Why We Use Private Trusts in Australia: The Income Tax Dimension Explained

Alex C Evans*

Abstract

The trust has become a pervasive vehicle in the Australian economic landscape. In 2015–16, returns were lodged with the Australian Taxation Office for 845 925 trusts and the total reported business income derived through trusts was $368 billion. There has been enormous growth both in the number and use of private trusts since the late 1970s. Although the markers have been evident for decades and were appreciated in practice, private trusts did not feature heavily in Australian academic literature until more recently. Many of the existing analyses have broadly described that tax settings contributed significantly to the trust's popularity in both the public and private contexts. However, to date, none have clearly explained why the income tax settings acted as an accelerant for the movement towards private trusts. This article is novel as it explains the material income tax settings and correlates changes in those settings with statistical data that evidences that movement. The article argues that discretionary trusts have become popular, at least partly, because of favourable income tax treatment. The article sets out shortcomings of the Australian Labor Party's 2017 proposal to change the rules for taxing discretionary trusts and recommends two directions for future reform efforts by either major political party.

I Introduction

The trust relationship ('trust') is widely used in the Australia. While trusts are used in both the public ('public trusts') and private contexts ('private trusts'), this article focuses on private trusts.

It is difficult to make accurate general statements about private trusts because there are few disclosure requirements for trustees in Australia and the Australian Taxation Office ('ATO') only publishes data about trusts very

* Lecturer, School of Taxation & Business Law, University of New South Wales ('UNSW'), Sydney, Australia. The author is grateful to Professor John Taylor, UNSW Business School, for his comments on a previous draft and two anonymous reviewers for their insightful comments. The statistics in this article are accurate as at the date of acceptance for publication (30 January 2019).

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selectively for privacy reasons.[1] However, it is incontrovertible that private trusts are now commonly used by taxpayers in different circumstances for a variety of purposes. For example, the litigation involving the Hancock/Rinehart family trust was a high profile illustration of the use of trusts by high net wealth individuals,[2] and it is clear from previous Australian Government announcements regarding reforming the rules for taxing trusts that trusts are popular with farmers and small business.[3]

Although private trusts are often used in the traditional way — for intergenerational wealth transfer and asset protection — they are also used for carrying on business — in the sense that the trustee carries on business for the beneficiaries.[4] The use of private trusts in this way, referred to as the private 'trading trust',[5] is regarded as a peculiarly 'Australian idiosyncrasy'.[6] As an example, in the United States of America ('US'), carrying on a business is anathema to the private trust, and the US federal income tax code recharacterises trusts that do this as corporations.[7] Despite the fact this use of trusts is unusual, until recently both of the major Australian political parties had accepted it, with each publicly stating at different times words to the effect that 'where used appropriately' trusts are 'a legitimate structure through which Australians should

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1 Ashton de Silva et al, 'Current Issues with Trusts and the Tax System: Examining the Operation and Performance of the Tax System in relation to Trusts, with a Particular Focus on Discretionary Trusts linked to High Net Worth Individuals' (2017) 7 (Independent Report commissioned by the ATO) ('*RMIT Report*'). Among the few disclosure requirements, trustees are required to provide trustee beneficiary statements to the ATO: *Income Tax Assessment Act 1936* (Cth) div 6D ('*ITAA 1936*').

2 The ultimate action and decision in relation to the replacement of Ms Gina Rinehart as trustee was *Hancock v Rinehart* [2015] NSWSC 646 (28 May 2015). However, there were several earlier proceedings that were primarily designed to prevent the main litigation being pursued, see, eg, *Rinehart v Welker* [2012] NSWCA 95 (20 April 2012); *Welker v Rinehart (No 10)* [2012] NSWSC 1330 (31 October 2012); *Rinehart v Hancock* [2013] NSWCA 326 (3 October 2013). Other related questions of law have recently been decided in relation to this trust: see, eg, *Rinehart v Hancock Prospecting Pty Ltd* [2019] HCA 13 (8 May 2019).

3 See, eg, Peter Costello, 'Entity Taxation' (Media Release, No 008, 27 February 2001) <http://www.petercostello.com.au/press/2001/2445-entity-taxation-a> ('*Entity Taxation Retraction Media Release*'); Bill Shorten, 'Farmers Benefit with Changes to Trust Laws' (Media Release, No 25, 16 December 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=ressreleases/2010/025.htm&pageID=003&min=brsa&Year=2010&DocType=0> ('*2010 Announcement*'); Treasury, Australian Government, *Modernising the Taxation of Trust Income – Options for Reform: Consultation Paper* (November 2011) 2 <https://treasury.gov.au/sites/default/files/2019-03/Consultation_Paper_Modernising_Taxation.pdf> ('*2011 Consultation Paper*'). The statistics for 2015–16 also bear out that trusts are used at different scales: Australian Taxation Office ('ATO'), *Tax Statistics 2015–16*, Table 5 (2016) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics---previous-editions/Taxation-statistics-2015-16/> ('*ATO Tax Statistics 2015–16*').

4 The statistical information on which this labelling is based, however, is potentially unreliable because it is done under the self-assessment system: Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Family Businesses in Australia — Different and Significant: Why They Shouldn't Be Overlooked* (2013) 125–6 <http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/fam_bus/report/index>.

5 Kevin Lindgren, 'The Birth of the Trading Trust' (2011) 5(1) *Journal of Equity* 1.

6 Harold AJ Ford and Ian Hardingham, 'Trading Trusts: Rights and Liabilities of Beneficiaries' in Paul Finn (ed), *Equity and Commercial Relationships* (Lawbook, 1987) 48, 53; Nuncio D'Angelo, *Commercial Trusts* (LexisNexis, 2014) 72.

7 *Morrissey v Commissioner*, 296 US 344, (1935); US Treasury Regulation § 301.7701-4(a).

be able to conduct their personal and business affairs' and they were not a form of tax avoidance.[8]

The Australian Labor Party ('ALP') appeared to refine its position in July 2017 in relation to discretionary trusts, except ones used by farmers ('*ALP's 2017 Proposal*').[9] As articulated, the argument underlying the *ALP's 2017 Proposal* was that 'the vast majority of wealth in private trusts is held by the wealthiest households' and 'discretionary trusts are being used to reduce high income earners' tax liabilities through "income splitting"'.[10] Income splitting 'involves the transfer of income from a taxpayer with a high marginal tax rate to another person with a nil or low marginal rate' because then 'the income is subject to lower tax and this benefit can be shared between the high and low rate taxpayers'.[11] Income splitting commonly occurs between the higher earning taxpayer and their lower paid or unpaid spouse,[12] 'in return for domestic services or perhaps, love and affection, certainly for child-rearing services'.[13] Such 'deal(s)' happen when the tax unit is an individual (rather than tax being calculated based on the family's aggregated income) and where there are concessions or reduced rates for the second earner.[14] But it can also happen between the higher earning taxpayer and dependents, including adult children.

Discretionary trusts can facilitate income splitting between spouses and such practices are currently accepted by the ATO.[15] The *ALP's 2017 Proposal* involved imposing tax at 30% (the current tax rate for most companies) on distributions from a discretionary trust to beneficiaries aged over 18 years. This is an extension of the change made by the Coalition Government in 1980 to apply punitive tax rates, both in and out of the trust context, when parents divert income to their children aged under 18 years.[16] That practice developed because children generally do not have significant amounts of income from other sources, so each child could benefit from the tax-free threshold (the amount each taxpayer is permitted to earn up to before income tax is imposed). This meant that the tax burden across all the income was nil or very low. The ALP's proposed extension of that change makes some sense given more adults are continuing to live with and be somewhat economically dependent on their parents into their twenties and

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8 *2011 Consultation Paper*, above n 3, 2. For a statement from a previous Coalition Government, see *Entity Taxation Retraction Media Release*, above n 3.

9 Australian Labor Party, *A Fairer Tax System: Discretionary Trust Reform* (July 2017) <https://d3n8a8pro7vhmx.cloudfront.net/australianlaborparty/pages/7652/attachments/original/1501324995/170729_Shorten_Trusts_Fact_Sheet_FINAL.PDF?1501324995>.

10 Ibid.

11 Miranda Stewart, 'Domesticating Tax Reform: The Family in Australian Tax and Transfer Law' (1999) 21(3) *Sydney Law Review* 453, 466–7. See the discussion of property in Judith Grbich, 'The Position of Women in Family Dealing: The Australian Case' (1987) 15(3) *International Journal of the Sociology of Law* 309, 319.

12 Ibid 468. See also Patricia Apps, 'Chapter 3: Individual Taxation Versus Income Splitting' in Richard Krever and John Head (eds), *Tax Units and the Tax Rate Scale* (Australian Tax Research Foundation, 1996) 81.

13 Grbich, above n 11, 315.

14 Ibid.

15 Ibid.

16 *ITAA 1936* pt 3 div 6AA.

even later.[17] The ALP's proposal is broadly analysed in Part VII as part of a discussion of reform and future directions.

The pervasiveness of the trust in Australia is evident from the number of returns filed for trusts relative to other vehicle types. Data released by the ATO shows that in 2015–16, returns were filed for 845 925 trusts.[18] This is 95 241 lower than the number of returns filed for companies (941 166).[19] However, as Graph 1 below shows, based on returns filed, over the past 25 years, the growth in the number of trusts has outpaced the growth in the number of companies and, as a result, the number of trusts and companies are now very close. In contrast, the number of partnerships peaked in 1993–94 and has been declining since. In 2015–16, there were more than double the number of trusts (845 925) as partnerships (321 360).[20] Based on returns filed, trusts overtook partnerships as the preferred alternative to the corporation in 2002–03.

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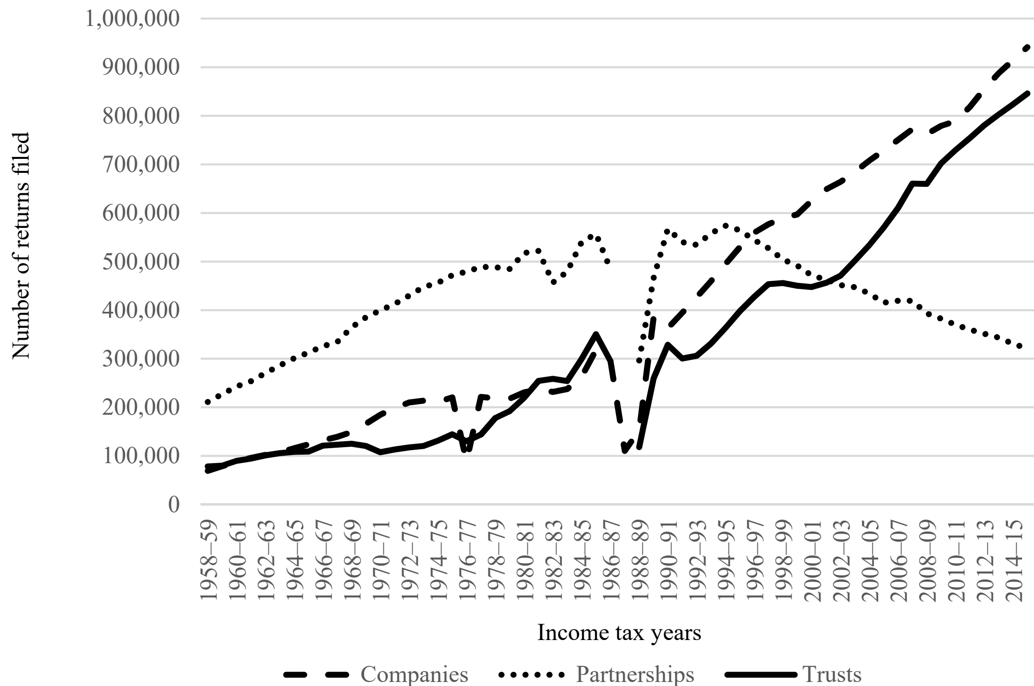
[17] Organisation for Economic Co-operation and Development ('OECD'), *Most Youth Live with their Parents and Patterns Have Changed since the Recession* (5 October 2016) Society at a Glance 2016 <https://doi.org/10.1787/soc_glance-2016-graph41-en>. See also Edgar Liu and Hazel Easthope, 'Multi-generational Households in Australian Cities' (AHURI Final Report No 181, UNSW-UWS Research Centre, February 2012).

[18] *ATO Tax Statistics 2015–16*, above n 3, Trusts Table 15. Note the *RMIT Report* states that in 2015, 2.6 million trusts were 'known' to the ATO. That report describes a distinction between active and inactive trusts, and this seems to correlate best with the number of trusts based on filed returns: *RMIT Report*, above n 1, 97.

[19] *ATO Tax Statistics 2015–16*, above n 3, Companies Table 9.

[20] Ibid Partnerships Table 14.

Graph 1: Number of returns filed for companies, partnerships and trusts from the 1958–59 income year to the 2015–16 income year[21]



21 Author's chart based on numbers of returns filed for companies, partnerships and trusts taken from *ATO Tax Statistics 2015–16*, above n 3, Snapshot Table 6. The graph omits information in particular years in which there was no reliable data for different reasons, for example in 1987–88 and 1988–89 the statistics only had partial coverage (they only included taxable companies).

