Entity TAXATION

Taxing trusts like companies

Overview

THE NEW TAX SYSTEM

Entity TAXATION

The Government will introduce legislation to tax certain trusts like companies with effect from 1 July 2001. To provide an opportunity for further community comment on the operation of the new arrangements, the Government has released an exposure draft of the proposed legislation and explanatory notes.

This briefing has been prepared to provide members of trusts, their advisers and other key stakeholders with an overview of the key features of the proposed entity tax legislation.

There has been extensive consultation in the development of this legislation. The exposure draft provides a further step in implementing the Government's policy announced in *A New Tax System* of introducing greater consistency in the taxation of entities.

Which entities does the entity tax legislation apply to?

The proposed legislation applies to non-fixed trusts - that is, essentially to discretionary trusts. Under this legislation, non-fixed trusts will be taxed like companies. As far as possible and in the interests of minimising compliance and restructuring costs, companies, fixed trusts, limited partnerships and co-operatives broadly retain their current tax treatment.

Because fixed trusts maintain their current tax treatment, the collective investment vehicle regime foreshadowed in the Ralph Report will not proceed.

Certain trusts not affected

Under the proposed legislation, certain trusts receive a different treatment from non-fixed trusts:

- *fixed trusts:* these trusts continue to receive flow-through treatment under the existing fixed trust provisions, and
- *excluded trusts:* these are trusts for which entity taxation is not appropriate due to the nature of the trust. Rules for determining excluded trusts are to be developed following consultations.

What is the effect of the proposed legislation?

Broadly, the new entity taxation treatment taxes non-fixed trusts like companies. It provides new rules for the treatment of distributions, and other transactions between non-fixed trusts and their members. These rules are comparable to those that apply to companies under the *Income Tax Assessment Act 1936*.

The proposed new rules tax non-fixed trusts at the entity level and impute the tax paid to members of the trust. The rules are designed to ensure that most tax preferences are assessed in the hands of members when distributed. Distributions of tax preferences by other types of entities generally result either in a cost base reduction of the relevant membership interest or receipt of an unfranked dividend.

Non-fixed trusts to be taxed like companies

Currently, non-fixed trusts are generally not liable to income tax. Instead, tax on trust income is paid by the beneficiary. Under the new entity taxation rules, all non-fixed trusts are liable to pay income tax on their taxable income at the company tax rate. The company tax rate will be 30 per cent for the 2001-02 income year and onwards.

Paying that tax generates franking credits in a trust's franking account. A non-fixed trust generally works out its taxable income in the same way as a company or entity taxed like a company.

What is a non-fixed trust?

A **non-fixed trust** is one where not all entitlements to its income and capital are fixed. Trusts that have both fixed and non-fixed elements (hybrid trusts) are therefore non-fixed trusts under the proposed legislation. For example, where some part of the income or capital of a trust may be distributed at the discretion of the trustee or another entity, the trust is a non-fixed trust.

A **fixed entitlement** is a vested and indefeasible interest in a share of the trust's capital or income (both current and future income).

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Non-fixed trusts now have 'members', rather than 'beneficiaries'

Under the proposed rules, members of a non-fixed trust include:

– beneficiaries and objects of the trust
– holders of interests that carry rights to manage or control the trust, and
– holders of rights under a loan to a non-fixed trust that gives rise to a contribution of capital to the trust.

Taxation to be based on distributions

Consistent with the current rules that apply to companies, distributions that non-fixed trusts make to their members in the form of:

– payments of money
– the transfer of property, or
– certain other specified transactions that are comparable to deemed dividends,

are recognised and taxed appropriately under the proposed legislation. Unlike the current tax treatment of trusts, if non-fixed trusts do not distribute all of their income, the trustee will be liable for tax only at the 30 per cent rate and there will be no other taxation consequences if the trust's after tax profits are retained in the trust.

In members' hands, distributions in consideration of cancellation or redemption of membership interests are divided up using 'the slice rule'. Other distributions are subject to 'the profits first rule' and assessable at the members' marginal rate of tax (which will be offset if the distribution is franked).

Available profits

Distributions to members are treated as coming from profits, to the extent of the non-fixed trust's available profits. When available profits are exhausted, distributions are treated as coming from contributed capital. Non-fixed trusts can also choose to distribute prior taxed amounts instead of available profits.

Available profits is the difference between the market value of the non-fixed trust's assets and its liabilities (less contributed capital and certain other amounts).

Non-fixed trusts may rely on their accounting records and statements to determine that a distribution is wholly from available profits. This means that a fresh valuation of the non-fixed trust's assets and liabilities is not required before making each distribution. The non-fixed trust can rely upon its accounting records when they represent a true reflection of its financial position. In certain circumstances, the Commissioner may substitute an appropriate value for the non-fixed trust's assets and liabilities.

