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Trusts and tax avoidance

Discussion paper

David Richardson
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Level 1, Endeavour House, 1 Franklin St
Canberra, ACT 2601
Tel: (02) 61300530
Email: mail@tai.org.au
Website: www.tai.org.au

Introduction

> The general public know there is something "not right" with the tax treatment of family trusts (discretionary trusts). Accountants and tax lawyers working with discretionary trusts know first hand that the income tax treatment has trouble passing the "smell test". Even the most aggressive tax minimisers would concede that.[1]

Now seems the appropriate time to address the issue of tax avoidance through trusts. The Government has made modest steps against high income earners who rort superannuation as a tax minimisation/avoidance strategy. According to a recent press report: the introduction of the transfer-balance caps in particular has led many investors to also look at alternatives.[2] The 'transfer-balance caps' refer to the limits on how much of accumulated superannuation an individual can transfer into the retirement phase so as to limit 'the tax-free benefits of retirement pahse accounts [that] can be used by high wealth individuals'.[3] This measure from the 2016 budget came into effect on 1 July 2017. Hence the anticipation of a flow of funds into trust accounts.

This paper examines aspects of the present use of trusts with a view to outlining the extent of the problem and examining who benefits.

[1] Boccabella D (2015) 'Using family trusts to minimise tax is on the nose: so why are policy makers silent?' *The Conversation*, 22 September.

[2] Hamilton W (2017) 'Family trusts can be as useful and practical as SMSFs', *The Australian*, 11 July.

[3] Australian Government (2016)'Budget measures', *Budget Paper No 2, 2016-17*, 3 May.

Extent of the problem

Putting money into self-managed super funds had been a popular strategy for tax minimizers, avoiders and estate planners. As mentioned earlier, some of those options are being closed off and the 2017 budget included a variety of measures to address some of the strategies of the very rich. A financial planning firm, *Planning for Prosperity*, points out that some of the main reasons for setting up trusts are:

- Protection from divorce or creditors and
- Discretion in the way trust capital and income is distributed to beneficiaries; 'an effective way to manage tax'.[4]

The latter of course involves income splitting between trust beneficiaries. While strategies against avoidance are to be applauded it does mean that avoiders/tax planners will seek other ways of avoiding if not evading tax. One of those areas involves the already extensive use of trusts. The Australian Taxation Office (ATO) says that 'Each year arrangements that are aggressive towards the tax system are promoted to taxpayers. These arrangements typically involve:

- reducing a participant's taxable income
- increasing their deductions against their income
- increasing rebates
- avoiding tax and other obligations entirely'.[5]

The ATO warns that taking the advice of promotors may land the taxpayer in trouble.

Discussion of trusts is normally confined to the specialist parts of daily newspapers under titles such as 'Smart Money' and the like. The casual reader would probably ignore most of the content and assume the topic is for a few nerds. Even those who read those segments probably assume they are just one of the few nerds who read such material. No doubt they and everyone else would be surprised to hear that indeed, trusts are a very significant part of the Australian economy.

It is now some years ago when the Henry Review into taxation looked at this issue and found 'the rules that set out how trusts are taxed are complex and give rise to

[4] Budreika R (2017) 'Family trusts:The pros and cons', 11 February at http://www.planningforprosperity.com.au/family-trusts-pros-cons/

[5] See ATO at https://www.ato.gov.au/General/Tax-planning/Tax-avoidance-schemes/

uncertainty and should be updated and re-written'.[6] Recommendation 36 reads; 'The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application'.[7] Henry seemed to be particularly concerned about 'Specific rules [that] target the alienation of personal services income to a partnership, trust or company. The rules are effectively aimed at personal services income (income from working) earned by people in employee-like cases (such as dependent contractors). The rules are designed to prevent income splitting and the deferral of tax. They also act to ensure that deductions relating to such alienated income are limited to those available to employees.…While these specific rules have had some effect, their scope is generally limited to employee-like cases, compliance is poor, they are complex and a good deal of uncertainty remains around their operation'.[8]

Henry was more interested in the theoretical structure of the tax system in a fiscal policy sense rather than from an administrative/legislative sense. Hence he says 'While the current income tax structure is broadly retained, the use of trusts for tax avoidance or evasion is, however, likely to remain an area of concern that may require targeted responses'.[9]