While there was an awareness of the popularity of trusts in Australia in practice, the growth in non-charitable, commercial trusts largely did not feature in Australian academic literature until 2005. When this growth was noticed, outside of government reform efforts, the literature primarily focused on public trusts or only selective aspects of the income tax treatment of private trusts.[22] However, critical analysis of the income tax rules and issues relating to private trusts did appear in practitioner-oriented commentary before 2005.[23] Although some Australian treatises on trusts continued to be produced periodically as a matter of course,[24] these did not clearly signal the huge growth in the number of private trusts. Academic literature has only focused on this and the private trust's growing sophistication more recently.[25]

Since 2005, others have explored how the trust evolved from being used in the more traditional way to being a business vehicle. Mees et al outlined the

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[22] On public trusts: Bernard Mees, Monica Wehner and Pamela Hanrahan, 'Fifty Years of Managed Funds in Australia' (Preliminary Research Report, Centre for Corporate Law and Securities Regulation, 2005); John Glover and Paul von Nessen, 'Unintended Consequences: International Accounting Standards, Public Unit Trusts and the Rule Against Perpetuities' (2006) 80(1) *Australian Law Journal* 675; Nuncio D'Angelo, 'The Trust: Evolution from Guardian to Risk-Taker, and How a Lagging Insolvency Law Framework has Left Financiers and Other Stakeholders in Peril' (2009) 20(4) *Journal of Banking and Finance Law and Practice* 279; Nuncio D'Angelo, 'The Unsecured Creditor's Perilous Path to a Trust's Assets: Is a Safer, More Direct US-style Route Available?' (2010) 84(12) *Australian Law Journal* 833; Nuncio D'Angelo and Helena Busljeta, 'The Trustee's Lien or Charge Over Trust Assets: A PPSA Security Interest or Not?' (2011) 22(4) *Journal of Banking and Finance Law and Practice* 251; Lindgren, above n 5; D'Angelo (2014), above n 6; Graeme Cooper, 'Comment: Reforming the Taxation of Trusts: Piecing Together the Mosaic' (2013) 35(1) *Sydney Law Review* 187. On private trusts, see, eg, Brett Freudenberg, 'Are Asset Revaluation Reserve Distributions "Ordinary Income" for Discretionary Beneficiaries?' (2005) 20(1) *Australian Tax Forum* 3; Brett Freudenberg, 'Are Transparent Companies the Way of the Future for Australia?' (2006) 35(3) *Australian Tax Review* 200; Brett Freudenberg, 'Fact or Fiction? A Sustainable Tax Transparent Form for Closely Held Business in Australia' (2009) 24(3) *Australian Tax Forum* 373; John Glover, 'Dissecting Trusts and Trusteeship: CGT and Stamp Duty Consequences' (2007) 36(4) *Australian Tax Review* 201; John Glover, 'Dissatisfied Beneficiaries: Challenging Discretionary Trustees' (2009) 83(2) *Law Institute Journal* 54; John Glover, 'Are the Lights Changing for Discretionary Trusts?' (2010) 84(1/2) *Law Institute Journal* 34.

[23] See, eg, Terry Murphy, 'Implications of Income Distributions' (The Tax Institute, Victorian Division, 16 March 1998); Terry Murphy, 'Trusts from Here to…' (The Tax Institute, Western Australian Division, 21 October 1999); Paul Hockridge, 'Review of Business Taxation: Implications for Trusts' (The Tax Institute, Victorian Division, 16 March 1998); Peter Slegers, 'Tax Analysis: The New CGT Legislation: More Certainty, but Technical and Policy Problems Persist' (1999) 33(8) *Taxation in Australia* 418; Peter Slegers, 'Trusts in Transition: Technical Paper – "Trusts and the New CGT Concessions"' (The Tax Institute, South Australian Division, 10 March 2000).

[24] See, eg, *Jacobs' Law of Trusts in Australia*: (LexisNexis Butterworths: 1st ed, 1958; 2nd ed, 1967; 3rd ed, 1971; 4th ed, 1977; revised reprint, 1979; 5th ed, 1986; 6th ed, 1997; 7th ed, 2006; 8th ed, 2016).

[25] See, eg, Lindgren, above n 5; Anthony Slater, 'Taxing Trust Income after Bamford's Case' (2011) 40(2) *Australian Tax Review* 69; Freudenberg (2005), above n 22; Freudenberg (2006), above n 22; Freudenberg (2009), above n 22; John Glover, 'Resettlements: Revenue Consequences of Varying Discretionary Trusts' (2005) 79(10) *Australian Law Journal* 109; John Glover, 'Shams, Reimbursement Agreements…and the Return of Economic Equivalence?' (2008) 43 *Taxation in Australia* 21; John Glover, 'Taxing Liquidation Distributions: An Assessment of Australian Deemed Dividend and Capital Gains Regimes and How They Interrelate' (2005) 34(2) *Australian Tax Review* 88; John Glover, 'The Rule against Perpetuities and Its Application to Unit and Discretionary Trusts' (2007) 14(3) *Australian Property Law Journal* 225.

evolution of the public trust in Australia.[26] D'Angelo provided a condensed summary of the development of the commercial public unit trust and the trading trust.[27] Lindgren gave a detailed account of the origins of the trading trust and focused on its evolution from the unincorporated joint stock company.[28] Slater described the change in the law around the turn of the 20th century that permitted trustees to use trust property for carrying on business in a broader article about the implications of the High Court's 2010 decision in *Commissioner of Taxation v Bamford*.[29] Both D'Angelo and Lindgren's accounts began with a detailed analysis of the relevant law and historical events in the United Kingdom ('UK'). Slater and D'Angelo's accounts identify that tax was a critical factor in the trust's evolution in Australia throughout the 20th century.[30] However, they do not explain the relevant tax settings, nor explain why those settings were so crucial in accelerating the significant shift towards trusts generally and private trusts in particular.

In 2013, Cooper observed that 'the last six years have seen enormous turmoil in the systems for taxing trusts'.[31] Cooper set out a chronology containing both the previous attempts at reforming the rules for taxing both private and public trusts and the legislative changes that had actually been made over time. In that process, he analysed the 'disparate range of causes and concerns which have coalesced around trusts'.[32] He argued that although 'the same policy and design issues' appeared in relation to private and public trusts, they were being 'solved' differently in different contexts.[33] Cooper argued that reform should be coherent across the two contexts. While Cooper's article is valuable, it did not explain what income tax factors led to the trust being used in either of the public or private context; it merely accepted this as a fact.

This article builds on existing knowledge in several important ways. First, it critically analyses the currently available statistical information on the number of trusts from 1958–59 to 2015–16. This information shows several key trends that, while they may have been known to those with extensive experience in practice, to date have not been identified in academic literature. For context, the Coalition Government's 2015 *Re:Think Tax Discussion Paper* only set out the numbers of companies, trusts and partnerships from the 1990–91 income year onwards.[34]

Second, the article explains how the method of taxation that largely applies to trusts (flow-through taxation) continues to be crucial to the development and popularity of the private trust. The article begins by setting out the anecdotal view that the shift towards private trusts occurred from the late 1970s into the 1980s,

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26 Mees et al, above n 22.
27 D'Angelo (2009), above n 22; D'Angelo, above n 6, 58–78.
28 Lindgren, above n 5.
29 (2010) 240 CLR 481 ('*Bamford*'); Slater, above n 25, 76–8.
30 Anthony Slater, 'Amendment of Trust Instruments' (Speech delivered at the Society of Trust and Estate Practitioners, Sydney, NSW, 29 September 2009); D'Angelo, above n 6, 77.
31 Cooper, above n 22, 187.
32 Ibid.
33 Ibid.
34 Treasury, Australian Government, 'Re:Think Tax Discussion Paper' (Discussion Paper, Commonwealth of Australia, 30 March 2015) 108, Chart 6.2 ('*Re:Think Tax Discussion Paper*').

before extending that analysis in three significant ways. First, it observes that the number and use of trusts have continued to increase since the 1980s. For reasons that are explained later, this is significant after the 1987 introduction of the imputation system for income derived through companies. The article argues that the reasons for this increase fall into two groups: elements of the income tax treatment that make using trusts, particularly discretionary trusts, very attractive; and external changes that created greater certainty regarding the tax treatment of trusts. The article then critically analyses why, when both the trust and partnership are taxed using forms of flow-through taxation, using a trust can be more advantageous. The article shows that a key anxiety surrounding private trusts is whether business should be able to be carried on using the trust form. Part VII examines possible directions and challenges for reform. The extension of the existing Australian literature in these ways is novel.

II Income Tax Law Terminology

As income tax law is a specialised and technical area, some background and terminology is necessary. First, there are two main methods for taxing income derived through vehicles — entity taxation and flow-through taxation. A full examination of each method is extensive and is not required for this article,[35] so an abbreviated summary is provided here. Entity taxation has long been associated with the corporation and flow-through taxation has been applied to partnerships and, by extension, trusts.[36]

A *Entity Taxation*

Under entity taxation, the vehicle (for example, a corporation) is treated as an entity and tax is applied at the entity level based on the entity's attributes, but tax is also applied at the owner level (in the corporate tax, this is the shareholder level). Without any reconciliation, this results in two layers of tax (the 'classical system').[37] This is the system used in the US. However, in other countries, due to the argument that the classical system can produce double taxation, the system integrates or reconciles the two layers of tax in some way. One method, which Australia introduced in 1987, is the imputation system. Under imputation, the extent to which the company has paid tax on its income is taken into account in calculating the tax that is payable at the shareholder level. In Australia, the actual mechanics are:

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35 That analysis is elsewhere: see, eg, Alex C Evans, 'The Design Elements of Entity Taxation' (2018) 47(3) *Australian Tax Review* 167; Alex C Evans, 'The Design Elements of Flow Through Taxation' (2019) 48(1) *Australian Tax Review* 42. Both derive from Alexandra C Evans, *What is a Conceptually Possible Flow Through Design for an Alternative Vehicle in the Private Context in Domestic Income Tax Legislation? With an Applied Case Study on the Australian Business Trust* (PhD, Sydney Law School, 2016) ch 3. This article draws on that previous work.

36 An analysis of the reasons for that alignment is extensive and will be provided in forthcoming work by the author. That work derives from Evans (2016), above n 35, ch 4.

37 Richard Vann, 'General Report: Trends in Company/Shareholder Taxation: Single or Double Taxation?' in Richard Vann et al (eds) (2003) 88a *Cahiers de Droit Fiscal International: Studies on International Fiscal Law* (Kluwer Law International) 21, 23 (note 4), 30.

- the dividend (say $70) that a resident shareholder receives is grossed up to reflect the extent to which the dividend is franked — this is shown by the amount of the franking credit (assuming the $70 dividend is fully franked, assume a $30 franking credit); and
- the shareholder includes the total amount ($100 = $70 dividend + $30 franking credit) in its assessable income, and then obtains a tax offset equal to the franking credit ($30).[38]

To determine the entity's tax liability, its taxable income must be calculated. In Australia, this is done in the same way as for individuals; that is, assessable income minus deductions.[39] An important source of deductions can be a prior year tax loss. A tax loss arises when an entity's total deductions exceed its assessable income in an income tax year.[40] A hallmark characteristic of entity tax designs is that losses are trapped at the entity level and the entity is usually restricted in its ability to apply them under what are referred to as 'loss utilisation rules'.[41] In other words, the losses are not allocated to the owners.

A further crucial hallmark of an entity tax system is that distributions to owners have a 'homogenous' character.[42] The best example is that, in the corporate tax context, distributions of profits from a company are characterised as dividends. This means that an amount does not retain its original character (that is, the character the amount had when the entity derived the income) when the amount is distributed by the entity to owners. To give an illustration, different types of income (rent, income from active business, interest) distributed by a company are received by shareholders as a dividend.[43] While shareholders may benefit from any franking credit attached to the dividend, they are denied the benefit of any tax preferences (broadly, anything that reduces the tax rate)[44] that arise because of the original source of the income.

There are two key types of tax-preferred income in Australia: capital gains and dividends. The main reason capital gains are tax-preferred is because, since 1999, the capital gains tax ('CGT') rules have provided concessional treatment to individuals and trusts when they hold an asset for 12 months or more before doing something that triggers the production of a capital gain (discount capital gains treatment).[45] For example, a taxpayer sells an asset and this produces a capital

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[38] *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') ss 207-20(1), (gross-up), 207-20(2) (offset).

[39] Ibid s 4-15.

[40] Ibid s 36-10. This can be modified by *ITAA 1997* s 36-55 where a company has excess franking offsets.

[41] See, eg, *ITAA 1997* s 36-17, which allows a corporation to deduct a tax loss from a prior year, and *ITAA 1997* sub-div 165-A, which lists requirements that a company must satisfy to use that tax loss in a later income year. *ITAA 1997* sub-div 165-CA replicates this for a capital loss.

