation credits, and was lower than the $12 billion received as net partnership distributions.

Distributions by entities to individuals, by income of recipient

101 Compared to trusts and partnerships, companies distribute proportionately more profits to higher income individuals.

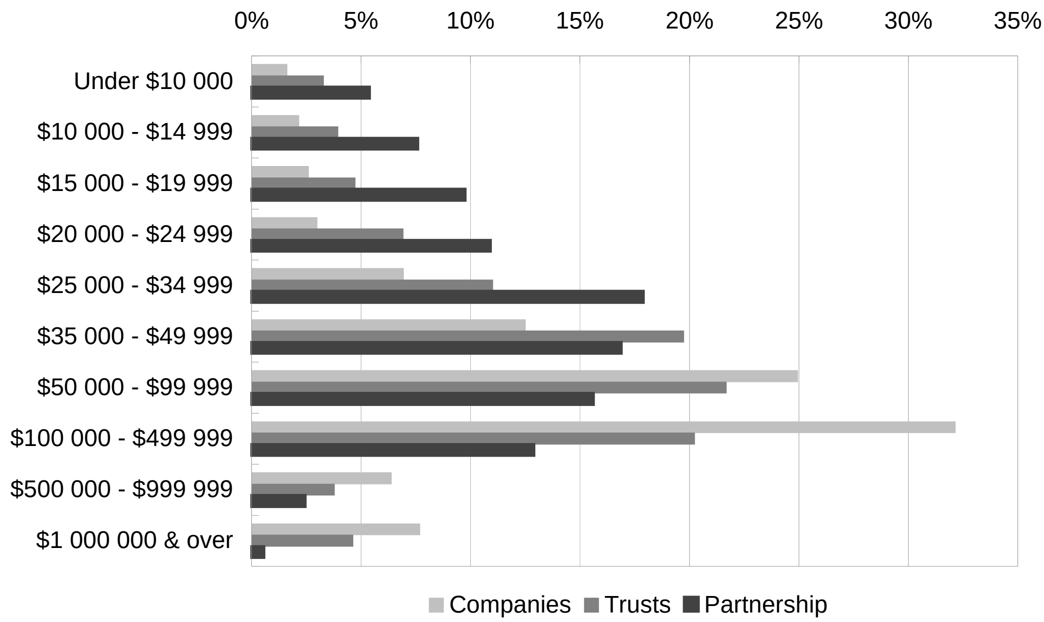
102 Individuals with total income over $100,000 receive about 45 per cent of distributions of company profits, 30 per cent of distributions of trust profits and 15 per cent of distributions of partnership profit.

103 Partnerships distribute proportionately more profits to lower income individuals.

104 Individuals with total income under $35,000 receive about 50 per cent of distributions of partnership profits, 30 per cent of distributions of trust profits and 15 per cent of distributions of company profits.

105 The profile of trust distributions to individuals lies between that of partnerships and companies.

Chart 2: Proportional distribution of profits by entities to individuals, by total income of receiving individual



The types of trusts

106 For the purpose of income tax returns, trusts are classified into three broad categories:

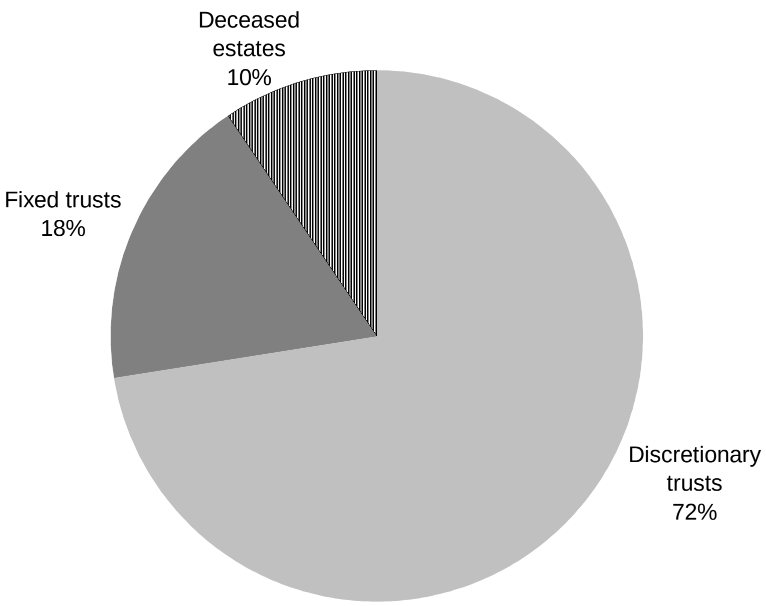
(a) fixed trusts, where the interests of beneficiaries are fixed in the trust deed or document establishing the trust;

