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Taxing Non-Fixed Trusts

Elaine Abery*

Abstract

Tax policy is evaluated according to three criteria: equity, efficiency and simplicity. This paper looks at the history of the withdrawn *New Business Tax System (Entity Taxation) Bill 2000*, which proposed to tax non-fixed trusts in a manner stated to be comparable to the taxation of companies.

The Bill attracted almost universal criticism. The three criteria for evaluating tax policy are applied to the Non-Fixed Trust Regime to understand why the Regime was not implemented.

The Non-Fixed Trust Regime did not succeed because it sought to apply a regime to non-fixed trusts that would have been much more onerous than that applying to other corporate entities. The Non-Fixed Trust Regime would have been less efficient, less equitable and less simple than the prevailing trusts taxation regime.

INTRODUCTION

The Ralph Review of Business Taxation[1] (the Ralph Report) recommended a fundamental change to Australian business taxation. One of its most important recommendations was for a Unified Entity Taxation Regime - whereby the taxation of corporate tax entities would be streamlined and improved.

The sheer volume of tax reform and public pressure resulted in a number of the Report's recommendations being abandoned shortly after the Report's release.

The Government's proposed method of implementing the Unified Entities Regime Recommendations was released as the *New Business Tax System (Entity Taxation) Bill 2000* (Exposure Draft) in October 2000. The Exposure Draft had a proposed date of effect of 1 July 2001 - a very short time frame for business to understand and apply the new law. It applied the Unified Entities Regime to tax non-fixed trusts in a manner that professed to 'substantially' approach the taxation of companies.

The Exposure Draft was an adapted version of the Ralph Review of Business Taxation's recommendations to fundamentally change the basis for business taxation in Australia. The Report proposed the introduction of a net income approach for calculating taxable income and a Unified Entities Regime to ensure that most corporate tax entities were taxed in a consistent manner.

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[1] The Report consisted of the following documents:

- Aust, *A Platform for Consultation* (Canberra: AGPS, 1999).
- Aust, *A Strong Foundation* (Canberra: AGPS, 1998).
- Aust, *A Tax System Redesigned* (Canberra: AGPS, 1999) (generally referred to as the Ralph Report).
- Aust, *Tax Reform: Not a New Tax, A New Tax System* (Canberra: AGPS, 1998).

The Exposure Draft was criticised for being overly complex, giving insufficient implementation time to taxpayers, and tarring all non-fixed trusts with the same 'tax avoidance' brush.[2] Not one submission praised it. The lifespan of the Exposure Draft was very short - it was withdrawn in February 2001.

In November 2002, the Board of Taxation released a report to the Treasurer and the Minister for Revenue and Assistant Treasurer on the Taxation of Discretionary Trusts. The Report recommended that discretionary trusts continue to be taxed in the traditional manner, with targeted anti-avoidance provisions where appropriate.

To understand why the Non-Fixed Trust Regime did not succeed, I first explore the background to Ralph's Unified Entities Regime. I continue by comparing the tax treatment of non-fixed trusts and companies before and under the proposed Non-Fixed Trust Regime. Then, I evaluate the proposed Non-Fixed Trust Regime according to the criteria for evaluating tax policy. Finally, I look at the Board of Taxation's Report on taxing discretionary trusts, before concluding that the Non-Fixed Trust Regime was not implemented because it was not equitable, efficient or simple.

BACKGROUND TO RALPH'S UNIFIED ENTITIES REGIME

'The essence of a well-constructed and operated tax system is that it is fair and is seen to be fair.'[3] In line with this goal, the Ralph Report recommended introducing a Unified Entities Regime whereby corporate entities (most trusts, companies, limited partnerships and unincorporated associations) be treated consistently, using a modified system of company taxation.

The Unified Entities Regime was one of the key recommendations of the Ralph Report, together with the Tax Value Method. The two were meant to together create a 'more certain, equitable and durable taxation system'[4]; one that would 'bring our system into the modern era and enhance the competitiveness of Australian business.'[5]

The following sections briefly discuss these two recommendations before proceeding to address their interactions with one another.

Unified Entities Regime

The principle underlying the Unified Entities Regime was that the same transaction should attract the same taxation treatment regardless of its form or structure. This accorded with the goals of taxation.