[42] Alexander Easson and Victor Thuronyi, 'Chapter 21: Fiscal Transparency' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (Part 1) (Kluwer, 2000) 925, 940. See also Peter Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge University Press, 2013) 13, 171. Corporate distributions are designated as dividends by *ITAA 1936* s 6 (definition of 'dividend').

[43] *ITAA 1936* ss 6 (definition of 'dividend'), 44.

[44] Harris, above n 42, 256; Alvin Warren, 'The Relation and Integration of Individual and Corporate Income Taxes' (1981) 94(4) *Harvard Law Review* 717, 777–86.

[45] *ITAA 1997* sub-div 115-A.

gain when the consideration the taxpayer receives exceeds its investment in the asset (the cost base).[46] In this case, the capital gain is reduced by 50% when the individual calculates its tax liability.[47] If the taxpayer only has one capital gain and it qualifies for discount treatment, the concession functionally cuts the rate that applies to the gain in half. There are other preferences for capital gains. Some capital gains are exempt, meaning that the amount of the capital gain is not included in the taxpayer's assessable income. An example is a capital gain that arises when a taxpayer sells an asset that they acquired before the CGT regime was introduced (pre-CGT assets).[48]

The second key type of preferred income in Australia is franked dividends. This is because, as discussed above, the shareholder obtains a tax offset equal to the franking credit and this reduces the shareholder's tax liability to reflect the tax the company has already paid.

B *Flow-Through Taxation*

Many features of flow-through taxation are in stark contrast with those of entity tax designs. First, under flow-through taxation, while tax law may recognise the vehicle as an entity for administrative reasons, tax is only applied at the owner level and the tax calculation is based on the owner's attributes.[49] Fairly pure flow-through designs attribute both net income (calculated as assessable income minus deductions) and net losses (where deductions exceed the entity's assessable income) to owners.[50] Owners can then apply losses from the vehicle to reduce any income from other sources — that is, losses that flow through the vehicle are not quarantined in the owner's hands. This can be very valuable for owners. Second, and again in stark contrast with entity taxation, under flow-through taxation, amounts may retain their original character as they move through the vehicle to the owners. This can be very valuable to an owner and can significantly reduce their tax liability, sometimes to nil, where the income is tax-preferred. As discussed above, the two key types of tax-preferred income are capital gains and franked dividends.

Under flow-through designs, any tax preference that arises due to the amount's original source generally flows through to the owner (flow through of preferences). For example, the legislation allows franking credits to accompany the distribution through a partnership or trust to the underlying owner.[51] In the

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46 Ibid s 104-10 (CGT event A1).

47 Ibid s 115-100.

48 Ibid s 104-10(5)(a) (CGT event A1). This exemption appears separately in many CGT events.

49 American Law Institute, *Federal Income Tax Project, Subchapter K: Proposals of Partners, Adopted by the American Law Institute* (American Law Institute, 1984) 5.

50 See, eg, the Australian partnership tax rules: *ITAA 1936* pt 3 div 5.

51 *ITAA 1997* sub-div 207-B. For a discussion of the nature of a franking credit and its attachment to a dividend, see *Federal Commissioner of Taxation v Thomas* (2018) 357 ALR 445, 447–50 [2]–[19].

trust context, this is subject to further qualifications.[52] Where those requirements are met, the beneficiary receives the dividend (or its allocated part) and benefits from any franking credit attached. Again, this can be extremely valuable for the reasons described above in relation the imputation system. The legislation provides for the flow through of capital gains to a beneficiary, subject to similar qualifications, and preferences attaching to the capital gain also flow to the beneficiary.[53]

C *Application of Each Method in Australia*

Subject to exceptions, in Australia the method of taxation generally follows legal form. That is, once a vehicle is established as a particular form, the income tax law respects that form and the vehicle is taxed under the rules for that vehicle. Generally, corporate tax rules apply to corporations, the partnership rules apply to partnerships and the rules for trusts apply to trusts.

The Australian corporate tax rules largely follow an entity tax design, but, as described above, since 1987 company and shareholder level taxes have been integrated under the imputation system.[54]

The Australian rules for taxing partnerships embody a fairly pure flow-through model as both net income and losses are attributed to partners and tax is only applied at the partner level.[55]

From the 5 May 2016, one of two sets of rules apply to trusts. The first set of rules apply to all trusts (the first paradigm).[56] Those rules largely embody a flow-through design as amounts are allocated to beneficiaries who are 'presently entitled to a share of the income of the trust estate' ('present entitlement').[57] Present entitlement is a technical tax term that was adapted from the trust law concept of entitlement.[58] Broadly, it requires the beneficiary to hold, at the end of the income year, an interest in the trust that is vested in interest and in possession, and for the beneficiary to have a right to call for that income.[59] But the first paradigm also incorporates elements from entity taxation: tax losses are trapped

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[52] Most importantly that the beneficiary is 'specifically entitled' to the franked distribution: *ITAA 1997* sub-div 207-C. Discretionary trusts must also have made the family trust election for this effect to be achieved. This is opaque in the legislation but this is through *ITAA 1936* pt 3A div 1A.

[53] *ITAA 1997* sub-div 115-C.

[54] Australia had a classical system from 1940 to 1987: Lynne M Oats, 'Undistributed Profits Tax in Australia' (1999–2000) 15(4) *Australian Tax Forum* 427, 429. There was a dividend deduction system from 1915 to 1922 and an imputation / exemption system from 1922 to 1940: Oats, 430, 431.

[55] *ITAA 1936* pt 3 div 5.

[56] Ibid pt 3 div 6.

[57] Ibid s 97.

[58] *Bamford* (2010) 240 CLR 481, 505. For further background, see Alex C Evans, 'The Legislative Origin of Present Entitlement in Australia' (2011) 40(4) *Australian Tax Review* 235.

[59] *Harmer v Federal Commissioner of Taxation* (1991) 173 CLR 264, 271 ('*Harmer*'), cited with approval in *Bamford* (2010) 240 CLR 481, 505. Justice Hill stated that 'the ability to demand and receive payment of income is "an indicia", but not a prerequisite for present entitlement': *Dwight v Commissioner of Taxation* (1992) 37 FCR 178, 189. Present entitlement needs only to exist at the end of the income year: *Colonial First State Investments Ltd v Federal Commissioner of Taxation* (2011) 192 FCR 298, 309 (Stone J).

at the trust level, and the trustee can be taxed as a proxy in particular circumstances, including where no beneficiary has the requisite entitlement, or the beneficiary is subject to a legal disability or is a non-resident of Australia for income tax purposes.[60] The second set of rules apply to a particular type of widely held trust called the Australian managed investment trust ('AMITs') and there is some excellent practically-oriented and applied literature on those rules.[61] However, further analysis, including the reasons why public trusts are taxed on a flow-through basis, will appear in future work by the author on public trusts.

III Detailed Analysis of the Statistical Information that is Currently Publicly Available

The statistics referred to in Part I above underscore the point that trusts are currently very popular in Australia. However, more detailed statistical analysis is required to identify when the shift in favour of trusts occurred and to show material aspects of trust demographics. Graph 1 above shows that, as a general trend, the number of trusts has grown over the past 60 years. Graph 1 and the data underlying it also show that the number of trusts, income-year-on-income-year, increased significantly at several points. Those changes are discussed, given context and correlated with changes in tax settings for trusts and companies in Parts IV and V below.

The *ATO Tax Statistics* also provide the number of trusts from 1996–97 to 2015–16 for which returns were filed each year based on the trust's classification: public, private fixed trust, private discretionary trust, private hybrid trust and other.[62] The 1996–97 income tax year is the starting point because it is the first time that the ATO's statistics are broken down based on trust type. As background, the Australian income tax legislation does not define a private trust. However, it does define a public unit trust as one in which units are: listed for quotation in the official list of a stock exchange in Australia or elsewhere; or offered to the public; or held by 50 persons or more.[63] Practically, private trusts are trusts that are not public trusts. A discretionary trust is a term of usage and refers to a trust where the trust deed gives the trustee power to choose to which of a class of potential beneficiaries (the appointee) to make a distribution and how much to distribute to the appointee. Hybrid trusts combine elements of a unit trust and a discretionary trust. Usually 'distributions of income to beneficiaries are

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60 *ITAA 1936* ss 95(1) (definition of net income), 97 (beneficiary taxation), 98 (trustee taxation as proxy for beneficiary).

61 *ITAA 1997* div 276, as inserted by *Tax Laws Amendment (New Tax System for Managed Investment Trusts) Act 2016* (Cth). For analysis, see Josh Cardwell, 'A Review of the Proposed AMIT Regime — Exposure Draft: Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill' (Paper, Challis Discussion Group, Sydney, 6 May 2015) (copy on file with author); Manuel Makas and Graeme Cooper, 'Australia Introduces New Attribution Managed Investment Trusts Regime' (2015) 15(4) *Tax Planning International Asia-Pacific* 4.

62 *ATO Tax Statistics 2015–16*, above n 3, Trusts Table 4; Table 4 in the relevant year's statistics for 1996–97 until 2015–16.

63 *ITAA 1936* s 102P.

fixed and distributions of capital are at the discretion of the trustee or vice versa'.[64] While this label has not been picked up in academic literature on the taxonomy of trusts,[65] the ATO's rulings have been discussing hybrid trusts since at least 2009 and the term has appeared in discussions of trusts in income tax treatises.[66]

The data shows that, at each point between 1996–97 and 2015–16, the vast majority of trusts were private trusts.[67] For example, private trusts comprised over 99% of the total number of trusts in 1996–97 and just over 98.71% in 2015–16. While there has generally been growth in the number of public trusts (both listed and unlisted) over the data period, the proportion of the total number of trusts they comprise has not changed materially. For example, the proportion was just under 0.3% in 1996–97 and just over 0.69% in 2015–16. The data also shows that, consistently across the data period, the majority of trusts were discretionary trusts. While the exact proportion varies each year, it was 71.6% in 1996–97 and 78.7% in 2015–16. The data shows that generally the number of discretionary trusts has grown income-year-on-income-year, with some notable exceptions. For example, the number decreased in 2000–01 and 2015–16. These drops reflect decreases in the total number of trusts and, as set out in Parts IV and V, in some cases they can be correlated with particular changes in tax law. Further, while there has been some variation between years, the proportion of the total number of trusts represented by the other trust types was within a fairly narrow range over the data period. For example, private fixed trusts represented nearly 16% of trusts in 1996–97 and over 13% in 2015–16; and hybrid trusts represented just under 0.5% of trusts in 1996–1997 and just over 1.3% in 2015–16.

Graph 2 below shows the amount of total business income derived through all types of trusts from 1989–90 to 2015–16. The 1989–90 income year is the starting point because it is the first time the ATO started recording the total business income figure. It is not possible to chart this relative to a total business income figure derived in Australia because the information required to do this is not released by the ATO.

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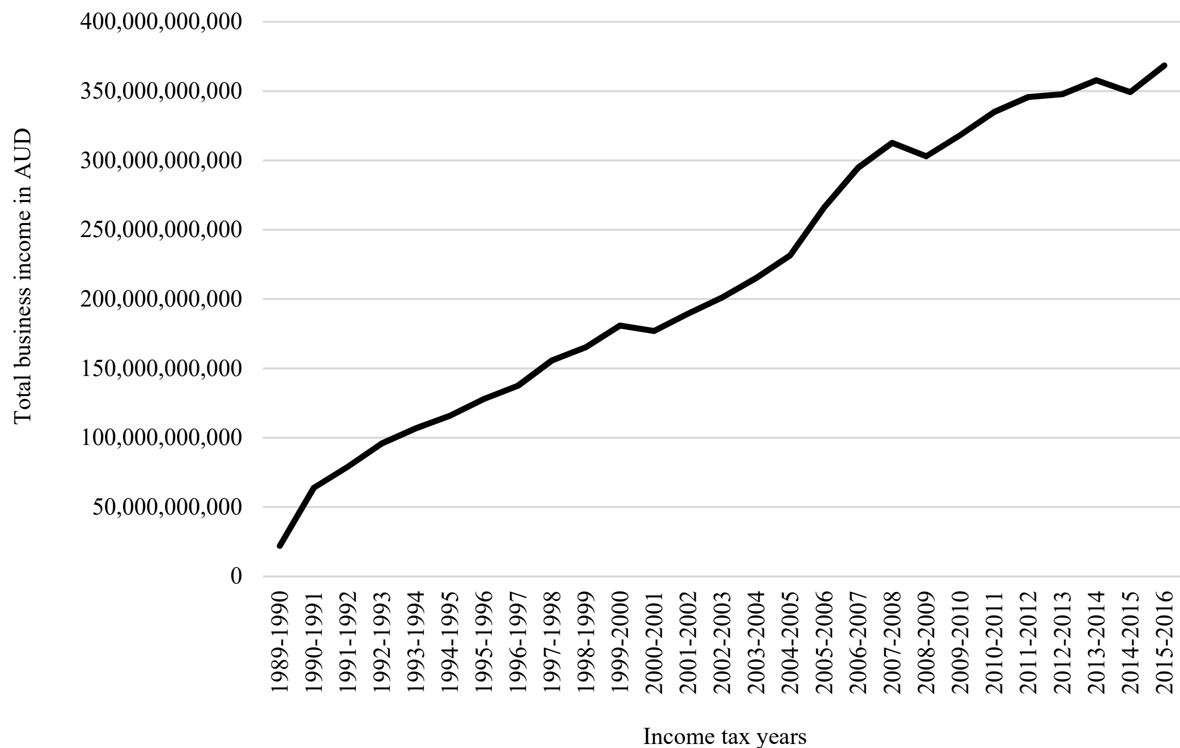
64 Gordon Cooper and Chris Evans, *Australian CGT Handbook 2013–14* (Thomson Reuters, 5th ed, 2013) 360 [19 060].