Numbers

According to the ATO in 2014-15 (the latest year available) there were 823,448 trusts with assets of $3.1 trillion and revenue (total business income) of $349.2 billion.[10] Of the 823,448 trusts 642,416 or 78 per cent were discretionary trusts which 'are established by the person who sets up the trust i.e. the trustee, and the trustee has the power to choose, at his or her own discretion, the amount of money that will be paid to each beneficiary under the trust… the trustee has the discretion to choose which beneficiaries receive payment and how much payment they receive'.[11]

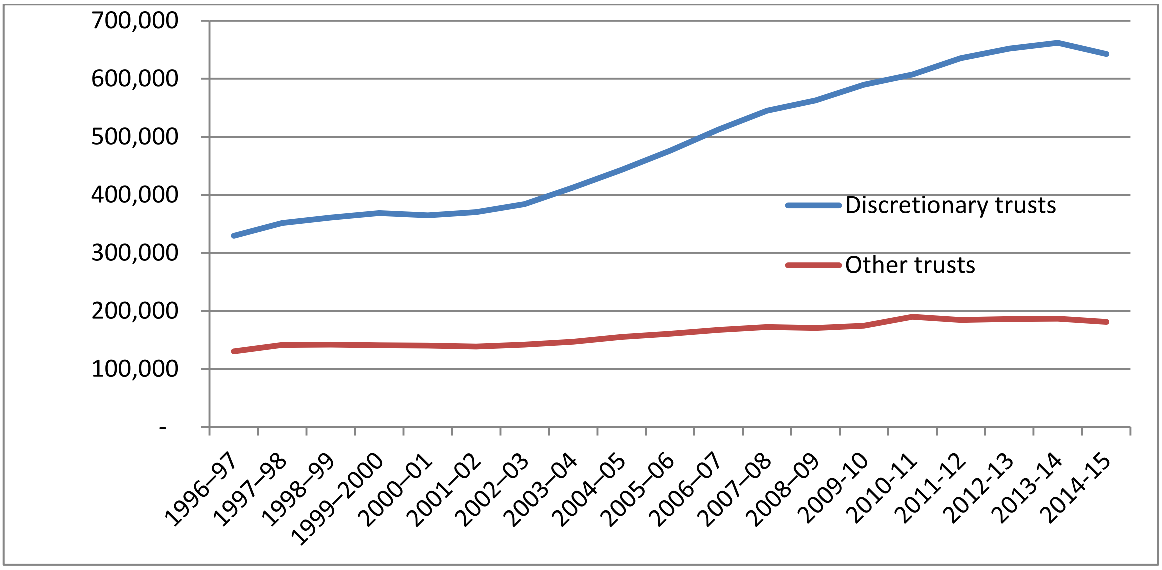
From the national accounts data for the year 2014-15[12] The Australia Institute estimates that 21.6 per cent of Australia's national income was run through a trust. To

[6] *Australia's future tax system: Report to the Treasurer, December 2009 Part One Overview,* p 42.
[7] Part One Overview, p 87.
[8] *Australia's future tax system: Report to the Treasurer, December 2009, Part Two, Detailed analysis*, volume 1, p 51.
[9] *Australia's future tax system: Report to the Treasurer, December 2009, Part Two, Detailed analysis*, volume 1, p 85.
[10] Data related to trusts comes from the ATO (2017) *Taxation Statistics, 2014-15*, at http://data.gov.au/dataset/taxation-statistics-2014-15 accessed 17 July 2017
[11] https://legalvision.com.au/difference-family-trust-discretionary-trust/
[12] ABS Cat no 5204.0.

most people this must seem very strange. We understand how individuals are taxed and recognise other taxable entities such as companies but most people would be unfamiliar with trusts. And the fact that they are so large, some 22 per cent of GDP, does sound very high. Moreover, trusts have been growing rapidly in recent years.

Figure 1 gives illustrates the data for the number of trusts for the period over which the ATO has made the data available.

Figure 1: Growth in trusts, number of trusts since 1996-97.



Source: ATO (2017) Taxation Statistics, 2014-15

Figure 1 shows how most of the growth has been in discretionary trusts which grew from 329,475 in 1996-97 to 642,416 in 2014-15, and increase of 95 per cent. The non-discretionary trusts grew by a more modest 39 per cent from 130,555 to 181,032 over the same period. Growth in discretionary trusts has far outweighed the growth in non-discretionary trusts.

Industries

Tax office data also allow us to examine those industries that tend to utilise trusts.

