A Balancing Act: Trusts and Entity Taxation in a Reformed Tax System

The Australian Society of Certified Practising Accountants

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Introduction

As Australia's leading accounting body, the Australian Society of Certified Practising Accountants (ASCPA) is working to ensure that we create a robust and fair tax system that will meet the needs of the country in the new millennium.

This report examines the impact of the proposed reform options to the entity tax regime by the Review of Business Taxation (RBT). In particular, it makes a strong case for the exclusion of family trusts from the entity regime, and makes a range of other recommendations to ensure that the reforms better reflect the needs of business, especially small business. It also includes some discussion of alternatives to the entity tax regime.

This report will be provided to the RBT to ensure that tax reform assists rather than hinders small business growth - benefiting our economic prosperity and employment growth.

In the interests of furthering the tax reform debate, the submission is also available to the general public via the ASCPA Internet site, CPA Online, at www.cpaonline.com.au.

Copies are also obtainable from the ASCPA by contacting Paul Drum - Senior Tax Counsel on 03 9606 9701 or via e-mail on drump@natoff.cpaonline.com.au.

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Executive Summary

The most significant issue for small business in the proposed business taxation reforms is the taxation of trusts. There are nearly 260,000 small businesses operating through a trust structure. The compliance burden of the proposed changes in this area will therefore be of particular concern to the small business sector. It is essential that the final recommendations from the Review of Business Taxation (RBT) in relation to entity taxation are sympathetic to the needs of this sector.

In principle, we do not accept that a major structural overhaul of the tax treatment of all trusts is necessary to achieve the results being sought by the RBT from the entity tax changes. We strongly believe that the best option to achieve reform is to allow discretionary trusts that make a family trust election under the current trust loss provisions, to be treated as excluded trusts. On its own, this would still allow for the flow through of tax preferences that the RBT has indicated it wishes to extinguish. To meet this concern, these family trusts could be subject to a withholding tax on the distribution of tax preferred income to beneficiaries.

This method of reforming trusts would go a long way to protecting the interests of small businesses, while keeping compliance costs to a minimum, and at the same time meeting the aim of the RBT to subject tax-preferred income to tax.

The paper is presented in two parts:

Part One examines in more detail this key recommendation for family trusts to be treated as excluded trusts. We also make other recommendations to work towards a more effective, efficient and equitable implementation of the reforms suggested by the RBT.

Part Two considers a number of other alternative options to the entity tax regime as currently proposed, including:

- excluding all trusts from the entity tax proposal;
- taxing trusts in the manner proposed for collective investment vehicles; or
- taxing trusts based on their purpose and use.

Part One recommendations

If the entity tax regime is implemented the following recommendations need to be factored into its operation and application to trusts:

- Discretionary trusts that make a family trust election under the current trust loss provisions should be treated as excluded trusts. To meet the aim of the RBT to subject tax-preferred income to tax, these family trusts could be subject to entity tax at the time of distribution of tax-preferred income to beneficiaries, with excess imputation credits refunded;

- Qualifying child maintenance trusts and testamentary trusts should be treated as excluded trusts;

- There should be no generally applicable profits first rule. If such a rule is introduced, there should be concessions for certain types of distributions. The US legislation may provide guidance on a possible approach;

- The proposed roll-over relief for life tenants should apply to disposals of all or a part of the life interest, and should be permitted within five years of the creation of the life interest as a minimum;

- Trust income should retain its character on distribution. Further, legislation should be introduced to ensure foreign source income of resident trusts that is distributed to non-residents is not taxable in Australia;

- Any review of rules for collection of unpaid entity tax should be targeted at arrangements deliberately designed to ensure an inability to pay tax. The rules existing under the corporations law and the *Crimes (Taxation Offences) Act* should be adapted to encompass trusts falling within the entity regime. The Revenue should not be distinguished from other creditors, at least in the absence of some form of intent to defraud;

- The proposal to apply CGT where assets are transferred to entities rather than to individuals by a legal personal representative (LPR) should be rejected, as it amounts to tax on unrealised gains and also imposes a de-facto death duty;

- The resettlement option should be rejected and the value shifting rules applied. Also the treatment of gifts and assets bequeathed to existing trusts and trust resettlements needs to be clarified;

- No new anti-avoidance legislation should be introduced unless its scope is very clearly defined;

- Capital gains tax (CGT) rollover relief should be extended to roll-overs of assets between trusts and also between companies and trusts;

- Existing trusts should continue to be dealt with under the current legislation and given, say, five years to facilitate the winding up of their affairs;

- Pre-existing loans from trusts to beneficiaries should be grandfathered to exclude them from the proposed extended Division 7A provisions;

- Corpus should be excluded from the profits first rule for an extended period after the implementation date;

- Transitional provisions should be introduced to overcome business cash-flow issues associated with the change to the entity tax regime;

- Regardless of whether trusts are taxed as companies, the anomaly identified relating to dividend reinvestment plans and companies should be addressed as part of the current tax reform process. The amending legislation should be made retrospective to the time the anomaly became law; and

- The double tax issue relating to temporary tax preferences and fixed interests in trusts should be amended to restore equity in the law.

