Income tax and trust law perspectives of the practical disregard of legal form in discretionary family trading trusts

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ABSTRACT

Estimates are that 70 per cent of all businesses in Australia are family owned. In small family businesses, participants focus on generating sufficient cash to fund working capital and to pay their personal expenses. Relying on the underlying social construct of a family business, family members justify their entitlement to business-generated cash by arguing that it is the family group that bears the entrepreneurial and trading risk. Objectively, their right to cash is constrained by the nature of their ownership rights and by the legal form they adopt to conduct the business.

This paper investigates the complexities that arise when family members use business funds to pay for their personal expenses, focusing on uncomplicated flat small family business structures that incorporate a discretionary trading trust. In particular, the paper presents income tax law and trust law perspectives of family member access to business-generated cash, investigating whether they consider and apply trust law principles when they take business-generated cash for private purposes and when they determine their income tax liability arising from the business.

The paper begins by reflecting on the social construct and features of family businesses in Australia and the importance of self-funded working capital. Secondly, the paper considers the legal forms adopted to conduct a family business and the role that income tax plays in a family's choice of business form. Third, the principles applied to tax family business income are considered using the vantage points of ownership rights, employment entitlements and family maintenance payments. In the fourth section, attention turns to the nature of trust law entitlements and beneficiary rights to cash in discretionary trusts. Three questions are considered: who are the trustees, how often can they exercise discretion, and which formalities are required to evidence appropriate and reasonable discretion. The validity of three alternate beneficiary arguments to justify their access to cash outside of the ambit of trustee discretion is also discussed. The remainder of the paper focuses on income tax law and considers how family groups rely on trust law principles to minimise their aggregate income tax. In turn, the paper considers the principle of income splitting, present entitlements compared to access to

cash, and how present entitlements, entitlements to income of the trust estate, access to trust cash for personal purposes and unpaid present entitlements are dealt with from an accounting and income tax perspective.

The paper concludes by reflecting on: the practical disregard of the essential legal form of a discretionary trust to enable ongoing family member access to cash, the family's reliance on trust law to justify income splitting to minimise income tax across the family group, the misclassification of access to cash prior to trustee discretion as drawings or loans, and how notional present entitlements often bear little resemblance to a lower practical access to cash. The resulting inconsistencies between access to cash, taxable income and accounting records underscore the continued and contemporary debate that regulatory reform of discretionary trading trusts is long overdue and necessary in Australia.

Income tax and trust law perspectives of the practical disregard of legal form in discretionary family trading trusts

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I INTRODUCTION

Family businesses remain the dominant form of business organisation all over the world. The vast majority of family businesses are classified as small enterprises based on turnover and employment.[2] In these small enterprises, business and family identity are undeniably interwoven.[3] There is deep trust among generational participants,[4] often built on the promise of future equity or asset ownership rights linked to succession.[5]

Generational participants work towards the long-term preservation of the family legacy, reputation and assets, which are necessarily influenced by the delicate balancing act between generating sufficient cash to fund the working capital of the business on the one hand, and to fund the personal expenses of the family members on the other hand. In family businesses, decisions are thus framed against economic and non-economic private goals.[6]

Relying on the underlying social construct of a family business, family member participants may well be justified in arguing they are entitled to take cash generated by the family business to fund their personal expenses on an ongoing basis with little or no formality for two reasons. Firstly, it is the family group that bears the entrepreneurial and trading risk. Secondly, family

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[2] See, eg, Thomas Glauben et al, 'Probability and Timing of Succession or Closure in Family Farms: a Switching Regression Analysis of Farm Households in Germany' (2009) 41(1) *Applied Economics* 45, 45; Maximilian Lude and Reinhard Prügl, 'Why the Family Business Brand Matters: Brand Authentication and the Family Firm Trust Inference' (2018) 89 *Journal of Business Research* 121, 121; Torsten Schmidts and Deborah Shepherd, 'Social Identity Theory and the Family Business: A Contribution to Understanding Family Business Dynamics' (2013) 20 *Small Enterprise Research* 76, 76; KPMG, Submission to the Board of Taxation, *Second Discussion Paper: Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936*, 9 May 2014, 3; KPMG, *Family Business Survey 2018: Family Business – the Balance for Success* (KPMG, Family Business Australia and The University of Adelaide, May 2018) 3; Australian Small Business and Family Enterprise Ombudsman, *Small Business Counts: Small Business in the Australian Economy* (2016) 34.
[3] Torsten Schmidts and Deborah Shepherd, above n 2, 78.
[4] Michael Gilding, 'Families and Fortunes: Accumulation, Management Succession and Inheritance in Wealthy Families' (2005) 41(1) *Journal of Sociology* 29, 42.
[5] Bernie O'Sullivan, *Estate & Business Succession Planning* (The Tax Institute, 2013) 178.
[6] See, eg, Parliamentary Joint Committee on Corporations and Financial Services, *Family Businesses in Australia – Different and Significant: Why They Shouldn't be Overlooked* (March 2013) 12, 75–8, 82–3, 207–8; Jess H Chua et al, 'Sources of Heterogeneity in Family Firms: An Introduction' (November 2012) *Entrepreneurship Theory and Practice* 1103–5, 1107; Michael Gilding, above n 4, 34–5.

business equity is a 'patient capital' and flexible, risk averse form of financing as participants continually reinvest in the family business through their 'sweat equity'.[7] Objectively, family member participants' right to take business-generated cash for personal purposes is constrained by the nature of their ownership rights (if they have any), by the legal form adopted to conduct the business, and by complexities that arise from income tax law.

