DARWINIAN EVOLUTION OF THE TAXATION OF TRUSTS: A COMPARATIVE ANALYSIS

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This article will undertake a comparative analysis of the evolution of trusts in Australia and the United States. While the concept of a trust is well understood in both jurisdictions, it will be shown that the way trusts have been used in a commercial and taxation law context is quite different in the United States as compared with Australia.

The article will commence by examining the American and Australian experiences with trusts, including a brief examination of how trusts are used and how many trusts file tax returns. This will provide an important context and backdrop to the ensuing discussion and analysis.

In terms of any examination of the evolution of trusts, the British roots to the concept of a trust are important and will be analysed next in the article. Following this, a discussion of trust attributes in the United States will be undertaken.

The next part of the article will examine in more detail how and why trusts are used in Australia, focusing specifically on some of the taxation implications of the use of trusts in Australia. A comparative analysis will be undertaken in the United States context, showing how similar tax outcomes can be arrived at without using the technique of a trust.

The article will conclude by examining some important tax and public policy implications of the use of trusts in both Australia and the United States.

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1. INTRODUCTION

1.1 The American Experience

Whether they realise it or not, Americans frequently encounter the concept of a trust in their everyday working, savings and personal lives. Who has not heard of a bank or savings and loan trumpeting the benefits of an IRA (individual retirement account),¹ Keogh,² Simplified Employee Plan (‘SEP’), or of a for profit employer setting up a §401(k), pension, profit sharing or bonus plan retirement account, or a not for profit employer establishing a §403(b), or the United States (‘the US’) government maintaining a social security trust fund. For the more sophisticated or wealthier, they or their attorney or Certified Practising Accountant (‘CPA’) will recommend or establish a living or family trust, revocable or irrevocable trusts, an estate trust, a Crummey Trust, a Totten Trust, or a Life Insurance Trust. When you give money or property to a charity, you are really giving to a tax-exempt trust. Businesses utilise trusts in bankruptcy situations, or to defer executive compensation of their upper management ranks (a rabbi trust), or utilise an Employee Stock Ownership Trust (‘an ESOT’) to transfer some corporate ownership to its employees, or to facilitate buying out a small business owner by a company’s employees. In the context of a Subchapter S corporation, shareholders utilise a Qualified Subchapter S Trust (‘a QSST’)⁴ or an Electing Small Business Trust (‘an ESBT’)⁵ to share the wealth with their children or grandchildren.

If one were to look at the Internal Revenue Service Statistics of Income as to returns filed, far and away the most common tax return

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¹ IRC § 219 (1986). Unless otherwise indicated in this article, all references to provisions of legislation are references to sections of the Internal Revenue Code of 1986.
² IRC § 404 (1986).
³ Subchapter S of the IRC (1986).
⁴ IRC § 1361(d) (1986).
⁵ IRC § 1361(e) (1986).
filed is the individual tax return with almost 131 million tax returns filed in 2004. Second most common is the trust return with 3,688,048 million tax returns filed in 2004. To put these numbers in perspective, the largest number of business entity tax returns filed in 2004 are for S corporations, with approximately 3,000,000 filed, followed by regular (C) corporation tax returns (2.6 million) and then partnership tax returns.

If one were trying to explain what a trust is to a layperson or a child, one might use words that sound like slogans for a local police force: the purpose of trusts is to preserve and protect the assets for the trust’s beneficiaries.

Several terms of art are used in the trust legal and tax context. The one who sets up the trust is the donor or grantor. The ones who are to benefit from the trust are the beneficiaries or heirs, and the one who conserves the assets in the trust is the fiduciary or executor.

1.2 The Australian Experience

Like the American experience, trusts commonly are encountered in Australia. For example, many family businesses in Australia are conducted via ‘family trusts’, where the beneficiaries of such a trust typically include members of the family of the person who conducts the business. Superannuation fund investments (pension plans in American-speak) normally also involve trust arrangements, as do many charities. Unit trust investments and cash management trusts are also utilised in Australia.

Trust accounts are used by many lawyers to hold client funds. Professionals (doctors, lawyers, accountants) also commonly use ‘service trusts’ under service entity arrangements (see Appendix 1).

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6 Form 1040 and its progeny, Form 1040A and Form 1040EZ.
7 Form 1041.
8 Form 1120S.
9 Form 1120.
10 Form 1065.
These service trusts look a lot like ‘loan out’ companies that are used in the entertainment industry in America. Essentially, they impose a family controlled middleman between the service provider and the client or the company they work for. This middleman provides some services in return for earnings that will then be allocated and taxed to family members who are in a lower income tax bracket.