Part Two recommendations

Some other alternatives to the Government's entity tax proposal to which the RBT must give serious consideration are:

- That trusts be recognised as the structure that best meets the design principles established in *A Strong Foundation* and as such, remain outside the reforms suggested for other entities to be taxed like companies; or

- If trusts are to be taxed as companies, they should be treated in the same manner as that proposed for collective investment vehicles (CIVs); or

- Trusts that are 'carrying on an enterprise' be taxed as companies. Trusts used for passive investment or asset protection that satisfy the trust loss family trust rules should not be subject to the proposed entity tax regime.

Scope and purpose of the paper

The Government's policy is to implement an entity tax regime that will include the taxation of trusts. This proposal has been extensively outlined in both *A New Tax System* (*ANTS)* and *A Platform for Consultation.* Based on this policy decision there are a number of issues that need to be taken into account to ensure implementation meets the criteria of efficiency, equity and simplicity.

We acknowledge that there is a trade-off between this criteria but believe that simplicity has not been given due weight in the proposed reforms.

Most importantly, there is nothing in the entity tax proposals that would simplify or reduce the compliance costs in respect of trusts. On the contrary, it is difficult to envisage how the proposals could be made more complex. For example, the capital distributions rules, including the profits first rule and the slice approach will add significantly to compliance costs. Even describing these proposals runs to several pages.

This submission examines the proposal to tax trusts under an entity tax regime, including recommendations on how this proposal could be most effectively implemented. It also considers, where possible, the impact of the proposal on the costs of compliance for small business.

Why small business?

Small businesses make a significant contribution to the Australian economy. Small businesses lodged nearly 4 million tax returns in 1996-97. This represented over one third (34%) of all returns lodged, 30% of total income, 24% of all taxable income and 27% of net tax.[1]

The small business sector is also a major provider of employment in Australia. For example, small business provided over 3,247,300 jobs, or over 50% of the total private sector jobs in 1996-97.[2]

The link between small business and trusts

Trusts are an important business and investment vehicle for small business. This is evidenced by the fact that there were 427,431 trust returns lodged with the ATO in 1996-97.[3] The majority of these trusts (60%) are clients of the ATO's Small Business Line. Less than 1% of trusts reporting business income were clients of the ATO's Large Business Income line.[4]

[1] Australian Taxation Office, *Small Business Statistics* 1996-97, p. 33-34.
[2] Australian Bureau of Statistics, *Australia Now- A Statistical Profile, Special article – Employment generation by the small business sector* 1999, p. 2.
[3] Australian Taxation Office, op cit., p.81.
[4] Australian Taxation Office, op cit., p. 83.

Small business and costs of compliance

Compliance and costs of compliance are significant issues for small business. Much of this stems from the current complexity of our tax laws. This has been identified and covered extensively in the ASCPA's previous submission to the RBT titled *Tax reform issues for small business*[5].

[5] Chris Evans and Angela Ryan, *Tax reform issues for small business*, ASCPA April 1999, especially pp58-62.

1. The proposed entity tax regime

The following is a list of specific issues and recommendations based on the proposed entity tax regime as outlined in *ANTS* and *A Platform for Consultation.*

Family trusts be treated as excluded trusts

There is a strong case to treat family trusts as excluded trusts under the entity tax regime. This would enable discretionary trusts, that make the family trust election under the existing trust loss rules, to be excluded from the entity tax proposal.

However, recognising the Government policy to prevent the flow through of tax preferred income, it would be possible to introduce provisions to ensure that distributions of tax preferences were taxed at entity level. Such a move would meet the Government's objective, while at the same time not subjecting small business to a complete overhaul in how trusts are taxed.

From an equity perspective, this arrangement would put discretionary trusts on a level footing with fixed trusts which currently are subject to s104-70 and s110-25 ITAA97 (previously s160ZM ITAA36)[6].

As tax-preferred income would be taxed, this proposal is revenue positive for the Government.

The key argument for family trusts to be treated as excluded trusts under the entity tax regime is because of the major disruption and upheaval that would be created without such an exclusion. Studies of compliance costs all show that small business already bear a disproportionate burden of compliance costs[7]. Reform should be aimed at reducing that disproportionate burden, not adding to it.

As the small business sector makes extensive use of trusts, additional compliance costs associated with the tax treatment of trusts will be concentrated on this sector. As the small business sector is already being asked to bear the highest proportionate costs in relation to the other major leg of tax reform – the GST – it is important that business tax reforms keep additional compliance costs for small businesses to an absolute minimum.

In addition, small business makes a substantial contribution to the Australian economy and employment.