This paper investigates these constraints and complexities, focusing on uncomplicated flat family business structures that incorporate a discretionary trading trust. In particular, it investigates whether family member participants consider and apply trust law principles when they take business-generated cash for private purposes and when they determine their income tax liability arising from the business which is conducted using a trust. If it is found that family members do not apply these principles, it strengthens the case for regulatory intervention in discretionary trading trusts.

The paper begins by reflecting on the social construct and features of family businesses in Australia and the importance of self-funded working capital in these businesses. Secondly, the paper considers the legal forms available to conduct a family business and the role that income tax plays in the family's choice. Next, the principles applied to tax family business income are considered using the vantage points of ownership rights, employment entitlements and family maintenance payments. In the fourth section, attention turns to the nature of discretionary trust entitlements and beneficiaries' rights to access business-generated cash. Three questions are considered: who are the trustees, how often can they exercise discretion, and which formalities are required to evidence appropriate and reasonable discretion. The validity of alternate beneficiary arguments to justify their access to cash outside of the ambit of trustee discretion also receive attention, being participation as principal, agent or delegate. The remainder of the paper focuses on income tax law and considers if, and to what extent, family groups rely on trust law principles to minimise their aggregate income tax. In turn, consideration is given to the principle of income splitting, the nature of present entitlements compared to access to cash, and how present entitlements, entitlements to income of the trust estate, access to trust cash for

[7] See, eg, Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 12, 75–8, 82–3, 207–8; The Australian Centre for Family Business, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, *Family Businesses in Australia – Different and Significant: Why They Shouldn't be Overlooked*, (Page 10, 11, 12, Submission 3, The Australian Centre for Family Business, Faculty of Business, Bond University, March 2013) 188; Jess H Chua et al, above n 6, 1103–5, 1107; Michael Gilding, above n 4, 34–5.

personal purposes and unpaid present entitlements are dealt with from an accounting and income tax perspective.

II FAMILY BUSINESS FEATURES AND FINANCING PERSONAL EXPENSES

Small family businesses are an established and enduring feature of the Australian economy.[8] It is estimated that 70 per cent of all Australian businesses are family owned, and that nearly three-quarters are small enterprises with a turnover of $12 million or less per annum.[9] From a policy perspective it may be argued that the family business sector has not received commensurate attention. This position is due in part to the focus of successive Australian governments on the promotion and support of small, medium and micro enterprises ("SMMEs"), amongst others, through income tax concessions.[10] One school of thought suggests that family businesses are a subset of SMMEs, and that by default, they benefit from a range of initiatives available across the sector, requiring no further special attention.[11]

This argument fails to recognise that family businesses have a different dynamic in which members rely on one another, where participation is not necessarily premised on a particular skill set, and where profit sharing may not be commensurate with personal financial risk or exertion.[12] Compared to non-family businesses, evidence suggests family businesses are risk averse, are focused on long-term goals and apply flexible decision making. These businesses also have a greater commitment to retaining staff (who may or may not be family members), higher labour productivity, and make a contribution to the community in which they operate. Family businesses also face unique challenges related to succession, family labour divisions,

[8] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, xiii; KMPG, Submission to the Board of Taxation, *Second Discussion Paper: Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936*, 9 May 2014, 3; KPMG, *Family Business Survey 2018: Family Business – the Balance for Success* (KPMG, Family Business Australia, The University of Adelaide, May 2018) 3; Australian Small Business and Family Enterprise Ombudsman, above n 2, 34.
[9] KPMG, above n 2, 3; KPMG, *Family Business Survey 2018: Family Business – the Balance for Success* (KPMG, Family Business Australia and The University of Adelaide, May 2018) 3; Australian Small Business and Family Enterprise Ombudsman, above n 2, 34.
[10] See, eg, Commonwealth, *Budget 2018–19: Budget Overview* (8 May 2018) 4; Commonwealth, *Re:think Better Tax System, Better Australia* (Treasury, Tax Discussion Paper, March 2015) 105–20; Commonwealth, *Budget: Budget Strategy and Outlook*, Budget Paper No. 1 (10 May 2011) 1–31; Australian Liberal Party, *Backing Small Business* (Issue No 2, 2018) <https://www.liberal.org.au/our-plan/small-business>.
[11] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, xiii, 24–7.
[12] Julio Diéguez-Soto, Aurora Garrido-Moreno and Montserrat Manzaneque, 'Unravelling the Link Between Process Innovation Inputs and Outputs: The Moderating Role of Family Management' (2018) 9(2) *Journal of Family Business Strategy* 114, 116–17; Kimberly A Eddleston et al, 'Governance and Trust in Family Firms: An Introduction' (Entrepreneurship Theory and Practice, November 2010) 1043, 1044.

the type of management structure and style best suited to limit conflict between business and family needs, and challenges related to the availability of financing if they are to retain complete family ownership and control over the business.[13]

As a matter of principle, family businesses seek to limit ownership to family members, avoiding external equity and even external debt. Instead, family businesses favour a flexible approach to internally generated cash to fund business working capital and the personal financial needs of family member participants.[14] Using risk aversion (a feature of family businesses highlighted above) as a point of departure, growth strategies funded by external debt or equity may be forfeited to preserve the family-based nature of the economic activities and to retain complete family ownership and control over the business,[15] illustrative of the different vantage point from which the family views financing decisions and cash flow management. From a practical perspective, family member participants view business-generated cash as a revolving line of personal credit for them, arguing these are likely to flow back to the family business in the form of 'sweat equity' which is a valuable asset for the family business.[16]

In small family businesses there are practical constraints on the availability of internally generated cash due to the size and scale of the business and its overall profitability. Nevertheless, family businesses prefer funding through retained earnings over debt, and debt over non-family equity.[17] As a result, there is ongoing pressure on the family group regarding the extent to which it may be possible to fund their private commitments and personal expenses from business-generated cash flow. Using small businesses in drought stricken parts of Central West Queensland as an example, 40 per cent of small business owners do not take a wage as a means to ensure business survival, regardless of the legal form used to conduct their business.[18]

