



# **The Trouble with Trusts**

**Report on the use of discretionary trusts to avoid tax**

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# Executive summary

## The Trouble with Trusts: Report on the Use of Discretionary Trusts to Avoid Tax

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This is an edited version of a submission made by ACOSS to the Board of Taxation in May 2002. It deals with the tax treatment of discretionary trusts (popularly known as "family trusts").<sup>1</sup> It argues that these entities are, in many ways, an ideal vehicle for income tax avoidance and puts forward a series of options to curb their use for this purpose.

A crack-down on the abuse of discretionary trusts to avoid tax was a key element of the Government's tax reform package. It was the most important of a small number of measures proposed to close off income tax avoidance opportunities for the well-off.

The need for such action has been officially acknowledged since at least 1985. It was acknowledged again by the Treasurer and the Taxation Commissioner in 1998, and in 2000 by the Government's Review of Business Taxation. The Government's proposed solution to the problem - taxing trusts as companies - was a core element of the agreements reached with the Australian Democrats and the Australian Labor Party to implement changes such as the GST, income tax cuts, and Capital Gains Tax cuts - many of which benefited high income-earners.

### Growth in the number of trusts

The overall number of trusts in Australia has risen dramatically from 120,000 in 1982 to 450,000 today. According to the ATO, most of the increase over the 1990s was due to the increased number of discretionary trusts. It is noteworthy that in 1998-99:

- Only 6% of trusts were for the purpose of primary production, despite widespread publicity two years ago over the alleged detrimental effects reform of their tax treatment would have on farmers.
- 29% of trust profits (\$2.6 billion out of a total of \$9.2 billion) accrued to 2% of tax-payers with incomes above \$100,000 - more than twice the percentage of taxable income from all sources (11%) received by that class of tax-payers.

### Their use for tax avoidance

Over the past 20 years, concerns have been raised about the use of discretionary trusts to avoid income tax. A raft of legislation has been passed to close various loopholes in their tax treatment that were exploited for avoidance or evasion purposes.

Discretionary trusts have long been recognised as the ideal entity for income splitting purposes, due to the flexibility with which trust income can be distributed in a given year to family members on the lowest marginal tax rates.<sup>2</sup>

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<sup>1</sup> Trusts are a set of obligations and rights whereby assets are transferred to a trustee to be held or invested on behalf of a group of beneficiaries. Discretionary trusts are trusts in which the trustee has discretion to allocate the income and assets of the trust to beneficiaries as it sees fit, subject to the trust deed and (usually) directions from the individual who transferred the assets (the transferor). Unlike the case of public "unit trusts" that solicit investments from the general public, the potential beneficiaries of discretionary trusts are usually closely related to the transferor and have no fixed entitlement to the income or assets of the trust.

<sup>2</sup> See quotes from various official reports on page 10.

Other well-documented strategies used by high income-earners to avoid tax by the use of these trusts include:

- trust stripping (identified and legislated against in the 1980s);
- trafficking in tax losses (identified and legislated against during the 1990s);
- the use of complex networks of trusts to re-characterise income, for example to "convert" ordinary business income to capital gains (identified and partly legislated against in the 1990s).

As each of these avoidance strategies was struck down, another emerged in its place. One of the strategies reportedly still in use is to revalue assets within a discretionary trust and distribute income arising from this revaluation as a tax free capital gain to beneficiaries. This is possible due to a loophole on the Capital Gains Tax legislation that effects *only* discretionary trusts and no other business or investment entity.

However, there have only been two attempts to fundamentally reform the tax treatment of these trusts - in 1986 and 2000. The first - the application of Capital Gains Tax to the untaxed and preferentially taxed income of trusts - was not applied to discretionary trusts, due to an unintended loophole in the legislation.

The second - the Government's draft "entity taxation" legislation - was withdrawn in the face of political resistance from the tax "industry", and technical criticisms. A key objective of that legislation was to tax different entities such as companies and trusts in like manner. Unfortunately, this provoked criticism of the Bill on the grounds that it only dealt with discretionary trusts.

### **Flaws in their tax treatment**

Although like treatment of different entities this is a useful reference point for policy, it is not a fundamental principle for a fair and efficient income tax system. The basic principle is that *individuals should be taxed on their income in a timely manner at their appropriate marginal tax rate*. The system should be designed so that transfers through entities like trusts are taxed in a timely manner in accordance with this principle. Attention should be paid to the economic substance of these transfers rather than their legal form. In this regard, the tax treatment of discretionary trusts is flawed in three ways:

1. Tax preferences (concessions) to encourage certain types of investment (such as capital gains tax and accelerated depreciation concessions) flow through to the beneficiaries of trusts, despite the fact that they effectively enjoy the benefits of limited liability, and many are not even investors. Similar tax treatment is denied to corporate shareholders on the grounds that they enjoy limited liability which reduces their investment risk.
2. There is no effective mechanism (such as the company income tax) to ensure that trust income is brought to tax in a timely manner. This is necessary to guard against tax avoidance and evasion practices involving the use of trusts (or networks of trusts) to conceal or re-characterise income, or to delay taxation. Indeed, the capital gains of discretionary trusts may escape tax entirely, due to the above-mentioned loophole.
3. A person who transfers income and assets to a discretionary trust usually continues to exercise effective control over those assets and income, yet he or she can still enjoy the tax benefits of splitting income with beneficiaries who are family members. Income that is distributed in this way should instead be taxed in the hands of the ultimate controller of the trust.

