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Contents

1. Executive Summary

A structural change for the taxation of small and medium size business was suggested under the Entity flow-through regime (EFT), a joint report from the Institute of Chartered Accountants in Australia and Deloitte.[1] The *Entity flow-through submission* introduces a tax regime that adopts the taxation structure of partnership.

The EFT regime is designed to reduce the compliance complications of the present tax system by minimising the need for integrity provisions in tax law. However, the EFT regime could not apply to discretionary trust because it could not overcome the issue of present entitlement before the discretionary trust is distributed. This report suggests a recommendation that supplement the EFT regime by overcoming the issue of present entitlement in discretionary trust.

The report recommends that a mandatory cut off date should be introduced for the distribution of trust income in a discretionary trust each financial year. The cut off date would solidify the discretionary trust into a fix trust, so that tax is able to flow from the trust to the beneficiary. Hence, business entities operating under a discretionary trust could elect to fall under the EFT regime.

The recommendation is suggested with practical measures for its implementation. It is then weighed on its advantages and disadvantages. The report concludes with suggestions of further issues that could be raised to develop the recommendation.

[1] Deloitte and Institute of Charted Accountants in Australia, *Entity flow-through (EFT) submission* (2008) <http://www.icaa.com.au/A121363053> at 10 August 2008.

2. EFT regime to ease complexity and costs for compliance

The EFT regime proposes to give small and medium size business an election, to be taxed as a partnership. Every small and medium size business entity, except for those operating under a discretionary trust can elect to be under the EFT regime.

The advantage of a flow through regime is that the entity becomes transparent for tax purposes. Hence it would reduce the need for integrity provisions.[2] As more integrity provisions become redundant, the tax law would become less complex and hence less expensive for small and medium size business to manage their tax obligations.[3]

The entity retains its legal status and has limited liability protection for its assets. Hence the system retains the attractiveness of limited liability for its members, and introduces a less complex and cheaper alternative for taxation purposes.

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[2] Deloitte and Institute of Charted Accountants in Australia, *Entity flow-through (EFT) submission* (2008) <http://www.icaa.com.au/A121363053> at 10 August 2008.
[3] Ibid.

3. Issues that small and medium size business face under discretionary trust

The present rigid taxation integrity provisions that are associated with discretionary trust do not accommodate the practical problems of small and medium size business. Unlike other trusts, discretionary trust is more prone to unwittingly separate net income from income of a trust. Small and medium size business is more susceptible to be entangled in such arrangements, because they often do not have enough financial resources to ascertain adequate tax counsel, and often have scarce or nil tax knowledge. They would then be greatly penalised under the integrity provisions.

An example of such a situation is a small hardware store operating as a discretionary trust and is facing financial problems; the owner of the business is the trustee and a beneficiary along with his wife. In order to keep the business running, the owner sells some of the business equipments, which equates to a capital gain. The owner uses the profit from the sale to improve his business. In most situations, as the money from the profit was not passed onto the beneficiaries (income of trust), the owner does not realise that he is required under taxation law to distribute the capital gain to capital beneficiaries in the trust (net income of trust). As a consequence, a capital gain audit by the ATO would come to the conclusion that under taxation law, the capital gain is kept in the trust and s99A or s99 *ITAA* would apply to tax the owner at the top marginal rate upon the capital gain. The owner may even have penalties and interests imposed depending upon the frequency and length of time that the situation occurred.

Another example that is observed from small and medium size business operating under a discretionary trust is that the owner often treats the trust as a sole trading business, and withdraws the money from the trust for personal use. At the end of the financial year, the owner would distribute the profit of the business to the beneficiaries. Often the money withdrawn from the business would be accounted as expenses or not recorded in the business financial records. An audit by the ATO would result in the finding that the withdrawn money was a loan under Division 7A *ITAA97* and that the withdrawn money should have been distributed to the beneficiaries as an income. The owner may have penalties and interest imposed for the accounting error.

Hence, it can be seen that the overregulation of discretionary trust by integrity provisions can exacerbate non compliance of taxation law. The solution is to recognise that the current taxation regime can be overwhelming for a small and medium size business operating under a discretionary trust, especially in the present economic crisis. A structural change is needed to assist small and medium size business to manage their taxation affairs. It is suggested that the EFT regime should be implemented for all small and medium size business, which includes those operating as a discretionary trust.