- Efficiency: the regime would have been more efficient through less interference with the free operation of the market.
- Equity: it would have been more equitable because taxpayers in the same position would have been treated in a similar manner.

[2] See, for example, the following submissions to the Exposure Draft: PriceWaterhouseCoopers 3 November 2000; KPMG Tax, November 2000; CPA Australia, November 2000.
[3] McLay D, 'Tax issues for the charitable sector', [1999] *New Zealand Law Journal*, p 61.
[4] Aust, *A Tax System Redesigned* (Canberra: AGPS, 1999), p 2.
[5] Letter from John Ralph to the Treasurer accompanying *A Tax System Redesigned*, above n 4, dated 30 July 1999.

- Simplicity: it would have been simpler because it sought to avoid the existing complex structure of both law and transactions that exploited legal loopholes. It should therefore have reduced compliance and administrative costs.[6]

The Unified Entities Regime aimed to provide simple, clear and fair treatment of entities under taxation law and to reduce opportunities for tax avoidance.[7] As such, together with the Tax Value Method, it aimed to create a more certain, equitable, durable and modern tax system that would make Australian business more competitive.

Tax Value Method

As noted above, the Tax Value Method and the Unified Entities Regime were the cornerstones of the Ralph Review of Business Taxation. It is useful, in this context, to understand how the Tax Value Method would have worked.

The Tax Value Method, also called the 'net income model', broadly proposed to work out taxable income according to the equation:

income - liabilities +/- net change in the tax value of assets +/- adjustments.

This method succinctly expresses the current method for calculating taxable income. It was argued that it would thus have required less legislation.

The Ralph Report combined with the introduction of the Goods and Services Tax and a new Pay As You Go withholding regime in a very short time proved to be too much tax reform for Australia. The Tax Value Method was quickly abandoned[8] as too radical a change, due to concerns of taxpayers and their advisers that the Method was uncertain, complicated and would result in significant compliance costs.[9] Government also announced that the Unified Entities Regime would only apply to non-fixed trusts.

However, as pointed out in submissions on the Exposure Draft, the Tax Value Method and Unified Entities Regime complemented one another and were designed to be implemented together.[10] In addition, the Unified Entities Regime would have subjected all corporate entities, and not just non-fixed trusts, to the same taxation. Once the Tax Value Method was abandoned and the Unified Entities Regime rules were applied only to non-fixed trusts, the logic of implementing the Unified Entities Regime was becoming disjointed.

Rules that were to be contained in the Tax Value Method would have alleviated practical difficulties that were left unaddressed in the Non-Fixed Trusts Regime. For example, recognition of the practical difficulties in taxing the annual change in value

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[6] Aust, *A Platform for Consultation* (Canberra: AGPS, 1999), p 471.

[7] Aust, *Tax Reform: Not a New Tax, A New Tax System: Overview* (Canberra: AGPS, 1998), p 115.

[8] The Tax Value Method was put on hold indefinitely, pending the outcome of a review by the Board of Taxation. It was abandoned subsequent to the Board of Taxation's report: Aust, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (Canberra: AGPS, 2002).

[9] Announcement by the Treasurer on 28 August 2002, in 'Tax Treatment of Trusts', Issue 173 30 August 2002 *Latest Tax News*, paragraph 1.

[10] See, for example, the National Farmer's Federation Submission to the *New Business Tax System (Entity Taxation) Bill 2000*.

of all assets was addressed in Recommendation 4.1 (in relation to the Tax Value Method), which proposed that unrealised gains would not be taxed.[11]

It can thus be seen that once the Tax Value Method was abandoned and it was decided to apply the Unified Entities Regime only to non-fixed trusts, the logic of Ralph's system was becoming disjointed. Implementing the Non-Fixed Trust Regime out of context introduced new problems. The following section discusses this proposed Non-Fixed Trust Regime.

WHAT IS THE TAXATION TREATMENT OF NON-FIXED TRUSTS?

This section compares the tax treatment of companies and trusts prior to the Ralph Report with that proposed under the Non-Fixed Trust Regime.

Tax treatment before Ralph

Companies

Broadly, profits were taxed in the company at the company tax rate, whether or not those profits were distributed to shareholders. When these profits were distributed to shareholders, a franking credit applied to ensure that shareholders were able to benefit from the tax paid at the company level. However, if a company had tax preferred income (eg capital gains), the benefit of the tax preferences at the company level was lost to the shareholder, who paid tax at their marginal rate on the entire amount they received from the company.

