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House: House of Representatives
Presented by: Hon. P.J. Keating, M.P., Treasurer

Short Digest of Bill

To introduce trust recoupment tax for recovery of income tax avoided through the use of certain new generation trust-stripping schemes. The schemes are designed to apply income of a trust to a tax exempt beneficiary (a charity) who, though having a vested and indefeasible interest in the income of the trust estate is not presently entitled to it until the vesting day (usually eighty years hence). The effective enjoyment of the benefit remains in the hands of beneficiaries who do not have a tax exempt status.

Outline

The Bill provides for the recoupment of income tax sought to be avoided. First, the Bill details the circumstances in which liability to the tax arises. The Bill then defines 'primary taxable amount', the base of calculating the tax to be assessed. It is a characteristic of recoupment tax legislation that provision is made for tracing benefits received from tax avoidance schemes into the hands of persons other than those primarily liable. Three supplementary quantities are defined for the purpose of calculating these liabilities. Tax rates in respect of the four defined amounts are specified in an associated Bill, the Trust Recoupment Tax Bill 1984. A further associated Bill, the Trust Recoupment Tax (Consequential Amendments) Bill 1984, specifies the status of trust recoupment tax collections for purposes of Federal-State financial relations and tax administration.

Taxation of trusts

Income of a trust flows from the trustee to the beneficiary when it is earned. The trustee is obliged to deal with income according to the terms of the trust deed, which may require for example immediate payment to the beneficiary, or capitalisation and accumulation until a specified event occurs. In the former case, the beneficiary, as the person entitled to receive income, is
generally liable to tax on it at personal rates. However, in certain situations, e.g. where the beneficiary is non-resident, the trustee is made liable to tax on behalf of the beneficiary. In the latter case, the trustee is liable to tax on the accumulating income.

For resident trusts, the important question is whether the beneficiary is 'presently entitled'. If the beneficiary is presently entitled, the trust income is included in and taxed as part of the beneficiary's income (section 97, Income Tax Assessment Act). Otherwise, where no beneficiary is presently entitled, the trustee is taxed, generally at a 60% rate (sections 99A, 99).

'Trust-stripping'

Tax avoidance schemes exploit these provisions by using a beneficiary which is tax exempt, either because it is a charity or because it has tax losses which can be used to offset the income earned. The chosen beneficiary is 'presently entitled' but the income is either not paid, or is paid and later recovered. Under the Act, if a beneficiary has a vested and indefeasible interest in the trust estate but is not presently entitled to the income, section 95A(2) deems the beneficiary to be presently entitled.

Anti-avoidance provisions directed at particular schemes identify the particular circumstances of the tax avoidance scheme and then prescribe a taxation treatment differing from that which would otherwise apply. Section 100A is directed at schemes involving payment to a tax-exempt charity and later recovery of the amount as paid. The section therefore relies on the existence of a 'reimbursement agreement', as defined. Where it applies, section 100A requires that the trustee be taxed under section 99A (at a 60% rate).

Measures against trust-stripping

Section 100A was added by the Income Tax Assessment Amendment Act 1979 and applies to income dealt with after 11 June 1978. Similarly to many trust taxation provisions, it is expressed to apply to only the last in a chain of trusts through which income is successively passed, so as to avoid double taxation. More significantly, it is limited to trusts which return the benefit of their tax exemption through a 'reimbursement agreement'. It leaves open tax avoidance schemes using paper losses or trading losses in the final trust to offset against the income and ensure that no tax is paid.
On 5 March 1980, the Treasurer announced amendments to section 100A to counter these schemes. The amendments, introduced in 1981 but applying to income dealt with after 5 March 1980, made two changes. First, it was no longer sufficient for a trust to pass on the income to a further trust in order that section 100A not apply. Section 100A would apply only to the extent that a beneficiary of the further trust was 'presently entitled' to the income. The practice of leaving the income in the trust and offsetting losses against it was thereby thwarted. Secondly, deductibility was denied to certain of the paper losses previously used. The amendments extended the size of section 100A's existing sanction, viz. assessment of the trustee to tax at section 99A rates.

On 11 May 1982, the Treasurer announced further measures against trust-stripping, to apply from that date. Examples of schemes then still being offered were appended to the statement. The May 1982 announcement indicated that should legislation prove deficient after that date in preventing trust-stripping schemes, it would be amended retrospectively to that date to close the loophole. Further, those who continued to engage in trust-stripping would be subject to penalty tax at a rate not lower than that prescribed by Part IVA of the Income Tax Assessment Act, the general tax avoidance provision.

A Press Release from the Minister for Finance on 28 April 1983 indicated that the approach of the present Government would include retrospection to an earlier date (1 July 1980) in respect of certain schemes still being entered into after 11 May 1982.

The trust-stripping arrangement exploited the deeming provision of the Act in relation to present entitlement by allocating income to a tax exempt charity. As the charity is not entitled to the income until the vesting day (usually eighty years hence), tax was avoided. Further when the income was to be distributed to the charity, the present value of the benefit was negligible.