65 For example, there is no discussion of this term in John Heydon and Mark Leeming, *Jacobs' Law of Trusts* (LexisNexis Butterworths Australia, 8th ed, 2016) ch 3.

66 ATO, *Taxation Determination — Income Tax: Is Interest on a Loan Fully Deductible under Section 8-1 of the ITAA 1997 When the Borrowed Moneys are Settled by the Borrower on Trust to Benefit the Borrower and Others?*, TD 2009/17, 15 July 2009, Example 4. The *ATO Tax Statistics* show that there were 9275 hybrid trusts (ie 1.2% of the trust population) in 2012–13: ATO, *Taxation Statistics 2012–13* (2013), Table 4, <https://data.gov.au/dataset/taxation-statistics-2012-13/resource/b4437e2d-7a92-4b1e-a98f-4d535c8d2e4f>. See the above definition for hybrid trust in Cooper and Evans, above n 64.

67 This removes the percentage represented by 'Public unit trusts' and 'Other' categories in the supporting data.

Graph 2: Graph showing the total business income derived through trusts from 1989–1990 income year to the 2015–2016 income year[68]



[68] Author's graph based on *ATO Tax Statistics 2015–16*, above n 3, Trusts Table 1.

Graph 2 makes clear that the total business income derived through all trusts has grown significantly over this period. This is also clear from the fact that the 2015–16 figure ($368 468 000 000) was 16.78 times the 1989–90 figure ($21 984 566 019). Another indication is that average change across the time period was 14%.

From 2011–12 to 2015–16, the ATO's statistics correlate total business income with the scale of the trust through which it was derived.[69] The ATO classifies entities in the following way for the purpose of these statistics.

Table 1: How the ATO determines entity size in *ATO Tax Statistics*[70]

Entity size	**Total business income**
Loss	Less than $0
Nil	Equal to $0
Micro	$1 to less than $2 million
Small	$2 million to less than $10 million
Medium	$10 million to less than $100 million
Large	$100 million to less than $250 million
Very large	$250 million or more

The *ATO Tax Statistics* data shows two important points. First, the majority of trusts by number (between 57.8% and 58.61% across the data period) are nil trusts; that is, they either derive $0 business income or their allowable deductions generate taxable income of nil.[71] The statistics do not provide general explanations of how trusts get to either result. There are, however, legitimate ways either result could happen, including, for example, where business expenses exceed the assessable income in any one year, or where the trustee can deduct a tax loss from a prior year. Because this proportion is so high, it would be valuable for the ATO to provide general explanations in future statistics. The next biggest group by number is micro trusts (comprising between 37.8% and 38.58% across the data period) followed by loss trusts (comprising between 0.066% and 0.0975% across the data period). The large and very large groups comprise a much smaller proportion of the

[69] *ATO Tax Statistics 2015–16*, above n 3, Trusts Table 15.

[70] Ibid 'Definitions and calculations' <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2015-16/?anchor=Definitions#Definitions>.

[71] This is because the ATO takes the $0 figure from Box 'S' in Item 5 in the Trust Tax return, which is a net income figure: see ATO, *Trust Tax Return* (2016) <https://www.ato.gov.au/uploadedFiles/Content/MEI/downloads/Trust-tax-return-2016.pdf>.

total number of trusts – between 0.0179% and 0.021%, and 0.004% to 0.0066% respectively across the data period.

Second, the *ATO Tax Statistics* data shows that the bulk of total business income derived through trusts (between 85.04% and 87.12% across the data period) is derived through micro-, small- and medium-sized trusts, with around one-third (ranging between 29.73% and 31.1% in the data period) of total business income concentrated in micro trusts.

These points clearly show that the most profitable business activities are concentrated at the micro, small and medium scale. The ATO publishes further information correlating, among other items, scale, total business income and broad industry type, but this is only available for micro and small trusts and is potentially unreliable because it is a self-labelling system.[72] However, the one point worth noting from 2015–16 is that over 86% of nil/loss trusts self-report as falling outside one of the industry groups (the biggest being 'construction', 'financial and insurance services' or 'rental, hiring and real estate services'). This suggests that most loss trusts are concentrated in non-commercial areas.

IV Trusts in the Private Context Pre-Imputation

A *Significant Change in the Way Trusts Could be Used*

Before the 1970s, private trusts were primarily used in Australia in the more traditional way, as a mechanism for succession planning and intergenerational transfer of wealth. Vann has argued that before the 1970s in Australia, 'most small business seem[s] to have been either in corporate or partnership form'.[73] This is supported by Graph 1 above.

The trust was not an alternative to the company before the 20th century because the orthodox view was that a trustee could not use trust assets in carrying on a business without clear authorisation in the trust deed, otherwise the trustee would be in breach of their fiduciary obligations.[74] Slater has argued that:

> The reason was that the conduct of the business involved the undertaking of risks and liabilities which could put the entirety of the trust fund at risk, thereby imperilling the interests of the remaindermen for the sake of producing a larger income for the life tenant.[75]

However, that position changed in the early 1900s.[76] In two decisions in 1901 and 1903 following English precedents, Australian judges held that a trustee who held a power of conversion over a testator's assets had an implied power to carry on

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72 *ATO Tax Statistics 2015–16*, above n 3, Trusts Table 5.

73 Richard Vann, 'Structure of SME Taxation' (Paper presented at Looking Forward at 100 years: Where Next for the Income Tax?, Tax and Transfer Policy Institute, Crawford School of Public Policy, Australian National University, 28 April 2015) Slide 8 <https://taxpolicy.crawford.anu.edu.au/sites/default/files/events/attachments/2015-04/richard_vann_ttpi_conference_27_28_april_2015.pdf>.

74 Slater, above n 25, 77.

75 Ibid 76–7.

76 Ibid.

the testator's business for a period at the trustee's discretion or until the beneficiaries attained majority.[77] However, Slater has argued that this view did not become broadly accepted until the 'last quarter of the [20th] century'.[78] Consequently, trading trusts largely lay dormant until the 1970s.

B *The Anecdotal Explanation for the Movement towards Trusts*

To date, the anecdotal view in tax has been that the most significant migration towards trusts occurred from the late 1970s through to the mid-1980s due to the combined effect of the income tax settings for private companies and a series of changes that made using companies even more unfavourable. Existing literature cites two main settings as crucial background.

1 *The Introduction of the Imputation System*

The first setting is that, as discussed above, until the introduction of the dividend imputation system in 1987, a company's income was subject to two layers of tax, because Australia taxed income derived through companies using a classical system.[79] This produced a heavy tax burden because, during this time, high rates of tax applied to both private companies (generally 45% from 1940 through to 1977) and individuals (the top rate was well above 60% throughout the 1970s).[80]

2 *Tax Settings for Private Companies*

The second setting was that Australia imposed undistributed profits tax on private companies to prevent them from being used as tax shelters. Sheltering in this context refers to the practice of directing income to a company to access a lower tax rate than the natural taxpayer's rate where the taxpayer is a shareholder in the company. This allows for tax at the higher rate to be deferred until the company distributes to the natural taxpayer (the shareholder). Undistributed profits tax was nothing new — it had been imposed since 1922.[81] Broadly, undistributed profits tax required a private company to distribute half of its after-tax business profits to shareholders within a year ('the minimum distribution requirement'). If a company did not meet

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[77] *Southwell v Martin* (1901) 1 SR (NSW) 32, 35; *Re Hammond; Hammond v Hammond* (1903) 3 SR (NSW) 270, 272. The English precedent cases include: *In re Chancellor* (1884) 26 Ch D 42; *In re Crowther* [1895] 2 Ch 56.

[78] Slater, above n 25, 76–7. Slater refers to a paper written by Adrian Abbott. Mr Slater QC and Mr Abbott no longer hold a copy of it.

[79] The dividend imputation system is now largely contained in *ITAA 1997* pt 3-6. Note that before the introduction of imputation, the intercorporate dividend rebate meant that dividends received by one company from another were exempt from tax: *ITAA 1936* s 46. Section 46 was removed, with the introduction of the consolidation rules for companies, in relation to franked dividends paid on or after 1 July 2002, and unfranked dividends paid on or after 1 July 2003: *New Business Tax System (Imputation) Act 2002* (Cth).

[80] Slater, above n 25, 77. For historic rates, see Treasury, Australian Government, *Brief History of Australia's Tax System* (2006) Economic Roundup Winter 2006 <http://archive.treasury.gov.au/documents/1156/HTML/docshell.asp?URL=01_Brief_History.asp>.

[81] Oats, above n 54, 430. The way in which the base was calculated was adjusted several times after the introduction of the undistributed profits tax: Oats, above n 54.

the minimum distribution requirement, undistributed amounts were taxed at 50% in addition to paying company tax.[82]

During the 1960s and 1970s, the Australian Government closed off several avenues of tax planning and avoidance that had previously been available to taxpayers who used private companies. Those practices included schemes that were designed to avoid the application of undistributed profits tax either by: causing the company to fall outside the definition of a private company; and paying dividends through a series of companies (referred to as 'snakes' and 'chains')[83] so as to make the dividends effectively tax-free due to the intercompany dividend rebate.[84] The Government also made a series of other changes that made the private company less favourable.[85] In chronological order, first, it significantly tightened the loss utilisation rules that applied to companies between 1964 and 1973.[86] These changes put more restrictions on a company's ability to apply unused losses from a previous year. The initial change correlates with an income-year-on-income-year increase of over 10% in the number of trusts between 1965–66 and 1966–67.[87] Second, during the 1970s, the Government expanded the definition of private company.[88] This made it much harder to avoid the private company classification and therefore undistributed profits tax. Third, it reduced the intercorporate dividend rebate for private companies to discourage 'snakes' and 'chains'.[89] Fourth, the Government introduced a new regime that empowered the Commissioner of Taxation to determine that an amount loaned, paid or credited by a private company to a shareholder or their associate was really a distribution of profits and to recharacterise it as a dividend.[90] Such recharacterisation was disadvantageous because dividends were then subject to two layers of tax and, as outlined above, this could result in a very heavy tax burden.

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82 Taxation Review Committee, Commonwealth of Australia, *Full Report: 31 January 1975* (1975) 225 [16.15] ('*Asprey Report*').

83 Oats, above n 54, 449.

84 Richard Vann, 'Structural Issues in the Taxation of Small Business' (Unpublished Draft dated 8 June 2015) 11 (copy on file with author). Vann also noted that 'trafficking in excess distribution companies; dividend stripping; extracting value from companies in ways that did not attract deemed dividend treatment': at 11.

85 Other changes were that the excess distribution provisions were repealed in 1973 after their abuse: Oats, above n 54, 451.

86 *Income Tax Assessment Act 1965* (Cth); Commonwealth, *Parliamentary Debates*, House of Representatives, 'Notes to the Treasurer's Second Reading Speech on *Income Tax Assessment Act 1965* (Cth)'; *Income Tax Assessment Act 1966* (Cth) ss 9, 10; Slater, above n 25, 77; Comment, 'Amendments to Income Tax and Social Services Contribution Assessment Act — Outline of Proposals' [1964] (November) *Taxation in Australia* 189, 191–2; Comment, 'Amended Section 80 – Losses of Previous Years to be Allowable Deductions' [1964] (November) *Taxation in Australia* 223, 224.

87 See above n 21 for the source of the data.

88 Anthony Slater, *Law and Taxation of Company Distributions in Australia* (CCH, 1982) 3,002 [343], 20,103 [1002]. See also Oats, above n 54, 450.

89 Oats, above n 54, 448–50.

90 *ITAA 1936* s 108. In 1998, this was developed automatically to deem those amounts to be dividends: *ITAA 1936* div 7A.

3 *Broader Factors*

Beyond the settings above, there are two broader factors that are likely to have played a role in the migration towards trusts.