So what exactly does a ‘trust’ refer to in Australia? Similar to other jurisdictions, a trust is simply descriptive of the legal relationship between one person, the ‘trustee’, who is under an obligation to hold property or income for the benefit of others (beneficiaries). So in simple terms, a trustee has ‘legal’ ownership of property (for example, the assets of a business or investment) but holds that property on behalf of and for the benefit of others — the beneficiaries — who are entitled to the fruits of that ownership.11

Two of the principle trusts which are commonly encountered in Australia are a discretionary trust and a fixed trust. A discretionary trust is one in which the trustee has a wide discretion in relation to dealings with the trust property. For example, the trustee may be able to distribute all of the trust income to one beneficiary and none to others. It is this flexibility with the application of trust income and capital that has seen discretionary trusts become very popular in Australia from a tax point of view as it allows trustees to spread income among beneficiaries to minimise the overall tax burden.

A fixed trust is one in which each beneficiary of the trust has a fixed (or proportionate) interest in the income or capital (or both) of the trust. Therefore, the trustee has no discretion in relation to distributing income or capital other than in accordance with the fixed entitlements of the respective beneficiaries.

In terms of the creation of trusts, trusts are generally created either by a trust deed while the creator (settlor) is alive (referred to as

an inter vivos trust) or may arise upon the death of someone by their will (commonly referred to as a deceased estate or testamentary trust).

Turning to the most recent statistical data relating to trusts in Australia, the experience is quite similar to that in America. Like the US, by far the most common tax return filed is the individual tax return, with some 11.2 million returns filed in 2004–05. For the same period approximately 534 000 trust returns were filed which is almost a 20 percent increase over 1998–99 while companies accounted for approximately 708 000 lodgements (compared to 600 000 in 1998–99), and partnerships nearly 435 000 (compared to 500 000 in 1998–99). The statistical data reveals that the growth in the number of trusts has been similar to that of companies in recent years, with the number of partnerships actually decreasing.

Approximately 2.1 million individuals received a distribution from a partnership or trust in 2004–05 (compared with 1.9 million individuals who received a similar distribution in 1998–99). In the US, by contrast, the fastest growing filed entity is partnerships or LLCs primarily because as will be discussed below, they are used in place of the Australian trust to spread income among family members.

This statistical data is interesting as it provides a context and dimension to the increased use of trusts in Australia. With this background it is useful to now examine in more detail how and why trusts are used in the Australian and the US context.

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12 What follows relies on the Australian Taxation Office, *Taxation Statistics 2004–05* (2007) 1. At the time of writing, this was the latest statistical information that was available in the Australian context.


14 Ibid.

Professor Maitland, an equity scholar, once advanced the view that the development of trusts was ‘the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence.’\textsuperscript{16} He also claimed that the concept of a trust was ‘an “institute” of great elasticity and generality’.\textsuperscript{17} While some might argue that the English legal system has contributed more significant concepts to jurisprudence than the idea of a trust, it is generally accepted that the flexibility of a trust — especially the discretionary trust — has made it one of the most common vehicles used in the structuring of business relationships in Australia, and in family wealth planning in Australia and the US. As such, Marks notes that in Australia the trust pervades all types of business transactions, such as the form of a business organisation or its liquidation, investments and financing, risk-shifting, and the settlement of disputes, and family wealth planning.\textsuperscript{18}

Trusts have also been commonly employed in estate and succession planning and in the administration of the property of people upon their death.\textsuperscript{19} As will be discussed below, this is in marked contrast with the US experience where entities that conduct business much like a corporation or partnership may \textit{not} be treated as a trust for tax purposes.

Of note in the Australian context is the federal income tax, which since 1916 has had a significant influence on business transactions and family wealth, and hence the ‘inevitable mix of trusts and taxation’.\textsuperscript{20} Indeed trusts have been used for tax planning since

\begin{thebibliography}{9}
\bibitem{17} F W Maitland, \textit{Selected Essays} (1936) 129, as cited in Marks, above n 16, v.
\bibitem{18} Marks, above n 16, v.
\bibitem{19} Ibid.
\bibitem{20} Ibid.
\end{thebibliography}
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medieval times\textsuperscript{21} and they continue to be used as favourable tax vehicles and to protect assets from creditors and court orders.\textsuperscript{22}

Apart from using trusts for income tax planning, it is interesting to examine how trusts have been used in Australia over time. One of its original uses was as a vehicle or device in family wealth planning to easily and conveniently effect an intra-family transfer of property.\textsuperscript{23} Related to this was the ability to manage, minimise or avoid death and estate duties by transferring assets into a trust. However, in jurisdictions such as Australia where death and estate duties have been abolished, this rationale has diminished in importance over time and instead, trusts have been increasingly used to run family businesses. In the US, however, where the estate and gift tax system is very much alive, it is often used to avoid transfer taxes. Thus, the estate and gift tax system is part of the environmental change where the original use of trusts has changed in Australia but not in America.