Business cash flow management is thus influenced by family circumstances and long-term family goals. Even if external debt financing is sought, business financing and the private lives

[13] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 40–2, 76–7.
[14] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 194.
[15] *Income Tax Assessment Act 1997* (Cth) s 8–1; Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 188, 194, 196–7; Tim Mazzarol and Delwyn Clark, 'The Evolution of Small Business Policy in Australia and New Zealand' (2016) 23(3) *Small Enterprise Research* 239, 254.
[16] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 84, 85; The Australian Centre for Family Business, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, *Family Businesses in Australia – Different and Significant: Why they Shouldn't be Overlooked*, (Page 10, 11, 12, Submission 3, The Australian Centre for Family Business, Faculty of Business, Bond University, March 2013) 188.
[17] Tim Mazzarol and Delwyn Clark, above n 15, 254.
[18] Dana Kelly, *Beyond the Dust: Impact of Drought on Town Businesses in Central West Queensland and Some Solutions* (Western Queensland Drought Committee Report, March 2018) 63.

of the family invariably merge,[19] as personal guarantees or family asset debt collateralisation is often necessary, irrespective of the legal form adopted to conduct the business.[20] The concept of 'merging' is also relevant to the extent to which the family group pools their resources to fund business operations and working capital without contributors insisting on new or additional ownership rights.[21]

The practical merging of family and business, and of family and business-generated cash are less clear when viewed against the legal ownership and entitlement rights of participants. So too are there significant differences between family member participants' access to cash for personal purposes, and how the economic benefits generated by the business are taxed across the family group. Under circumstances where there is continued pressure on the family business to generate sufficient cash to fund working capital, participants are likely to have higher taxable income compared to their practical access to cash to fund their personal expenses. In order to preserve cash to fund working capital in the business, it is unlikely that they would take more cash than is necessary to meet their most urgent personal needs.

This paper will also show that some family members who have little or no participation in carrying on the business, are allocated taxable income arising from it without any access to cash (other than perhaps the amount required to pay the resultant income tax). Others may have significantly more access to cash than is reflected in reference to their taxable income. This strategy of income splitting to reduce the overall income tax burden across a family group is particularly prevalent in discretionary trusts, but is also present in other legal forms used to conduct a family business.

III THE LEGAL FORMS ADOPTED TO CONDUCT A FAMILY BUSINESS IN AUSTRALIA

The legal form adopted to conduct a family business enables family members to benefit from operations using their ownership interests, employment rights or through discretionary entitlements. The same interests, rights or entitlements should also explain their access to

[19] Tim Mazzarol and Delwyn Clark, 'The Evolution of Small Business Policy in Australia and New Zealand' (2016) 23(3) *Small Enterprise Research* 239, 254; Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 190.
[20] The Australian Centre for Family Business, Submission to the Parliamentary Joint Committee on Corporations and Financial Services, *Family Businesses in Australia – Different and Significant: Why They Shouldn't be Overlooked* (Page 10, Submission 3, The Australian Centre for Family Business, Faculty of Business, Bond University, March 2013) 188.
[21] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 188.

business-generated cash to fund their personal expenses. The legal form used to conduct the family business also drives the taxation of the economic benefits that flow from it and facilitates family business succession.

There are no reliable country data available about the preference for any particular business form used to conduct a family business in Australia with respect to sole traders, partnerships, private companies and discretionary trusts. Based on the estimate that 70 percent of all businesses in Australia are family owned,[22] it is likely that Australian Bureau of Statistics ("ABS") national data about the number of active businesses in the private sector as at 30 June 2017 (Table 1) would broadly reflect the position in family businesses.[23]

	Number	**Percentage**
Companies	839 507	38%
Sole traders	586 547	26%
Trusts	544 410	24%
Partnerships	267 442	12%
Actively trading private sector businesses	2 237 906	100%

Table 1: Actively trading private businesses as at 30 June 2017

It is only in reference to family farming that data are available about the preference for any particular legal form to conduct a family business. Australian Bureau of Agricultural Resource Economics and Sciences ("ABARES") data suggest that partnership structures are dominant in family farming; sole traders make up roughly 20% of family farms; and trusts and corporate structures are used to a lesser extent.[24] In so far as sole traders are concerned, the Parliamentary Joint Committee on Family Businesses examined whether a sole trader should fall under the umbrella of a family business if it can pass to a next generation as part of a family business succession plan.[25] While the mere possibility of succession to a next generation is likely too low of a threshold to warrant characterisation as a family business, data that 20% of family farms operate as sole trader businesses support this proposition in the agricultural sector.

Turning to other data sources about family businesses, there is no current tax policy statement about family businesses. The concept 'family business' does not appear in the principle income

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[22] KPMG, above n 2, 3; KPMG, *Family Business Survey 2018: Family Business – the Balance for Success* (KPMG, Family Business Australia, The University of Adelaide, May 2018) 3; Australian Small Business and Family Enterprise Ombudsman, above n 2, 34.

[23] Australian Bureau of Statistics, *8165.0 – Counts of Australian Businesses, including entries and exits, Jun 2013 to Jun 2017* (Table 10, 20 February 2018) Australian Bureau of Statistics <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8165.0Jun+2013+to+Jun+2017>.

[24] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 33–4, 37–8.