(b) discretionary trusts, where the trustee can choose the beneficiary who will receive distributions of income or capital or both from the trust; and

(c) deceased estates, where the trustee manages the assets of a deceased person on behalf of beneficiaries usually identified in the deceased person's will. Generally, a trustee cannot distribute income or assets of a deceased estate until the debts of the deceased person are determined.

107 Most trusts that lodged tax returns in 1998-99 identified themselves as discretionary trusts.

Chart 3: Types of trusts



Trends over time

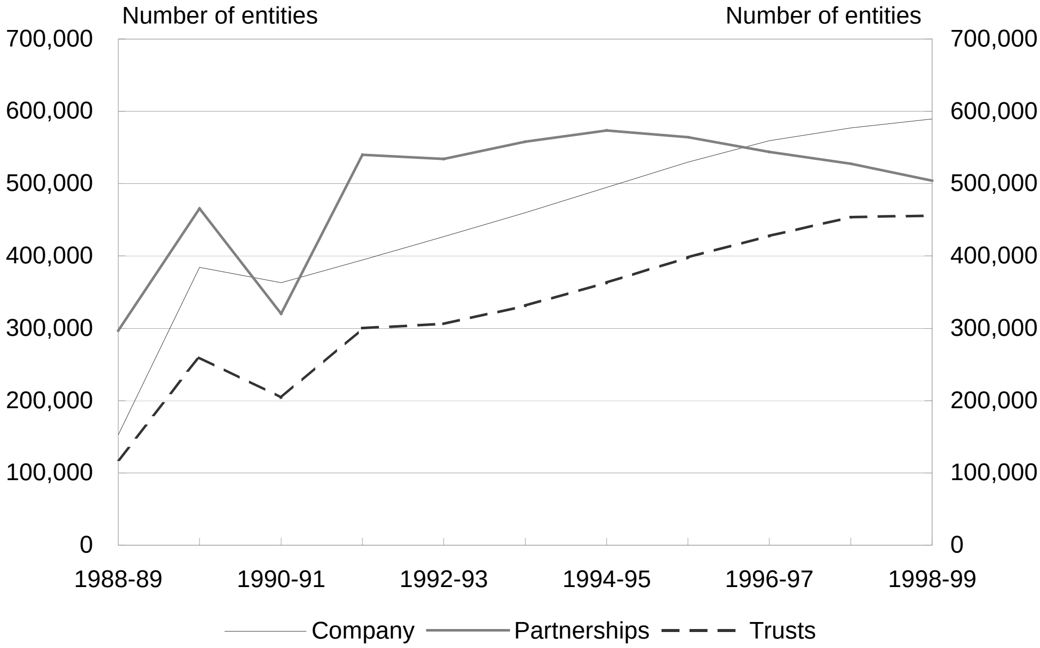
108 As at 11 November 1999, the number of trusts that had lodged tax returns stood at about 460,000[11]. The number of trusts lodging tax returns increased from about 120,000 in 1988-89 to about 460,000 (as at 11 November 1999), an average increase of about 19 per cent per year.