In its modern form in Australia, the trust can achieve two main outcomes. First, ‘with careful planning wealth may be kept within a family unit and be under some sort of control of the head of the family’.\textsuperscript{24} Second, and perhaps more significant — at least in a business context — is the ability to transfer business assets to a trust. These assets commonly operate as an income source and the trust can then be used to minimise the tax burden by sharing, deflecting or shifting income among the various beneficiaries of the trust in a way

\textsuperscript{21} Cynthia Coleman, Geoffrey Hart and Dale Boccabella, \textit{Australian Tax Analysis} (4\textsuperscript{th} ed, 2001) 647.
\textsuperscript{23} An excellent discussion and analysis of the evolution of trusts in Australia appears in Marks, above n 16. What follows in this section relies on this source.
\textsuperscript{24} Marks, above n 16, 2.
that would achieve a lower overall tax outcome than that which would result if the income was taxed to the head of the family.\textsuperscript{25}

A related and powerful incentive to split income under the Australian tax regime has been its progressive rate structure with high marginal tax rates.\textsuperscript{26} Though Australia’s top marginal tax rates have steadily fallen in the past three decades, from 69 percent in 1970 to 60 percent in 1980, to 47 percent since 1990 and now down to a maximum rate of 45 percent (from the 2006–07 year onwards), the highest rate nevertheless still applies at relatively modest levels of income: above A$150 000 for the year ended 30 June 2007 rising to income above A$180 000 for the year ended 30 June 2009.\textsuperscript{27} This underscores the incentive for high-income earners to split income to minimise their tax liabilities.\textsuperscript{28}

Since Australia’s progressive rate structure rises quite quickly with modest levels of income, there can be considerable tax savings achieved, quite legally, when distributions are made by a trustee to beneficiaries who are at low or zero marginal tax rates (for example, those earning less than the tax-free threshold of A$6000 currently


\textsuperscript{26} Some also argue that the current disparity between the Australian corporate tax rate of 30 percent and the highest individual marginal tax rate (currently 45 percent) adds to the incentive to split income.

\textsuperscript{27} At the time of writing the Australian Dollar was about 85 US cents. Thus, A$150 000 is the equivalent of US$127 500.

\textsuperscript{28} It should be noted that the government in Australia has continued to increase the level of income before the highest marginal rate of 47 percent applies: above $70 000 for the year ended 30 June 2005, and proposed to apply above $95 000 for the year ended 30 June 2006 and above $125 000 for the year ended 30 June 2007. See Thomson ATP, Weekly Tax Bulletin: 2005 Budget Report Special Issue (10 May 2005) 697.
pay no tax in Australia).\textsuperscript{29} Hence, if a trustee is able to distribute within the tax-free threshold to one (or several) beneficiaries who have no (or low) income, this can result in considerable tax savings. As Renton notes, however, though tax savings may be produced by such arrangements, there may be non-tax features to such scenarios that might make it unattractive and these considerations would need to be borne in mind as part of any tax planning with trusts.\textsuperscript{30}

In America, a major reason for utilising trusts is also income shifting, but primarily related to investment income rather than business income. The US income tax rates are similarly progressive in nature, but the maximum rate (35 percent) does not apply until taxable income reaches $350 000 in 2007. However, the recently expanded ‘kiddie tax’ rules limit the ability to shift income to under 24 year olds. Before 2006, children under 14 would be subject to tax on investment income at their parent’s tax rate, defeating the purpose of income shifting. Beginning in 2008, children under 24 who are full-time students will pay tax at their parent’s tax rate on portfolio income, unless they have significant earned income.

Also, in the US if the trustee does not distribute the trust’s income to the beneficiary, then the trust will pay a tax on income above $11 000 at the maximum marginal rate of 35 percent. This discourages trustees from accumulating earnings at the trust level and forces them to distribute trust income or invest in tax exempt bonds or growth assets. In America, a family limited partnership (‘an FLP’) commonly would be utilised to take the place and function of a discretionary trust because as will be discussed below, a business may not be run by the trustee. The FLP would be controlled by the founding and controlling elder generation (alpha male or

\textsuperscript{29} The ability to use the low-income earners offset in Australia may constitute an additional benefit. The maximum offset for 2006–07 is $600 which is reduced by four cents for every dollar of taxable income over $25 000, phasing out completely when taxable income exceeds $40 000.

\textsuperscript{30} Renton, above n 11.
female) and income and distributions may be allocated to the younger generation who are in lower tax brackets.

