eJournal of Tax Research

Volume 3, Number 2 December 2005

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eJournal of Tax Research (2005) vol. 3, no. 2, pp. 274-287

Taxing Non-Fixed Trusts

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Abstract

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 This paper looks at the history of the withdrawn *New Business Tax System (Entity Taxation) Bill 2000*, which proposed to tax non-fixed trusts in a manner stated to be comparable to the taxation of companies.

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

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

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

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

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

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

Profits first rule

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

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

The rule met with almost universal condemnation.

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

WHAT ARE THE CRITERIA FOR GOOD TAXATION POLICY?

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

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

Efficiency

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

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

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

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

It can thus be seen that the Non-Fixed Trust Regime contravened the criterion of efficiency, becau6 Tm Tm0r226 Tm(proposed to33.98 0 0 10.98 141.840.9226 Tm Tw 10.98 0 0 10.

Equity

'Equity requires that tax contributions be socially just.'[20] Tax literature usually

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

THE BOARD OF TAXATION'S REPORT

The Board of Taxation reported on 22 November 2002, approximatel 637.70013 Tm(22)Tj0.9ynu3.7

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

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

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

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