(a) *The Use of Trusts in Avoidance Practices*

First, the favouring of private trusts coincided with a period of significant tax avoidance activity in the late 1970s and early 1980s and the literature observes that trusts were often used in that activity.[91] One of the key advantages of the lack of restrictions on trusts described above was the opportunity trusts provided for income splitting, which was explained in Part I. As an example, Vann has argued that as the tax-free threshold for individuals increased from '$416 in 1971–1972 to $4,595 in 1984–1985', it became popular to 'create present entitlements in beneficiaries [below the threshold] without actually distributing income to them' to minimise the overall tax burden on income derived through a trust.[92] This appeared to have a significant impact on the movement to trusts — there was a sustained increase of over 17% in the number of trusts income-year-on-income-year between 1983–84 and 1985–86.[93] The practice, described above, caused the Australian Government to state in its 1985 *Draft White Paper* that trusts had become 'widely regarded as providing the most effective and flexible means of splitting family income for tax purposes'.[94] While the Government considered treating private trusts as companies for tax purposes to close off the possibilities for income splitting in 1985, it did not pursue this, recognising that it would only push the income-splitting problem to partnerships.[95]

(b) *The Use of Trusts in More Sophisticated and Marketed Structures*

Others have also suggested that, as the treatment of trusts became more favourable relative to the treatment of companies, legal and accounting advisers developed and began to recommend particular structures to their clients involving trusts.[96] At the time, firms could market such structures fairly heavily and it is likely that this, at least in part, contributed to their use.[97] Such marketing is now effectively prohibited under rules that impose penalties for people who promote schemes and structures designed to avoid tax.[98]

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[91] Vann, above n 84, 11; Trevor Boucher, *Blatant, Artificial and Contrived: Tax Schemes of the 70s and 80s* (ATO, 2010) chs 12, 26, 54. For some behaviours involving trusts, see Treasury, Australian Government, *Reform of the Australian Tax System: Draft White Paper* (Australian Government Publishing Service, 1985) 53 [5.9] ('*Draft White Paper*').

[92] Vann, above n 84, 11. It is noted that after 1980, this was only effective where the beneficiaries were not children because of the introduction of *ITAA 1936* pt 3 div 6AA.

[93] See above n 21 for the source of the data.

[94] *Draft White Paper*, above n 91, 53 [5.7].

[95] Ibid 54 [5.13].

[96] Vann, above n 73, Slide 7.

[97] I am indebted to a generous anonymous reviewer for this observation.

[98] *Taxation Administration Act 1953* (Cth) div 290 (promoter penalty law).

Initially, the structures were simple and the business was separated from the trust in the traditional way — that is: the business was carried on by a corporation; the assets used in that business were held subject to a trust; the trustee leased the assets comprising the trust property to the company; and the company paid the trustee rent.[99] Over time, more complex structures emerged with the trustee taking over the role of carrying on the business — that is, the trust was created over assets used in the business and the trustee was a company.[100] Protection of the trust property from third party liabilities in connection with the business under this second structure appears to rely on a view that: the trustee's right of indemnity (as against the trust property) can be excluded or reduced in the trust deed; the trustee's right of recourse against the beneficiaries is very narrow; and the scope for subrogation by third parties to the trustee's right is also narrow.[101]

4 *The Anecdotal View*

The anecdotal view is that the factors described above caused the trust to become a more attractive alternative to a private company by the late 1970s. For clarity, the comparative advantages of using a trust at this time can be distilled to the following list:

1. Income derived through a trust was only subject to one layer of tax.
2. Although accumulated income was taxed punitively from 1964 onwards,[102] the punitive treatment could be avoided by ensuring that a beneficiary or beneficiaries were presently entitled each year.
3. Loss utilisation rules were not imposed on trusts until 1998,[103] so until then there were no restrictions on a trustee applying a past year loss in the trust context.
4. The recharacterisation rules in div 7A of the *ITAA 1936* did not apply to trusts until 2004 and even then, they could be 'overcome' using certain techniques.[104]

The anecdotal account is supported by the historical data that underlies Graph 1.[105] Table 2 (below) shows the income-year-on-income-year changes

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[99] Nathan Isaacs, 'Trusteeship in Modern Business' (1929) 42(8) *Harvard Law Review* 1048, 1058.

[100] See, eg, Vann, above n 73, slide 7. See also Parliamentary Joint Committee on Corporations and Financial Services, above n 4, 124.

[101] As background, the trustee's right of indemnity is first against the trust property: Denis S K Ong, *Trusts Law in Australia* (Federation Press, 4th ed, 2012) 336; Donald Hill, 'Present Entitlement and Trust Accounting' (1983) 17 *Taxation in Australia* 850, 855. The trustee can only pursue beneficiaries who are absolutely entitled with respect to the trust personally when the trust property is insufficient to satisfy the trustee's right of indemnity: Ong, 336; *Hardoon v Belilios* [1901] AC 118, 124.

[102] *ITAA 1936* s 99A, as inserted by *Income Tax and Social Services Contribution Assessment Act (No 3) 1964* (Cth).

[103] Ibid sch 2F, as inserted by *Taxation Laws Amendment Act (Trust Loss and Other Deductions) Act 1998* (Cth).

[104] Vann, above n 84, 12.

[105] See above n 21 for the source of the data.

between 1974–75 and 1981–82.[106] It shows that the number of trusts grew significantly during this period.

The anecdotal view appears to assume that the shift towards trusts would decrease after 1987, with the introduction of imputation, because then income derived through both companies and trusts would be subject to one layer of tax. However, contrary to that, the increase in the number of trusts since 1987 — almost parallel to the growth in the number of companies (Graph 1 above) — indicates that the trust continued to offer some comparable advantage even after the introduction of imputation.

Table 2: Income-year-on-income-year changes in the number of trusts between 1974–75 and1981–82

Between which income tax years	% change in number of trusts (year-on-year)
1974–75 and 1975–76	10.05%
1976–77 and 1977–78	10.67%
1977–78 and 1978–79	23.70%
1978–79 and 1979–80	7.97%
1979–80 and 1980–81	14.17%
1980–81 and 1981–82	15.99%

V The Ongoing Comparative Advantage of a Trust Post-Imputation

This Part critically analyses the comparable advantage of a trust and argues that the reasons fall into two main groups. The first group are elements of the income tax treatment that make using trusts, particularly discretionary trusts, very attractive. The second group comprises external changes that created greater certainty regarding the tax treatment of trusts.

[106] The data for 1975–76 and 1976–77 is not included as there appears to be an error in the number of companies in 1976–77: see above n 21 for the source data. It is unclear if the data for partnerships and trusts for these years is accurate.

A *Group 1: Elements of the Income Tax Treatment that Make Using Trusts, Particularly Discretionary Trusts, Very Attractive*

There are three dimensions to the favourable income tax treatment of trusts. The first is the treatment of income derived through trusts, the second is the CGT treatment of trusts and the third is the combined effect of the imputation system and refundability of franking credits. These are considered in turn below.

1 *Treatment of Income Derived through Trusts Generally*

As stated in Part II above, the first paradigm treats the trust as a fiscally transparent vehicle to the greatest extent possible. When the beneficiary is taxed, the net income is not taxed at the trust level. Rather, the beneficiary is taxed on its share of the net income at the beneficiary's tax rate.[107] Further, as described in Part II, amounts may pass through to the beneficiary with their character intact. For example, a dividend is taxed to the beneficiary as a dividend and a capital gain is taxed to the beneficiary as a capital gain.[108] In addition, amounts that flow from a trust are not quarantined in the beneficiary's hands. For example, if the trustee derives a net capital gain of $100 in the 2017–18 income year and that net capital gain is successfully streamed to Beneficiary A, Beneficiary A can apply any unused net capital loss from other sources against the $100 net capital gain from the trust to reduce Beneficiary A's overall income tax liability.[109] As explained in Part II, this is in stark contrast to the treatment of a dividend received by a shareholder in a company and it can be a significant benefit.

As the *ALP's 2017 Proposal* identified, discretionary trusts can be used for income splitting. It can be achieved using the following steps: the higher earning taxpayer gifts the family property to a trust; the family solicitor becomes the trustee; the higher earning taxpayer is employed by the trustee to carry on the business; the income from those activities can then be directed to the people to whom the trustee appoints the trust's net income; and the higher earning taxpayer maintains control in the form of being able to take back the trust property in the event of the failure of the marriage.[110] The legislation does not try to prevent such practices, for example, by reallocating the net income back to the higher earning taxpayer.[111] It taxes the trust's current year net income to the potential beneficiary in whose favour the

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[107] *ITAA 1936* s 97.

[108] For franked dividends and capital gains, this is achieved through special rules that were introduced in 2011: *ITAA 1997* sub-div 115-C, div 207-B; Ibid div 6E. Before then, the view in practice was that such amounts could be streamed to beneficiaries based on the decisions in *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 and *Tindal v Commissioner of Taxation* (1946) 72 CLR 608, and there had been some support for that position in ATO rulings: see, eg, ATO, *Income Tax: Capital Gains Provisions: Interpretation and Operation*, IT 2328, [13] (withdrawn 2008); ATO, *Income Tax: Distribution by Trustees of Dividend Income under the Imputation System*, TR 92/13, [4].

[109] *ITAA 1997* s 102-5. If Beneficiary A qualifies as a small business entity, it can also access a range of concessions: *ITAA 1997* div 328.

[110] Grbich, above n 11, 325; Stewart, above n 11, 468.

[111] Evans (2016), above n 35, ch 5, 196, 197–8, 218–19.

trustee has exercised its discretion.[112] Putting aside the potential application of the general anti-avoidance provisions, the income tax legislation does not restrict the exercise of the trustee's discretion. The only limitations come from the trust deed and the trustee's compliance with the general law of trusts. This means that a trustee can choose to appoint the income of a trust to the person within the class of potential beneficiaries (the appointee) with the lowest marginal tax rate. The rate may not be the reason that the trustee selects that person. The trustee may select the youngest adult for some objective reason, such as that they have the lowest income from sources outside of the trust and need cash, or some subjective reason, such as being the grandmother's favourite.

From a trust perspective, the selection criteria are irrelevant, what matters only is that it is consistent with the terms of the trust and the trustee's obligations at trust law. However, the way in which the trustee exercises their discretion can minimise the overall tax that is paid on income flowing through a discretionary trust. Further, assuming the trustee's discretion is broad, the trustee can change the appointee from one year to the next. This can also result in tax minimisation over time. Again, such a change could be motivated by non-tax reasons, such as, continuing the example above, the oldest adult could become the grandmother's new favourite. Again, beyond the general anti-avoidance rule, the income tax legislation does not currently contain any measures to curb the extent to which a trustee exercises their discretion to minimise tax. For example, there is no requirement that the trustee identify the appointee at the start of each income year. The income tax legislation merely requires the trustee to exercise their discretion by the end of the income tax year (30 June).[113] The statistical analysis in Part III above showed the popularity of the discretionary trust. It is argued that this is partially due to this freedom to select persons within a class of potential beneficiaries, which is not possible through a company, coupled with the ability to split income. This is sometimes loosely referred to in practice as the flexibility of a discretionary trust.

2 *CGT Treatment of Trusts*

As stated above, the second favourable dimension of the tax treatment of trusts is the CGT rules. There are two key points. The first applies to all trusts.[114] As described in Part II above, the legislation has provided discount capital gains treatment for individuals and trusts. If the discount treatment applies, an individual or trust is able to reduce their capital gain by 50% in calculating their net capital gain.[115] In the context of a trust, the benefit of the discount is passed to the

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[112] *ITAA 1936* ss 95A(1), 97, 101. For a recent discussion of the application of these sections, see *Hart v Federal Commissioner of Taxation* [2018] FCAFC 61 (20 April 2018) [47]–[57].

[113] Trustees were previously given extra time (two months) to exercise their discretion, but the ATO removed this latitude on 24 August 2011: see ATO, *Trusts: Interpretation of Section 101 in Relation to Section 99 and 99A under 1964 Amending Legislation*, IT 328 (withdrawn); ATO, *Discretionary Trusts: Section 101 – Resolutions of Trustee*, IT 329 (withdrawn). The rule for streaming capital gains to specifically entitled beneficiaries does, however, allow two additional months: *ITAA 1997* s 115-228(1) (definition of 'share of net financial benefit', para (c)).

[114] It is noted that, unlike at general law, the income tax legislation treats a trust as a separate entity for tax law purposes: *ITAA 1997* s 960-100(f).

[115] Ibid s 115-100(a). The net capital gain is calculated using the method statement in s 102-5.

beneficiaries who are specifically entitled to the capital gain.[116] The discount treatment is not available to companies.[117]

The second point applies only to discretionary trusts. The CGT rules produce capital gains or capital losses for taxpayers when certain trigger events happen. One event that applies to trusts is when the trustee pays a beneficiary an amount of trust capital in relation to their interest in the trust. This is 'CGT event E4' ('E4').[118] Broadly, E4 brings to account distributions of trust capital that have not previously been taxed to the trustee and would otherwise not be taxed in the beneficiary's hands. The ATO's interpretation of E4 is that it cannot happen in relation to a discretionary trust because persons within a class of potential beneficiaries do not have an 'interest in the trust', which is one of the conditions for E4 to apply.[119] While this position is correct as a matter of law,[120] it means that amounts of trust capital are able to be distributed to potential beneficiaries of a discretionary trust tax-free. This is inconsistent with distributions of capital made by fixed trusts (because E4 applies) and the return of share capital by companies (because CGT event G1 applies).[121]

The availability of discount treatment to trusts, and by extension beneficiaries, and not to companies is a significant advantage of using a trust generally. The combination of the flexibility in allocating the tax liability on current year net income of a trust to persons selected by the trustee and the fact that discretionary trusts are excluded from CGT event E4 make discretionary trusts an extremely attractive alternative to a company.