Table 1: Trust numbers by industry

	Number of Trusts no.
Construction	60,388
Professional, Scientific and Technical Services	58,510
Financial and Insurance Services	57,042
Rental, Hiring and Real Estate Services	48,150
Agriculture, Forestry and Fishing	27,971
Retail Trade	27,572
Accommodation and Food Services	19,778
Health Care and Social Assistance	19,446
Manufacturing	16,588
Other Services	15,324
Transport, Postal and Warehousing	14,558
Administrative and Support Services	11,336
Wholesale Trade	10,964
Arts and Recreation Services	5,288
Education and Training	3,797
Information Media and Telecommunications	3,104
Mining	1,315
Public Administration and Safety	1,277
Electricity, Gas, Water and Waste Services	1,192
Total of above	403,600

Source: ATO (2017) Taxation Statistics, 2014-15

Table 1 shows that the industry with the most trusts is construction at 60,388 closely followed by 'professional, scientific and technical services' at 58,510 trusts and 'financial and insurance services' at 57,042 trusts. Generally it seems that the industries that include a large number of small operators are likely to utilise trust arrangements. Presumably the financial and insurance service category includes a host of self-managed superannuation funds and the like. While these figures are interesting we do not wish to make too much of them given that Table 1 includes 403,600 trusts which implies that 51 per cent of trusts are not assigned to an industry. However, we would point out that the construction industry in particular is notorious for avoidance/evasion involving cash-in-hand transactions.

Revenue forgone

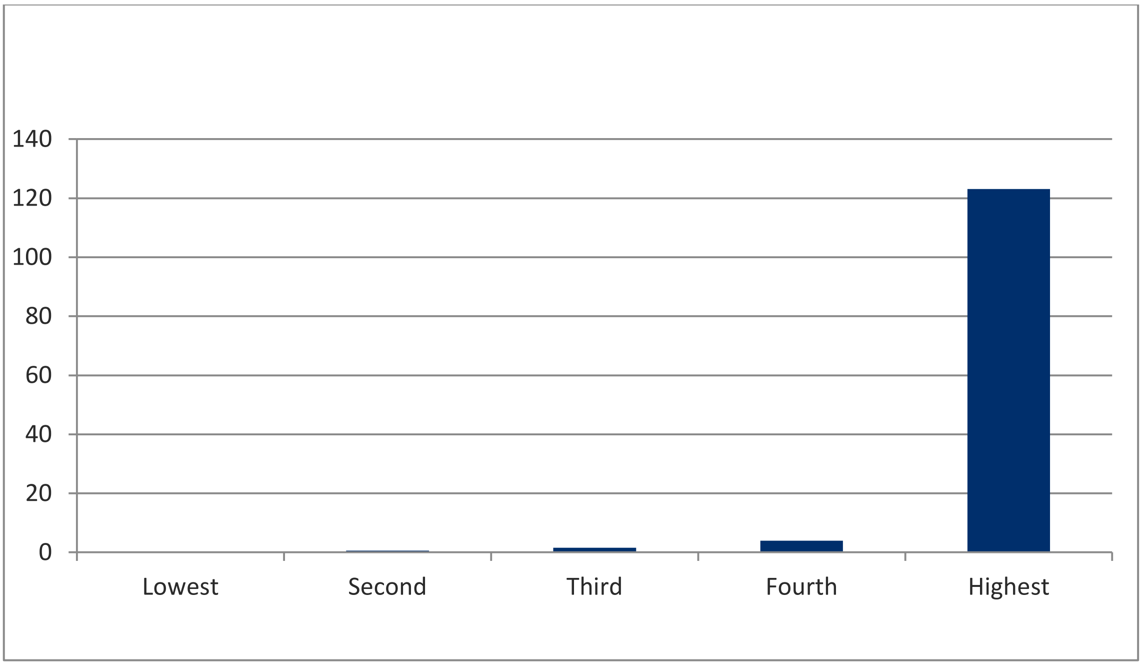
One observer, Dale Boccabella, Associate Professor of Taxation at the University of NSW, has estimated the revenue loss at $2 billion per annum.[13] It is hard to imagine anyone would set up a trust unless there was another legitimate reason or there were tax advantages of at least one per cent of income. An alternative and very conservative estimate would be that the revenue foregone might be one per cent of the total business income received by trusts or $3.5 billion. Given the ATO figures for the number of taxpayers, tax avoidance through trusts would cost each taxpayer an average of $202 per annum on Boccabella's figures and $354 per taxpayer if the one per cent assumption is correct.

[13] Millar R and Schneiders B (2017) 'The tax minimisation tool that nobody wants to talk about', *The Age*, 6 April.