## Proposals to deal with tax avoidance through discretionary trusts

The opportunity for structural reform in this area must not be squandered. The problems identified above cannot be addressed by applying more legislative band aids. We advance two proposals to reform the tax treatment of discretionary trusts.<sup>3</sup>

### 1. Either:

#### **(1) Introduce a general withholding tax on trust income and capture tax preferences (concessions) within the trust;<sup>4</sup>**

This would bring the tax treatment of discretionary trusts more into line with that of companies. This was the broad strategy adopted in the Government's draft entity tax legislation (though there are probably simpler alternatives available).

### Or:

#### **(2) Apply the capital gains tax to untaxed and tax-preferred income distributed to beneficiaries.**

This would close off an unintended loophole in Capital Gains Tax (CGT) legislation that applies exclusively to discretionary trusts, and would bring the CGT treatment of these trusts into line with that of other entities (including fixed trusts). It would be relatively simple to legislate and administer.

One of the two alternative measures outlined above is needed to help ensure that trust income does not escape tax by the time it is distributed to beneficiaries. It should raise revenue broadly equivalent to estimates provided by the Review of Business Taxation: that is, up to approximately \$700 million per year.

#### **2. The Taxation Office should tax income that is distributed through discretionary trusts from a tax-payer to other parties on a non-commercial basis (for example to family members) as though it remains the income of the tax-payer concerned, in cases where that tax-payer is the ultimate controller of the trust.**

The Government did not intend to crack-down on income splitting through discretionary trusts when it introduced its draft entity tax legislation. Nevertheless, this is essential to prevent high income-earners from receiving a substantial tax benefit that is not available to the vast majority of tax-payers. Recent social security legislation prevents the "deprivation of income" by transfers to family members through trusts to avoid social security income tests. Anti-income splitting rules also apply in income tax law to prevent tax avoidance by Australian residents using foreign trusts. However, this does not apply generally to Australian trusts or companies. For consistency, this principle should extend to all private companies and trusts.<sup>5</sup>

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<sup>3</sup> It would be desirable to exempt some trusts from these changes, such as trusts established to manage the affairs of individuals incapable of doing so themselves.

<sup>4</sup> A tax at a rate equal to the top marginal tax rate plus Medicare Levy already applies to the undistributed profits of discretionary trusts. However, this does not apply to distributed profits. This tax could be extended to all trust income and treated as a withholding tax. A lower 30% tax rate would be consistent with the tax treatment of companies but the problem of high income-earners taking advantage of the lower corporate rate to defer tax on their income would then have to be addressed.

<sup>5</sup> Broadly speaking, income splitting is currently permitted in respect of investment income but not earned income. This is unfair. Income splitting generally is unfair in a progressive tax system based on individual income, because individuals on the highest marginal tax rates benefit the most.



# The Trouble with Trusts:

## Report on the Use of Discretionary Trusts to Avoid Tax

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### 1. A brief history of the tax treatment of trusts

The tax treatment of discretionary trusts has been the subject of debate over many years.

In 1985, trusts were identified as a major tax avoidance vehicle in the Draft White Paper on Taxation reform.

By that stage, the number of trusts had grown from 117,616 in 1972-73 to 258,846 in 1982-83. Two major reasons for this growth identified by the Treasury were their more generous tax treatment compared with companies, and the use of so-called "family trusts" (discretionary trusts) as an income splitting device.

Legislation introducing the new Capital Gains Tax in 1986 included a measure to address income tax avoidance through trusts (though not the income splitting problem). This measure would have led to the taxation of untaxed or preferentially taxed trust income as capital gains in the hands of beneficiaries. However, due to an alleged drafting flaw this was not applied to discretionary trusts by the ATO, as explained in Taxation Determination 97/15.

In the mid 1980s, there was a decline in the number of trusts. However, between 1989 to 1998 their number rose by more than 50% to 455,841.

In 1995, the Australian Taxation Office advised the then Treasurer that in the previous year, 80 individuals with a net worth of over \$30 million returned taxable incomes of \$20,000 or less. Elaborate trust structures played a key role in the tax avoidance techniques used to achieve this outcome. In some cases, it appears that income tax was simply evaded through the concealment or re-characterisation of income within these structures. The Treasurer was later advised that the revenue at risk from the abuse of trusts for this purpose by 100 high wealth individuals was \$500 million to \$800 million per annum.

In part to address this problem, legislation was passed in 1998 requiring the trustees of discretionary trusts to identify the "ultimate beneficiaries" of the trust, in cases where the transferor was a beneficiary. This was designed to assist the ATO in tracing the flow of income through discretionary trusts, especially complex networks of trusts. Prior to this, legislation was passed in 1997 to combat trafficking in trust losses to avoid income tax, although most "family trusts" were excluded from this measure.

In 1997, the Taxation Commissioner again highlighted the abuse of discretionary trusts by high income-earners to avoid tax.

To address this problem, the New Tax System package announced the following year committed the Government to taxing most trusts in like manner to companies. This was a key equity measure in the proposed package. It was the major structural change in the package to curb income tax avoidance by high income-earners.

As such, it was an important feature of the subsequent tax reform agreement between the Government and the Australian Democrats, leading to the legislation of a Goods and Services Tax (GST) in 2000.

The trust measures in a New Tax System were estimated to raise \$900 million in revenue in their second year of implementation, declining to \$430 million in year four.<sup>6</sup>

However, they were not legislated at the same time as the GST. Instead, these measures were referred for consideration to the Review of Business Taxation.