Cancellation or redemption of membership interest

Distributions to a member for cancellation or redemption of their membership interests are treated as coming from contributed capital to the extent of the member's share of the non-fixed trust's contributed capital, then its share of taxed profits and then of untaxed profits (this is known as 'the slice rule').

Contributed capital is the amount that has been contributed or settled in the non-fixed trust, less the amount of such contributions that have been returned.

Separate contributed capital sub-accounts are required for each class of membership interest so that a member's share of contributed capital can be determined under the slice rule.

Loans to a non-fixed trust by its members

A loan made by a member or their associate to a non-fixed trust on non-commercial terms, that is not fully repaid within 12 months after the end of the income year in which it was made, gives rise to a contribution of capital.

Subsequent repayments of capital or interest in respect of such loans are treated as distributions from the non-fixed trust to the member and are covered by the profits first rule.

This rule applies to non-commercial loans made to non-fixed trusts on or after 22 February 1999.

Imputation rules extended to non-fixed trusts

The exposure draft extends the imputation rules for companies to non-fixed trusts. Consistent with the current rules governing the flow-through of franking rebates to beneficiaries of non-fixed trusts, beneficiaries of a non-fixed family trust will be entitled to a franking rebate.

Tax effect of distributions on members

The tax effect of distributions to members depends on the source of the distribution and any imputation credits attached. Distributions of available profits are assessable income for most members.

Distributions of contributed capital to holders of a membership interest in a non-fixed trust reduces the cost base of that interest and may be treated as a capital gain to the extent that it exceeds the cost base. Special rules apply to distributions of contributed capital to members holding certain discretionary interests with a zero cost base. Under these rules distributions of contributed capital made by non-fixed trusts will not be assessable provided:

- all contributions of capital made to the non-fixed trust have been made by, and all the members of the non-fixed trust are, individuals; or
- all contributions of capital made to the non-fixed trust have been made by, and all the members of the non-fixed trust are, members of a family group.

Distributions of prior taxed amounts are generally not assessable income nor are they exempt (and generally do not reduce carry-forward losses).

Primary production averaging maintained

A member of a non-fixed trust is taken to carry on a business of primary production (and hence is entitled to apply averaging), provided the member receives a distribution from a trust in the income year in which the trust carried on the primary production business.

As primary producers, members of a non-fixed trust are eligible to make a farm management deposit.

Transitional arrangements

Transitional measures will ensure that the rules do not inappropriately affect existing trusts. In particular, they maintain the existing treatment for assets acquired by trusts before 23 December 1999 both for gains on pre-CGT assets and post-CGT assets. The amount of any gain untaxed under the current law is added to the trust's contributed capital.

There are also transitional measures covering:

- certain entities that restructure in the period prior to the commencement of the non-fixed trust regime, and
- members of the original entity who receive replacement interests in the new entity.

There will be no capital gains tax consequences for members whose interests are converted into interests in a new entity in such a restructure. The capital gains values of their old interests will pass to the new ones.

Comparing entity taxation rules and current law

New law	Current law
Non-fixed trusts to be taxed like companies. Their distributions to be taxed like company dividends. Corporate unit trusts and public trading trusts to continue to be taxed like companies.	The net income of a trust is usually taxed to the beneficiaries who are presently entitled to the trust's net income. Net income to which no beneficiary is presently entitled is taxed to the trustee at the maximum marginal rate. Corporate unit trusts and public trading trusts are taxed like companies.
'Member' to be used to refer to beneficiaries and certain others with interests in non-fixed trusts.	The term used for investors in a non-fixed trust is 'beneficiary'.
'Distribution' to be used to refer to the benefits that non-fixed trusts transfer to their members.	Beneficiaries are taxed, not on transfers of benefits, but on their share of the trust's net income.
Most distributions to be taken to be distributions of profits to the extent possible and then of contributed capital.	Trust beneficiaries are taxed on their share of the trust's net income.
Non-fixed trusts must keep an account of the contributed capital of each class of membership interest.	There is no general requirement to keep contributed capital accounts.
Non-fixed trusts (and companies) to be able to frank distributions to their members, so that income tax paid at the trust level is imputed to members.	The imputation system only applies to companies and dividends and to entities that are treated like companies, such as public trading trusts.

Further information and comment

For more details of the proposed entities taxation treatment, see the exposure draft and explanatory materials, which are available at the Treasury website: **www.treasury.gov.au**.

Comments on the exposure draft should be received by 3 November 2000 and should be addressed to:

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