The present legislation applies retrospectively to schemes entered into on or after 1 July 1980. In the manner of recoupment tax legislation generally, it enables tax to be assessed against and recovered from persons who have gained tax benefits through operation of the tax avoidance scheme. In such schemes it is quite likely that even when the entity properly liable to income tax is identified, it will have ceased to exist or will have been rendered incapable of paying the tax as assessed. The Bill enables the amount to be collected by assessing recoupment tax to the persons benefited.
Main Provisions

The Bill is to operate from the date of Royal Assent. It is associated with the Trust Recoupment Tax Bill 1984, which imposes the tax, and also with the Trust Recoupment Tax (Consequential Amendments) Bill 1984.

Sub-clause 5(1) specifies the criteria for determining when trust recoupment tax is to be assessed. The criteria include (i) that the beneficiary's interest arose as part of a tax avoidance scheme entered into on or after 1 July 1980, (ii) the beneficiary's 'present entitlement' is under section 100A of the Income Tax Assessment Act and not otherwise, and (iii) the present value of the benefits the beneficiary will derive from the trust is less than 50% of the relevant trust income.

'Present value' calculations allow the value of payments in the future to be discounted to their present worth. The calculation is based on a particular rate of interest. Under sub-clause 5(5), a rate of interest of 10% is to be used. Since the present value of $100,000 to be paid in 80 years time is less than $100, schemes which employ section 95A(2) and so have the effect of deeming present entitlement to a tax exempt charity, but enable the bulk of the income to be used elsewhere for a long period, are caught by the criteria.

Clause 5 establishes for the trustee of such a trust a 'primary taxable amount' equal to the amount to which the beneficiary is deemed presently entitled and on which the trustee has escaped tax at section 99A (60%) or section 99 rates.

The Income Tax Assessment Act avoids double taxation in a successive chain of trusts by making the final trust liable to tax. In contrast, sub-clause 5(2) of the Bill provides that where income is paid from a head trust to a sub-trust in connexion with a scheme, the income of the head trust will give rise to a primary taxable amount in respect of the head trust. The primary taxable amount of the sub-trust will be correspondingly reduced.

The Bill caters for such contingencies as the trust no longer existing or has been sold on or is unable to pay trust recoupment tax on a primary taxable amount. Tax avoidance arrangements using trusts are often quite flexible so that the liable entity becomes a "moving target". Provision for 'tracing' of benefits to the persons ultimately receiving them are common in recoupment tax legislation and overcome any inability to pay tax by the trusts in the scheme.
Clause 6 provides for a 'secondary taxable amount' to be calculated with reference to an 'eligible beneficiaries class' in specified circumstances including likely or actual inability of the trust to pay trust recoupment tax. Sub-clause 6(4) provides that the 'eligible beneficiaries' comprise those who have derived, or might reasonably have been expected to derive, a benefit through the primary taxable amount.

The associated taxing Bill levies tax on primary and secondary taxable amounts at 60%, the maximum rate of personal income tax.

Clause 7 specifies circumstances where other persons can elect to be subject to trust recoupment tax and the liability of the trustee is thereby extinguished. The clause is complex and may be applied successively. Sub-clause 7(1) permits natural persons and companies, other than trustees, ('eligible persons') to request that the clause apply to them. In this case, paragraph 7(7)(c) exempts the trustee from trust recoupment tax on the 'relevant taxable amount' (which may be less than the primary taxable amount). The income is notionally distributed to the eligible persons, who are then assessed on it under sub-clause 7(7) at personal rates. Where an eligible person is a non-trustee company, sub-clause 7(3) first allows persons who would have received the company income to request that clause 7 apply. Secondly, the notional income so calculated in respect of the company is an 'elected taxable amount' (sub-paragraph 7(7)(a)(ii)).

Sub-clause 7(2) then allows those notionally receiving the company income to have clause 7 apply to them in relation to the elected taxable income. The significance of that election is that under sub-clause 7(8) the company is made liable in respect of a 'company taxable amount' rather than in respect of the elected taxable amount, and the company income is notionally distributed to the beneficiaries, who are assessed on it at personal rates.

Trust recoupment tax rates in respect of 'elected taxable amounts' and 'company taxable amounts' are specified in the taxing Bill as 75% and 46% respectively. The former represents the combined effect of notional company tax and personal tax at the maximum rate (60%) on the residue. The provision thus further illustrates the intention of the legislation to tax benefits received at the maximum personal rate, but allow those benefiting from the tax avoidance scheme to elect to have the benefit included in their own income and taxed at the applicable personal rate.
Penalty tax is imposed by clause 12. In respect of tax avoidance schemes entered into after 28 April 1983 and before commencement of the Bill, penalty tax is imposed so that the trust recoupment tax levied in respect of a year of income is indexed to the consumer price index.

Where a tax avoidance scheme was entered into after commencement of the Bill, penalty tax of double the amount of trust recoupment tax is imposed, except in respect of trust recoupment tax levied initially on a trustee but which is not paid and is therefore levied secondarily on other persons. In this matter, the Bill's treatment is similar to Part IVA of the Income Tax Assessment Act 1936.

For further information, if required, contact:

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