So the modern day use of the trust in Australia may be summarised as being both for wealth planning and as a common vehicle for tax planning. Marks summarises the tax position thus:

The tax advantage of the trust — and the reason for the complexity of the applicable tax rules — is that although in law a trust is regarded as a fiduciary *relationship* (but in which the fiduciary holds property or an interest in property for the benefit of another person or for some committed object or purpose), for tax purposes, by virtue of the provisions of the *Income Tax Assessment Act*, the trust may be treated as an independent *entity*. That is, the trust may be treated like a company and, through the trustee, it may be taxed in its own right.31

As will be discussed below, in America the trust may not be used ‘like a company’ and that is a major reason for the Darwinian evolution of trusts morphing into different uses in different tax environments. The interesting historical question that will be discussed next is what the root of this commonly used tool is.

### 2. BRITISH ROOTS TO TRUSTS

It is clear that the root of the US and Australian law is the British ‘common law’ system. By common law we mean the law that was made and applied by the courts, as compared with legislation.32 It is also clear that trust roots derive from the British ‘equity law’. The two (common law and equity) are neatly summarised by Helen Hodgson as ‘the original and proper law of England, formerly administered in the Common Law Courts … as opposed to the

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31 Marks, above n 16, 2–3.
32 The French system is called a civil one because it takes its roots primarily from legislation.
system called equity which was administered in the Court of Chancery.’

The term equity derives from natural justice or fairness doctrine. It has built up its own set of rules and laws that were formulated over the centuries by the Court of Equity. Since the 13th century, equity law evolved separate from the common law. Essentially it was needed to address inequities and deficiencies of the common law system. For example, if a person borrowed money and gave a note representing the debt, paid back the loan, but foolishly did not receive the note back, the creditor could enforce the payment a second time under the common law of the time. Although this result may be technically correct under the common law, it is obviously not an equitable result. The King of England, who had delegated his judicial power to the courts, had retained the power to intervene when the equity situation warranted it.

As the common law resulted in so many requests for regal redress of these egregious situations, the King of England, in the 14th century, delegated his authority over equity issues to the Chancellor, who was the keeper of the King’s Seal and a member of the Great Council. The Chancellor’s court was known as the Chancery and was different from the Courts of Westminster and Nisi Prius common law courts in several fundamental ways. For example, the equity court would be conducted in English rather than the Common Law Court’s Latin; Chancery could enforce dictates of conscience while the common law was much more rule based; and the Chancellor was not bound by precedent and procedural formalities, which allowed the decision and remedy to be tailored to the facts and circumstances. Since the degree of justice was proportional to the Chancellor’s conscience, over time the Equity Court acquired its own body of law and principles such that by 1683,

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equity had developed its own precedents and by 1827\(^{34}\) had its own rigid system.

Issues that arose in a world of overlapping Common Law and Chancery Courts were: which took precedence and can you have redress in both courts? In the 1870s, these dilemmas and potential inconsistencies were somewhat ameliorated in Great Britain by the *Judicature Acts* which brought both systems of law into one court, but allowed the court to decide the case under the common law or the equity precedents and procedures.

Today, the British Chancery Court has jurisdiction over the following areas: trusts, property, married women’s property, deceased estates, and guardianship. The British courts have enforced the fiduciary duty concept to protect persons that may have an equitable interest in property and prevent them from being defrauded or otherwise being abused or taken advantage of. This fiduciary relationship is one that the tax and legal system in the US enforces very seriously. The relationship exists when a person occupies a position of trust in that they have a duty not to place their personal interest before, above or in conflict with the equitable interest party. The trustee, the fiduciary party of a trust, owes the highest degree of fiduciary duty to the beneficiaries of the trust.\(^{35}\) The trustee must treat equal beneficiaries equally, beneficiaries with different rights fairly, and must not act capriciously, arbitrarily or unreasonably.

The concept of a trust is a direct descendant of the equity concept of ‘use’. This is the idea that property (land) could be conveyed for a specific purpose and time (including permanently, which today would be described as irrevocably). Thus, in the Middle Ages, a crusader could put his property into a ‘use’ while he was fighting the infidels (or raping and pillaging, depending on your view point) in the Middle East with a trustee watching over the property for the

\(^{34}\) Ibid 2.  
\(^{35}\) The term often used to describe the care that trustees should take in investing on behalf of the trust and its beneficiaries is the ‘prudent man rule’.
benefit of his wife and children. Over time, the use or trust was used to convey land permanently to perhaps avoid the pre-1540 law of primogeniture. If a wealthy person felt that the first born male was not as responsible as the second or third born child, he could transfer land permanently into a ‘use’ for the beneficial interest of the non-first born child(ren) and thus avoid the law of the land. Similarly, it was used to circumvent the Mortmain Statutes which were 13th century laws that limited a person’s ability to transfer property to a corporation (possibly to protect the property from creditors). Common law courts did not recognise the ‘use’, but Chancery courts did. In the 15th and 16th centuries, ‘uses’ were used for a very American and somewhat Australian purpose, to avoid estate taxes. Basically, a ‘use’ was set up to avoid feudal dues and death duties (typically 10 percent of the value of the estate). It became so common a behaviour to utilise ‘uses’ that in 1536, King Henry VIII passed the Statute of Uses which made the rules surrounding ‘uses’, especially as to equity ownership, as legally enforceable.