[25] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 33–4, 37–8.

tax legislation.[26] As a result, there are no Australian Taxation Office ("ATO") data available about the number of family businesses that exist.[27] Contemporary tax reform debate merely recognises that small family businesses operate as sole traders, partnerships, private companies and through discretionary trusts.[28]

On the basis that discretionary trusts are settled for family groups,[29] it is only in reference to some trusts that the concept of 'family' appears in income tax legislation. A 'family trust' is defined in s 272–75 of the *Income Tax Assessment Act 1936* (Cth),[30] as a trust that has made a written 'family trust election'.[31] Broadly, the election has income tax advantages limited to rollover relief during business restructure and fewer requirements when applying past trust tax losses against current year taxable income,[32] but has the significant disadvantage that family trust distribution tax is levied at 47 per cent on payments and distributions outside a particular family group.[33]

In brief, a family trust election is only possible in the case of a discretionary trust that passes the family control test that involves the family group controlling the appointment of capital and income in the trust, or controlling the position of the trustee.[34] Small family businesses operating through a discretionary trust or flat business structure incorporating one, fits the family trust mould well,[35] but not all discretionary trusts choose to make a family trust election. There are no data publicly available about the number of discretionary trusts with family trust elections. Anecdotal evidence seems to suggest the number is low, arguably due to complexities associated with a family trust election.[36] Beyond circumstances where a family

[26] *Income Tax Assessment Act 1997* (Cth); *Income Tax Assessment Act 1936* (Cth).
[27] Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 72.
[28] Commonwealth, *Re:think Better Tax System, Better Australia* (Treasury, Tax Discussion Paper, March 2015) 106, 107, 108.
[29] See, eg, Michael Evans, *Equity and Trusts* (LexisNexis Butterworths, 3rd ed, 2012) 390–4; Gino Dal Pont and Tina Cockburn, *Equity and Trusts in Principle* (Lawbook Co, 2005) 246, 248–9.
[30] *Income Tax Assessment Act 1997* (Cth) s 995; *Income Tax Assessment Act 1936* (Cth) s 272–75.
[31] *Income Tax Assessment Act 1936* (Cth) s 272–80(1).
[32] Dale Pinto, 'Family Trust Elections and Interposed Entity Elections' (2004) 19 *Australian Tax Forum* 501, 504–6.
[33] *Income Tax Assessment Act 1936* (Cth) s 271–15.
[34] *Income Tax Assessment Act 1936* (Cth) ss 272–87(1), 272–87(2).
[35] Anna Ziaras, *Australian Trusts Tax Handbook 2018-19* (Thomson Reuters, 2018) 186–9; Dale Pinto and Nicole Wilson-Rogers, 'Navigating the Labyrinth: Evaluating Trust Loss Rules, FTEs and IEEs' (2009) 38 *Australian Tax Review* 237, 253; Dale Pinto, 'Family Trust Elections and Interposed Entity Elections' (2004) 19 *Australian Tax Forum* 501, 504–6.
[36] See, eg, Julie Overton, 'Defining Conjugality in the Family' (2005) 20 *Australian Tax Forum* 513, 515, 517–20; Dale Pinto and Nicole Wilson-Rogers, 'Navigating the Labyrinth: Evaluating Trust Loss Rules, FTEs and IEEs' (2009) 38 *Australian Tax Review* 237, 237, 238; Dale Pinto, 'Family Trust Elections and Interposed Entity Elections' (2004) 19 *Australian Tax Forum* 501, 502.

trust election is relevant, discretionary trusts and family trusts are largely regarded as one and the same.[37]

On the basis that discretionary trusts are settled for family groups,[38] 2015–16 ATO data about the number of discretionary trusts disclosing business income in trust income tax returns provide clear evidence of the significant adoption of this business form in a family business context and in family farming (Table 2).[39]

	Number	**Percentage**	**Aggregate business income**
With business income from primary production	21 347	3%	$17 741 580 520
With business income from non-primary production	207 258	31%	$166 634 263 440
Total of discretionary trusts with tax file numbers	**665 650**		

Table 2: Presence of discretionary trading trust

The choice of the legal form most suited to conduct a family business considers a range of commercial and family factors including:[40] asset protection, limited personal liability, transferability of ownership rights and succession, flexibility, opportunities to stream income and cash to participants, making deductible payments into superannuation for family members, growth opportunities, ease of entry and exit, privacy of financial affairs and income tax.

The stark reality in Australia, even in the absence of complex family business structures, is that the taxation of small family businesses is extremely complex, with extraordinarily inconsistent results for the same economic activity using different legal forms. As a result, taxation is a significant consideration in the choice of family business form. Taxation also impacts commercial restructuring decisions, succession plans, the availability of free after-tax cash flow, and growth and innovation strategies.[41]

[37] Michael Evans, above n 29, 390–4.

[38] See, eg, Michael Evans, above n 29, 390–4; Gino Dal Pont and Tina Cockburn, above n 29, 246, 248–9.

[39] Commonwealth, *Australian Taxation Office Taxation Statistics 2015-16 Trusts* (Table 4, 18 April 2018) <https://data.gov.au/dataset/d170213c-4391-4d10-ac24-b0c11768da3f/resource/ab46f96d-fbe6-4bb7-8150-b63aa77c2e80/download/taxstats2016trusts04trusttype.xlsx>.

[40] See, eg, Barbara Trad and Brett Freudenberg, 'All Things Being Equal: Small Business Structure Choice' (2017) 12(1) *Journal of the Australasian Tax Teachers Association* 136, 143, 152, 159; Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (A Report to the Assistant Treasurer, November 2014) 6; Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (Second Discussion Paper, March 2014) 18; Productivity Commission, *Business Set-up, transfer and Closure* (Productivity Commission Inquiry Report, No. 75, 30 September 2015) 85; Anna Ziaras, above n 35, 240–43; Paul L Dowd, 'Amendments to Division 7A' (2010) 44(8) *Taxation in Australia* 460, 460, 462.