Recommendation 1.1

Discretionary trusts that make a family trust election under the current trust loss provisions should be treated as excluded trusts. To meet the aim of the RBT to subject tax-preferred income to tax, these family trusts could be subject to entity tax

[6] However there is a separate outstanding issue relating to the reduction of fixed interests later in this paper.
[7] Chris Evans and Angela Ryan, op cit., Appendix A p 58 – 62.

at the time of distribution of tax-preferred income to beneficiaries, with excess imputation credits refunded.

Other excluded trusts

Given the good policy reasons for excluding qualifying child maintenance trusts and testamentary trusts from the penalty taxing rules in Division 6AA of *ITAA* 1936, which are to continue post tax reform, it would be appropriate to treat these trusts as excluded trusts. To subject them to tax under the entity tax regime, and later refund tax to beneficiaries, is inefficient and an unnecessary compliance burden.

Recommendation 1.2

Qualifying child maintenance trusts and testamentary trusts should be treated as excluded trusts.

Profits first rule

The RBT proposes the introduction of a profits first rule. It states that:

> *19.11 A profits first rule would treat an entity distribution as coming from profits to the extent that there were 'distributable profits' available. Once distributable profits were reduced to zero, distributions would be treated as coming from contributed capital.*
>
> *19.12 Central to the operation of the profits first rule would be the definitions of contributed capital (discussed below) and distributable profits. Distributable profits could be defined as the market value of the entity's net assets less contributed capital at the time of distribution.*
>
> *19.13 In practice, most entities would be able to rely on book values in calculating distributable profits. This is because distributable profits would not commonly be exhausted by an entity's distribution. However, book values would not be appropriate in a number of situations. For example, if:*
>
> - *distributable profits are close to being exhausted (in which case using market values would increase distributable profits where there are unrealised capital gains);*
> - *book values are greater than market values (a result of unrealised capital losses, which would overstate the level of distributable profits); or*
> - *there is an in-kind distribution (in which case there would be taken to be a distribution at market value).*
>
> *19.14 In such cases an accurate measure of net market values would be necessary.*[8]

[8]Review of Business Taxation, *A Platform for Consultation*, February 1999, p. 427- 428.

The statements that '*In practice, most entities would be able to rely on book values in calculating distributable profits. This is because distributable profits would not commonly be exhausted by an entity's distribution.*' are not accurate for the majority of discretionary trusts. In fact, most discretionary trusts have default beneficiary clauses to ensure that all realised profits are distributed each year and not maintained in the trust to be taxed at penalty rates.

The proposed profits first rule is not supported. The compliance costs associated with determining an accurate measure of net market value will be problematic for all businesses.

The costs of compliance in determining '*an accurate measure of net market values'* as proposed under the application of the profits first rule would be particularly onerous for small business as they would have to go through an asset revaluation each year to determine if there were unrealised profits.

Profits first and returns of capital

There are also other potential major problems associated with the profits first rule and discretionary trust beneficiaries. Although not clear from *A Platform for Consultation,* it is conceivable that the withdrawal of capital by way of corpus distribution to a beneficiary (whose parent might have settled that sum on trust or gifted the amount some years earlier) may be treated as a distribution out of profits. This could occur if, on revaluation of the trust's assets to their market value, there are distributable profits. This seems to be harsher than under the slice approach (where there is an extinguishment of a beneficiary's interest).[9]

Furthermore, the *RBT* notes that contributed capital might not arise (or it would be limited) where the settlor retains rights (other than as trustee) in relation to the property, or the trustee is required to pay for the property[10]. It should be made clear that this rule will not apply simply because the settlor is an appointor or guardian of the trust, or perhaps a default beneficiary.

Recommendation 1.3

There should be no generally applicable profits first rule. If such a rule is introduced, there should be concessions for certain types of distributions. The US legislation may provide guidance on a possible approach.

Life interests

The *RBT* proposes roll-over relief if a life tenant disposes of his or her life interest within one year of its creation[11]. There are two concerns with this proposal. First, roll-over relief should apply whether all or only part of a life interest is disposed of (for nil consideration to a remainderman). Second, the one year window proposed is

9 As pointed out in the Review of Business Taxation, op cit., (at para. 22.74, p. 496-497), beneficiaries of discretionary trusts who cannot be said to have any interest in the trust will never have a cost base for their interest and distributions to them will always be profit distributions.

10 Review of Business Taxation, op cit., p. 433

11 Review of Business Taxation, op cit., p. 505.

far too short. Indeed, there is no need for any time limit. If a limit must be imposed, it should be no shorter than five years. It often takes a considerable period for the estate of a deceased to be administered and for a surviving spouse to determine what income and assets they will need to support themselves for the remainder of their lives. Often, these people are elderly, conservative, and are unable to make important and far reaching decisions without considering them over substantial periods of time.

Recommendation 1.4

The proposed roll-over relief for life tenants should apply to disposals of all or a part of the life interest, and should be permitted within five years of the creation of the life interest as a minimum.

Non-residents in receipt of foreign-source income

Under the current law, if the foreign source income of a resident trust is distributed to non-residents, no Australian tax is payable. Given the residence of the beneficiary and the source of the income, this is a sensible outcome. Problems are likely to arise if the existing definition of resident trust estate is maintained in these circumstances, ie. if only one of a number of trustees is an Australian resident, the trust would be a resident trust and subject to entity taxation.