11 This figure is lower than the 470,000 figure used throughout this paper because it represents only those trusts which lodged 1998-99 returns before 11 November 1999. This figure, presented in the *1998-99 Australian Taxation Statistics*, is used in this section to improve the consistency of the comparison across years.

109 Over the same period, the number of companies rose from about 150,000 to 590,000, at an average increase of about 20 per cent per year. The number of partnerships rose from about 300,000 to about 500,000 over this period, at a much slower average rate of increase of about 10 per cent.

110 From 1993-94 to 1997-98, the number of trusts and companies grew at a similar rate (an average rate of about 8 per cent for trusts and 6 per cent for companies); the number of partnerships remained fairly constant.

Chart 4: Comparison of the number of entities over time



Numbers of entities, by sector

111 In 1998-99, industry groups were coded using the Australian and New Zealand Standard Industrial Classification System (ANZSIC). One limitation on this data is that the ANZSIC coding relates only to the primary industry in which the entity is involved.

112 The main industry grouping for each entity (leaving aside the 'Other' category) were:

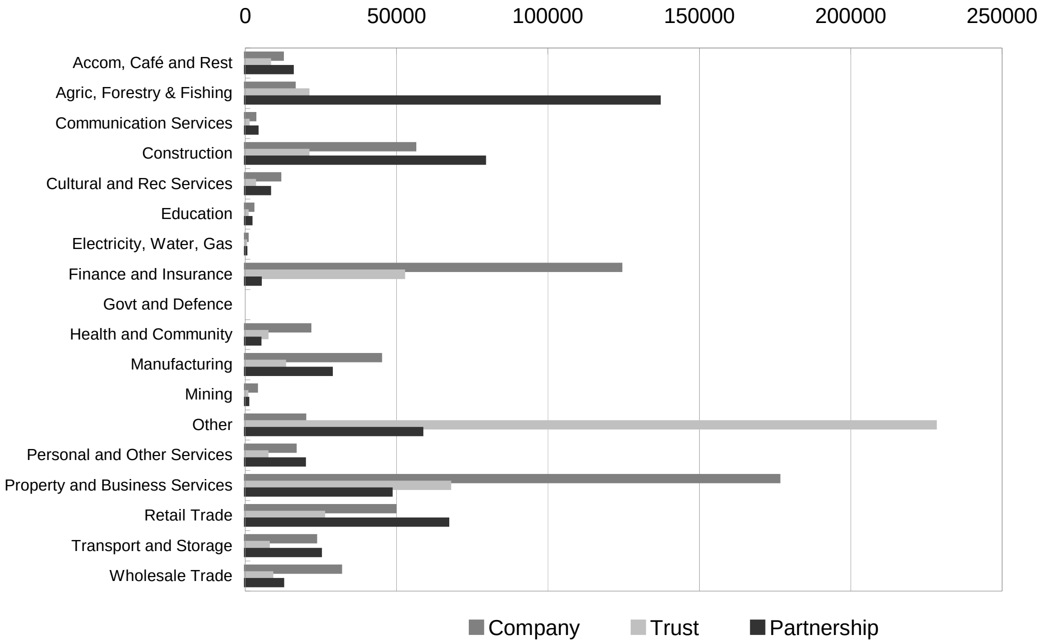
a) for both companies and trusts, the property and business services sector (about 30 per cent of both companies and trusts that identified an industry); and

b) for partnerships, the primary production sector (about 30 per cent of partnerships that identified an industry).

113 It may be noted that the number of trusts that were identified as operating in the primary production sector is relatively minor, at only 6 per cent of trusts that identified an industry. However, this does not necessarily warrant a conclusion that changes in the tax treatment of trusts will have little impact on farmers. Property held in trust as a non-financial asset investment may be used in a primary production business (which could be operated

through a partnership, for example). As discussed later, a significant proportion of trusts do not earn any business income.