In 1999, the Review of Business Taxation released its draft report, which argued that inconsistencies in the tax treatment of different business and investment entities were inefficient, inequitable, and undermined the integrity of the income tax system.

The Review's final report was also released in that year. Once again, it proposed that discretionary trusts be taxed in like manner to companies. However, the Review also advocated a lower corporate income tax rate generally and argued that certain trusts, including public unit trusts, be excluded from this measure. This reduced the estimated revenue impact of taxing trusts like companies to around \$700 million in year two, declining to around \$300 million in year four.

In 2000, draft legislation to tax discretionary trusts as companies was introduced. Other elements of the broader entity tax regime proposed by the Review were held in abeyance.

In February 2001, this legislation was abandoned by the Government on the grounds that it was not feasible to tax discretionary trusts as companies. The Budget Papers for 2001-02 estimate that as a result, \$450 million in revenue will be foregone in year two, declining to \$300 million by year four.

The issue of the appropriate tax treatment of discretionary trusts was then referred to the Board of Taxation for consultation and advice.

This is what the 1985 *Draft White Paper on Tax Reform* said about the reasons for growth in the number of trusts during the 1970s and 1980s.

*"Tax minimisation has been the most important consideration underlying this substitution (of trusts for other business structures, although other factors in the case of private trusts (e.g. greater flexibility in distributing income and greater freedom from auditing and regulatory controls) have also played a part."*<sup>7</sup>

The *New Tax System* statement of 1998 had this to say about differences in the tax treatment of trusts and companies:

*"These outcomes are most unfair. Wealthier individuals with access to legal and accounting advice can target particular investments and structures to take advantage of the differences in tax treatment - and minimise the amount of tax they pay. The rest of the community subsidises the wealthy investor."*<sup>8</sup>

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<sup>6</sup> This estimate was mainly based on the capture of tax preferences within trusts, if they were taxed as companies.

<sup>7</sup> Treasury, *Draft White Paper on Taxation Reform*, page 52.

<sup>8</sup> Treasurer (1998), *A new tax system*, p108.

## 2. A statistical profile of trusts

The Australian Taxation Office (ATO) reports that in 1998-99 they were aware of 455,841 trusts. Regrettably, the Taxation Statistics do not provide separate estimates of the number of discretionary trusts. However, the vast majority of trusts are probably discretionary trusts and the ATO notes that they constitute most of the recent growth in the overall number of trusts.

Of the 455,841 trusts:

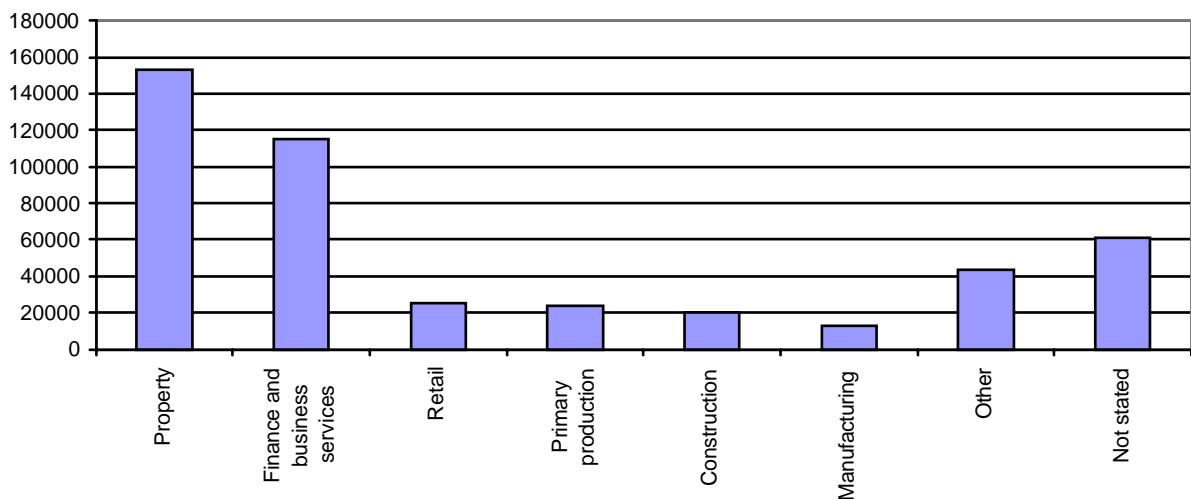
- 121,900 are categorised by the ATO as falling within their "individual non-business" line. Approximately 100,000 of these operate within the property sector. Many of these would be discretionary "family" trusts for the purpose of investment in property. Others would be trading trusts established for property development purposes.
- 333,289 are categorised within their "small business" line. Most are probably discretionary trading trusts, used to operate a small business and split the profits among family members.
- 652 are classified within their "large business and international" line. Most of these are probably fixed public trusts. Many operate within the retail sector.

### (1) Number of trusts by industry

The graph below indicates that the vast majority of trusts operate in either the property industry (39%) or the finance and business services industry (29%).