Income tracing would assist here. However we believe specific provisions would be required to ensure that foreign source income of resident trusts that is distributed to non-residents is not taxable in Australia.

Recommendation 1.5

Trust income should retain its character on distribution. Further, legislation should be introduced to ensure foreign source income of resident trusts that is distributed to non-residents is not taxable in Australia.

Tax liabilities of entities

It is proposed that procedures for collection of unpaid tax liabilities need to be reconsidered[12]. The proposal is that those individuals who were knowing parties to an arrangement which resulted in the entity being unable to pay its tax liability should themselves be liable to pay the tax. It also suggests that the test be extended to parties related to the knowing parties.

While some changes may be required to protect the revenue, any changes should be limited in their application to circumstances where a ‘knowing party’ conspired or entered into an arrangement with the intention of rendering the entity incapable of paying its tax liabilities. It would be inequitable and contrary to any notion of justice to make an individual liable for an entity’s tax liabilities if that person has neither taken part in stripping the entity of its ability to pay nor derived any benefit from rendering the entity incapable.

[12] Review of Business Taxation, op cit., paras. 21.37- 21.41, p. 476-477.

A strict set of criteria needs to be developed rather than a general rule, and there should be no Commissioner's discretion. If the proposed rules are too broad the results could be absurd. For example, a bona fide entity may trade profitably in year one producing a tax liability and then trade unprofitably in year two. If the entity is unable to pay the tax liability, the Commissioner could potentially seek redress against the individuals operating the entity's business and/ or related parties.

Recommendation 1.6

Any review of rules for collection of unpaid entity tax should be targeted at arrangements deliberately designed to ensure an inability to pay tax. The rules existing under the corporations law and the Crimes (Taxation Offences) Act should be adapted to encompass trusts falling within the entity regime. The Revenue should not be distinguished from other creditors, at least in the absence of some form of intent to defraud.

Treatment of asset transfers by a legal personal representative (LPR)

Currently there is CGT rollover relief for direct generational transfers of assets between individuals where the transfer is a consequence of the death of one of the individuals. Rollover relief also applies where assets are transferred to a Legal Personal Representative (LPR) then to a trustee of a testamentary trust. That is, it is possible to defer tax on capital gains by transferring property to taxpayers with perpetual lives such as companies or trusts using the rollover provisions. According to *A Platform for Consultation* this type of arrangement offers a significant avenue for tax avoidance[13]. The RBT proposes that the CGT rollover relief accorded to individuals should still continues, but where assets are transferred to entities by a LPR a capital gain or loss will arise.

The current provisions are necessary to protect the interests of minors and others under legal disabilities. It is of concern that any changes will severely disadvantage those people who need a greater degree of care and protection.

There is no mischief or avoidance under the existing law in relation to rollover relief on transfers of assets by a LPR to an individual or entity. A capital gain/loss will be realised by an individual, or other entity when the bequeathed assets are eventually disposed of. Currently tax on accrued gains on assets can be deferred indefinitely by either individuals or entities, by simply not disposing of the assets. This does not amount to tax avoidance, merely tax deferral.

Recommendation 1.7

The proposal to apply CGT where assets are transferred to entities rather than to individuals by a LPR should be rejected, as it amounts to tax on unrealised gains and also imposes a de-facto death duty.

[13] Review of Business Taxation, op cit., paras. 22.84- 22.100, p. 499-502.

Trust resettlements

Currently neither trust law nor taxation law is clear as to what constitutes a resettlement. The RBT sets out circumstances that could be taken into account in developing a broad statutory definition which states:[14]

22.51 ……..Circumstances which could be taken into account in developing statutory tests for resettlements are explained by the following questions.

- *Have new beneficial interests in the trust property been created, and are those new interests substantial? This might occur because the trustee acquires a beneficial interest, or because a new class of beneficiaries is introduced.*
- *Have existing rights or beneficial interests been varied in a manner that changes the substance or nature of the interests?*
- *Have there been any changes in the purpose for which the property is held?*
- *Has a new charter of future rights and obligations been created?*
- *Has a new or different relationship been established (bearing in mind that a trust is the relationship or circumstance in which a trustee holds property for another person or purpose)?*
  - *An indication that a new or different relationship has been established may be if a new person (a beneficiary) or a new purpose is introduced.*
  - *Another indication may be if a varied regime of interests is provided for, different in substance from that which previously existed.*
- *Has additional property been settled on the trust that results in the creation of a second trust, even if that trust is on the same terms as the first trust?*

22.52 The statutory resettlement rules could potentially apply in a wide range of situations, including the following:

- *an arrangement which involves the takeover or merger of two or more trusts;*
- *changes or additions to the beneficiaries or classes of beneficiaries in trusts (for example, to include spouses, new employees, or related companies or trusts); and*
- *an exercise by the trustee of a power of advancement or appointment.*

Such a broad statutory definition of resettlement is of concern, as existing case law and stamp duty legislation indicate that a resettlement is not triggered nearly as easily as would occur under such a definition.