Chart 5: Number of entities by industry sector



Attachment D: The use of trusts to earn business income

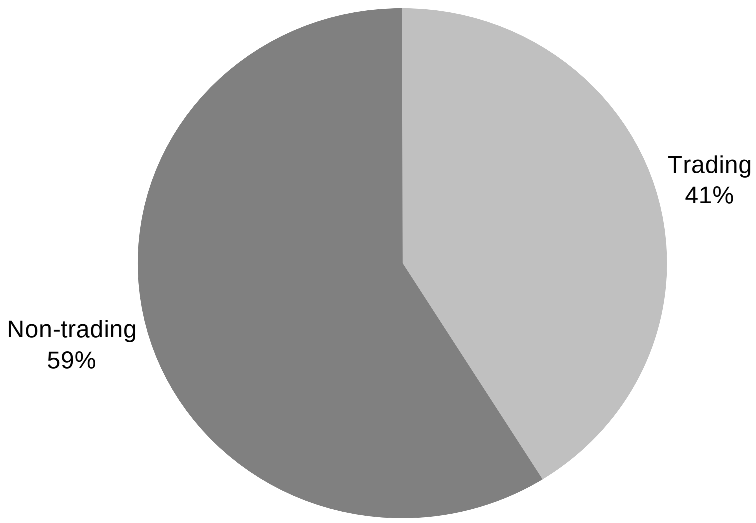
114 This attachment profiles companies, partnerships and trusts in the Australian economy, using information from 1998-99 income tax returns.

115 Trusts, partnerships and companies are alternative structures for operating a business. A range of factors is taken into account when determining the entity structure that is to be adopted for a particular business venture. The following section considers the data about the extent to which trusts are used to earn business income.

The use of trading trusts

116 In 1998-99, about 200,000 trusts reported earning business income (trading trusts).

Chart 6: Trading vs Non-trading trusts



What types of trusts are used as trading trusts?

117 Of the 200,000 trusts that reported business income in 1998-99, about 160,000 were discretionary trusts. Accordingly, discretionary trusts reporting business income comprised 47 per cent of all discretionary trusts in 1998-99 (total discretionary trusts in 1998-99 were 340,000).

118 Discretionary trusts also comprised a significant portion of non-trading trusts. However, the proportion of deceased estates was significantly higher among non-trading trusts.

Chart 7: Trading trusts — types of trusts

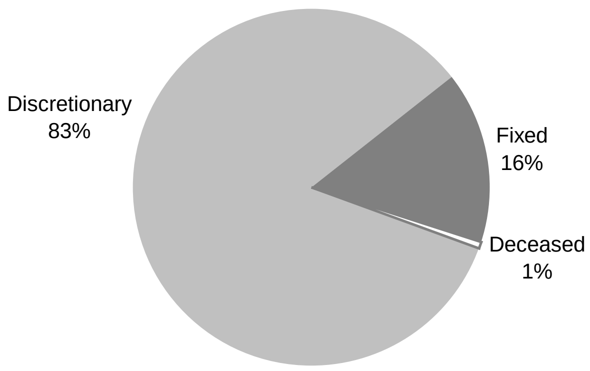
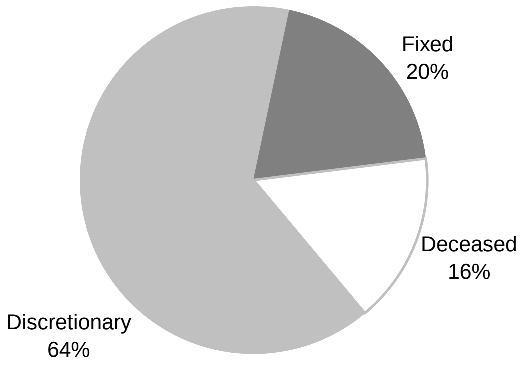


Chart 8: Non-trading trusts — types of trusts



How much income do trading trusts earn?

119 About 85 per cent of trading trusts operate within the $1 to $1 million business income range. This is a similar proportion to companies, but significantly less than the proportion of partnerships. (Nearly all partnerships that earn business income operate in this income range.)