[41] See, eg, The Board of Taxation, *Review of Small Business Tax Concessions* (Consultation Guide, May 2018) 10; Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 137–9, 144, 172; Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (Discussion Paper, December 2012) 1, 2, 29, 30; Commonwealth, *Tax Reform: Not a New*

Individuals who are willing to engage with complexity can structure their family and business affairs to minimise their personal tax liabilities and increase free cash flow generated by the business. But the cost associated with doing so and the cost of finding a better or more optimal structure as the business grows may also be a disincentive for growth and innovation in family businesses. In the case of discretionary family trusts, which are commonly used as part of succession planning and are considered an attractive vehicle to minimise income tax across a family,[42] there are significant concerns that trust law is not well understood by business owners and that legal questions may arise if the trust is not administered according to trust law and the trust deed.[43]

IV THE PRINCIPLES APPLIED TO TAX FAMILY BUSINESS INCOME

Briefly, there is no one model that is applied to tax business income in Australia, and hence no particular model relevant to tax family businesses. The view that entities are merely conduits through which individuals receive business income is evident in the taxation of sole traders, partnerships and to some extent in discretionary trusts. Using the conduit model of taxation, there is complete integration between the business and some family member participants based on ownership rights in sole trader and partnership businesses, and this integration extends to business profits and losses.[44] Any access that the sole trader or a partner in a partnership has to business-generated cash is treated entirely separate to taxable income generated by the business, and is recorded against their drawings accounts.[45] In so far as discretionary trusts are concerned, partial or 'de facto' integration is achieved, as losses are trapped in the trust and profits that are not distributed incur tax payable by the trustee at the highest marginal tax rates

Tax, a New Tax System: The Howard Government's Plan for a New Tax System (August 1998) 109; Commonwealth of Australia, The Board of Taxation, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (November 2002) 5.

[42] See, eg, Commonwealth, *Re:think Better Tax System, Better Australia* (Treasury, Tax Discussion Paper, March 2015) 62; Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (A Report to the Assistant Treasurer, November 2014) 6; GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 806; Barbara Trad and Brett Freudenberg, above n 40, 136, 143, 152; Productivity Commission, above n 40, 85.

[43] Commonwealth, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (The Board of Taxation, November 2002) 6.

[44] See, eg, *Income Tax Assessment Act 1936* (Cth) ss 92(1), 92(2); *Income Tax Assessment Act 1997* (Cth) s 36–10.

[45] Floyd A Beams et al, *Advanced Accounting* (Pearson Education Ltd, 12th ed, 2015) 536–7; Phillipa Greig et al, *Accounting Concepts & Applications* (VCTA, 4th ed, 2008) 91, 142.

applicable to individuals.[46] Compared to sole traders and partnerships, integration in the way that discretionary trusts are taxed is unrelated to ownership rights, as will be explained below.

In the case of companies, an entity taxation model applies to tax profits at the company level at a flat rate.[47] In the event that after-tax profit is distributed as dividends, the prevailing imputation system provides tax relief for shareholders who are liable for tax on dividends and any resulting franking credits, but their entitlements are premised on share ownership.[48] In a private company, it is entirely possible that shareholder loans and director loans could exists to facilitate access to cash, but these are subject to a range of anti-avoidance provisions for income tax purposes.[49]

Regardless of the legal form adopted to conduct the business, a family member participant may also be formally employed, in which event they will be liable for personal income tax on their employment income. An employment relationship that results in a family member getting access to business-generated cash is generally unproblematic, and rely on labour law and work entitlement rights. Family business employers are under an obligation to withhold taxes from their family member employees under the Pay As You Go income tax system,[50] have obligations under Australia's superannuation guarantee system,[51] are liable for fringe benefits tax that arise from employee fringe benefits,[52] and have to comply with the resultant reporting obligations to the ATO.[53] From an income tax perspective, employment-related expenses are claimed as a deduction against the assessable income of the business,[54] and are taxed in the hands of the family member employee.[55] Aside from the application of the general anti-avoidance provisions,[56] and provisions such as those in s 26–35 of the *Income Tax Assessment Act 1997* (Cth) and s 109 of the *Income Tax Assessment Act 1936* (Cth), employment-based

[46] See, eg, Commonwealth of Australia, The Board of Taxation, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (November 2002) 8–10; RL Deutsch et al, *The Australian Tax Handbook 2018* (Thomson Reuters 2018) 931–3; Anna Ziaras, above n 35, 100–110.
[47] Commonwealth, *Re:think Better Tax System, Better Australia* (Treasury, Tax Discussion Paper, March 2015) 82–3, 86.
[48] *Income Tax Assessment Act 1936* (Cth) ss 6(1), 44; *Income Tax Assessment Act 1997* (Cth) ss 202–5, 202–70.
[49] See especially *Income Tax Assessment Act 1936* (Cth) div 7A.
[50] *Tax Administration Act 1953* (Cth) sch 1.
[51] RL Deutsch et al, above n 46, 1425–7.
[52] *Fringe Benefits Tax Assessment Act 1986* (Cth) pt IIA, divs 1–2.
[53] RL Deutsch et al, above n 46, 1752–9.
[54] *Income Tax Assessment Act 1997* (Cth) s 8–1(1).
[55] *Income Tax Assessment Act 1997* (Cth) s 6–5.
[56] *Income Tax Assessment Act 1936* (Cth) pt IVA.

access to business-generated cash warrant no further discussion as long as pay is reasonable and made in relation to work performed.[57]

Beyond ownership- and employment-based income, there is nothing to prevent a sole trader or partner in a partnership from gifting cash to family members or making maintenance payments to them, whether they participate actively in the business or not. The decision to do so relies on the sole trader's ownership rights and a partner's entitlement rights over business-generated profits that result in the availability of cash.[58] From a cash flow perspective, gifts and maintenance payments are likely ineffective to reduce the overall family tax burden, as gifts and maintenance payments are not tax deductible expenses of the business.[59] In the case of a company, the legal nature of the corporate form prevents private gifts and maintenance payments to family members unless it is recorded against the name of a shareholder or employee (often a director), as the assets of the company is its own property.[60] From an income tax perspective, the shareholder or employee will bear the income tax burden in the first instance,[61] and the outcome is likely ineffective as a means to reduce the aggregate family tax burden.