*Significantly, given the publicity surrounding claims about the effects of the Government's abandoned entity tax regime on farmers, only a small minority - 23,812 or 6% of all trusts - operate within the primary production industry. The vast majority of family farms operate through partnerships.*

**Trusts by industry (1998-99)**



Source: Taxation statistics (1998-99)

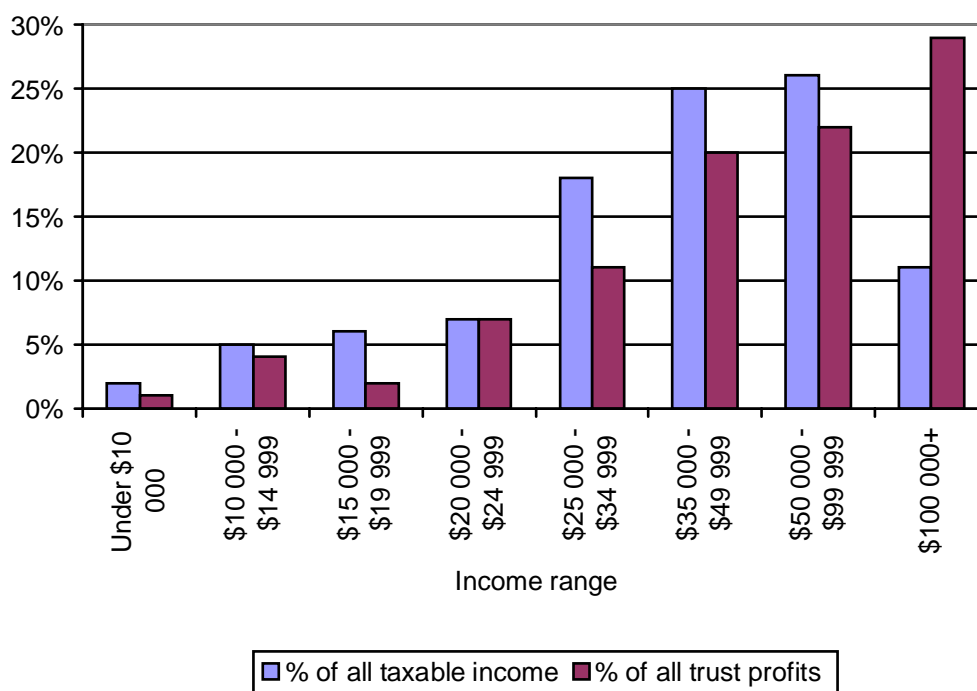
## (2) Distribution of trust profits

The graph below shows how the profits allocated to individual tax-payers by trusts in 1998-99 were distributed among tax-payers, by total income level.

*This shows a heavy weighting towards allocations to high-income individuals, despite the large numbers of low-income aged persons who invest in public unit trusts:*

- *The 2% of tax-payers on \$100,000 or more were allocated 29% of all trust profits, although this class of tax-payer received just 11% of all taxable income.*

**Distribution of trust profits, compared with all taxable income received by individuals (1998-99)**



Source: Taxation statistics (1998-99)

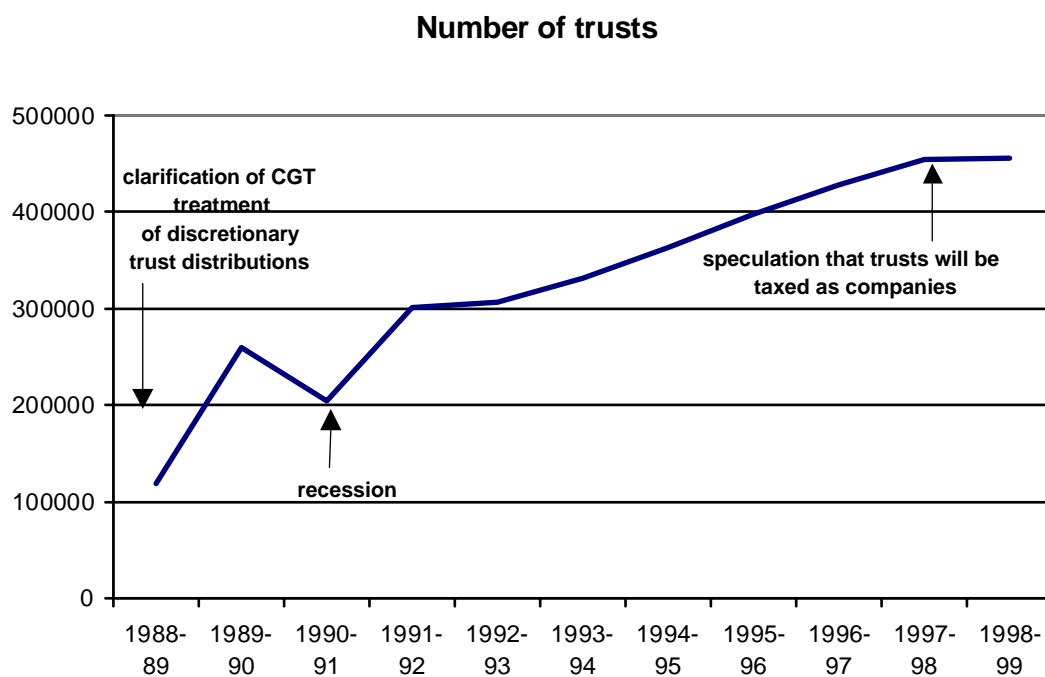
## (3) Growth in the number of trusts

There has been spectacular growth in the number of trusts over the past 20 years, especially in the early 1980s and through the 1990s. The Australian Taxation Office indicates that most of this growth in the 1990s is due to increases in the number of discretionary trusts.