4. Why discretionary trusts need to fall under EFT regime

Discretionary trust's entities could not elect to be under the EFT regime as beneficiary in a discretionary trust is not presently entitled, until distribution of the trust income is made by the trustee in their favour.[4]

The solution proposed by the *Entity flow-through (EFT) submission*, is that EFT should not be extended to discretionary trust and that discretionary trust should continue to be subject to Division 6 of the ITAA36. The problem with the proposal is that discretionary trust remains to be a popular vehicle for businesses. The statistics collected by the ATO from the income tax returns of the 2006 financial year indicates that 427 532 business entities were in the form of a discretionary trust, and accounted for 75.1% of different trust entities operating in Australia in the 2006 financial year. This is a 0.8% increase from the 2005 financial year.[5]

Despite the onerous compliance requirements imposed upon discretionary trust, it remains a popular choice for businesses because of its flexibility in distributing income and capital. It also allows the trustee to select the most favourable tax distribution for beneficiaries, by taking advantage of the tax free threshold. By excluding discretionary trust in the operation of the EFT regime, it is cutting off a large portion of small and medium size businesses that intends to operate under a discretionary trust. This means that the EFT model would be less attractive and effective in being a better alternative to the present tax system for small and medium size business.

With the introduction of the EFT regime, it is possible that the use of discretionary trust would become even more popular as it allows greater tax manipulation as compared to its counterparts (companies, sole traders, partners etc.) operating under the EFT regime. Therefore, the introduction of the EFT regime, which excludes discretionary trust, could exacerbate the problem of creating a simpler and less expensive alternative to the present taxation system for small and medium size business. It is then necessary that a means for discretionary trust to be included in the EFT regime is found.

[4] Deloitte and Institute of Charted Accountants in Australia, *Entity flow-through (EFT) submission* (2008) <http://www.icaa.com.au/A121363053> at 10 August 2008.
[5] Australian Taxation Office, *Taxation Statistics 2005-06: Trusts* (2006) <http://ato.gov.au/content/downloads/00117625_2006CH6TRU.pdf> at 30 September 2008.

5. Issue of present entitlement in a discretionary trust

In *FC of T v Whiting*[6], it was held that a beneficiary possesses present entitlement when it is able to demand payment of income from the trustee. The case of *Taylor v FC of T*[7] and *Walsh Bay Developments v FC of T*[8] elaborated the concept, stating that present entitlement exists where the beneficiary has absolute and indefeasible vested interest in possession in the share of the trust property when the interest is derived.

In the case of *Harmer & Ors v FC of T*[9], a payment was made into the court pending judgment. The interest that was accrued from the deposited money was taxed at the highest marginal rate because none of the claimants (beneficiaries to payment) had present entitlement. The High Court held that after payment into the court, the claimants had an interest in the money to insist that it is properly administered and applied for the purpose of distribution according to the judgment. However, none of the claimants were beneficially entitled to the payment or the interest unless and until the judgment is made in their favour. This means that the claimants' interest were contingent upon the judgment in their favour. It can be seen that the payment was held in a fashion of a discretionary trust, which would be distributed according to the judgment of the Supreme Court.

Hence it can be derived that a beneficiary of a discretionary trust only possess at best a contingent interest in possession, which is not certain enough to give them present entitlement to the trust property. This is because the trustee has the discretion to distribute to any of the other discretionary beneficiaries. Therefore beneficiary of a discretionary trust does not possess present entitlement until the trustee distribute in their favour.

In some instances, the trustee of a discretionary trust may not elect to distribute to any discretionary beneficiaries. In such a situation, the trust deed may instruct that the distribution will automatically be made to the default beneficiary. If the trust deed does not contain such a provision, then the income will be trapped in the trust and may be taxed by s99A or s99 *ITAA36*[10].

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6 *Federal Commissioner of Taxation v Whiting* (1942) 68 CLR 199.
7 *Taylor v Federal Commissioner of Taxation* (1970) 119 CLR 444.
8 *Walsh Bay Developments Pty Ltd & Anor v Federal Commissioner of Taxation* 95 ATC 4378.
9 *Harmer & Ors v FC of T* 91 ATC 5000.
10 *Income Tax Assessment Act 1936* (Cth).

6. Recommendation to supplement EFT regime

To overcome the uncertainty of present entitlement in a discretionary trust, it is recommended that a cut off date for distribution of trust income should be introduced. This means that the trustee must distribute all income and capital accrued in the trust each financial year before a cut off date.

A cut off date would in effect solidify the discretionary trust into a fixed trust. After the cut off date, it will be known which of the beneficiary is entitled to the trust income and capital and the proportion of their entitlement. Tax would then flow through to the nominated beneficiary, according to their entitlements and would be included in their income tax at the end of the financial year.