3 *The Combined Effect of the Imputation System and Refundable Credits*

As discussed above, trusts are often used in combination with other vehicles, particularly the company, in fairly sophisticated structures. A recent structure, that became popular after the introduction of cash refunds to taxpayers for excess franking credits in 2000, is for a discretionary trust that is used to carry on business to have a corporate beneficiary, sometimes known as a 'bucket company',[122] often as the default beneficiary.[123] In this structure, the trustee will generally distribute to

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[116] Ibid sub-div 115-C.

[117] This is no accident. The exclusion of companies is made complete by *ITAA 1997* s 115-225 which unwinds the effect of the discount where the trustee is taxed on accumulated income under *ITAA 1936* s 99A. For the logic behind excluding companies, see Peter Costello, 'The New Business Tax System' (Media Release, No 058, 21 September 1999) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1999/058.htm&min=phc&DocType=0>, Attachment D <http://ministers.treasury.gov.au/ministers/phc/content/PressReleases/1999/attachments/058/D.PDF>.

[118] *ITAA 1997* s 104-70.

[119] See ATO, *Taxation Determination — Income Tax: Capital Gains: Does CGT Event E4 in Section 104-70 of the Income Tax Assessment Act 1997 Happen if the Trustee of a Discretionary Trust Makes a Non-Assessable Payment to: (A) A Mere Object; or (B) A Default Beneficiary?*, TD 2003/28, 26 November 2003.

[120] *Gartside v IRC* [1968] AC 553.

[121] *ITAA 1997* s 104-135.

[122] *Re:Think Tax Discussion Paper*, above n 34, 108. For discussion of structures involving bucket companies, see *RMIT Report*, above n 1, 73.

[123] 'A discretionary trust deed often nominates a person who will be entitled to the income of the trust if the trustee fails to exercise their discretion. That person is called the default beneficiary': Cooper and Evans, above n 64, 360 [19 060]. Practically, discretionary trust deeds almost always provide a

individuals with lower rates first and then to the bucket company. The goal is to cap the tax rate at the corporate tax rate (30%). The company can then loan some money back to the trust (provided this complies with div 7A of the *ITAA 1936*, which essentially requires that the loan have arm's length terms) or distribute it to shareholders. Sometimes the individual potential beneficiaries of the discretionary trust are also the company's shareholders; sometimes the shareholder is a second discretionary trust.[124] As described above, Australian tax law allows franking credits to flow through a trust with the dividend to the beneficiary. Where the beneficiary is an individual and has a tax rate that is less than the level of company tax paid, under current law, the beneficiary can be refunded the difference.[125] The 2019 Federal Election result seemed to show, at least in part, how important the cash refund for individuals and superannuation funds is to particular demographic groups as commentators have argued that campaigning around this issue may have contributed to the Coalition's victory.[126]

These three dimensions of the income tax treatment for trusts are very significant. Each is valuable in isolation, but they are extremely valuable when used in combination, which is possible when discretionary trusts are used.

B *Group 2: External Changes that had a Positive Effect or Created Greater Certainty for the Taxation of Trusts*

There were two main sources of external change that helped to make private trusts more attractive. The first was the High Court decision in *Harmer*,[127] and the second was unsuccessful attempts by successive governments to reform the rules for taxing trusts.

1 *The* Harmer *Decision*

The decision in *Harmer* was handed down on 12 December 1991. That decision was significant for all trusts because it contained a very broad definition for present entitlement ('the *Harmer* definition').[128] As stated in Part II, present entitlement is the primary mechanism for determining whether the net income of a trust is taxed to the beneficiary at the beneficiary's rate or to the trustee of a trust as a proxy or at a

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default beneficiary because this means that the trustee will avoid being assessed on the trust's net income at a punitive rate: *ITAA 1936* s 99A.

124 See, eg, Ben Walker, *Bucket Companies: The Least Known and Most Underutilised Strategy to Save Thousands in Tax*, Inspire Tax Planning <https://inspire.business/bucket-companies-save-thousands-in-tax/>.

125 *ITAA 1997* s 67-25(1).

126 Australian Labor Party, 'A Fairer Tax System: Ending Cash Refunds for Excess Imputation' (12 March 2018) 7 <https://d3n8a8pro7vhmx.cloudfront.net/australianlaborparty/pages/7652/attachments/original/1520827674/180313_Fact_Sheet_Dividend_Imputation_Reform.pdf?1520827674>. For commentary, see, eg, Jennine Khalik, 'How the Coalition Played a Long Game To Win the Franking Credits Debate', *Crikey* (online), 21 May 2019 <https://www.crikey.com.au/2019/05/21/franking-credits-victory-election/>; Benjamin Clark, 'Australia Can't Build a Future on Franking Credits', *Crikey* (online), 21 May 2019 <https://www.crikey.com.au/2019/05/21/franking-credits-future/>.

127 (1991) 173 CLR 264.

128 Ibid 271.

punitive rate.[129] Before *Harmer*, the meaning of present entitlement primarily derived from three cases and practitioners were required to conglomerate and reconcile statements of principle from those cases. While two of those cases, *Federal Commissioner of Taxation v Whiting*[130] and *Taylor v Federal Commissioner of Taxation*,[131] were High Court authorities and they advanced the meaning for present entitlement as a concept, they were old, their factual backgrounds were specific, and the statements of principle were difficult to read as a cohesive and lineal progression.[132] The third case, *Commissioner of Taxation v Totledge*,[133] contained a more sophisticated articulation and it used terms that were more easily applicable in real life; however, it was a Full Federal Court decision. The *Harmer* litigation came as a gift for practitioners. This was because the parties put an agreed statement of the meaning of present entitlement to the High Court bench. The High Court decision states that definition on the basis that the parties had removed it from contention in the case:

> The parties are agreed that the cases establish that a beneficiary is 'presently entitled' to a share of the income of a trust estate if, but only if: (a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and (b) the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.[134]

However, that statement has since been viewed as having received High Court endorsement. This was most notable in the High Court's 2010 decision in *Bamford*, which stated:

> The effect of the authorities dealing with the phrase "presently entitled" was considered in *Harmer v Commissioner of Taxation*, where it was accepted that a beneficiary would be so entitled if, and only if…[*Harmer* definition stated].[135]

As shown in Table 3 (below), there was a sustained increase in the number of trusts from 1991–92 through to 1997–98.[136] This correlates with the period following the *Harmer* decision.

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[129] *ITAA 1936* ss 97 (to the beneficiary), s 99A (to the trustee at the punitive rate). As stated above in Part II and above n 60, the trustee is taxed as the beneficiary's proxy in some cases.

[130] (1943) 68 CLR 199 ('*Whiting*').

[131] (1970) 119 CLR 444 ('*Taylor*').

[132] For further discussion of these cases, see Alex Evans, 'The Evolution of the Meaning for Present Entitlement in Case Law' (Paper presented at Postgraduate Law Conference, Sydney Law School, 30 October 2013).

[133] (1982) 60 FLR 149 ('*Totledge*').

[134] *Harmer* (1991) 173 CLR 264, 271 (citations omitted).

[135] *Bamford* (2010) 240 CLR 481, 505.

[136] See above n 21 for the source of the data.

Table 3: Income-year-on-income-year change in the number of trusts from 1991–92 to 1997–98

Between which income tax years	**% change in number of trusts (year-on-year)**
1991–92 and 1992–93	1.88%
1992–93 and 1993–94	8.31%
1993–94 and 1994–95	9.60%
1994–95 and 1995–96	9.58%
1995–96 and 1996–97	7.39%
1996–97 and 1997–98	6.13%

It is argued that the permissive definition in *Harmer* was appealing to practitioners and those who favoured using trusts because: it was clear and expansive; it was stated in a High Court judgment and so it removed the need to reconcile the statements in *Whiting, Taylor* and *Totledge*; and it provided certainty and stability for taxpayers in a complex area of the law. The fact that there has not since been a case directly challenging the substantive meaning of present entitlement reflects how favourably the *Harmer* definition is viewed in practice.[137]

2 *Unsuccessful Reform Attempts by the Australian Government*

A second significant boost to certainty for trusts came when the Coalition (Howard) Government abandoned its initiative to tax trusts as companies (the '*Uniform Entity Tax Proposal*') on 27 February 2001.[138] Table 4 (below) shows that the number of trusts decreased following the announcement of this proposal.[139]

Table 4: Income-year-on-income-year change in the number of trusts from 1997–98 to 2001–02

Between which income tax years	**% change in number of trusts (year-on-year)**
1997–98 and 1998–99	0.49%
1998–99 and 1999–2000	-1.27%
1999–2000 and 2000–01	-0.54%
2000–01 and 2001–02	1.87%

[137] For the refinements of this definition, see above n 59.
[138] *Entity Tax Retraction Media Release*, above n 3.
[139] See above n 21 for the source of the data.

As it was initially announced, the *Uniform Entity Tax Proposal* would have taxed trusts as companies. The rationale for that reform was to create a system so that 'similar activities, investments and entities' were taxed similarly (referred to as tax neutrality and also ensuring equity).[140] While this objective is desirable, the proposal has since been criticised for being too focused around an anti-avoidance concern,[141] and for giving rise to other problems, including creating new distortions between the treatment of individuals who owned property directly or were beneficiaries of a trust.[142] It also would not have solved the income-splitting problem, and it would have encouraged deferral of tax.[143]

As the Table 5 (below) shows, there was then a sustained period of increase in the number of trusts between 2002–03 to 2007–208.[144]

Table 5: Income-year-on-income-year change in the number of trusts from 2001–02 to 2007–08

Between income tax years	**Percentage change in the number of trusts (year-on-year)**
2001–02 and 2002–03	3.28%
2002–03 and 2003–04	6.56%
2003–04 and 2004–05	6.26%
2004–05 and 2005–06	6.81%
2005–06 and 2006–07	7.08%
2006–07 and 2007–08	8.26%

The sustained increase over time correlates with the period following the announcement that the *Uniform Entity Tax Proposal* would not be pursued. The reason for this increase was arguably that the abandonment signalled something greater than the failure of the proposal — it provided great certainty going forward for those who favoured using trusts. This was because the process had demonstrated

140 Australian Government, *Review of Business Taxation: A Tax System Redesigned: More Certain, Equitable and Durable* (1999), Chairman's Introduction, 2; Section 12 (Distributions) <http://rbt.treasury.gov.au/publications/paper4/>. See also Australian Government, 'A Strong Foundation: Establishing Objectives, Principles and Processes' (Discussion Paper, Commonwealth of Australia, November 1998) 63–4 [6.11]–[6.14] ('Ensuring equity'), 75 [6.67]–[6.68] <http://rbt.treasury.gov.au>.

141 See, eg, Slater argued that the *Uniform Entity Tax Proposal* was 'framed solely as an anti-avoidance measure, rather than structural reform': Slater, above n 25, 91.

142 Matthew Marcarian, 'The Future Taxation of Trusts in Australia – A Proposal' (2003) 38(5) *Taxation in Australia* 244, 245.

143 Ken Henry et al, 'Australia's Future Tax System: Report to the Treasurer' (Report, Australia's Future Tax System Review Panel, December 2009) 85 ('*AFTS Report*'). See also Board of Taxation, 'Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer' (Commonwealth of Australia, November 2002) 4 [12] <http://taxboard.gov.au/consultation/taxation-of-discretionary-trusts/> ('*Board of Taxation's Discretionary Trust Report*').

144 See above n 21 for the source of the data.

the power of the National Farmers' Federation and small business lobby in opposing changes in this area.[145] The Howard Government's experience in relation to the proposal showed how difficult reform of the rules for taxing trusts would be both politically and technically.

This certainty was enhanced when political events prevented the Labor (Gillard) Government from undertaking its planned reform of the rules for taxing trusts in 2012.[146] Again this is borne out by the statistics. The number of trusts continued to increase after the 2011–12 income year, but income-year-on-income-year growth has been much slower since (between 2.59% and 3.30%), than in previous periods.[147] Reform proposals by two governments of different parties reintroduced uncertainty because, combined, it signals that reform is more likely.

VI Why Use a Trust over a Partnership?