*Growth in the number of trusts appears to be linked to developments in the tax treatment of discretionary trusts.*

The rate of growth slowed in the mid 1980s after measures to curb the abuse of trusts for tax avoidance purposes were included in the 1986 tax reform package. However, after the key measure<sup>9</sup> was rendered ineffective by an alleged drafting error, growth resumed. It slowed again in the late 1990s, under the shadow of speculation that trusts would be taxed as companies.

The graph below shows growth in the number of trusts over the decade from 1988 to 1998.



Source: Taxation statistics (1998-99)

### 3. Discretionary trusts and tax avoidance

This submission focuses on the tax treatment of discretionary private trusts since (in large part due to their beneficial tax treatment) these entities are well suited to income tax avoidance and are widely used for that purpose. While there are issues surrounding the tax treatment of public unit trusts, they are not widely used for tax avoidance purposes.

Private trusts are entities into which funds are transferred by a *transferor* to be managed by a *trustee* on behalf of a group of *beneficiaries* (usually family members of the *transferor*). The trustee is chosen by an *appointor*, who is usually the effective controller of the trust. That person is usually the transferor, who may also be a beneficiary in his or her own right.

The distinguishing feature of *discretionary* private trusts is that the beneficiaries have no fixed entitlement to these funds. Each year, the trustee determines which beneficiaries will receive any distributions of income from the trust, in accordance with the trust deed.

This feature distinguishes them from *public investment trusts*, in which investors purchase "units" that entitle them to a fixed share of trust income. It also distinguishes them from *fixed private trusts*, including many testamentary trusts (those whose beneficiaries have a fixed interest in the assets and income of the trust).

<sup>9</sup> The application of Capital Gains Tax to untaxed or preferentially taxed distributions from discretionary trusts.

Discretionary trusts are used by high income-earners to avoid tax in two ways, by splitting income with family members and by concealing or re-characterising income (for example by re-characterising ordinary income as capital gains).

## (1) Income splitting

Although it was not the Government's intention to crack down on income splitting in its 2001 "entity tax" legislation, we argue below that it seriously undermines the fairness and integrity of the personal income tax system.

Discretionary trusts are an ideal structure for income splitting. Other structures such as private companies and fixed trusts are also used for this purpose, but discretionary trusts have greater flexibility:

- Income is easily transferred each year to beneficiaries with the lowest tax rates.<sup>10</sup>
- The transferor can divest him or herself of formal ownership of assets while exercising a high degree of control over them (and any income derived from them), since the beneficiaries have no fixed entitlement to share in trust income.
- There is no general legal requirement for the public disclosure of the beneficiaries of a discretionary trust, although to address this problem the income tax law was recently amended to require disclosure of the "ultimate beneficiaries" of discretionary trusts in cases where the transferor is also a beneficiary.

Curbing income splitting through trusts only would not resolve this problem. This requires the consistent application of anti-splitting rules to transfers made through entities. However, it is vital that discretionary trusts are targeted for such action, as they are widely used for income splitting purposes.

This is what the *Draft White Paper on Tax Reform* said in 1985 about the use of discretionary trusts to avoid tax:

*"The family trust structure has been utilised frequently for artificial tax avoidance purposes."*<sup>11</sup>

and

*"Trusts are widely regarded as the most providing the most effective means of splitting family income for tax purposes."*<sup>12</sup>

## (2) Concealment or re-characterisation of income

Examples of the abuse of discretionary trusts to conceal or re-characterise income include:

- trust-stripping practices, in which the income of trusts was made to appear to be the income of a tax exempt body such as a charity although it was effectively controlled by the tax-payers concerned;

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<sup>10</sup> This tax advantage of discretionary trusts is often combined with the key tax advantage of incorporation (the capacity to retain profits in a company where they are taxed at the rate of 30%) by the device of including a private company among the beneficiaries. If in a given year, none of the other beneficiaries has a tax rate below 30%, trust income can be "parked" in the company.

<sup>11</sup> Treasury, *Draft White Paper on Taxation Reform*, page 53.

<sup>12</sup> Treasury, *Draft White Paper on Taxation Reform*, page 53.

- the use of complex networks of trusts to re-characterise ordinary business profits (for example, in property development) as capital gains;
- the conversion of taxable distributions into untaxed capital gains through asset revaluations.

Discretionary trusts have also been used to transfer tax losses between individuals, despite the intention of the income tax law that tax losses are captured within these trusts.

A range of entities is used to conceal the source, destination, or true economic character of income for tax purposes, including private companies and discretionary trusts. Other entities, especially private companies, are often used *in conjunction with* discretionary trusts for these purposes. Nevertheless, discretionary trusts are particularly useful for these purposes for two reasons: their flexibility and their liberal tax treatment.

Discretionary trusts have a "black box" character. As income is transferred through discretionary trusts - especially through complex networks of trusts - it can be difficult to clearly identify:

- its underlying economic character (for example, ordinary income may be "converted" into capital gains);
- its true owners and controllers (for example, it is not always clear who directs the trustee in the exercise of its discretion);
- its ultimate beneficiaries (for example, there is no general legal requirement to make information on beneficiaries publicly available).

In the absence of inside knowledge, tracing the elaborate transactions that occur within complex networks of trusts can be a very difficult exercise.

Aside from artificial income splitting and asset revaluations, legislative action has been taken to address the tax avoidance and evasion practices identified above:

- Anti trust-stripping legislation was enacted in the 1980s.
- Legislation was enacted in the late 1990s to restrict trafficking in trust losses and to require trustees to identify the "ultimate beneficiaries" of certain discretionary trusts.