It is not necessary to define what constitutes a resettlement especially if the value shifting rules option (Option 2 in *A Platform for Consultation*) is applied to unit trusts, which is logical. However the treatment of gifts and assets bequeathed to existing trusts in regards to resettlement of a trust is unclear.

[14] Review of Business Taxation, op cit., pp.491-492.

Recommendation 1.8

The resettlement option should be rejected and the value shifting rules applied. Also the treatment of gifts and assets bequeathed to existing trusts and trust resettlements needs to be clarified.

Anti-avoidance

The *ANTS* package proposed the introduction of an anti-avoidance measure dealing with *taxation minimisation opportunities driven by the different treatment of trusts and companies*[15], with immediate effect.

The uncertainty created by announcements of this type are worse than ‘legislation by press release’. No taxpayer could reasonably anticipate what this means, let alone structure their affairs or carry on business so as to ensure that such a measure would not apply.

The comment is not clarified or expanded on by the RBT in any of their discussion papers either.

We recommend that no such anti-avoidance measure be introduced unless its scope is very clearly defined.

Recommendation 1.9

No new anti-avoidance legislation should be introduced unless its scope is very clearly defined.

Trusts and CGT rollover relief

If trusts are taxed as companies it would follow that the CGT rollover relief should be extended to rollovers of assets between trusts and also between companies and trusts.

Recommendation 1.10

CGT rollover relief should be extended to rollovers of assets between trusts and also between companies and trusts.

Transitional provisions

Both *ANTS* and the RBT outline certain transitional provisions in relation to trusts and the entity tax regime. However for equity reasons further transitional measures should be considered. These include:

- Winding up rule – existing trusts should continue to be dealt with under the current legislation and given, say, five years to facilitate the winding up of their affairs to overcome ‘fire-sale’ activity;

[15] Commonwealth of Australia, *Tax reform – not a new tax a new tax system* (ANTS), p. 121-122

- There should be quarantining and grandfathering for pre-existing loans from trusts to beneficiaries to exclude these from the proposed extended Division 7A provisions;

- Corpus should be excluded from the profits first rule for an extended period post implementation date;

- If we move from taxing entitlements to taxing distributions there should be a mechanism to allow a credit for tax which might not be payable until the following year. In the absence of any certainty of the final outcomes, there is a risk there are significant cash flow issues relating to the replacement of inter alia, provisional tax for some beneficiaries to PAYG for trusts.

Recommendation 1.11

Existing trusts should continue to be dealt with under the current legislation and given, say, five years to facilitate the winding up of their affairs.

Recommendation 1.12

Pre-existing loans from trusts to beneficiaries should be grandfathered so that they are excluded from the proposed extended Division 7A provisions.

Recommendation 1.13

Corpus should be excluded from the profits first rule for an extended period after the implementation date.

Recommendation 1.14

Transitional provisions should be introduced to overcome business cash-flow issues associated with the change to the entity tax regime.

Cost base of shares for dividend reinvestment plans

There is currently an anomaly in s6BA ITAA36 that affects the cost base of shares acquired by companies under dividend reinvestment plans. Essentially it creates a double tax situation for companies.

As indicated above, the problem is currently limited to companies. However if trusts are taxed as companies, this anomaly will be extended to trusts that invest in dividend reinvestment plans also.

Many small businesses and 'mum and dad type' taxpayers invest in shares through trusts. It is important that the RBT tax reform process be used to address anomalies in the law where identified even if the issue is not specifically part of the original framework proposed in ANTS and *A Platform for Consultation*.

Recommendation 1.15

Regardless of whether trusts are taxed as companies, the anomaly identified relating to dividend reinvestment plans and companies should be addressed as part of the current tax reform process. The amending legislation should be made retrospective to the time the anomaly became law.

Double taxing of unit trust beneficiaries

The current operation of the income tax laws creates an iniquitous outcome regarding the taxation of beneficiaries on tax preferred income.

For example, assume a unit trust has accounting income of $100 but taxable income of $80 after allowing for, say, accelerated depreciation of $20 in a year. Currently the unit trust distributes $100 and the beneficiary will be assessed on $80. However the cost base of the beneficiary's units will be reduced to reflect the distribution of part of the corpus of the trust (the $20) by virtue of the operation of s104-70 and s110-25 ITAA97 (previously s160ZM ITAA36).

In the most simple case the depreciation timing difference will reverse in year 2, such that the trust has an accounting profit of $80 but net income for tax purposes of $100. The beneficiary receives $80 and is subject to tax on $100. However, the cost base adjustment from year 1 does not reverse. The beneficiary has been subject to tax on $180 plus a cost base reduction (or assessable gain) of $20, representing a total taxable base of $200. However the total profits of the trust are only $180.