As stated in Part II above, Australia applies fairly pure rules to partnerships in the sense that partners are allocated their share of both partnership net income and losses. Despite this, Graph 1 showed that the number of partnerships peaked in 1994–95 and trusts overtook partnerships by number in 2002–03. One question that the existing formal literature has not analysed is: why are trusts favoured over partnerships? The only recent observation was in the Coalition (Abbott) Government's 2015 *Re:Think Tax Discussion Paper*, which stated that 'the reduction in the number of partnerships may reflect the relative decline in the number of entities in the farm sector due to consolidation'.[148] That may have been a contributing factor, but this Part argues that there are two more compelling reasons from an income tax perspective. Those reasons are the following.

A *Characteristics of Trusts*

First, some characteristics of trusts and their income tax treatment are particular to trusts. Most significantly, with a trust, it is possible to give different people rights to the income and capital. By comparison, it is fundamental to a partnership that partners have a right to income corresponding with their contributed capital and exposure for future liability.

In the US, the most popular small business structure, the limited liability company ('LLC'), is treated as a partnership for income tax law purposes. There are onerous rules to ensure that any special allocations (that do not correspond with the partner's interest in the partnership) are only respected if they reflect the way in

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145 *Entity Tax Retraction Media Release*, above n 3. See also the wording of the ALP's 2010 proposal to review the rules for taxing trusts in *ITAA 1936* div 6: *2010 Announcement*, above n 3.

146 The proposed reform by the Labor (Gillard) Government stalled after the release of the Policy Options Paper in October 2012: Treasury, Australian Government, 'Taxation of Trust Income — Options for Reform' (Policy Options Paper, 24 October 2012). See Alex Evans, 'The "Economic Benefits Model" for Trusts — Fools' Gold?' (2014) 43(3) *Australian Tax Review* 162, 162.

147 See above n 21 for the source of the data.

148 *Re:Think Tax Discussion Paper*, above n 34, 107.

which the partners 'share the economic burden and benefits of those items'[149] (the 'substantial economic effect restriction').[150] This restriction has been subject to fairly significant criticism in the US,[151] and it is onerous to administer. However, it is 'generally considered to be a robust way of protecting the design against the most blatant attempts to avoid or minimise the collective tax liability'.[152] That problem does not exist for the Australian trust, because income tax law respects the trust deed's allocation to beneficiaries and the division between income and capital beneficiaries.

A corollary of the first point is that, as discussed in Part VA(1) above, in the discretionary trust context, income tax law currently also respects the manner in which trustees appoint income among members of a class of potential beneficiaries. This means that there is greater flexibility in dividing current year income and the corresponding tax liability in discretionary trusts than is possible in the partnership context. Currently, the Australian partnership rules provide very simply for the allocation of net income compared with the US partnership rules.[153] For example, our rules do not give allowance for special allocations and we do not currently have the substantial economic effect restriction. The simplicity of our rules is at least partially attributable to the fact that, due to the decline in the number of partnerships, our partnership rules have not been as contested as the US rules. When it is possible to carry on business through both trusts and partnerships, it should come as no surprise that the statistics clearly show that taxpayers are opting for the vehicle that provides the most flexibility.

B *Application of CGT Rules to Partnerships*

The second reason for using a trust rather than a partnership is that the application of the CGT rules to partnerships was initially very uncertain. After the CGT rules were introduced, from 19 September 1985, it was unclear what the CGT asset was — the partner's interest in the partnership or the partner's interests in the partnership's assets. An ATO interpretive decision released on 22 June 1989 was followed by a series of special rules in 1990 to clarify that capital gains and losses result to the partners individually both when the partnership deals with the partnership assets and when there are changes in the partners' fractional interests in the partnership.[154] While it is unlikely that this lack of clarity was the sole reason for

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149 George Yin and David Shakow, *Federal Income Tax Project: Taxation of Private Business Enterprises – Reporters' Study* (The American Law Institute, 1999) 79 ('*ALI Reporters' Study on Private Business Enterprises*'); US Treasury Regulation § 1.704-1(b)(ii)(a).

150 US Treasury Regulation § 1.704-1(b)(2)(i). See Michael Graetz and Deborah Schenk, *Federal Income Taxation: Policy and Principles* (Foundation Press, 6th ed, 2009) 516; Richard Doernberg, Howard Abrams and Don Leatherman, *Federal Income Taxation of Corporations and Partnerships* (Aspen, 4th ed, 2009) 476, 572–81, 616–20; *ALI Reporters' Study on Private Business Enterprises*, above n 149, 388–90.

151 *ALI Reporters' Study on Private Business Enterprises*, above n 149, 80–5.

152 Evans (2016), above n 35, ch 3.

153 In Australia: *ITAA 1936* pt 3 div 5. In the US: *Internal Revenue Code 1986* 26 USC (1986), sub-ch K ('*IRC 1986*').

154 The initial ruling was ATO, *Income Tax: Capital Gains: Application to Disposals of Partnership and Partnership Interests*, IT 2540. The rules now include: *ITAA 1997* ss 106-5(1) (capital gain or loss is made by the partners individually), (2) (partner has cost base in their individual interest in the

the move away from partnerships in favour of trusts, it is likely to have provided an additional justification for preferring trusts. Although others have previously expressed that there is 'uncertainty' surrounding the application of the CGT rules to trusts and the rules are complex,[155] there are at least clear rules for trusts (CGT 'E' events) and, as described in Part VA(2) above, there are currently well-known loopholes that mean that CGT liability does not arise in particular circumstances.

Once taxpayers started using structures involving companies and trusts for all the reasons discussed in Parts IV and V, there was very little to lure them back to partnerships, and changing structures generally triggers a CGT event. If implemented as announced, the *ALP's 2017 Proposal* would likely have made the partnership more attractive.

VII Reform and Future Directions

This Part considers future directions and challenges for the income treatment of private trusts.

The heart of the problem with private trusts is that they are taxed using flow-through taxation (that is, taxed as pass-throughs) and they came to be used as a business vehicle before the Australian Government turned its mind to whether this was actually a good idea from a general law or tax policy perspective.

Australian political parties and academic commentators often express polar views about whether the use of trusts is good or bad, with the discussion recently focused on the bad.[156] This article argues that it is not that simple and, for a sustainable solution, the analysis needs to be more nuanced, particularly because: discretionary trusts are used for carrying on small business and small business is currently important to the Australian economy, contributing to both employment and production;[157] and the use of trusts to transfer wealth (that is, trust capital) is an

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partnership), 108-5(2) (definition for CGT asset). For more detailed discussion, see Cooper and Evans, above n 64, [21 000ff]; C J Taylor, *Capital Gains Tax: Business Assets and Entities* (Lawbook, 1994) ch 10.

155 Cooper and Evans, above n 64, [19 010].

156 See, eg, Royce Millar and Ben Scheiders, 'The Tax Minimisation Tool that Nobody Wants to Talk About', *The Sydney Morning Herald* (online), 6 April 2017 quoting Dale Boccabella; Australian Council of Social Service ('ACOSS'), 'Ending Tax Avoidance, Evasion and Money Laundering through Private Trusts' (ACOSS Policy Briefing, November 2017) <https://www.acoss.org.au/ending-tax-avoidance-evasion-and-money-laundering-through-private-trusts/>; David Richardson, 'Trusts and Tax Avoidance' (Discussion Paper, The Australia Institute, July 2017) <http://www.tai.org.au/sites/default/files/P428%20Trusts%20and%20Tax%20Avoidance%20-%20Richardson%20-%20FINAL.pdf>.

157 See, eg, Ellis Connolly, David Norman and Tim West, 'Small Business: An Economic Overview' (Roundtable Paper, Reserve Bank of Australia, May 2012) 3 <https://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/01-overview.pdf>. Note that, while the number of small business employees increased by 4.3% between 2009 and 2017, the share of private sector employment in selected industries fell from 46% at the end of June 2009 to 44% at the end of June 2017: Geoff Gilfillan, 'Small Business Sector Contribution to the Australian Economy' (Parliamentary Library Statistical Snapshot, Parliament of Australia, 15 October 2018) <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1819/SmallBusinessSector>. This is consistent with international trends: OECD, 'OECD Compendium of Productivity Indicators 2017' (18 May 2017) 66 <https://www.oecd-

accepted succession practice. Further, income tax law design is complex and designs need to be careful and sophisticated for solutions to be sustainable and robust in the context of modern business practice.

As discussed in Part I above, the *ALP's 2017 Proposal* would have imposed tax at the rate of 30% on distributions made by discretionary trusts to appointees over 18 years of age.[158] The point of the proposal was broadly to produce the same tax result as if a company was used instead of a trust. Functionally, this is a different way of achieving the objects of the *Uniform Entity Tax Proposal*. The heart of the argument, which has now been made by both of the major political parties at different times, appears to be that in the business context, the trust is really a 'disguise', and the taxpayer would have used a company except to minimise or avoid tax.[159] There are several problems with this argument.

A *Business Trusts*

A significant feature of the *ALP's 2017 Proposal* was that it excluded farming trusts. This was politically expedient for historic reasons — as discussed above, the National Farmers' Federation mounted such an effective lobby against the *Uniform Entity Tax Proposal* that the Coalition was forced to abandon it.[160] But business trusts were squarely within the *ALP's 2017 Proposal*. This was problematic and the reasons are worth noting for any future reform of this area by either political party.

The *ATO Tax Statistics* analysed in this article show that the trust has been the primary alternative vehicle to a company in Australia since 2002–03. Currently, the only other alternative is the partnership. One key limitation with the current Australian partnership form is that it does not provide partners with limited liability, either legally or functionally. As described in Part V, there are other legitimate non-tax reasons why taxpayers favour trusts. The primary ones are flexibility and asset

ilibrary.org/economics/oecd-compendium-of-productivity-indicators-2017/labour-productivity-by-firm-size-manufacturing-and-business-services_pdtvy-2017-graph40-en>.

[158] This rate may not be consistent with the rate that applies to all corporations. While for small corporations, the rate will drop progressively to 25% between now and 2025–26: *Tax Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth), that drop will not currently be extended to all corporations: *Tax Laws Amendment (Enterprise Tax Plan No 2) Bill 2017* (Cth) was negatived by the Parliament of Australia, Senate, Committee of the Whole, 22 August 2018.

[159] Taken to its extreme, the legal form of this argument is that the trust is a 'sham': *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449, 454. However, in Australia only a narrow conception of sham has been adopted: *Raftland Pty Ltd as trustee of the Raftland Trust v Federal Commissioner of Taxation* (2008) 238 CLR 516, 557 [129]. For literature favouring a broader view, see Miranda Stewart, 'The Judicial Doctrine in Australia' in Edwin Simpson and Miranda Stewart (eds), *Sham Transactions* (Oxford University Press, 2013) 51, 59 onwards (in particular 63 [3.44]); Michael Kirby, 'Of "Sham" and Other Lessons for Australian Revenue Law' (2008) 32(3) *Melbourne University Law Review* 861, 864. For other discussion, see Tony Pagone, 'Sham Trusts' (2012) 41(3) *Australian Tax Review* 119; A H Slater, 'Sham and Substance' (1999) 28(4) *Australian Tax Review* 197; Chris Evans, 'Containing Tax Avoidance: Anti-Avoidance Strategies' [2008] UNSW Law Working Paper Series 40; Glover, 'Shams, Reimbursement Agreements', above n 25.

[160] See above n 3.

protection (which includes group use of assets to ensure that the assets retain as much value over time as possible).[161]

If the tax treatment of trusts becomes unfavourable, experience in the US suggests that taxpayers are likely to demand an alternative vehicle or form taxed as a flow-through that does provide limited liability, particularly for carrying on small business. Others have previously floated the idea of Australia introducing a flow-through company,[162] implicitly with the hope that this would entice taxpayers to shift from a trust back to the corporate form on the basis that that is the most natural vehicle in the private context.

The income tax discussion of a flow-through company in Australia has previously focused on two models based on vehicles in the US – the S Corporation ('S Corp') and the LLC. The S Corp was created as a special vehicle for small business in the late 1950s.[163] The LLC was first recognised in Wyoming in 1977 as the result of lobbying from the oil industry and the form then spread across other states.[164] S Corps are taxed under a special regime *Internal Revenue Code of 1986* 26 USC sub-ch S ('*IRC 1986*')). LLCs are treated as partnerships for US federal income tax purposes and are taxed under the US partnership rules (*IRC 1986* sub-ch K).[165] US literature has observed that, from a design perspective, sub-ch S is more of a pure flow-through model than sub-ch K.[166] However, the only way US Treasury could achieve such a pure model for the S Corp was by heavily restricting its attributes. For example, originally an S Corp could only have 10 shareholders, it could not have any foreign shareholders and the types of income it could derive were curtailed.[167] Several of these attributes have been relaxed over time. For example,

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[161] Brett Freudenberg, 'Advisors' Understanding of Tax Compliance for Choice of Business Form' (2013) 4(1) *Global Review of Accounting and Finance* 1; *RMIT Report*, above n 1, 8.