So who are the beneficiaries of trusts?

Given their significance and rapid growth in trust numbers it is important to carefully consider which groups benefit from the opportunities created by the existence of trusts. The Australian Bureau of Statistics gives estimates of household wealth which includes specific assets such as bank accounts, shares and other categories and, for our purposes, includes a series for the value of private trusts. These figures are shown for households by quintiles starting with the bottom quintile of wealth holders and ending up at the highest quintile. That data is presented in Figure 2.

Figure 2: Value of private trusts by household quintiles ($'000)

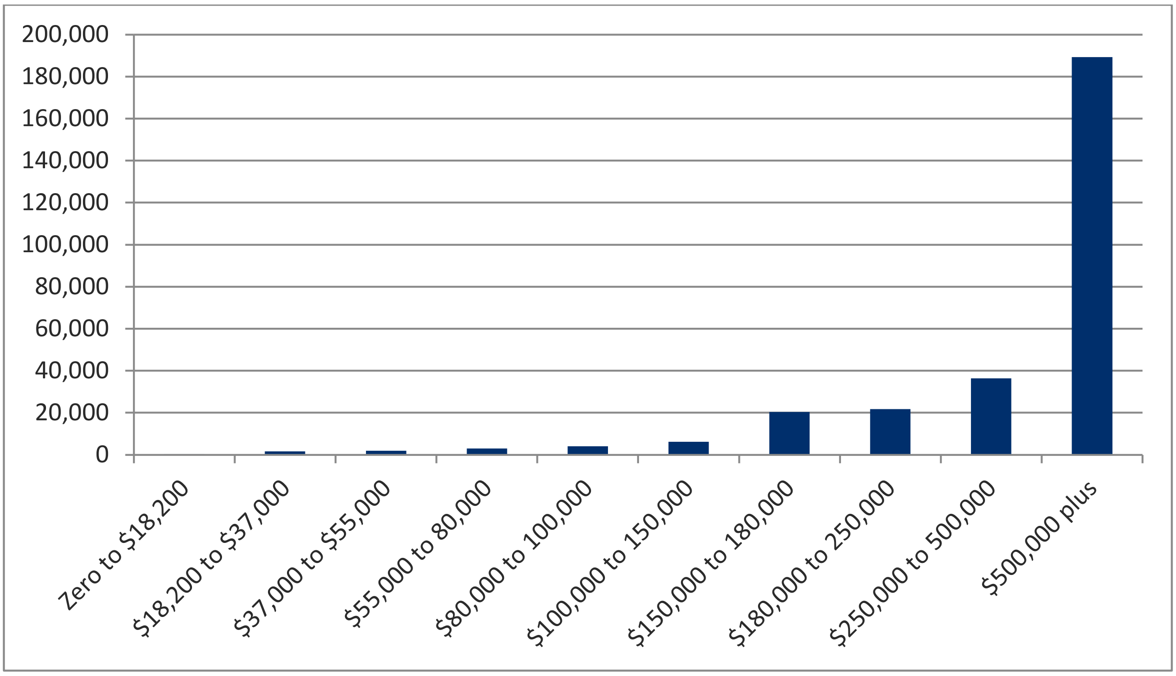


Source: ABS (2015) *Household Income and Wealth, Australia, 2013–14*, Cat no 6523.0, 16 December.

Figure 2 shows clearly that virtually all wealth held in all private trusts is by the 20 per cent wealthiest households who hold an average $123,100 in private trusts. Indeed, while the net wealth of the top 20 per cent is 71 times the bottom 20 per cent, in relation to private trusts the top 20 own 1231 times the amount owned by the bottom 20 per cent. Put differently the top 20 per cent account for 95 per cent of the value of all wealth held in trusts.

In order to examine income from trusts we have to rely again on tax office data. That data shows distributions from partnerships and trusts combined. While it is not possible to get data that matches income quintiles we can at least obtain trust (and partnership) distributions by tax bracket. Incidentally trusts account for 70 per cent of the total business income from partnerships and trusts so the tax office figures should give us a good approximation to the pattern of distributions from trusts alone.[14]