Chart 9: Proportion of trading trusts, by amount of business income

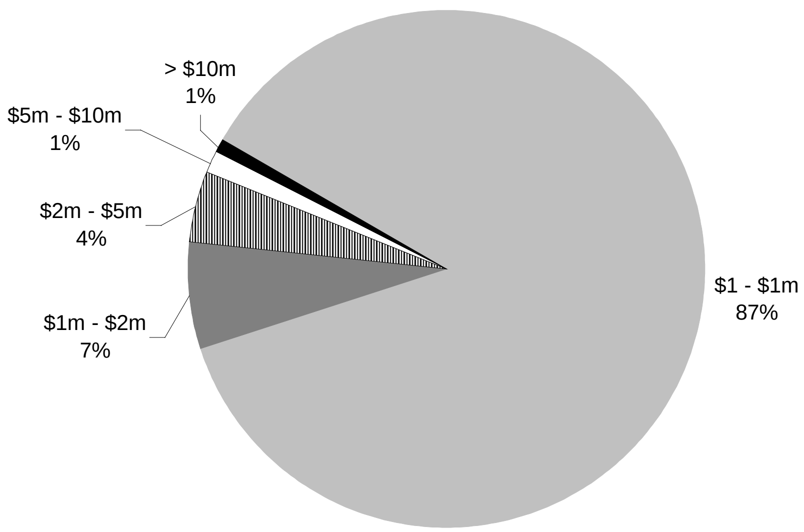


Chart 10: Proportion of trading companies, by amount of business income

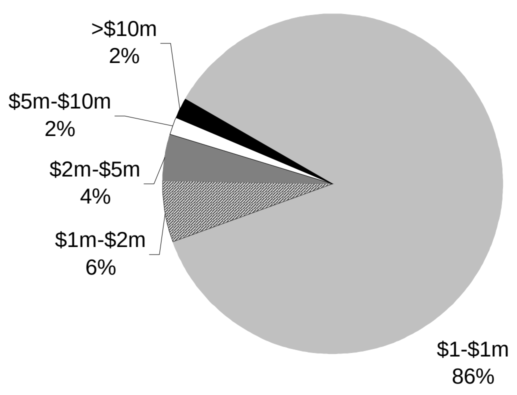
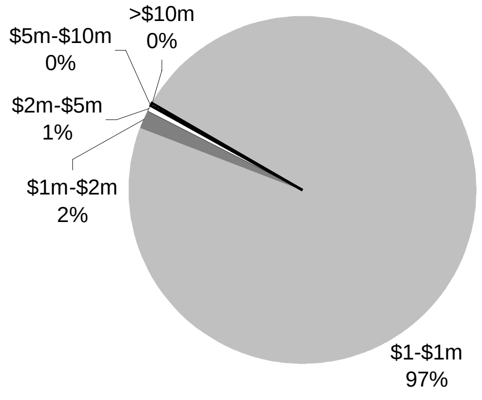


Chart 11: Proportion of trading partnerships, by amount of business income



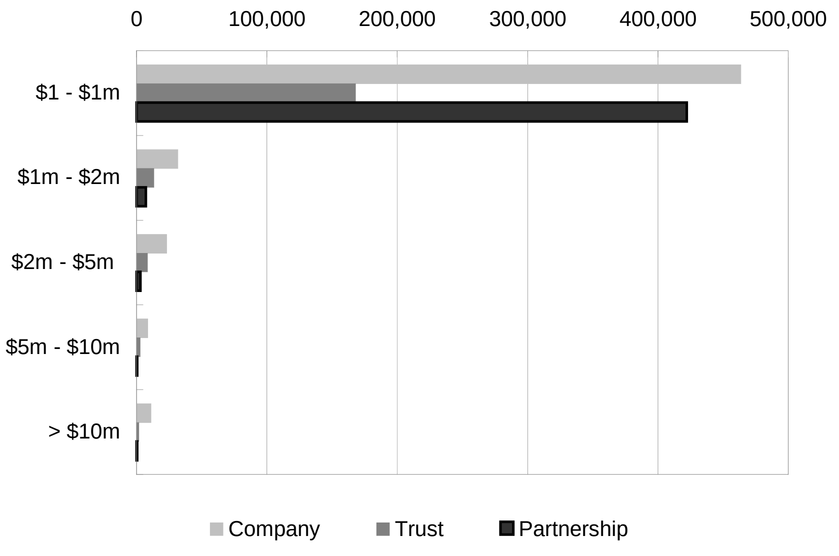
Comparative use of entity to earn business income, by turnover