However, these partial measures do not address the fundamental flaws in the tax treatment of discretionary trusts. It is these flaws in the tax system, as much as the flexibility benefits of discretionary trusts, that give rise to opportunities for tax avoidance and evasion. Other structures such as companies have also been used for similar tax avoidance purposes (for example, asset stripping and income splitting), but their tax treatment makes this more difficult, or more costly.

## 4. Principles for the taxation of trusts

There are three basic flaws in the tax treatment of discretionary trusts:

1. Tax preferences (concessions) to encourage certain types of investment (such as capital gains tax and accelerated depreciation concessions) flow through to the beneficiaries of trusts, despite the fact that they effectively enjoy the benefits of limited liability and many are not even investors. Similar tax treatment is denied to corporate shareholders on the grounds that they enjoy limited liability, which reduces their investment risk.
2. There is no effective mechanism<sup>13</sup> (such as the company income tax) to ensure that trust income is brought to tax in a timely manner. This is necessary to guard against tax avoidance and evasion practices involving the use of trusts (or networks of trusts) to conceal or re-characterise income, or to delay taxation. Indeed, the capital gains of discretionary trusts may escape tax entirely, due to the above-mentioned loophole.
3. A person who transfers income and assets to a discretionary trust usually continues to exercise effective control over those assets and income, yet he or she can still enjoy the tax benefits of splitting income with beneficiaries who are family members. Income that is distributed in this way should instead be attributed to the ultimate controller of the trust for tax purposes.

The last of these tax flaws also applies to other entities. However, it is the *combination* of flawed tax treatment and the flexibility benefits of discretionary trusts that makes them an ideal structure for tax avoidance purposes.

A consistent taxation regime for all business and investment entities is the holy grail of tax reform, desirable yet probably unattainable. Attempts to apply horizontal equity principles to the taxation of different kinds of entities can confuse policy debate rather than shed light. The consistent tax treatment of different entities may be a useful reference point for policy, but it is not a fundamental or universal principle for fair and efficient taxation. Rather, the basic principle is that *individuals should be taxed on their income in a timely manner at their appropriate marginal tax rate*. This means that attention should be paid to the economic substance of transactions conducted through entities rather than their legal form.

On this basis, a set of common principles can be applied to the taxation of entities generally. These correspond to the three flaws in the tax treatment of discretionary trusts listed above.

### **(1) Individuals should only benefit from tax concessions to the extent that they undertake investment risk.**

Where an entity absorbs investment risk, only the entity and not its individual owners or beneficiaries should directly benefit from tax preferences associated with investment by the entity (such as Capital Gains Tax concessions).

This is a long-standing principle of Australian taxation law, although it has not been consistently followed. This is the reason that flow-through tax treatment is denied corporate shareholders and partners in most limited liability partnerships. The non-application of this principle to discretionary trusts is inconsistent.

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<sup>13</sup> An entity-level tax currently applies to the income of discretionary trusts, but only in the rare event that trust income is not at least notionally distributed to beneficiaries each year. However, this tax is not effective in preventing the use of discretionary trusts to avoid and evade tax.

There is another, more pragmatic argument against the flow-through of tax concessions to corporate shareholders and the beneficiaries of trusts. Where investments are managed by these entities, tax incentives work more efficiently to encourage the desired investment behaviour when they are concentrated at the entity level.

In the case of discretionary trusts, this argument is reinforced by the fact that most of the beneficiaries of these trusts *are not investors*. Compare, for example the status of an investor in a public company or public unit trust who puts up his or her own capital, with that of an adult child who is the object of a discretionary trust established using capital provided by his or her parent. The former is an investor with a fixed entitlement to share in the profits of the trust. The latter is a passive recipient of transfers from another family member. It is difficult to see the point of extending investment tax concessions to the beneficiaries of discretionary trusts.

### **Tax preferences and investment risk**

This is what the 1985 *Draft White Paper on Tax Reform* said about tax concessions and risk:  
*"Family trusts are a close substitute for private companies as a vehicle for operating businesses and making investments, and they can, through the use of a corporate trustee and an appropriate trust deed, confer the benefits of limited liability on the persons involved."*<sup>14</sup>

This was echoed a decade later by the 1998 *New Tax System* statement:  
*"Companies, fixed trusts and discretionary trusts all offer investors the prospect of limited liability - shielding them from full personal liability for making good the entity's financial liabilities. And yet there is different [tax] treatment of distributions out of profits freed from taxation by tax preferences. ...[Unlike the other cases]...the beneficiaries of discretionary trusts enjoy the best of both worlds, benefiting from both limited liability and the flow-through of tax preferences."*<sup>15</sup>

The *Review of Business Taxation* had this to say:  
*"Distributions of tax preferred income from discretionary trusts are not taxed in the hands of trust beneficiaries. Investors in trusts are able to attract effective limited liability like company shareholders but, unlike shareholders, may obtain the flow through of tax preferences."*<sup>16</sup> and:  
*"Allowing full flow through of tax incentives (to corporate shareholders) would impose significant revenue costs for little apparent benefit since many incentives are currently perceived as meeting their objectives at the entity level."*<sup>17</sup>

## **(2) Where an entity undertakes investment or business activity, there is a case on practical grounds for withholding tax from the entity.**

The basis for this principle is the practical difficulty of allocating the income of entities to their owners for tax purposes in a timely way. In the absence of an entity-level tax, untaxed earnings of the entity could accumulate over many years before they are distributed and its owners would be privileged over direct investors.<sup>18</sup>

Alternately, assigning entity income to the owners or beneficiaries as it accrues (and before it is distributed to them) could create cash flow problems for the latter.<sup>19</sup>

<sup>14</sup> Treasury, *Draft White Paper on Taxation Reform* page 54.