Leaving aside the position of a sole trader, partner in a partnership, shareholder in a private company (all related to ownership rights), family member employees (access to cash based on employment rights) and gifts or maintenance payments, there is another practical way in which family members are able to access business-generated cash on an ongoing basis to fund their personal expenses: they merely take the cash when they require it and the receipts are recorded against drawings or loan accounts, only to be reconciled or offset against entitlements (either their own entitlements or those of other family members) at the end of an accounting period.

Under these circumstances, the legal form of the business which constrains family member participant access to cash, is thus disregarded using the social construct that the business belongs to the family and that family member participants have the freedom to do with the family assets what they wish. While no data are available about the number of family members who participate in sole trader and partnership businesses, and in private companies on a basis

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[57] See, eg, *Re Jones and Federal Commissioner of Taxation* (2003) 52 ATR 1063, 1066–7 [12]–[14], 1067 [18], 1073 [51].

[58] See, eg. Paul Latimer, *Australian Business Law* (CCH, 33rd ed, 2014) 656–7, 660–1, 767–70.

[59] *Income Tax Assessment Act 1997* (Cth) ss 8–1(2)(b), 26–40.

[60] Robert P Austin and Ian M Ramsay, *Ford, Austin and Ramsay's Principles of Corporations Law* (LexisNexis Butterworths, 17th ed, 2018) 134–5 [4.170].

[61] See, eg, *Income Tax Assessment Act 1997* (Cth) s 6–5(4); *Income Tax Assessment Act 1936* (Cth) ss 102B, 109.

other than ownership and employment rights, the extent to which the practice is prevalent in discretionary trading trusts suggests it is common. Based on 2015–16 ATO data, 167 840 (61.5 per cent) of the 272 929 discretionary trusts with a main source of income from trading recorded no salary or wage expenses.[62] To state the obvious: a discretionary trading trust is settled for a particular family and the family relies on the business to fund their personal needs in the short-, medium- and long-term. Unless it is the family members themselves who operate the business, others cannot be expected to do so without reward in the form of salaries and wages. The curios position in discretionary trusts is thus that family members are able to participate and benefit from operations, but are neither owners nor employees.

V THE NATURE OF DISCRETIONARY TRUSTS AND TRUST ENTITLEMENTS

Historically, family trusts were used to hold farms and similar passive assets, but the associated trading activities never involved land held on trust.[63] In equity, trustees 'are bound to preserve the capital of the trust estate for those entitled to the corpus in remainder, and they are bound to invest it in such a way as will produce a reasonable income for those enjoying the income for the present'.[64] Trustees must apply 'such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide'.[65] As trading is inherently risky, a discretionary trading trust challenges the overarching principle of the preservation of trust property that trust law holds trustees to.[66]

When it became in vogue in Australia in the 1970s and 1980s to use discretionary trusts to conduct business mainly due to generous facilitating amendments to income tax law, conceptual debates whether it is appropriate to do so never found traction. In the ensuing years, society and the courts have largely accepted that trustees of discretionary trusts can and do conduct business.[67] To address the risk of increased trustee liability associated with trading, it is commonplace, even in uncomplicated family discretionary trusts, to appoint a corporate

62 Commonwealth, *Australian Taxation Office Taxation Statistics 2015-16 Trusts* (Table 4, Accessed on 26 October 2018) <https://data.gov.au/dataset/d170213c-4391-4d10-ac24-b0c11768da3f/resource/ab46f96d-fbe6-4bb7-8150-b63aa77c2e80/download/taxstats2016trusts04trusttype.xlsx>.

63 A H Slater, 'Taxing trust income after Bamford's case', (2010) 40 *Australian Tax Review* 69, 78-9; Peter Agardy, *Trading Trusts Explained* (LexisNexis Butterworths, 2018) 17–18.

64 *Re Whitley* (1886) 33 Ch Div 347, approved on appeal *Learoyd v Whiteley* (1887) 12 App Cas 727.

65 *Re Whitley* (1886) 33 Ch Div 347, approved on appeal *Learoyd v Whiteley* (1887) 12 App Cas 727.

66 A H Slater, above n 63, 77, 79.

67 A H Slater, above n 63, 77; Peter Agardy, above n 63, 17–18.

trustee.[68] As highlighted above, discretionary trusts remain an attractive vehicle to minimise income tax,[69] despite the risk of significant changes to the taxation of trusts fuelled by the Australian Labor Party's 2017 policy statement on the taxation of discretionary trusts framed against the notion that Australia has a 'two class tax system' that favours those with financial means.[70] In addition, discretionary family trusts also remain a widely-used business vehicle despite concerns that trust law is not well understood and that legal questions may arise if the trust is not administered according to trust law and the trust deed.[71]