Unrealised gains were not taxed.

Trusts

Broadly, as long as all trust income was attributed to an individual, 'flow-through' taxation applied. That is, the income was not taxed at the trust level. At the individual level, all trust income distributed to that individual retained its character. This meant that individuals received the full benefit of tax-preferred income.

Income that was not attributed to an individual was assessed to the trustee, who paid the top marginal tax rate plus the Medicare Levy on that amount (48.5%).

Unrealised gains were not taxed.

Treatment under Non-Fixed Trust Regime

The Exposure Draft purported to apply rules to non-fixed trusts 'comparable' to those applying to companies.[12] As such, the Exposure Draft would 'tax non-fixed trusts at the entity level and impute the tax paid to members of the trust... [M]ost tax preferences [would be] assessed in the hands of members when distributed.'[13]

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[11] National Farmer's Federation Submission, above n 10. However, the interaction between this aspect of the Tax Value Method and Unified Entities Regime is unclear. Recommendation 12.4 states that where 'a distribution exceeds profits recorded in the entity's accounts, it will be necessary to establish the fair value of assets in order to determine the extent to which there are profits (generally unrealised gains) not recognised in those accounts.' (Aust, *A Tax System Redesigned*, above n 3, p 434). It would seem that the taxation of unrealised gains in the hands of members is explicitly proposed in the Unified Entities Regime. This would have been alleviated by the Tax Value Method proposal that explicitly stated that unrealised gains would not be taxed to the entity.

[12] Aust, *Entity Taxation: Taxing Trusts like Companies Overview* (Canberra, 2000), p 3.

[13] Aust, *Entity Taxation*, above n 12, p 3.

Removing 'flow through' taxation for trusts would have addressed the major taxation difference between trusts and other corporate entities. It would have removed trusts' advantage of being able to pass tax preferences to their beneficiaries.

However, two major differences existed between the taxation of companies and the proposed Non-Fixed Trust Regime. These differences are sourced in the Ralph Report's Unified Entities Regime recommendations:

- the profits first rule; and
- the non-commercial loan rules.

The profits first rule and non-commercial loan aspects of the Non-Fixed Trust Regime received almost universal criticism in submissions on the Exposure Draft. The following sections briefly describe these two aspects of the Non-Fixed Trust Regime.

Profits first rule

The profits first rule was contained in recommendation 12.3 of the Ralph Report. It aimed to treat distributions from entities to members first as income of the members to the extent of the entities' available profits and then from contributed capital once available profits had been exhausted. The available profits of the entity were defined consistently with the Tax Value Method. That is, the excess of the entity's net assets over contributed capital.

The rule aimed to limit (a) streaming of dividend and contributed capital distributions depending on the tax positions of the entities' members and (b) deferring paying tax on the entity's income.

The rule met with almost universal condemnation.[14] The most contentious aspect of the rule was that it would have applied to effectively tax unrealised gains. This is because the definition of net assets included any unrealised gains or losses on those assets.

Non commercial loans

Recommendation 12.22 dealt with the non commercial loans. It recommended that rules substantially similar to the loan provisions relating to private companies in Division 7A of the *Income Tax Assessment Act 1936* apply to loans between all closely held entities and their members. It aimed to ensure that otherwise taxable distributions of profits to members could not be converted into non-taxable distributions.

Again, this rule met with almost universal criticism. In particular, the combination of the profits first rule and non commercial loan provisions was seen to impose a regime that was 'excessive and cumbersome'.[15] The Institute of Chartered Accountants submitted that '[w]ithout the profits first rule... the proposed rules for non-commercial loans from members to trusts...' would be unnecessary.[16]

[14] The only exception I found was Richard Vann: Vann R, 'Australia's Policy on Entity Taxation', (2001) 16(1) *Australian Tax Forum*, 33-66.

[15] PriceWaterhouseCoopers Submission to the *New Business Tax System (Entity Taxation) Bill 2000*, p 2.

[16] ICAA Submission to the *New Business Tax System (Entity Taxation) Bill 2000*, p 5. It is interesting to note that non commercial loan provisions that apply to non-fixed trusts have since been introduced into Subdivision EA of Division 7A of the *Income Tax Assessment Act* 1936.