In respect of trusts falling outside the entity tax regime (assuming an entity tax regime is introduced) this anomaly could be rectified by either:

- allowing the beneficiary an increase in the cost base of the units in year 2; or
- allowing the beneficiary a deduction in year 2 for the excess of net income for tax purposes over accounting profit.

For entities subject to tax under the entity tax regime, options to alleviate double tax in the context of a full imputation system have been considered in Chapter 15. Option 2 is the preferred option.

If the entity tax regime is implemented, the application of this anomaly in the law will be extended to a much larger range of taxpayers.

However, regardless of the outcome of the entity tax regime, this is an issue that needs to be corrected.

Recommendation 1.16

The double tax issue relating to temporary tax preferences and fixed interests in trusts should be amended to restore equity in the law.

2. Alternatives to the entity tax proposal

The RBT is considering proposals constrained by the principle of revenue neutrality. We have not had access to any other options the Government and Treasury have considered, and their relative costings, in arriving at the options they have published.

Therefore, it has not been possible to develop arguments for all alternatives canvassed in Part Two of this submission that meet the revenue neutrality criterion. The RBT is in a better position to obtain these details from Treasury in determining whether any of the alternatives proposed in this paper are achievable.

Exclude all trusts from the entity tax proposal

ANTS and RBT proposals

The ANTS policy document proposed that trusts should be taxed like companies. The rationale for this proposal is that: 'It does not make sense for exactly the same investment to attract very different tax treatment simply because it is put through a trust rather than a company'.[16]

Prima facie this rationale has some merit from the perspectives of simplicity and consistency. However there is more than one way to ensure consistent treatment - one is to treat trusts like companies as proposed in ANTS, while the other is to treat companies like trusts.

If the principles that are set out in the RBT's first report, *A Strong Foundation* are adhered to then it becomes evident that trusts should be the entity of choice and that companies should be treated like trusts.

Trusts to be excluded from the entity tax regime

In setting out its policy design principles, the first RBT report *A Strong Foundation* stated, inter alia, that there should be:

- *Integration of ownership interests. For business tax - as distinguished from commercial or legal - purposes, entities should be considered as extensions of their ultimate owners.*

- *Horizontal and transitional equity. Under the integration principle, ability to bear tax ultimately refers only to natural persons, not entities, so that for tax purposes all income ….. should be taxed comparably,* and

- *Taxation of comprehensive income. Comprehensive income is defined as the sum, over an annual period, of the taxpayer's current revenue less current costs, plus the net change in the value of the taxpayer's assets and liabilities.* [17]

[16] Commonwealth of Australia, op cit., p 113.
[17] Review of Business Taxation, *A Strong Foundation*, December 1998, p.69.

When considered collectively, these three principles suggest that the most desirable form of vehicle for investments would be one that:

- is a totally transparent structure;

- where all income that accrues in a year is attributed to a natural person in that year, and

- the income is taxed in a manner consistent with the tax treatment that would have applied had that person made that investment directly.

If we look at the business and investment vehicles available, only a trust meets the desired criteria of being totally transparent, and under which all income is attributed in the year it is derived.

In law, a trust is not really a separate taxable entity, despite the fact that a return of trust income must usually be filed by the trustee. Trust income is generally taxed in the year it is derived by the trust, and it is taxed either to the trustee or the beneficiaries (or a portion is taxed to each):

- Trust income assessable to a beneficiary is generally aggregated with the beneficiary's other assessable income and is assessable at whatever rate of tax is applicable to the beneficiary. It is clear, then, that the trust is only an extension of the ultimate owner or objects of the trust; and

- Where income is not assigned to a beneficiary, the income becomes assessable to the trustee at the top marginal tax rate.

What this demonstrates is that the trust model is the one that most closely satisfies the principles outlined in *A Strong Foundation*. What appears to emerge from the RBT proposals to tax trusts as companies is to take this perfectly transparent form, and make it into something that is opaque. The proposal entirely contradicts the principles the RBT has itself identified.

The proposal to tax trusts as companies also presumes that the current companies or the proposed entity tax regime are superior to all other alternatives, which is in itself a rebuttable presumption.

The key to taxing trusts is attribution, not distribution. In that sense, the focus of many of the RBT proposals on distribution and retention miss the point. If taxation at the entity level was really intended to replicate that of companies, it might be expected that the trustee would be the taxpayer of first resort in respect of entity level tax paid on current year income (with beneficiaries then making up the difference/claiming the excess in relation to their individual tax rate at a later point in time, which would be in the year of distribution rather at the time of attribution). Is this what is intended as this would actually result in a timing revenue loss to Government?

Recommendation 2.1

That trusts be recognised as the structure that best meets the design principles established in A Strong Foundation, and as such, remain outside the reforms suggested for other entities to be taxed like companies.

Trusts taxed as collective investment vehicles

What are the problems the RBT wants to address in relation to trusts?