The essence of trust law determines there is no equity that a beneficiary can own in a discretionary trust, and that no party holds both legal and beneficial ownership over trust property. The trust property does not 'belong' to the family, nor does it belong to the settlor, trustee, or those who disposed of their assets in favour of the trust. Before vesting occurs, there is merely a duty upon the trustee to preserve the trust property.[72] Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ explain '[t]he use of terms such as "beneficial interest" is apt to mislead when applied to beneficiaries' interests in a discretionary trust'.[73] In the absence of theoretical knowledge of the principles of equity and the law of trusts, it is self-evidently hard for family member participants to conceptualise a vehicle without a constant or fixed meaning, where legal and beneficial ownership of trust assets is not settled in one person or entity, yet is a vehicle which is able to hold and actively toil with assets to conduct a trading business, benefiting no one specifically beyond mere expectancy, over which beneficiaries have no control.[74]

This position stands in stark contrast against the ongoing practical access that family member participants have to cash generated by the discretionary trading trust to pay for their personal expenses. While it may be that in practical terms, controlling the position of the trustee is

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[68] GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 805.
[69] See, eg, Commonwealth, *Re:think Better Tax System, Better Australia* (Treasury, Tax Discussion Paper, March 2015) 62; Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (A Report to the Assistant Treasurer, November 2014) 6; GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 806; Barbara Trad and Brett Freudenberg, above n 40, 136, 143, 152; Productivity Commission, above n 40, 85.
[70] Australian Labor Party, *A Fairer Tax System: Discretionary Trusts Reform* (Policy Document, 30 July 2017) 1, 2.
[71] Commonwealth, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (The Board of Taxation, November 2002) 6.
[72] Michael Evans, above n 29, 567–8.
[73] *MSP Nominees Pty Ltd v Commissioner of Stamps (SA)* 1999 198 CLR 494, 509 [34].
[74] GE Dal Pont, '1984–2014: The Life of the (Non-Constructive) Trust in the High Court' (2015) 36 *Adelaide Law Review* 179, 188; Samantha J Hepburn, *Principles of Equity and Trusts* (The Federation Press, 4th ed, 2009) 392; Gino Dal Pont and Tina Cockburn, above n 29, 16–17, 246–7, 311–12, 329–30; Susan Barkehall Thomas and Vicki Vann, *Trusts* (LexisNexis Butterworths, 2008) 3–7, 231–4, 243–5, 251–4.

construed as absolute family ownership of the business, which in turn justifies ongoing beneficiary access to cash for personal purposes, there is no basis for this proposition in trust law. Unless specifically catered for in the trust deed, beneficiaries are unlikely to have any legal entitlement to cash until the trustee exercises discretion. Three relevant questions therefore arise which may explain ongoing access to business-generated cash on the part of beneficiaries in discretionary family trusts: who are the trustees, how often are they expected and able to exercise discretion, and which formalities are required to evidence appropriate and reasonable discretion.

A *Who are the trustees of a family discretionary trust?*

As is the case for all trusts, the trust deed must identify at least one trustee.[75] In Queensland, up to four trustees may be appointed.[76] A trust deed can identify an appointer able to remove and appoint the trustees. In a family business operated using a discretionary trust, or in a flat business structure that incorporates one, succession may be effected by varying the appointer. Trust deeds often name a private company as the trustee. Corporate trustees usually have more than one shareholder, often spouses named as principal beneficiaries in the trust deed. These shareholders are also commonly the directors of the corporate trustee, and likely appointers, if any are named in the trust deed. Under these circumstances, succession is commonly effected through a change in share ownership in the corporate trustee with little difficulty.[77]

As trustees are liable for trust debts, using a corporate trustee provides some limited liability protection, but this does not extend to all directors under all circumstances as set out in the *Corporations Act 2001* (Cth).[78] Section 197 deals specifically with corporate trustee directors, and lifts the corporate veil between the trustee company and its directors to protect unsecured trust creditors who may not be aware or have knowledge of whether the trustee company, acting through its directors, are acting within the scope of the trust deed. This provision also has the

[75] RP Meagher and WMC Gummow, *Jacob's Law of Trusts* (Butterworths, 6th ed, 1997) 4 [105].
[76] *Trusts Act 1973* (Qld) s 11(2).
[77] See, eg, Peter Radan, Cameron Steward, *Equity and Trusts* (LexisNexis Butterworths, 2nd ed, 2005) [17.4.10]; Harwood Andrews Lawyers, *Trust Structures Guide 2011* (The Tax Institute, 2011) 88; Peter Agardy, above n 63, 45–7, 81–3, 118–19, 125, 129–30.
[78] *Corporations Act 2001* (Cth) s 197.

effect of making the directors of the corporate trustee individually and jointly liable together with the corporation if the directors act outside of the scope of the powers as trustee.[79]

Whether through a corporate trustee or not, in a family discretionary trust some members of the family group usually have complete control over the position of the trustee. As the trust is settled for the family group and often has succession in mind, the actions of the trustee will seek to benefit the family group as a whole, in particular the primary beneficiaries and those beneficiaries identified as successors in the family business. Trustee decisions are governed by the trust deed in the first instance,[80] and by corporations law in the case of corporate trustees.

There are two common ways in which trustees get access to cash that may be distributed to family members who are beneficiaries of the family discretionary trust. First, cash could be generated through the application of trust property in a business that has no separate legal existence. Second, cash could be generated by a private company set up to conduct the business, in which event some of the trust assets may be placed under the ownership control of the private company, or the company can rent these from the trust. The trustee will be the sole shareholder of the private company and the trustee's access to cash arises from rent that the trust receives (if the company actually pays rent to the trust, as compared to when it is merely recorded in accounting records) and from dividends paid to the trustee as sole shareholder in the company. Dividend decisions are in the remit of the directors of the private company who are charged with the management of the corporation and who stand under the usual duties of care, diligence and good faith.[81] The appointment and removal of directors reside in the trustee as sole shareholder.[82]