Since the Industrial Revolution, the major non-tax reason for using trusts was to protect and distribute family assets. For example, for many years in England, women were not allowed to own property. Trusts were used to protect women’s equitable interest in property.

Where the British origins and the Australian and US applications today are in total agreement is in what a trust is. It is its application that has diverged over time. For example, the observation from Underhill’s Law of Trusts and Trustees that

A trust is an equitable obligation binding a person (trustee) to deal with property of which he is a legal owner (trust property), for the benefit of persons (beneficiaries or cestuis que trust) of whom he may himself be one, and any one of whom may enforce the obligation

\[\text{Statute of Uses 1536, 27 Hen 8, c 10.}\]
\[\text{Underhill’s Law of Trusts and Trustees (12th ed, 1970) 3.}\]
would be recognisable by any law or tax practitioner in any of the three countries discussed in this article.

This quote outlines the essential elements of a trust. The trustee is the person with technical or legal possession of the property but with a fiduciary duty to protect it for the beneficiaries of the trust. The grantor or settlor is the person who established the trust and whose wishes are generally where the trustee takes his instructions from. The trust may be irrevocable or revocable. The trust property or corpus may be personal or real property, tangible or intangible in nature. An equitable interest in the trust property is held by the beneficiary or beneficiaries of the trust. There are two times that trusts are created: during the lifetime of the grantor or settlor (inter vivos) or at death (testamentary, by will or family trust).

3. US TRUST ATTRIBUTES

True to the origins of the trust species, the US tax law has kept to its British roots and not changed what qualifies for trust treatment and the way it treats trusts. Essentially, the US distinguishes a vehicle for running a business from an ‘ordinary’ trust. The former (often called a ‘business’ trust) is subject to either partnership or corporate tax rules, while the latter is utilised to conserve or protect the trust assets and if it distributes the income, will be taxed at the beneficiary’s rates. If the income is accumulated at the trust level, it will be taxed at a high tax rate at a very low level of income (at about $11 000 of taxable income the trust is subject to a 35 percent tax rate, which is to be contrasted with a married couple or single taxpayer that will reach the 35 percent rate at about $350 000).

The regulations define an ‘ordinary’ trust as an arrangement where the trustees take title to property for the sole purpose of protecting or conserving the assets for the beneficiaries under the rules applied in chancery or probate courts. This derives directly

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38 US Treasury Regulation 301.7701-4(a).
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from the British system discussed above. The regulations go on to distinguish for tax purposes a trust from an association that will be taxable under the entity rules that apply to corporations, partnerships, LLCs, S corporations, etc. The simply stated, but more difficult to apply, difference is that the latter treatment involves the following two crucial factors: (1) associates (2) who have the objective to carry on business and divide the gains therefrom. The courts look at the trust agreement as to what the trustee and beneficiaries are allowed to do as much as what they actually do.  

It is not always clear when the trustees are conserving the assets and when they are running a business. The courts have stated that a trust devoted to liquidation of real estate or the passive holding of real estate and the collection of income there from … [is] not taxable as an association; and that a trust … [will] be deemed an association if its principal objects and activities … [involve] dealing in real estate, development of tracts of land, construction of improvements, or the purchase, management, or sale of properties. The regulations go on to state that a trust will be treated as an ‘ordinary’ trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and therefore, are not associated in a joint enterprise for the conduct of business for profit.

On the other hand, ‘business’ trusts (sometimes called ‘commercial trusts’, ‘Massachusetts trusts’ or ‘common law trusts’) are created or used ‘simply as a device to carry on a profit-making business which normally would have been carried on through business organisations’. Consistent with this, the court in Nee v Main

39 See, eg, Reynolds v Hill, 39 AFTR 1055 (8th Cir, 1950); Nee v Main Street Bank, 37 AFTR 1464 (1949).
41 US Treasury Regulation 301.7701-4(a), (b).
Street Bank held that an entity ‘created as a vehicle for conducting a business enterprise or [which] has been made generally to serve as such a vehicle’ will be taxed as a ‘business’ trust. In effect, if the trust walks like a business entity and quacks like a business entity, the US tax law will tax it like a business entity. Given the tax rates discussed above, this is not all bad. The Howard case taxpayer cited above could have avoided its tax issue today by making a check the box election as a partnership and the beneficiaries would treat the income (whether or not distributed) as of the same character as if earned by the business trust. The tax rate would have been determined at the beneficiaries’ tax brackets. This treatment would be the same as an ordinary trust in which the income was actually distributed. It is only if the association is taxed as a corporation that a dramatically different tax consequence would have resulted. This illustrates how the US and Australian business practices relative to trusts have morphed over time. The US would use a partnership while Australia would typically use a trust to accomplish similar goals.

