NON-FIXED TRUST (ENTITY) TAX - SUBMISSIONS ON DRAFT BILL[1]

by John Morgan

1 A new regime is not required

A new regime is not required simply to collect tax at trust level and give credit to beneficiaries for that tax. I agree with the Tax Institute submission on policy issues, that:

- this could be done under the existing trust provisions (Division 6[2]) as explained below. This system is already designed for trusts and is already "road tested". You don't have to pass complicated legislation, get everyone to learn it and develop new case law about new concepts. You don't have the complication of artificially deeming trusts to be like companies before raising the tax. And by making a few changes within an existing system you reduce the risk of making unintended mistakes.
- this could be done as a form of withholding under the PAYG system. We could have extended the domestic withholding system (under the equivalent of the old "Tax File Number" system) so it applied to any trust distribution where the trustee did not have the beneficiary's Tax File Number (instead of to certain unit trusts only). This is probably all that was ever necessary for tax integrity.

Either of these measures would allow the Parliament to repeal of the "ultimate beneficiary statement" provisions which are harsh, inefficient, and hugely unpopular.

2 Use the existing Division 6 system

The Tax Institute suggested taxing the desired class of trusts under an existing Division 6 provision (section 99A) and then passing credit for that tax to beneficiaries under the (revised) general imputation provisions.

I would like to suggest another Division 6 mechanism which may be even simpler in that there is no need to integrate Division 6 into the general imputation provision.

There is already effectively an imputation system in Division 6, and it could work for "Company Rate Trusts" (however defined) as follows:

- The trustee of a Company Rate Trust would be assessable on all trust income whether it was accumulated or not.

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[1] New Business Tax System (Entity Taxation) Bill 2000 - exposure draft released on 11 October 2000

[2] Division 6 of Part III of the Income Tax Assessment Act 1936 (Cwth)

- Accumulated trust income is already taxed to the trustee under section 99 or 99A. And adjustment to one of those sections would be necessary to ensure that the appropriate tax rate that applied.
- If the income is distributed (or a present entitlement is created) during the year, the beneficiary is assessed (usually under section 97). In certain circumstances though, the trustee can also be assessed and the beneficiary gets a credit for the tax payable by the trustee. This is currently what happens when minors or foreign beneficiaries are presently entitled to trust income (under section 98, 98A & 100), and it could easily be extended so that it applied to any income of a Company Rate Trust to which a beneficiary is presently entitled. The new provision would need to make sure that it was the company rate that applied to the trustee.
- When accumulated trust income passes out to a beneficiary, existing provisions can be used also. Such distributions are not normally assessable under Division 6 (section 99B(2)(c)(ii)). Also the relevant capital gains tax provisions (such as section 104-70) remain appropriate and probably do not require amendment. We have thrashed out over the last 15 years when a non-assessable distribution creates a capital gain and when it does not, and it would be better to not go through all that again.
- But unlike full imputation, this would leave high and low rate beneficiaries with, respectively, no further tax to pay on top of the company rate, and no refund of the company rate paid by the trustee on the accumulated income.
- If it was thought worthwhile, this shortcoming could be solved by adjusting section 99B to assess the beneficiary (section 99B assesses beneficiaries on all trust distributions unless excepted, and the normal exception for income on which the trustee has already paid tax could be removed). The beneficiary would need to get a credit for the company rate of tax paid by the trustee (by an extension of section 100).
- In the event that the corporate rate changed, the trustee might be required to keep separate "baskets" of accumulated income for each rate, and state out of which basket a distribution is made.

3 Further opportunity to rationalise - a "TLIP" rewrite of Division 6

As I've indicated, relatively short and simple changes could be made for the moment, if the existing trust regime machinery is used.

But there is a convenient opportunity to review the effectiveness of these changes, and further rationalise or stream-line the system when Division 6 is being rewritten and transferred to the 1997 *Income Tax Assessment Act*[3]. This could be done in a calm and considered way outside the glare of political controversy.

[3] I am assuming that tax reform will move on to a "Tax Law Improvement Project" style of rewriting of the remaining 1936 Act provisions to move them into the 1997 Act (but this time with wider scope to suggest policy changes which would streamline and rationalise the law.).

4 Elect to be a "Company Rate Trust" (and dispense with the "non-fixed trust" concept)

I believe that if the Government persists with a regime for "non-fixed trusts", the definition will always be fraught with difficulty, and as a result we will always run the risk of seriously endangering collective investment style trusts and their unsuspecting investors.

I wanted to advance the idea of allowing any trust to elect to be a "Company Rate Trust", meaning that it would be subject to tax and beneficiaries would get credits as set out above. Trusts might elect this treatment to get access to the corporate tax rate.