120 Companies are the dominant corporate form in every business income range, and their dominance steadily increases as business income increases.

121 Partnerships are a popular vehicle for business where the income does not exceed $1 million, but they are rarely used where business income exceeds this level.

122 Trusts are the least used corporate form for earning business income. However, they are more popular than partnerships when business income exceeds $1 million.

Chart 12: Numbers of business entities, by business income



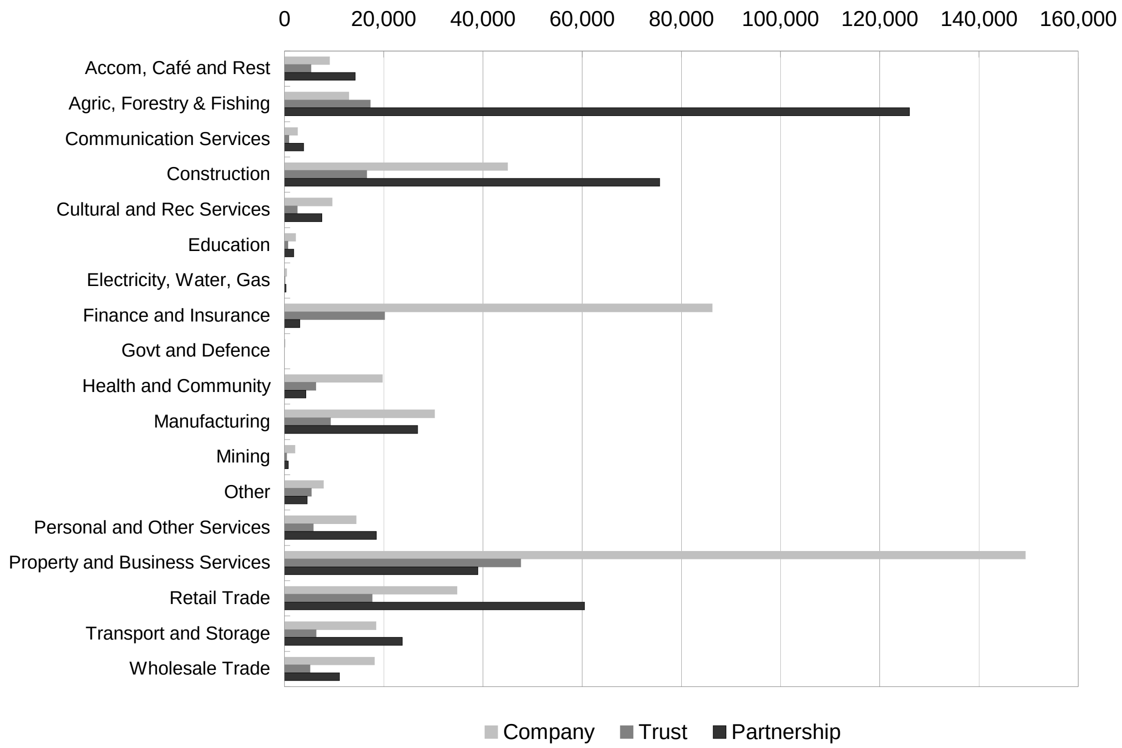
Choice of trading entity within the $1 — $1 million income range, by sector

123 Within this income range, trusts are not the dominant entity form in any of the industry groupings.

124 Companies dominate a number of industry groupings, notably the property and business services and finance and insurance sectors.