The introduction of a mandatory cut off date supplementing the EFT regime would simplify the tax law regulating discretionary trust. The provisions in Division 6 of the *ITAA36* would not be required, as present entitlement would be resolved by a mandatory cut off date, and legal disability is dealt with by Division 6AA of the *ITAA36* under the EFT regime. Hence, it would not be necessary to determine whether the beneficiary is a minor, and has the right to demand payment of the trust distribution, in determining whether the tax should be allocated to the trustee or the beneficiary and the rate of tax that applies.

Under the EFT regime and recommendation, the tax would automatically flow with the distribution to the beneficiary. Hence, the beneficiary would be taxed at their own marginal rate. If the beneficiary is a minor, then Division 6AA would apply and they will be tax at the top tax marginal rate.

The present taxation of discretionary trust discouraged the accumulation of income within the trust, by encouraging the trustee to distribute the trust income each financial year. If the trustee does not distribute the income each financial year, then it would bear the tax of the trust at the top marginal rate plus Medicare levy.[11] Hence, s99A *ITAA36* is setting a voluntary cut off date for distribution of income in the discretionary trust. This measure can be described as a coercive incentive for the trustee to avoid being taxed at the highest tax rate.

However, the practical side effect of this approach is that the trustee may elect not to distribute, because there could be financial gains from accumulating income in the trust or it could minimise the tax for the beneficiary. For example, in a discretionary family trust, a trustee has a low or no income, whereby the beneficiaries have a high income, therefore it would be a tax advantage for the trustee not to distribute the trust income and bear the tax. Hence s99A *ITAA36* could be manipulated for tax planning.

The proposed recommendation is not a drastic change from the present taxation of discretionary trust. As mentioned above, s99A is presently acting as a voluntary cut off date for distribution of trust income. However, the provision can be manipulated for tax planning and financial gains.

The recommendation introduces a practical solution, to ensure that the beneficiary is presently entitled for the EFT regime to operate, while also simplifying the duty of distribution for the trustee.

[11] Section 99A, *Income Tax Assessment Act 1936* (Cth).

7. Implementing the recommendation

It is recommended that the distribution of trust income for each financial year must be made within the 1st to the 14th of July, and the 14th of July is the final cut off date. The cut off date is recommended to be after the end of a financial year, to prevent a gap of time whereby the trust income is accumulating in the trust. The 14th of July is selected because it coincides with the cut off date for payment summaries to be distributed from employer to employee.

Since the EFT regime is designed to assist small and medium size business; it is assumed that the trust would have some employees, and that joining important cut off dates would lessen the complexity and expense of managing the business's tax affair. It is also reasonable to assume that 14 days would be ample time, for a trust of the size of a small and medium business to make distribution.

Also, designating the cut off date to be the 14th of July would allow time for the beneficiary and trust to manage and lodge their individual tax return before the individual tax return cut off date of 31st of October. This would allow a couple of months for potential mishaps, which requires amendments to the distribution, before the individual tax return is due to be lodge.

It is recommended that a form should be designed for the trustee to make the election for the distribution. The form should have 3 copies. A copy should be lodged to the ATO before 14th of July, another copy should be sent to the beneficiary who is entitled to the benefit, and the final copy should be kept by the trustee for 5 years as part of the trust's tax record. The form should clearly identify the nominated beneficiary, detail whether the beneficiary is eligible for a capital or income distribution and its portion. The distribution on the form should only be for the financial year that has recently ended.

8. Regulating the recommendation

A provision to enforce the mandatory distribution should be enacted, with non-compliance penalties to the trustee. If the trustee does not distribute by the cut off date then the trust income would automatically be distributed to the default beneficiary.

The penalty for non-compliance should be based on the Australian Taxation Office (ATO) compliance model.[12] It should be scaled on the trustee compliance behaviour, and consider circumstances surrounding the non-compliance. For example, the trustee made an election for distribution but has carelessly misspelt the name of a beneficiary, and an amendment is made a month after the cut off date. The trustee has attempted to comply but has made a careless error which caused the non-compliance. It is suggested that the trustee would then be penalised 25% of the distribution.

If a trust deed expressly limits the application of the cut off date, then the tax law will prevail and severe the condition in the deed.

[12] Australian Taxation Office, *Compliance Model* (2008) <http://ato.gov.au/print.asp?doc=/Content/5704.htm> at 30 September 2008.