Figure 3: Average distributed income by taxable income bracket



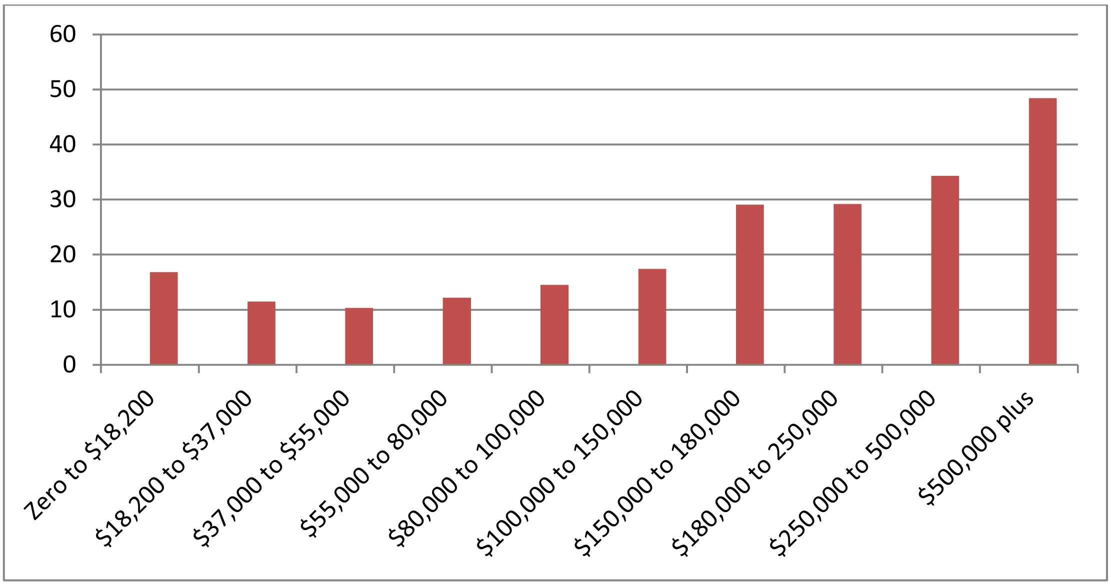
Source: ATO (2017) Taxation Statistics, 2014-15

Figure 3 is very interesting. Average non-farm trust (and partnership) distributions are much higher for high income earners. Over half of all the distributions (51.2 per cent) are to people in the top bracket shown here. These people account for just 0.43 per cent of all taxable individuals. Those over $250,000 account for 65 per cent of the distributions but only 1.81 per cent of taxable taxpayers. All but the top four per cent of income earners or those earning under $180,000 receive only 13.1 per cent of distributions from trusts (and partnerships).

It is also useful to examine the proportion of taxable taxpayers who receive a distribution in each tax bracket. On average 13.6 of all taxable taxpayers receive a distribution from a trust (or partnership). Figure 4 shows the proportions in each tax bracket who have some distribution/s.

[14] Figure 3 excludes a small number of primary production distributions.

Figure 4: Proportion of people receiving trust (and partnership) distributions by tax bracket (%).



Source: ATO (2017) Taxation Statistics, 2014-15

Figure 4 clearly shows that higher income earners are most likely to receive a distribution from a trust (or partnership). Hence 48.4 per cent of those with incomes over half a million dollars—almost half—receive some sort of distribution.

Conclusions

Now the Government has addressed other avoidance opportunities it is now appropriate to address the issue of tax avoidance through trusts. The present paper outlines the extent of trust usage in Australia and examines who are the beneficiaries of trust arrangements.

The main attraction of trusts seems to be tax avoidance. Some years ago the Henry review into taxation recommended updating and rewriting the rules around trusts. The strong growth in trusts in recent years adds to the urgency of re-examining that recommendation. The latest figures show there are 823,448 trusts with assets of $3.1 trillion and revenue (total business income) of $349.2 billion. The total business income run through trusts is now running at 21.6 per cent which suggests that the avoidance involved could amount to a very substantial figure. Generally it seems that the industries that include a large number of small operators are likely to utilise trust arrangements. The construction industry, which is notorious for avoidance/evasion, accounts for more trusts than any other industry.

The cost to government revenue of avoidance through trusts would be somewhere between $202 and $354 per taxpayer per annum under fairly conservative assumptions.

An examination of who is using trusts and who benefits from trusts shows they are heavily biased towards the very rich. Virtually all wealth held in all private trusts is by the 20 per cent wealthiest households who hold an average $123,100 in private trusts, or 95 per cent of the total. A similar picture is obtained by examining the income distributions from trusts. People with taxable incomes of $500,000 or more account of just 0.43 per cent of the population but 51 per cent of all trust distributions. Those earning under $180,000, still a high income, receive just 13 per cent of trust income. Trust use is so common among the higher incomes that almost half of those on $500,000 or more receive some sort of trust distribution.