125 Partnerships dominate the agriculture, forestry and fishing industries, and also the construction industry.

Chart 13: Number of entities in the $1 to $1 million business income range, by industry sector



Attachment E: Recent amendments to the treatment of trusts

126 Since the early 1990s, the Government has amended the law dealing with planning opportunities involving trusts a number of times. Five substantial recent amendments include:

Use of non-resident trusts to transfer funds offshore — Division 6AAA Part III ITAA 1936

127 This Division was inserted into the ITAA 1936 in 1991 to minimises the practice of transferring funds to non-resident trusts set up in low or no tax jurisdictions, with a locally resident trustee who generally acted in accordance with the wishes of the person establishing the trust. A common procedure was to allow income to accumulate in the trust, then to repatriate the income through a series of companies and finally, a loan to an Australian resident entity.

128 The Division operates to ensure that the income of certain non-resident trust estates is attributed to Australian residents and, together with the Foreign Investment Fund measures contained in Part XI of the ITAA 1936 reduces the practice of using non-resident trusts for tax minimisation purposes.

Inappropriate utilisation of losses — Schedule 2F ITAA 1936

129 This schedule was inserted into the ITAA 1936 in 1998 to limit the practice of trafficking in loss trusts. This practice allowed the beneficiaries of trusts who were carrying losses to sell their interest in the trust, making the loss available to the new beneficiaries to reduce the tax otherwise payable on other sources of income.

130 To prevent the practice, the new provisions look at whether there is a relevant change in the individuals who will benefit from any deduction for the tax losses or debt deductions compared to the individuals who may have benefited from the loss or deduction when it was actually incurred. The provisions establish a range of tests that a trust must satisfy if it is to deduct current and prior year losses and debt deductions.

Circulating distributions and tracing distributions through to the ultimate beneficiaries — Division 6D Part III ITAA 1936

131 This Division was inserted into the ITAA 1936 in 1999 to provide the Commissioner of Taxation with the information required to ensure that the assessable income of ultimate beneficiaries correctly includes any required share of the net income of a trust, and that the net assets of ultimate beneficiaries reflect the receipt of tax-preferred amounts. Before this Division was enacted, all or part of the net income of a trust estate could be passed through a series of trusts with no ultimate beneficiaries assessed on that net income. This could occur either because no ultimate beneficiary existed or the ultimate beneficiary could not be identified.

132 Now the trustee of a closely-held trust with a trustee beneficiary must disclose to the Commissioner of Taxation the identity of the ultimate beneficiaries of certain net income and tax-preferred amounts of the trust. If the trustee fails to comply or if no ultimate beneficiaries exist, ultimate beneficiary tax is imposed at the highest marginal rate plus Medicare levy on the net income.

Personal services income rules — Part 2-42 ITAA 1997

133 The tax regime for personal services income was inserted into the ITAA 1997 in 2000 to prevent individuals reducing their tax by alienating their personal services income to an interposed entity, such as a trust. The alienation of income in this way allowed income to be retained in the entity and either taxed at the lower rate available to the entity or diverted to associates, allowing individuals to pay a lower overall rate of tax. The use of interposed entities also created entitlement to a range of business deductions that would otherwise not be available to an individual providing the same services as an employee.

134 The provisions include personal services income in the assessable income of the individual whose personal efforts or skills generated the income, even if it was alienated to another entity. Deductions that may be claimed by the individual or interposed entity are restricted, so they broadly correspond to the deductions available to employees.

Revised social security means test treatment of private trusts and private companies

135 The Government also introduced measures to ensure that, from 1 January 2002, income support recipients who hold their assets in private companies or trusts receive comparable treatment under the means test to those Centrelink customers who hold their assets directly.