9. Disadvantages of the recommendation

It is acknowledged that the introduction of a mandatory cut off date would reduce some flexibility of a discretionary trust. However, as discussed above it is not a substantial change to s99A *ITAA36*, which acts as a voluntary cut off date with incentives for compliance. Also, the change does not substantially alter the nature of a discretionary trust, as it continues to allow the trustee the discretion in selecting the beneficiary entitled and the proportion of the entitlement. The only change is that the trustee discretion of when to distribute the accrued capital and income of the trust must all be made by the 14th of July.

It is anticipated that there would be a cost involved in publicising, implementing and enforcing the change. The introduction of a cut off date for discretionary trust is intended to supplement the EFT regime, so that discretionary trust could be included under its operation. As discussed in the *Entity flow-through (EFT) submission*, the costs involved in introducing and enforcing the EFT regime, would be offset by the revenue raised from having a more efficient and less complex tax system for small and medium size business.[13] As mentioned earlier, discretionary trust is a popular vehicle for small and medium size business, hence its integration into the EFT regime would increase revenue raised in the regime.

Also, as mentioned earlier, discretionary trust with a voluntary cut off date could be manipulated for tax minimisation and financial planning. A mandatory cut off date would reduce tax minimisation and financial planning, hence raising revenue for the Government.

Transitional issues may arise from the introduction of a mandatory cut off date. The *Entity flow-through (EFT) submission* provides for roll-over provisions for existing entities desiring to be taxed under the regime.[14] It is suggested that the transitional requirements be included with the EFT roll-over provisions.

It could be argued that a mandatory cut off date would be an extra duty for the trustee and be more complicated for users of a discretionary trust. However, the certainty that it creates would simplify the obligations that a trustee owes to the trust.

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[13] Deloitte and Institute of Charted Accountants in Australia, *Entity flow-through (EFT) submission* (2008) <http://www.icaa.com.au/A121363053> at 10 August 2008.
[14] Ibid.

10. Advantages of the recommendation

There are many advantages that a mandatory cut off date will provide to the taxation of a discretionary trust. The most significant, is that it will overcome the problems of present entitlement for small and medium size business, to elect to operate under the EFT regime.

It is suggested that a mandatory cut off date could also be introduced for discretionary trusts of all sizes. Since the beneficiary will be presently entitled after distribution is made and known to the beneficiary, the legislative implementation of a mandatory cut off date would relinquish the complex common law that determines present entitlement. This would assist the court in other discretionary trust issues such as determining whether a beneficiary has standing to enforce a distribution.

It is argued that a mandatory cut off date would lessen the complexity and costs of tax compliance. This can be achieved, because the obligation of a trustee for distribution is definite and is understood by the trustee and the beneficiary. Since there is a mandatory cut off date, then the beneficiary could remind and assist the trustee in making the distribution. The distribution would be a routine similar to lodgement of an income tax return.

Another advantage is that the distribution by the trustee is more transparent as they are required to lodge a form to the ATO and the entitled beneficiary. This would create certainty to where the trust income is going; hence less court proceedings for debate of distribution from beneficiaries. It would also assist the ATO in monitoring whether the income tax return of the trust and beneficiary are correctly made, as it would have a record of the trust distribution.

As discussed above, the duty of the trustee in regards to distribution would also be simplified. This would lessen the possibility of an error in distribution, and encourage more people to become trustees of a discretionary trust.

11. The future

The EFT regime is a response to the community demand for tax to be less complex and costly to administer for small and medium size business. The recommendation proposed is intended to supplement the EFT regime suggested in the *Entity flow-through submission.* The analysis of the recommendation in this report is not intended to be comprehensive.

The suggestion is intended to raise discussions of avenues to include discretionary trust under the operation of the EFT regime. It is acknowledge that further measures, are required to address the issues relating to implementing the recommendation to the EFT regime, before it can be operational. An example of further discussion needed is the drafting of the recommendation in the *ITAA97.* Further discussion is also needed for enforcement and penalty measures for non compliance, and how it would affect the attractiveness of the EFT regime.

The recommendation is intended to be a practical solution to revert the trend of relying on integrity measures to patch up loopholes in the tax system. The report advocates that with the supplement of the recommendation, the EFT regime is a workable structural change that can ease the complexity and costs of managing tax affairs, for small and medium size business.

It is hoped, that the recommendation is also considered to be an alternative to the over complex Division 6 *ITAA36* regulating trusts of all sizes and types. As discussed above, the recommendation would overcome the problem of present entitlement. A provision could be implemented to apply Division 6AA, with the recommendation to overcome the issues of present entitlement and legal disability in taxation of trusts. However, this would raise different issues beyond the scope of this report.