The fine line between an ‘ordinary’ trust and a ‘business’ trust is illustrated by a recent revenue ruling which held that a Delaware Statutory Trust (‘a DST’) was an ‘ordinary’ trust because the trust agreement limited the trustees’ activities to the collection and distribution of the income from real estate held by the trust. The ruling went on to state that if the trust granted additional powers such as the ability to dispose of property and acquire new property or renegotiate the lease with existing tenants or enter into leases with new tenants or renegotiate the existing mortgage, then the DST would have been classified as a ‘business’ trust. Note it is the power to do these things allowed by the trust indenture and not the actualisation of these powers that will cause the entity to be treated as a business entity.

42 The US tax system treats a C corporation as a separate entity and distributions therefrom are subject to double taxation.
Similarly, a fairly recent court case faced the same issue of whether a financial arrangement was an ‘ordinary’ trust or a ‘business’ trust. In *AMC Trust v Commissioner*[^44] a family that ran an asphalt repair and maintenance business as a sole proprietor and then an incorporated entity formed a bevy of trusts where the trustees were the same family members that had been running the businesses before the trusts were created. They continued to operate the asphalt business in the same manner using the same controls, business bank accounts and business assets. The court held that the trusts were shams and solely tax motivated. The taxpayers argued that the trusts were for ‘asset protection’ but the court found that the only creditor this arrangement was protecting the business from was the US Treasury. Also, since there was no change in business operations, no economic interest was transferred to independent trustees and there were no meaningful restrictions on the trusts’ operations, the trusts were to be ignored.

### 4. AUSTRALIAN TRUST ATTRIBUTES

Historically, the nature of how trusts have been used and developed in Australia largely derives from the British roots of the trust. Hence, in terms of the regulation of trusts in Australia, Ford and Lee note that there has been no movement to codify the principles of trust law.[^45] Rather, the law relating to trusts in Australia derives from English law and a vast body of case law.

However, while Australian State and Territory courts rely on principles of equity embodied in old English cases, legal developments arising from those English principles in the Australian courts have not been uniform.[^46] A ready example of this lack of

[^46]: Coleman, Hart and Boccaabella, above n 21, 646.
uniformity exists in the various Trustee Acts\textsuperscript{47} which regulate the powers and investments of trustees.

Evans notes that it is axiomatic that trusts are not separate legal entities.\textsuperscript{48} Rather, in the Australian context, the trustee is regarded as the legal owner of the trust property and the income of the trust, while the Income Tax Assessment Act 1936 (Cth) (‘the ITAA36’) proceeds on the basis that income is assessed to those who are beneficially (presently) entitled to it.\textsuperscript{49}

The relevant provisions and balance between equitable reality and taxation policy is contained in Division 6 of Part III of the ITAA36. While it is beyond the scope of this article to detail the taxation rules that apply to trusts in Australia, it is nevertheless instructive to briefly summarise the scheme of the taxation of trusts in Australia and identify the main charging provisions that relate to the taxation of trusts.

The starting point is to ascertain the ‘net income’ of the ‘trust estate’. The law defines net income as the total assessable income of the trust estate calculated ‘as if the trustee were a taxpayer’ less allowable deductions (excepting some exclusions not relevant for present purposes). Beneficiaries are then taxed on this income to the extent they are presently entitled\textsuperscript{50} to it. If no beneficiary is presently entitled, then the trustee is taxed in a residual capacity. Such income is normally taxed at the highest marginal rate of tax including

\textsuperscript{47} The relevant legislation is the Trustee Act 1925 (NSW); Trustee Act 1958 (Vic); Trusts Act 1973 (Qld); Trustee Act 1936 (SA); Trustees Act 1962 (WA); Trustee Act 1898 (Tas); Trustee Act 1907 (NT); Trustee Act 1957 (ACT).
\textsuperscript{48} Michael Evans, Equity and Trusts (2003) 671.
\textsuperscript{49} Ibid.
\textsuperscript{50} The concept of ‘present entitlement’ under the Australian rules is a defined legal concept which essentially means a beneficiary has an immediate right to payment of a share of the trust income (ie absolutely or unconditionally entitled to the relevant amount).
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Medicare levy (currently 46.5 percent).  
Apart from being taxed in a residual capacity as described, trustees can also be taxed in a representative capacity (for example, on behalf of beneficiaries who have a legal disability [for example, beneficiaries under the age of 18] or on behalf of non-resident beneficiaries).