More so than any other part of the Non-Fixed Trust Regime, these two aspects and their interaction led to the widespread rejection of the Non-Fixed Trust Regime and its subsequent withdrawal. They stand in direct contrast to the established criteria of good taxation policy, explicitly accepted by the Ralph Report.

WHAT ARE THE CRITERIA FOR GOOD TAXATION POLICY?

Traditional analysis of alternative tax policies commonly employs three criteria: efficiency, equity and simplicity.[17] These criteria are regularly used in government enquiries to evaluate a tax and were adopted in the Ralph Report. For these reasons, I use these criteria to analyse the proposed Non-Fixed Trust Regime.

The criteria were widely used in submissions to the Exposure Draft to condemn the Non-Fixed Trust Regime as not being efficient, equitable or simple.

Efficiency

Economists favour this criterion, regarding it as more 'objective' than equity. Efficiency is evaluated by determining whether a change in taxation law results in changed individual behaviour. Any change in taxation law involves choices between which goods and services to purchase, or which activities to pursue. If a change in behaviour results then, unless the law specifically intends that change, the law is viewed as inefficient. The heterogeneity of society should not be altered by a tax system.[18]

Government expenditure and taxation affect most economic activity. The goal of efficiency is to ensure that these effects are kept to a minimum. Incorrect assumptions about efficiency often result in society foregoing annual benefits due to underinvestment. These tax-induced misallocations of resources include tax encouragements to invest through one vehicle rather than another.

The Unified Entities Regime was intended to treat corporate entities, including trusts, consistently. This would have met the Ralph Report's investment neutrality principle; the same investment should attract the same tax consequences, regardless of the vehicle employed. This would have removed tax incentives to conduct an investment through one vehicle type rather than another.

However, as discussed above, the Non-Fixed Trust Regime proposed to tax non-fixed trusts in a more onerous manner than any other entity was taxed, including taxing unrealised gains under the profits first rule. This led some submissions to the Exposure Draft to conclude 'that the Government is on a deliberate course to discourage Australians from using non-fixed trusts for any purposes, let alone effective tax planning.'[19]

It can thus be seen that the Non-Fixed Trust Regime contravened the criterion of efficiency, because trusts would have been taxed in a manner more onerous than other entity types. This would have encouraged taxpayers not to invest through trusts, but rather through a company or other vehicle.

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[17] Edwards, M, 'Relevance of Economic Analysis for Feminists', [1985] 1 *Australian Feminist Studies*, 55-66, at 57.

[18] YWCA of Canberra, *Senate Inquiry into the GST and A New Tax System: Submission to the Senate Community Affairs Reference Committee*, (Unpublished, 1999).

[19] ICAA Submission to the *New Business Tax System (Entity Taxation) Bill 2000*, p 14.

Equity

'Equity requires that tax contributions be socially just.'[20] Tax literature usually discusses two types of equity: horizontal equity and vertical equity. Economists favour horizontal equity, the idea that people who earn 'equal' amounts should pay the same amount of tax, so that they are in comparable positions after tax, whether earnings are received as capital or income. The notion of vertical equity is that tax liability increases with the welfare of the taxpayer, so that those with a greater 'ability to pay' pay more tax. However, one of the difficulties in tax design is that ability to pay is not easily measured.[21]

Just as the Non-Fixed Trust Regime would have contravened the criterion of efficiency, it would have contravened the criterion of equity. The Regime would have taxed some gains twice: an unrealised gain would have been taxed once under the profits first rule when a distribution was made to the member and a second time when the gain was realised and distributed to the member.[22] Effectively, subjecting unrealised gains to taxation (and perhaps double taxation) if they occurred through a non-fixed trust but not if they occurred through any other entity type is inequitable. A person with the same investment made through a non-fixed trust or through a company would have received very different tax outcomes.

Simplicity

A simple tax system is one where taxpayers clearly understand the nature of their tax liabilities, how much tax is to be paid and why the tax is imposed. Taxpayer costs of compliance with their tax obligations should be minimised and taxes should be easy and cheap to administer.

Although the existing rules applying to trusts could not be described as simple, they had the advantage of being 'business as usual'. As such, because the rules were broadly understood by taxpayers and their advisers and systems were already in place to assist compliance with the existing law, compliance costs were steady.