This simple concept might have other benefits too. In that it could replace the "Family Trust" election so that Company Rate Trusts would enjoy the current entitlements of "Family Trusts" including being able to carry forward losses and flow through franking credits (if keeps the 45 day rule after implementing the new benchmark franking system). We could dispense with the complicated system of defining family trusts and permitted ranges of beneficiaries and could also dispense with the system of double taxing distributions outside the permitted class of beneficiaries.

If the trust is paying tax like a company, it should be sufficient to have carry forward loss rules and franking credit entitlements similar to companies.

5 "Non-fixed trusts" - at least fix up the definition

If the Government persists in its plans to have a "non-fixed trusts" concept, then it should:

- give serious attention to the definition - at present it is likely that there will be no unit trust that is a fixed trust unless it falls within the "safe harbour" provisions of the carry forward loss provisions (s.272-5(2)[4]). And this "safe harbour" is even narrower than the "collective investment vehicle" definitions which were expressly rejected by the Government in introducing this draft. Also it would cause turmoil in Australian investment markets;
- there should be an "untainting" style of provision which allows trusts that have inadvertently allowed an offending discretion into their deed to make their way back to normal Division 6 style of trust assessments; and
- the capacity for a trust to retrospectively become a "non-fixed trust" back to the beginning of a tax year must be removed. Distributions could already have been made on a pre-tax basis which cannot be unwound.

4 Of Schedule 2F of the Income Tax Assessment Act 1936.

6 At least scrap the "profits first" rule and the "non-commercial loan" rules

If the Government resolves to continue with entity level tax for "non-fixed trusts" (however defined) they should at least dispense with the hardship and complication of the profits first / slice rule and the non-commercial loans rules as:

- there is no basis for taxing these trusts in a different (and more harsh) way than private companies. The complications and the cost will be immense as the Tax Institute's technical submission and policy submission indicates;
- the capital gains tax rules should be changed to allow trusts to vary their deeds without fear of triggering a "resettlement" and arguably crystallising all latent capital gains in the trust. Companies can change their constitution without running the risk of crystallising all latent gains, and trusts should be taxed like companies in this respect too. This is a general point, but it will have special significance immediately, as Trustees may wish to remove discretions from their deed to escape the new regime;
- there should also be provisions allowing the trustee to "roll out" assets to individuals or companies if these changes force parties to restructure out of the trust environment.

7 At least scrap the "unrealised" and "anticipated" profits

If the Government accepts none of the above submissions, then it should at least change the "profits first" rules so that the "available profits" which must be distributed first, are not calculated on an "unrealised" basis.

- Failure to do so will create substantial problems. For instance, capital gains intentionally taxed concessionally, which will go into the "contributed capital account" on realisation, remain in "available profits" until realised and could result in distributions that are taxable to the beneficiary. This will confound the ultimate policy objectives for those intentionally concessional gains. It will also mean that trusts will have to realise every asset on which it has a gain before it can distribute any of its capital as capital.
- This will mean that all the assets of the trust will have to be valued every time a distribution is made including every time a deemed distribution is made (which is a very wide range of cases).
- The profit limitation on assessing deemed dividends for companies (in section 109Y of Division 7A) currently calculates available profits for those purposes on a book value not a market value, and there is no reason for the trust provisions not being consistent with this.

If the idea of taxing beneficiaries on "unrealised" gains is bad, then the idea of taxing beneficiaries on "anticipated" gains in the trust is worse. It can lead to patently ridiculous results such as a beneficiary being taxed despite getting no permanent benefit, and the trust having never made a profit. Consider the following as an example:

- A person may create a unit trust as an investment vehicle by subscribing $100 for 100 units, then the trustee may borrow $1 million from a bank to make the investment. Let us then assume that the investment opportunity was deferred, and in the interim the trustee loaned the borrowed money to the unit holder interest free for a short period that straddled the end of the tax year, but then it proved impractical to invest so the beneficiary repaid the money to the trust which repaid the loan to the bank and then wound up the trust by distributing the $100 to the unitholder.
- The unitholder would be assessed on the $1 million amount of loan from the trustee. This is because the loan is a deemed distribution (under section 156-80), and the distribution will be treated as "from profits" under s.154-5. The deemed distribution can be treated this way even though the trust never had any profits because distributions are treated as coming from "anticipated profits" even after all "available profits" and "contributed capital" have been exhausted (under section 157-20(c)).
- It is hard to imagine having an actual distribution that could be made after "available profits" and "contributed capital" was exhausted, but it is possible to have a deemed distribution as this example shows. To assess the beneficiary on the basis that it is out of "anticipated profits" can be patently invalid as the example also shows. The regime for companies is not subject to this absurdity as the provisions applicable to them for deeming dividends are limited (by section 109Y) to the amount of the company's "distributable surplus" (which is like "available profits" except it is calculated on a book basis, not a market value basis). There is no basis for these trusts to be treated less sensibly than companies.

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