<sup>15</sup> Treasurer (1998), *A new tax system*, p 109.

<sup>16</sup> Review of Business Taxation, *A Platform for consultation* page 51.

<sup>17</sup> Review of Business Taxation, *A Platform for consultation* page 17.

<sup>18</sup> This remains a problem (though to a lesser extent) where a withholding tax is levied at a lower rate than the personal income tax rates of the owners. This is the major flaw in the present corporate income tax system.

<sup>19</sup> This problem is often addressed in the case of discretionary trusts by notionally distributing income (actually, an entitlement to income) to beneficiaries and entering this onto the books of the trust as a loan to the beneficiary.

A related problem from a revenue protection standpoint is that in the absence of an entity level tax, income distributed by complex structures such as large public companies to their owners might escape tax that would ordinarily be paid by the owners as direct investors. This is due to the practical difficulties in characterising and tracing income within some of these structures, especially where the company or trust is part of a network of entities.

If tax is raised at the entity level, it is desirable to refund it as income is distributed to the owners. This is the purpose of the dividend imputation system.

If no withholding tax is raised, an alternative mechanism must be found to address these problems.

### **(3) Individuals should not be able to use entities to split their income with others.**

This practice undermines the integrity of our personal income tax system, which is progressive and based on individual income.

It is also inequitable, since some families have the opportunity to split their income while others do not. Moreover, in a progressive income tax system based on individual incomes, income splitting by definition mainly benefits those on higher incomes. This is because the difference between their marginal tax rate and those of other family members is likely to be greater than in the case among low income-earners.

As a general rule, income transfers between individuals that are not commercial in nature should not be effective for tax purposes. This rule is inconsistently applied in Australian income tax law. It is generally applied to the splitting of income from personal exertion, but not to the splitting of investment income. This particularly benefits individuals on high incomes, who receive the bulk of investment income.

Ultimately, all individual tax-payers pay for this concession through higher personal income tax rates than those which would otherwise apply. In the 1985 *Draft White Paper on Tax Reform*, artificial income splitting was conservatively estimated to cost the revenue approximately \$500 million each year.

## **5. Alternative models for the taxation of discretionary trusts**

### **(1) Flow-through model**

The present system of taxation of discretionary trusts is based on a *flow-through model* in which trust income is taxed in the hands of the beneficiaries.

Some argue that this model should apply to the taxation of all entities: that is, the tax system should "see through" entities and apply tax directly to the individual owners and beneficiaries. In theory at least, flow-through tax treatment is consistent with the basic income tax principle outlined above. However, this presents a number of practical difficulties:

- It is difficult to trace the character, sources and ultimate recipients of income flowing through complex entities such as large public companies, or networks of entities.
- Bringing the income of entities to tax in a timely way in the hands of those individuals who are ultimately entitled to it, may create cash-flow problems for the individuals concerned.

On the other hand if this is not done, they will unfairly benefit from a deferral of tax on the income of the entity.

- Moreover, as argued above it is inappropriate to the extent that entities shield individuals from the economic risks associated with investment.

Flow-through tax treatment is inappropriate for *discretionary trusts* for two reasons.

First, the beneficiaries of discretionary trusts do not personally "own" a share of the underlying assets or income of the trust, nor do they control them.

Indeed, there is a strong argument in most cases for taxing the income of discretionary trusts in the hands of the *transferor*. This is the way in which the income of private trusts is now treated for social security purposes.

Following the passage of Social Security legislation last year<sup>20</sup>, the default position in social security law is that the income and assets of these trusts are assigned to the effective controller of the trust. This is designed to prevent that individual from circumventing social security income and assets tests by "parking" income or assets in trusts.

Second, as noted above, most beneficiaries of discretionary trusts are not *investors* in the trust and they effectively enjoy the benefits of limited liability.

## **(2) Corporate tax model**

To overcome these problems with the flow-through model as it applies to discretionary trusts, and to improve consistency in the tax treatment of different entities, the Government's draft entity tax legislation sought to tax discretionary trusts in like manner to companies.

The economic functions of discretionary private trusts are diverse and it is not clear whether they parallel those of private companies. In any event, this approach has been abandoned by the Government, citing practical implementation problems.<sup>21</sup>

Nevertheless, following the above arguments, some features of the corporate tax system could usefully be applied to discretionary trusts.

Two deserve emphasis: the capture of tax concessions within the entity, and an entity-level tax. In the absence of an entity level tax, an alternative mechanism is needed to protect the revenue from the abuse of discretionary trusts for income tax avoidance and evasion purposes.

An entity-level tax currently applies to the income of discretionary trusts, but only in the rare event that trust income is not at least notionally distributed to beneficiaries each year. Its purpose is to force the distribution of trust income annually to beneficiaries so that it may be brought to tax. This entity-level tax does not, however, prevent the use of discretionary trusts to avoid and evade tax, as the history of their abuse for these purposes shows.<sup>22</sup>

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<sup>20</sup> The Social security and veterans entitlements legislation amendment (private trusts and private companies - integrity of means testing) Act 2000.