136 As a result, in January 2001 revised means test forms were distributed to about 140,000 people with an involvement in a private trust or company. Over 5,000 recipients did not respond, forfeiting their entitlement to income support. In total, around 11,500 Centrelink customers had their payments or concession card cancelled and around 14,000 customers now receive reduced rates of income support. The measure has led to annual savings of around $100 million.

137 Approximately 65,000 entities were identified as being associated with an individual receiving income support payments. Of these, about 23,000 were identified as discretionary trusts (with income totalling about $250 million and assets totalling about $3.9 billion) and 37,000 were identified as small proprietary companies (with income totalling about $180 million and assets totalling about $3.6 billion).

Attachment F: Members, Charter of the Board of Taxation, conflict of interest declaration, and acknowledgements

Members

The members of the Board of Taxation are:

Chairman

Mr Richard F. E. (Dick) Warburton

Members

Mr John Bronger
Mr Tony D'Aloisio
Mr John Harvey
Mr Brett Heading
Mr Chris Jordan
Ms Jane Schwager

Ex officio members

Mr Michael Carmody (Commissioner of Taxation)
Mr Ken Henry (Secretary to the Department of the Treasury)
Ms Hilary Penfold QC (First Parliamentary Counsel)

Secretariat

Members of the Board's Secretariat who contributed to the preparation of this report were, Mr Murray Edwards (former Secretary), Mr Gerry Antioch (current Secretary), Mr Phil Bignell and Mr Robert Patch.

Charter

Mission

Recognising the Government's responsibility for determining taxation policy, and the statutory role of the Commissioner of Taxation, to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

Membership

The Board of Taxation will consist of up to ten members.

Up to seven members of the Board will be appointed, for a term of two years, on the basis of their personal capacity. It is expected that these members will be appointed from within the business and wider community having regard to their ability to contribute at the highest level to the development of the tax system. The Chairman will be appointed from among these members of the Board. Members may be reappointed for a further term.

The Secretary of the Department of the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel will also be members of the Board. Each may be represented by a delegate.

Function

The Board will provide advice to the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relationship to other Boards and Bodies

From time to time the Government or the Treasurer may establish other boards or bodies with set terms of reference to advise on particular aspects of the tax law. The Treasurer will advise the Board on a case by case basis of its responsibilities, if any, in respect of issues covered by other boards and bodies.

Report

The Chairman of the Board will report to the Treasurer, at least annually, on the operation of the Board during the year.

Secretariat

The Board will be supported by a secretariat provided by the Treasury, but may engage private sector consultants to assist it with its tasks.

Other

Members will meet regularly during the year as determining by the Board's work program and priorities.

Non-government members will receive daily sitting fees and allowances to cover travelling and other expenses, at rates in accordance with Remuneration Tribunal determinations for part-time public offices.

The Government will determine an annual budget allocation for the Board.

Conflict of Interest Declaration

All members of the Board are taxpayers in various capacities. Some members of the Board derive income from director's fees, company dividends, trust distributions or as a member of a partnership.

The Board's practice is to require members who have a material personal interest in a matter before the Board to disclose the interest to the Board and to absent themselves from the Board's discussion of the matter, including the making of a decision, unless otherwise determined by the Chairman (or if the Chairman has the interest, the other members of the Board).

The Board does not regard a member as having a material personal interest in a matter of tax policy that is before the Board merely because the member's personal interest may, in common with other taxpayers or members of the public, be affected by that tax policy or by any relevant Board recommendations.

Acknowledgements

The Board wishes to acknowledge the contribution of Mr Richard Friend, Mr Ken Schurgott and Mr Mark West, practitioners who assisted the Board of Taxation Secretariat, Treasury and ATO officials in the preparation of advice on the taxation treatment of discretionary trusts and their use by small business. Valuable assistance was also received from Professor Rick Krever.

The Board did not conduct public consultations or seek public submissions. However, it met with the Australian Council of Social Service (ACOSS) to consider community sector views about this area of tax law. It also considered submissions from ACOSS, the Business Coalition for Tax Reform and the Institute of Chartered Accountants in Australia.