Given this background outlined in alternative 1 above we can identify more closely what the Government perceives to be the major problem with trusts The key difference between companies and trusts that the RBT also makes mention of is that under a trust structure there is no 'washing out' of tax preferences/tax preferred income on distribution of trust income, whereas under a company structure distributions of tax preferred amounts are taxed in the hands of the recipient.

This relates to another principle espoused in the RBT's first report that states:

Business income should not bear more than a single layer of Australian taxation.[18]

However, *A Strong Foundation* leaves the question open as to whether or not tax preferences should be passed through – that is, whether no tax or a single layer of tax should apply[19]. The *Platform for Consultation* clarifies the position saying that the *potential negative ramifications of tax preference flow-through [primarily revenue loss, or costs incurred in making up the revenue elsewhere] argue against removing, for entities, the claw back of tax incentives already applying to companies*.[20]

Therefore it seems that the major 'problem' identified with trusts is that washing out of tax preferences does not occur. Consequently, the bulk of the proposed changes seem to be directed at taxing distributions of tax preferred income and unrealised profit distributions at the beneficiary level.[21]

While we do not concur with the notion that maintaining tax preference flow through for trusts is a problem, the question then becomes one of how this might be addressed without having to make the sort of major overhaul suggested in the RBT options. That is, can the 'problem' of tax preference flow through be addressed more directly than is proposed - thereby making the reforms less dramatic, and also less costly in terms of transition and compliance?

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[18] Review of Business Taxation, op cit., p. 69.
[19]Review of Business Taxation, op cit., p. 75.
[20] Review of Business Taxation, op cit., p.17-18.
[21] However it is also noted that it is proposed that the Division 7A provisions and FBT provisions will be extended to loans made to beneficiaries (and associates) of discretionary trusts and closely held fixed trusts and to fringe benefits provided to beneficiaries, as the case may be, to prevent beneficiaries accessing economic benefits from trusts via means other than trust distributions.

Even in the absence of any statistical data it is clear that the cost of introducing a system that addresses the Government's key issue of the flow through of tax preferences would be much less costly in terms of compliance and administration than the proposed comprehensive entity tax regime.

Further there is no cost to the revenue. In fact such a system would be revenue positive.

Many tax preferences may be removed

It is also likely that following the conclusion of the RBT review, many existing tax preferences may be removed or substantially reduced. Therefore the size of the tax preference problem will itself be reduced, although not eliminated.[22]

Nevertheless, this leaves the possibility that the reform required to address the Government's issue with tax preferences is to equate trusts with companies only insofar as distributions of tax preferred income are concerned.

Under the proposals for companies, is seems that the additional distributions tax (deferred company tax or the other options put forward) will apply when the distribution is made via a dividend to the shareholders. To emulate this situation, it would be appropriate for trusts to be treated in the manner outlined for collective investment vehicles, which states:

Under this option, tax-preferred income distributed by CIVs would be taxed in a way equivalent to distributions by entities. However, distributions of taxable income would retain their character, which would result in distributed capital gains and foreign source income being taxed in a different manner to similar distributions by other entities. This treatment would put CIVs, and business structures incorporating a CIV*, on a similar competitive footing to other entities*.[23]

Recommendation 2.2

If trusts are to be taxed as companies, they should be treated in the same manner as that proposed for Collective Investment Vehicles (CIVs).

Tax trusts according to their purpose and use

ANTS also identifies the advantage of limited liability afforded by an entity as a characteristic which should determine whether tax should be imposed at the entity level and whether tax preferences should flow through to the individual investor.[24]

Limited liability is an illogical basis for determining tax liability or a method of taxation.

[22] The RBT itself notes that tax preferred income can arise for reasons other than incentives.
[23] Review of Business Taxation, op cit., para.16.30, p. 375.
[24] Commonwealth of Australia, op cit., p. 109.

For example, partners can limit their liability arising out of their business activities simply by ensuring that they have divested themselves of all their assets by transferring them to a spouse or to a trust for the benefit of the family. Conversely, individuals carrying on a business through a company or a discretionary trust often must expose themselves to the liabilities of the entity by giving the guarantees usually required of small business operators by their lenders.

If in fact the aim is to subject all business activities to the same taxation treatment regardless of the entity in which it is conducted, then a more appropriate test would be one of whether the activity of the entity is an active business or passive investment.

One way of distinguishing between active trusts and passive trusts would be to adopt the concept of 'carrying on an enterprise' that is central to the proposed Goods and Services Tax (GST). If an entity is carrying on a business or enterprise for one revenue collection purpose, then it will also be carrying on a business or enterprise for other revenue purposes. Adoption of this definition would enable determination of whether a trust is active or passive. If the trust is active than the entity tax would apply. If the trust is passive then the current legislation would apply.

Trusts which are established as passive investment vehicles should continue to be taxed as they are under the present system, i.e., their income is taxed directly to the beneficiaries unless the trustee determines that no distribution should be made, in which case it is taxed to the trustee at the top individual marginal rate. To ensure that the passive investment vehicle is established and maintained for the benefit of the family for whom it was established, the flow through of income can be made dependent on the trust being a family trust as defined under, say, the trust loss provisions. This should provide a safeguard against the trust being so versatile as to allow tax avoidance. A similar approach is applied in the USA.