[162] Institute of Chartered Accountants in Australia ('ICAA'), *Entity Flow-through for SMEs – ICAA Government Submission* (1 July 2008) reproduced by GAA Accounting <http://www.gaaaccounting.com/entity-flow-through-for-smes-icaa-government-submission>; Freudenberg (2006), above n 22; ICAA and Deloitte, *Entity Flow-through (EFT) Submission* (10 April 2008); Brett Freudenberg, *Tax Transparent Companies: Striving for Neutrality? An International Comparative Legal Study of Tax Transparent Companies and Their Potential Application for Australian Closely Held Businesses* (PhD, Griffith Business School, 2009) (Freudenberg argued that it was not feasible to introduce a flow-through company due to high administrative costs for taxpayers).

[163] Evans (2016), above n 35, 4,5, citing 104 Congressional Record 388 (President Eisenhower), 389 (daily ed, 13 January 1958); Roberta Mann, 'Subchapter S: Vive le Difference!' (2014) 18(1) *Chapman Law Review* 65, 66; James Eustice and Joel Kuntz, *Federal Income Taxation of S Corporations* (Thomson Reuters, as at 2012) [1.02[3][a]].

[164] Evans (2016), above n 35, 4,5, citing Robert Keatinge, Larry Ribstein, Susan Pace Hamill, Michael L Gravelle and Sharon Connaughton, 'The Limited Liability Company: A Study of the Emerging Entity' (1992) 47 *Business Lawyer* 375, 383. See also Susan Pace Hamill, 'The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure' in Steven A Bank and Kirk J Stark (eds), *Business Tax Stories: An In-Depth Look at Ten Leading Developments in Corporate and Partnership Taxation* (Foundation Press, 2005) 295. It is noted that Freudenberg considered the LLC form and some dimensions of its income tax treatment in his work, including Freudenberg (2009), above n 162; Freudenberg (2009), above n 22.

[165] Evans (2016), above n 35, citing Doernberg, Abrams and Leatherman, above n 150, 498.

[166] Ibid 6, citing Doernberg, Abrams and Leatherman, above n 150, 498.

[167] Ibid 4, citing James Eustice and Joel Kuntz, Thomson Reuters, *Federal Income Taxation of S Corporations* (2012) 1.2[5][a][i], 1.02[6][a], 1.03[2][b][i]. The number of shareholders increased to: 25 in 1980; 35 in 1982; 75 in the mid to late 1990s; and 100 in 2005; *IRC 1986* § 1361(b)(1)(A); *ALI Reporters' Study on Private Business Enterprises*, above n 149, 120 (footnote 149); *American*

S Corps can now have up to 100 owners.[168] But the point is that the S Corp was an ongoing tax experiment around the limits of when flow-through treatment could be applied. The problem for advocates of an S Corp style flow-through company in Australia is that, in the US, the S Corp was a timely solution to assist small business in the late 1950s. Creating an Australian equivalent of the S Corp now would not be as attractive as the option taxpayers currently have in a trust. It would be extremely difficult to replicate the extent of flexibility that taxpayers currently enjoy using a trust form in corporate form. This is one of the reasons why the author has previously advocated reforming the income tax rules for trusts, rather than trying to introduce a new vehicle.[169]

A further, thornier problem that is often overlooked by those who advocate for a tax transparent company like the US LLC is that the US partnership rules that are used to tax LLCs have the same pressure points as our current rules for taxing private trusts. As discussed above, the allocation mechanism and the rule used to back-stop it in the US partnership rules (the 'substantial economic effect restriction') for special allocations are extremely complicated.[170] Arguing that an LLC style solution would solve the worst of our problems from an income tax perspective is, at best, an incomplete and naïve analysis.

B *Income Splitting*

As stated in Part I, a key driver behind the *ALP's 2017 Proposal* was to curtail income splitting. The income-splitting concern is real. But this has been well known for a long time and it is a perennial problem in the private context.

While it appears to have been forgotten, in the 1975 *Asprey Report*, the majority of the Asprey Committee proposed that for family partnerships and inter vivos trusts the Commissioner should

> be required to examine the whole of the facts surrounding the setting up of the trust and its operation and control [to determine] whether the shares of income as allocated to beneficiaries [could reasonably be seen as arm's length] when measured in relation to their beneficial interest in capital and property of the trust and their business and/or professional contributions to the production of the trust income ...[171]

Jobs Creation Act of 2004 26 USC § 232. It is noted that Eustice and Kuntz stated that the number of owners changed to 75 in 1996, while the *ALI Reporters' Study on Private Business Enterprises* indicated that this happened in 1998.

[168] Evans (2016), above n 35, 4, citing *IRC 1986* § 1361(b)(1)(A); *American Jobs Creation Act of 2004* 26 USC § 232.

[169] Evans (2016), above n 35, chs 1, 5.

[170] Doernberg, Abrams and Leatherman advocated against using the term 'special allocation' because it is based on the assumption that partners have a general interest in the partnership: Doernberg, Abrams and Leatherman, above n 150, 570, 572–81, 616–20. US Treasury Regulation § 1.704-1(b)(2)(i); Graetz and Schenk, above n 150, 516; *ALI Reporters' Study on Private Business Enterprises*, above n 149, 388–90.

[171] *Asprey Report*, above n 82, 150 [11.32].

Where this was not the case, the Committee advocated that the Commissioner tax the allocations 'at a deterrent rate'.[172] But this proposal was not unanimous. Parsons included a broad and important reservation:[173]

> The descriptions given in the chapter of unacceptable 'income-splitting' transactions fail to identify any such principle except a notion that a course of action is 'tax avoidance', and therefore unacceptable, if it is undertaken solely or primarily for the purpose of reducing income tax liability. In my view such a notion is not a satisfactory explanation nor, where it is adopted as such, is it a workable test of the operation of measures intended to deal with transfers of income.[174]

Further, Parsons noted that the rationale for the measures proposed by the majority appeared to be to prevent transfers of capital, and by extension income derived on gifted capital. However, he also noted that 'defeat of the principal technique of transfer of income — outright gift of capital — is beyond the limits of effective legal action'.[175] This reservation signals the complexity of the problem of income splitting in trusts and flow-through vehicles. To cure the problem, rather than just shifting it to another vehicle (that is, the partnership), more extensive reform is needed across the tax system. To reform the rules for taxing trusts in the future, consideration should be given to transfers of wealth (that is, capital and income accruing on that capital).

The other problem that appears to be becoming entrenched in Australia, at least politically, is that we seem to be comfortable to allow income splitting in discretionary trusts used by farmers, but not those used by non-farming families or small business. It is very difficult to justify this using the well-worn tax policy criteria of equity, efficiency and simplicity. Therefore, it appears to be politically motivated for the reasons described above. Such concessions are challenging because, once they are in the legislation, history indicates that there is enormous resistance to removing them. For equity reasons, whatever solution a future reform proposal comes up with in relation to income splitting should be applied uniformly across the tax system.

C *An Alternative to the ALP's Proposal to Reforming the Rules for Taxing Trusts*

If either major political party wishes to embark on reforming the rules for taxing trusts, there are other ways to resolve the problems raised in the *ALP's 2017 Proposal*. Key features of a possible design include:[176]

- While the trust would not be the taxpayer, the tax system would recognise the trust as an entity for the purpose of characterising each receipt as being a particular type of income (including dividend income, royalty, interest,

[172] Ibid.
[173] Ibid 157–60.
[174] Ibid 157.
[175] Ibid 158.
[176] Evans (2016), above n 35, ch 5, especially 178–80 ('Overview Summary'). This design builds on the elements and arguments outlined in Evans (2019), above n 35.

general business income and exempt income) or a gain, and each outgoing as a deduction, loss or non-deductible, and the trustee would file an informational return.[177]

- A sophisticated allocation mechanism. A key element is that it requires owners to be identified. Owners would be limited to persons who hold an interest in the trust. Appointees of discretionary trusts (colloquially called 'discretionary beneficiaries') would not be treated as owners.
- Amounts that are subject to a discretion or are retained in an income year would be reallocated and taxed to the settlor if the settlor has power to reclaim property and/or any power over any allocation. If that is not applicable (that is, if the settlor is not involved or if the owners or a related party created the vehicle), the amounts would be reallocated between and taxed to the owners according to their share. This sequence would dramatically change the landscape in Australia as it would address the most blatant issues around income splitting.
- Each owner's share is calculated as whatever they are entitled to, of all amounts as they are classified for tax purposes, as a proportion of the whole. This encompasses notional amounts.
- Tax-preferred amounts would be allocated individually. All other amounts would be allocated on an aggregated basis on the argument that the tax treatment of those amounts would not change between owners. All allocated amounts are net (that is, each deduction is apportioned to the item of income to which it relates).
- The design operates on a base-case model, but allows for some variation in owners' interests. However, in variation cases, the owner would be allocated both income and losses relating to their interest.
- Losses would be passed through to owners to the extent of their cost base in their interest in the trust.[178] An owners' cost base could increase by amounts it pays to satisfy the trust's debt.
- The design draws on models from the US income tax system and uses an integrated approach to resolve the problem of dual cost base, which prevents against double taxation and the conferral of double benefits.
- Where the owner is non-resident, the design applies a tentative tax on a gross basis.

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[177] Others have discussed this before, but not in advocating for a model for taxing trusts in Australia. Freudenberg referred to recognising the vehicle as an entity for tax purposes as 'entity acknowledgment' in his evaluation of the feasibility of introducing a tax transparent company: Freudenberg (2009), above n 22, 402–6. 'Entity acknowledgement' appears in quotations in Freudenberg's work but it is not attributed to another source.

[178] There is wide support for this approach, see: *IRC 1986* §§ 704(d) (partnerships), 1366(d)(1) (S Corporations). In sub-ch S, this reduction affects both the shareholder's equity and debt basis. See also Graetz and Schenk, above n 150, 516; US House Committee on Ways and Means, *Technical Explanation of the Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Pass-through Entities* (12 March 2013) <http://waysandmeans.house.gov/UploadedFiles/FINAL_Sm_Bus_Passthrough_Technical_Explanation_03_12_13.pdf> 47; Brett Freudenberg, *Tax Flow-Through Companies* (CCH, 2011) 86–8; Brett Freudenberg, 'Losing my Losses: Are the Loss Restriction Rules Applying to Australia's Tax Transparent Companies Adequate?' (2008) 23(2) *Australian Tax Forum* 125, 136. Some countries apply this technique to limited partnerships: Easson and Thuronyi, above n 42, 937.

Such a design goes further and addresses other, harder problems that the *ALP's 2017 Proposal* did not raise, such as the problem of dual cost base, and the notoriously difficult allocation issues encountered in the US partnership tax rules described in Parts VIA and VIIA above.

In addition to considering another way to reform the rules for taxing trusts, it would be valuable for Australia to consider the alternative forms that are used in the private context for carrying on business in other countries and to fully appreciate their income tax treatment. This could build on initial contributions by others,[179] and would make clear the best alternative form. Treasury could then consult with small business regarding that form. This is the most logical way forward for sustainable change in this area. This author's proposal, outlined above, was designed to be broadly applicable to any form used in the private context for carrying on business (that is, its application is not limited to the trust form). Consequently, if Australia does ultimately introduce a new vehicle/form for this context, the design outlined above could easily be adapted.

VIII Conclusion

In 2002–03 the trust became the favoured alternative vehicle in Australia. While there has been a growing understanding of the popularity and pervasiveness of the trust form in Australia, this article filled the gap in the extant literature by clearly articulating: the income tax settings that prompted the movement towards trusts, both pre and post-imputation; and the reasons why trusts continue to offer a comparative advantage over the partnership in Australia. The explanations were supported by statistical data.

While the ALP correctly identified an income-splitting concern with trusts in its 2017 proposal, this article argued that the ALP's fix was limited and short-sighted, and it was likely to make the partnership form more attractive and then push the income-splitting problem into partnerships. A more comprehensive solution is required to solve the income-splitting problem. Further, the other alternative form to a corporation in Australia is the partnership. In the US, a key alternative vehicle, the LLC, is generally taxed as a partnership. The US rules for taxing partnerships that are designed to prevent income splitting are very complex and onerous to administer. It is naïve for Australia to think that the partnership will be a simple answer to the trust problem in the private context irrespective of which major political party embarks on reform of this area in the future.

This author suggests that Australia pursues a two-pronged strategy in the future. First, although it is very difficult politically, it would be valuable to reform the rules for taxing trusts. Part VII of this article contained a high level summary of the key features of a possible design. Second, Australia should consider the

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[179] That body of work includes the following. Freudenberg considered select dimensions of alternative forms in selected countries (the LLC and S Corp in the US, the limited liability partnership in the UK and the Loss Attribution Qualifying Company in New Zealand): Freudenberg (2009), above n 22; Freudenberg (2011), above n 178. Stewart considered the limited partnership form in Miranda Stewart, 'Towards Flow Through Taxation of Limited Partnerships: It's Time to Repeal Division 5A' (2003) 32(3) *Australian Tax Review* 171.

alternative non-corporate vehicles/forms used in a range of countries and their tax treatment as this may aid the selection of an alternative form that meets taxpayer needs and resolves the issues the ALP identified as well as other hard technical ones.