<sup>21</sup> It would be useful to obtain clarification of these problems. For example, it appears that many of the criticisms of the proposed tax regime for discretionary trusts were directed against the proposed "profits first" rule rather than corporate tax treatment per se.

<sup>22</sup> This provision is designed to force trusts to distribute their income every year to the beneficiaries, at which point it is taxed at their marginal tax rates. However, this can be circumvented in a number of ways, for example through the use of multiple trust structures and by converting the distributions into loans.

On the other hand, the corporate tax model would not have addressed the income splitting problem. It also has a serious weakness of its own: private companies are often used to defer the payment of personal tax at the appropriate marginal tax rate, by retaining income within the company where it is taxed at a maximum rate of 30%. Extending the corporate tax model to trusts would have led to their exploitation for that purpose. This problem should first be resolved within the corporate income tax system.

## 6. Proposals for reform of the tax treatment of discretionary trusts

*Structural reform* is essential in this area. The history of the abuse of discretionary trusts to avoid and evade personal income tax demonstrates that a band-aid approach will fail. Moreover, it is more efficient to address the problems described above in a structural way, rather than draft new legislation every time a new loophole is identified.<sup>23</sup>

The Government, the Labor Party and the Australian Democrats have publicly committed themselves to action to address these problems. This opportunity for structural reform should not be squandered.

Consistent with the above analysis, we outline below two proposals for structural reform of the tax treatment of discretionary trusts.

### 1. *Either:*

#### **(1) Introduce a general withholding tax on trust income and capture tax preferences (concessions) within the trust;**<sup>24</sup>

- This would bring the tax treatment of discretionary trusts more into line with that of companies. This was the broad strategy adopted in the Government's draft entity tax legislation (though there are probably simpler alternatives available).

*Or:*

#### **(2) Apply the capital gains tax to untaxed and tax-preferred income distributed to beneficiaries.**

- This would close off an unintended loophole in Capital Gains Tax legislation that applies exclusively to discretionary trusts, and would bring the CGT treatment of these trusts into line with that of other entities (including fixed trusts).

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<sup>23</sup> For example, it is likely that the first proposal outlined below would address the current problem of the avoidance of tax through the revaluation of assets within discretionary trusts.

<sup>24</sup> A tax at a rate equal to the top marginal tax rate plus Medicare Levy already applies to the undistributed profits of discretionary trusts. However, unlike the case of companies, this does not apply to profits that are (notionally) distributed. This tax could be extended to all trust income and treated as a withholding tax. Levying this tax at the top marginal rate would prevent the avoidance of tax through the retention of earnings in the trust (to take advantage of the tax deferral benefits associated with a lower rate of tax on trust income). Alternatively, a 30% tax rate would be consistent with the tax treatment of companies. A mechanism akin to the dividend imputation system for companies could be adopted to ensure that this income is not taxed twice. However, consistent with the tax treatment of companies, this should not permit the flow-through of tax preferences to beneficiaries.

One of the two alternative measures outlined above is needed to help ensure that trust income does not escape tax by the time it is distributed to the beneficiaries. It should raise revenue broadly equivalent to the estimates provided by the Review of Business Taxation: that is, up to approximately \$700 million per year.

The *first approach* (withholding tax and capture of tax preferences) is consistent with the Government's draft entity tax legislation, though it could probably be implemented in a simpler way.

The key advantages of this approach are that:

- If a similar imputation system to that applying to companies is used, tax preferences would be captured within the trust.
- It would not be necessary to trace flows of income through and between trusts to their ultimate beneficiaries in order to tax the income of discretionary trusts.

If this were implemented for discretionary trusts, there would be case for *excluding* certain trusts (such as trusts for the purpose of holding assets on behalf of individuals unable to manage their own financial affairs). A list of potential exclusions is contained in the final report of the *Review of Business Taxation*.

Although the *second approach* means that only half the tax-preferred or untaxed income of discretionary trusts would be taxed in the hands of beneficiaries<sup>25</sup>, it has a number of advantages:

- It is consistent with the existing tax treatment of other trusts.
- It brings to tax much of the income that has hitherto avoided taxation within discretionary trusts.
- It avoids disputes over the characterisation of trust income as ordinary income or capital gains<sup>26</sup>.
- It would be relatively simple to legislate and administer.

If a variant of the corporate income tax model is not applied to discretionary trusts, then this is probably the simplest and most effective alternative.

**2. The Taxation Office should tax income that is distributed through discretionary trusts from a tax-payer to other parties on a non-commercial basis (for example to family members) as though it remains the income of the tax-payer concerned, in cases where that tax-payer is the ultimate controller of the trust.**

The Government did not intend to crack-down on income splitting through discretionary trusts when it introduced its draft entity tax legislation. Nevertheless, this is essential to prevent high income-earners from receiving a substantial tax benefit that is not available to the vast majority of tax-payers. Recent social security legislation prevents the "deprivation of income" by transfers to family members through trusts to avoid social security income tests. Anti-income splitting rules also apply in income tax law to prevent tax avoidance by Australian residents using foreign trusts. However, it does not apply generally to Australian trusts or companies. For consistency, this principle should extend to all private companies and trusts.

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<sup>25</sup> Given the 50% discount that applies to rates of tax on realised capital gains.

<sup>26</sup> For example, as a result of the revaluation of assets within the trust.