A Platform for Consultation outlines that the suggested approach for passive investments is appropriate for Collective Investment Vehicles (CIVs). From an equity viewpoint the same treatment should be afforded to investors at the smaller end of the scale.

Asset protection trusts should not be subject to entity taxation.

Recommendation 2.3

Trusts that are 'carrying on an enterprise' be taxed as companies. Trusts used for passive investment or asset protection that satisfy the trust loss family trust rules should not be subject to the proposed entity tax regime.

Summary of recommendations

Part One

Family trusts be treated as excluded funds

Recommendation 1.1

Discretionary trusts that make a family trust election under the current trust loss provisions should be treated as excluded trusts. To meet the aim of the RBT to subject tax-preferred income to tax, these family trusts could be subject to entity tax at the time of distribution of tax-preferred income to beneficiaries, with excess imputation credits refunded.

Other excluded trusts

Recommendation 1.2

Qualifying child maintenance trusts and testamentary trusts should be treated as excluded trusts.

Profits first rule

Recommendation 1.3

There should be no generally applicable profits first rule. If such a rule is introduced, there should be concessions for certain types of distributions. The US legislation may provide guidance on a possible approach.

Life interests

Recommendation 1.4

The proposed roll-over relief for life tenants should apply to disposals of all or a part of the life interest, and should be permitted within five years of the creation of the life interest as a minimum.

Non-residents in receipt of foreign-source income

Recommendation 1.5

Trust income should retain its character on distribution. Further, legislation should be introduced to ensure foreign source income of resident trusts that is distributed to non-residents is not taxable in Australia.

Tax liabilities of entities

Recommendation 1.6

Any review of rules for collection of unpaid entity tax should be targeted at arrangements deliberately designed to ensure an inability to pay tax. The rules existing under the corporations law and the Crimes (Taxation Offences) Act should be adapted to encompass trusts falling within the entity regime. The Revenue should not be distinguished from other creditors, at least in the absence of some form of intent to defraud.

Treatment of asset transfers by a legal personal representative (LPR)

Recommendation 1.7

The proposal to apply CGT where assets are transferred to entities rather than to individuals by a LPR should be rejected, as it amounts to tax on unrealised gains and also imposes a de-facto death duty.

Trust resettlements

Recommendation 1.8

The resettlement option should be rejected and the value shifting rules applied. Also the treatment of gifts and assets bequeathed to existing trusts and trust resettlements needs to be clarified

Anti-avoidance

Recommendation 1.9

No new anti-avoidance legislation should be introduced unless its scope is very clearly defined.

Trusts and CGT rollover relief

Recommendation 1.10

CGT rollover relief should be extended to rollovers of assets between trusts and also between companies and trusts.

Transitional provisions

Recommendation 1.11

Existing trusts should be treated under the current legislation and given, say, five years to facilitate the winding up of their affairs.

Recommendation 1.12

Pre-existing loans from trusts to beneficiaries should be grandfathered so that they are excluded from the proposed extended Division 7A provisions.

Recommendation 1.13

Corpus should be excluded from the profits first rule for an extended period after the implementation date.

Recommendation 1.14

Transitional provisions should be introduced to overcome business cash-flow issues associated with the change to the entity tax regime.

Companies and dividend re-investment plans

Recommendation 1.15

Regardless of whether trusts are taxed as companies, the anomaly identified relating to dividend reinvestment plans and companies should be addressed as part of the current tax reform process. The amending legislation should be made retrospective to the time the anomaly became law.

Double taxing of unit trust beneficiaries

Recommendation 1.16

The double tax issue relating to temporary tax preferences and fixed interests in trusts should be amended to restore equity in the law.

Part Two

Alternatives to the entity tax proposal

Recommendation 2.1

That trusts be recognised as the structure that best meets the design principles established in A Strong Foundation, and as such, remain outside the reforms suggested for other entities to be taxed like companies.

Recommendation 2.2

If trusts are to be taxed as companies, they should be treated in the same manner as that proposed for Collective Investment Vehicles (CIVs).

Recommendation 2.3

Trusts that are ‘carrying on an enterprise’ be taxed as companies. Trusts used for passive investment or asset protection that satisfy the trust loss family trust rules should not be subject to the proposed entity tax regime.

Glossary of abbreviations and acronyms

ABS	Australian Bureau of Statistics
ANTS	A New Tax System
ASCPA	Australian Society of Certified Practising Accountants
ATO	Australian Taxation Office
CGT	Capital Gains Tax
CIVs	Collective Investment Vehicles
DRP	Dividend Re-investment Plans
GST	Goods and Services Tax
ITAA36	Income Tax Assessment Act 1936
ITAA97	Income Tax Assessment Act 1997
LPR	Legal personal representative
PAYG	Pay As You Go
RBT	Review of Business Taxation