There will always be an initial increase in compliance costs in implementing any new tax regime. However, the simplicity aim is that once the regime becomes 'business as usual', compliance costs become smaller than under the previous system.

This could never have occurred for the Non-Fixed Trust Regime, as it would have required regular valuation of the trust's assets under the profits first rule. In fact, many submissions to the Exposure Draft suggested that valuation of all the trust's assets would have been necessary every time the trust made a distribution.[23] This is because many non-fixed trusts complete their accounts only once a year, but make distributions throughout the year. To know how much they could distribute and whether the distribution was from profits or capital, the trust would have had to ensure that its accounts were updated at the time of each distribution. This may have included a valuation of all of its assets.

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[20] Savage, E, 'Myths and misconceptions in the tax reform debate', [1985] *Legal Service Bulletin* (April), 55-60, at 55.

[21] Apps, P, 'Tax Reform and the Tax Unit', (1984) 1 *Australian Tax Forum*, 467-481, at 470.

[22] See, for example, the National Farmer's Federation and Stephen Page Submissions to the *New Business Tax System (Entity Taxation) Bill 2000*.

[23] See, for example, Arthur Robinson & Hedderwicks, 2 November 2000.

It can be seen that the Non-Fixed Trust Regime was not efficient, equitable or simple. It would have imposed high compliance costs on taxpayers and subjected investments conducted through trusts to higher tax than the same investment conducted through another business structure. The Board of Taxation submitted a report to the Treasurer on this.

THE BOARD OF TAXATION'S REPORT

The Board of Taxation reported on 22 November 2002, approximately two years after the Non-Fixed Trust Regime's release. It stated that 'any proposal for fundamental change to the taxation treatment of trusts must be justified by compelling policy arguments...'[24] The Board's enquiry focussed on identifying '"tax abuse in the discretionary trust area"... because that was the subject-matter of the withdrawn entities legislation...'[25] It recommended that:

- 'government consider options for amending the income tax law to improve the effectiveness and fairness of provisions intended to prevent individuals who are trust beneficiaries with high marginal tax rates accessing, without further tax liability, funds that have been taxed only at the company tax rate';[26] and
- 'the Commissioner of Taxation clarify and publish his views about the deductibility of interest on borrowings used to finance non-assessable distributions to beneficiaries of discretionary trusts.'[27]

Interestingly, despite rejecting the proposed new tax regime for non-fixed trusts, the Report stated that the proposed Non-Fixed Trust Regime would have taxed non-fixed trusts like companies. The significant differences between the proposed Non-Fixed Trust Regime and company taxation were not discussed.

CONCLUSION

It appears that taxing any trusts like companies has been definitively abandoned in Australia. It is a pity that the approach taken to attempt to introduce more integrity into the taxation of trusts culminated in the proposed Non-Fixed Trust Regime. This regime was inequitable, inefficient and far from simple.

The proposed Non-Fixed Trust Regime was an adapted version of the Ralph Review of Business Taxation's recommendations to fundamentally change the basis for business taxation in Australia. The Report proposed the introduction of a net income approach to calculating taxable income and a Unified Entities Regime to ensure that most corporate tax entities were taxed in a unified manner.

Although the proposed Non-Fixed Trust Regime was broadly true to the Unified Entities Regime, by divorcing the Unified Entities Regime from its context, the proposed Non-Fixed Trust Regime was bound for failure. First, the basic logic underlying the Unified Entities Regime was to tax most corporate tax entities in the

[24] Aust, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (Canberra: AGPS, 2002), p 1.
[25] Aust, above n 24, p 3.
[26] Aust, above n 24, p 1-2, Recommendation 3.
[27] Aust, above n 24, p 1-2, Recommendation 4.

same manner. Second, the basic building block of the Review, the net income model, had already been abandoned.

By applying the Unified Entities Regime recommendations only to non-fixed trusts, the context of the Regime was lost. The result was a tax regime that discriminated against non-fixed trusts. Non-fixed trusts would have been taxed on income (sometimes twice) that other entities were not taxed on and would have been subject to higher compliance costs in implementing a regime that required regular valuation of the trust's assets.

The Non-Fixed Trust Regime could not succeed, because it contravened the basic principles of tax legislation: it was not efficient, equitable or simple.

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