In concluding on this point, it is worthwhile restating that in Australia family trusts — which are in the main discretionary trusts where the trustee has complete discretion to apply the income of the trust estate among the beneficiaries of the trust — continue to flourish. Recent estimates put the number of family trusts in Australia at well over 450,000,  
and given the additional advantages of wealth planning and the flexibility that trusts offer for tax planning, it is likely to continue as an important feature of business planning in Australia. This is especially true following the decision of The Board of Taxation  
in 2002 not to proceed with any fundamental reforms in relation to the taxation of trusts, including abandonment of a proposal to tax trusts as companies, with the Board noting that:

The Board of Taxation considers that any proposal for fundamental change to the taxation treatment of trusts must be justified by compelling policy arguments before it could be supported. The Board is of the view that the efficiency and equity of the tax system

51 This rule generally applies to inter vivos trusts. By comparison, undistributed income of deceased estates (testamentary trusts) is normally subject to lower rates of taxation in the hands of trustees.
53 The Board of Taxation is an independent, non-statutory body established to advise the government on the development and implementation of taxation legislation and on the ongoing operation of the tax system: see The Board of Taxation, Welcome to The Board of Taxation Website (2000) Commonwealth of Australia <http://www.taxboard.gov.au> at 6 July 2005.
would not necessarily be improved by aligning the tax treatment of trusts and companies.\footnote{Board of Taxation, above n 13, 1.}

5. HOW THE US ARRIVES AT THE SAME SOLUTION WITHOUT THE TRUST TECHNIQUE

Like most adaptations in life, because the US tax system adheres more strictly to its British roots, it has developed other manifestations to deal with the same concerns and accomplish the same results as the Australian system does with trusts, just using other means. In the US, the primary associations or business entities are fivefold:

- the C or regular corporation, which has limited liability to all investors but involves a potential double tax on income and profits and does not allow special allocations of income to family members or other shareholders. Because the shares are easily transferable, the death of an owner does not end the corporation’s existence and the shares may be transferred by will or inter vivos;

- partnerships, of which there are a number of sub-types.\footnote{The most common ones are General Partnership (‘GP’), which requires all owners to have unlimited liability; Limited Partnership (‘LP’), which requires at least one owner to have unlimited liability (although this general partner is often a corporation or an S corporation); Limited Liability Company (‘LLC’), which has no unlimited liability owners; Limited Liability Partnership (‘LLP’), which is a special class of GP for attorneys and CPAs and gives limited liability for professional actions or misconduct by other partners.} The advantages of a partnership are that the income and property are only taxed once (at the owners’ level), losses pass through to the owners, the income can be specially allocated as long as there is substantial economic effect,\footnote{See IRC § 704(b) (1986).} and the character of the income at the entity level passes through to the owners. Also, for some
property (real estate), non-recourse liabilities will increase the owners’ basis for loss and if a partner guarantees the loan, he or she will get basis for loss as well. The primary disadvantage of a partnership is that undistributed income is still taxable to the owners and losses may be limited by ‘at-risk’ and ‘passive activity loss’ rules;

- S corporations, which are a fairly unique sub-species of corporate status in that they allow the pass-through nature of a partnership (including the character of the income or loss) but allow limited liability status. An S corporation also has some advantages in the area of self-employment tax, which may run as high as 15.3 percent. The disadvantage of the S status is that like a partnership, income is taxable to the shareholders, whether or not distributed, and basis for loss is not allowed for recourse or non-recourse real estate debt. In addition, who may own an S corporation is somewhat limited in that you may only have one class of stock (difficult to have special allocations), the maximum number of shareholders is 100 and the shareholders may not be corporations, partnerships or non-resident aliens. Most important, special allocations are not allowed;

- sole proprietorships (Schedule C), which are a common means of doing business for a ‘mom and pop’ operation. There is unlimited liability but only one level of tax on income and property; and

- Single Member LLCs (‘SMLLCs’), which are often used in conjunction with a sole proprietorship to provide limited liability. It is essentially what is referred to in the tax literature as a ‘disregarded entity’. That is, it has legal status, but no tax acknowledgement. Thus, if a SMLLC is owned by an individual where he does his business activity, the owner will still file an individual Schedule C, but he will have the protection from

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57 See IRC § 465 (1986).
58 See IRC § 469 (1986).
liability under state law. Similarly, if a partnership established a SMLLC to receive real estate in a like kind exchange, any environmental liabilities on the property will be segregated from the partnership assets by the SMLLC’s existence but will be deemed for tax purposes to be owned by the partnership and therefore will facilitate a s 1031 tax deferred exchange.

Given these five different types of entities, one can see that most of what trusts are used for in Australia can be accomplished in America without the tax avoidance problem that Australia seems to be under siege from. One issue not explicitly discussed above is the ability to transfer property to family members or inherit property. The US has both a gift tax and an estate tax system in place,\textsuperscript{59} while Australia does not. Although all of the interests (other than those in sole proprietorships) may be transferred to family members, tax professionals have developed a special type partnership, called the Family Limited Partnership (‘FLP’). Because of minority ownership and a lack of liquidity and marketability, many courts have allowed a discounted value (often in the 30 percent to 40 percent range) when the interests in an FLP are transferred to family members, thus reducing the gift tax upon transfer. This entity is entitled to run a business and distribute the income according to the partnership agreement, which may be proportional or non-proportional in nature. Distributions from the partnership are at the discretion of the controlling or managing members. This most closely resembles the look and purpose of the Australian discretionary trust.

6. TAX POLICY IMPLICATIONS

In America, the Clinton administration made trusts very unattractive and the W Bush administration has not revised this situation, in that undistributed earnings are heavily taxed at a very

\textsuperscript{59} It is presently scheduled to be repealed for one year, 2010, and then reinstated at less favourable exclusions and rates in 2011. This ridiculous situation is currently under review by Congress.
low level of taxable income (35 percent on any accumulated income over $11,000). Thus, a trustee is often placed between Scylla and Charibdes. That is, if the grantor or settlor’s wishes were to accumulate income for the benefit of a young beneficiary or a troubled one, either the trust has to invest in sub-optimal investments such as tax exempt bond income or distribute the income, which may not be consistent with the British roots of trusts. The tax policy solution for this dilemma would be to use a single low tax rate for trust accumulated income. The real life solution is that the trustee would invest in growth assets, rather than income ones. This would allow trustees to deal with the myriad of fiduciary relationships that may exist while minimising the tax impact of their decisions.

On the Australian side of the pond, a different tax policy solution may be optimal. Given the rampant use of trusts for primarily a tax avoidance purpose and given the complexity engendered by the use of trusts, a potential solution may be to adopt the US treatment of trusts and at the same time, with the revenue raised by this proposal, increase the progressivity of the individual tax rates. For example, making the highest marginal rate of 45 percent apply at, say, $250,000 would take care of most of the Australian population and may counter the brain drain recently highlighted in the press.

7. CONCLUSION

The US trust system has stayed more true to the original trust concept that comes out of the historical British ‘use’ law. Instead, America has adopted other mutations to fill the needs of the wealthy for tax planning purposes by establishing family limited partnerships and S corporations, which resemble the Australian discretionary trust.

They allow businesses to be run by one taxpayer, but the income to be allocated and distributed to other low tax bracket parties. Also, the US ‘kiddie tax’ was implemented to stop the allocation of income to young low bracket taxpayers. On the other hand, the Australian business and tax environment engendered a more radical change
from the British roots of the trust and utilises the discretionary trust to run a business by one group and allocate it to low tax bracket family members.

Appendix 1: Service Trusts in Australia

Professionals commonly use what are referred to as ‘service trusts’ under a service entity arrangement. According to the Australian Taxation Office, such an arrangement will generally show all or most of the following features: 60

- The taxpayer (and this could be a sole proprietor, a partner in a professional partnership or a company) carries on a business or professional practice in a field such as accountancy, law, medicine or pharmacy.
- There is a trust that is controlled, or a company that is owned or controlled, by the taxpayer or by the taxpayer and associates of the taxpayer.
- The taxpayer, alone or in partnership, enters into an agreement with the service entity for the taxpayer to pay certain fees and charges in return for the service entity providing certain services. These services could include staff hire, recruitment, clerical and administrative services, provision of premises, plant or equipment, or a combination of these services.
- Typically, the service fees and charges are calculated by way of a mark-up on some or all of the costs of the service entity (although a fixed charge may be agreed on by the parties up-front).
- The taxpayer (or professional partnership) claims a deduction for the service fees and charges as expenditure it has incurred in the conduct of its business.

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60 Australian Taxation Office, Your Service Entity Arrangements (2006). What follows on this point is drawn from this source.
The service arrangement either gives rise to profits in the service entity, for both accounting and tax purposes, or would give rise to profits in the service entity except for remuneration or service fees paid to associates of the taxpayer or the taxpayer’s partners.

The profits derived by the service entity are either retained by the service entity (usually where the service entity is a company), or distributed (directly or indirectly) to the taxpayer (or partners in the case of a partnership) or to associates of the taxpayer (and associates of the partners in the case of a partnership).

Example of a Typical Service Entity Arrangement

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61 Ibid 5.
Conventional service entity arrangements are typically entered into by lawyers and accountants, although service entity arrangements involving other professionals, such as medical practitioners and pharmacists, also exist in the Australian context. The professional practices that use service entity arrangements range from large practices to small and micro practices and individual practitioners.