Under these circumstances, intuitively, and for all practical purposes, family member access to cash is premised on the assumption the business is theirs: one or more primary family members are likely named as appointers in the trust deed, the trustees are key family members or a private company they control as sole shareholders and directors, and corporate decision and trustee discretion are theirs to exercise. Typically, the trust deed leaves no doubt that the beneficiaries are the family members. By naming primary and specific beneficiaries in the trust deed, succession is 'formalised' or is sufficiently apparent. The addition of a general class of beneficiaries (for example individuals related to the primary beneficiaries, and other

[79] Robert Baxt, *Corporations Legislation 2016* (Thomson Reuters, 2016) 242–3 [197.10], [197.30].
[80] Gino Dal Pont and Tina Cockburn, above n 29, 300–17.
[81] *Corporations Act 2001* (Cth) ss 180, 181, 198A.
[82] *Corporations Act 2001* (Cth) ss 201G, 203C.

companies, trusts and partnerships connected to, or controlled by the primary and specific beneficiaries) completes the picture that the trust is family-focused and trust property is applied for the benefit of the family. If a family member participant takes business-generated cash to pay their personal expenses, it would simply be allowed and tolerated within the constraints of the notional bargain that is struck between the family members.

In stark contrast, the legal position of the family in relation to trust law is vastly different. Trust law does not support the belief that the business 'belongs to the family'. While it may be possible to assert that the family controls the trust property that constitutes the business, and that the family controls all entitlement rights to assets and income, there can be no legal entitlement to cash generated by the family business until the trustee exercises discretion as expressly stated in the trust deed.[83]

B *Exercising trustee discretion*

The practical ability of a trustee to allow beneficiaries access to business-generated cash on an ongoing basis to fund their personal and living expenses will be constrained by the trust deed. To the extent that the trust is settled for the maintenance and advancement of beneficiaries, trustees necessarily exercise their discretion according to the needs and requirements of the beneficiaries.[84] As beneficiary maintenance often includes food, clothing, transport, housing and medical needs, trustees are required to exercise their discretion continuously.[85] While it is entirely possible that the purpose of a discretionary trust is twofold (maintenance and advancement of beneficiaries, and conducting the family business), there is likely much less emphasis on maintenance in trusts that involve a family business.

The default position in discretionary trust family businesses is that the trustees must carry out their obligations under the trust deed to give effect to the settlor's intention. If the settlor's intention is that trust property is applied to conduct a business for the benefit of the family beneficiaries, trustee discretion is best applied taking into account the nature of commercial business operations. When the trustee exercises discretion, it must be prudent, reasonable and

[83] See, eg, Robert Baxt, Edmund Finnane and Jason Harris, *Corporations Legislation 2016* (Lawbook Co, 2016) 97–8; Gino Dal Pont and Tina Cockburn, above n 29, 248–9; GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 634.
[84] Re Bukowsi [1954] QSR 286, 293–4.
[85] Gino Dal Pont and Tina Cockburn, above n 29, 248–9.

based on appropriate information, taking into account the terms of the trust deed, the nature of the trust property and the activities surrounding trust property.

The ongoing continuum of business operations are necessarily best presented in accounting records.[86] Trustees stand under the obligation to keep full and proper accounts of trust property,[87] and to provide trust accounts to potential beneficiaries named in the trust deed if they request these.[88] In Queensland, the *Trusts Act 1973* (Qld) does not prescribe the manner in which trust records should be maintained,[89] and no Australian accounting standard exists for trusts.[90] In a small family business, accounting systems that are able to produce financial statements that detail the profit or loss position at the end of an income year, disclose internal or self-dealings of the participants, and summarise the position related to the trust business assets and liabilities at the end of the income year (typically in a balance sheet), would meet most needs. There is no reason why the position should be any different in a discretionary trading trust. Accounting records thus convey relevant business information.[91]

Accounting for trust business activities in accounting records involves a systematic process that typically spans the same 12 month period of an income tax year in respect of which tax is payable.[92] The earliest date on which a trustee is able to confirm the existence of net income for business, accounting and tax purposes is at the end of an income year, taking into account that net income is no guarantee that gains have been realised or returned in cash.[93] Even if it is argued that trading profit is an abstraction, 'it is more generally recognised that profit measurement is a purposive activity, that the measurement, whilst being a measure of

[86] See, eg, Robert Baxt, Edmund Finnane and Jason Harris, above n 83, 95–6, 113; Queensland Law Reform Commission, *A Review of the Trusts Act 1973 (Qld)* (Interim Report, WP No 71, June 2013) [6.150]–[6.155]; Gino Dal Pont and Tina Cockburn, above n 29, 300; Michael Evans, above n 29, 603.
[87] See, eg, *Re Simersall* (1992) 35 FCR 584, 588–9; Michael Evans, above n 29, 583–4; Queensland Law Reform Commission, *A Review of the Trusts Act 1973 (Qld)* (Interim Report, WP No 71, June 2013) [6.147]–[6.149].
[88] See, eg, *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405, 431; Michael Evans, above n 29, 585–91; Queensland Law Reform Commission, *A Review of the Trusts Act 1973 (Qld)* (Interim Report, WP No 71, June 2013) [6.179]–[6.180].
[89] Queensland Law Reform Commission, *A Review of the Trusts Act 1973* (Report No 71, December 2013) [3.34]–[3.36].
[90] Bernard Marks, *Trusts & Estates: Taxation and Practice* (Taxation Institute of Australia, 2nd ed, 2009) 25–27.
[91] Norman Virgil Lee, 'Understanding the Concepts of Present Entitlement and Realisation in Subsection 109XA(1)' (2005) 20 *Australian Tax Forum* 625, 643.
[92] *Income Tax Assessment Act 1997* (Cth) ss 4–10(1), 995–1.
[93] Norman Virgil Lee, above n 91, 641.

something, is determined not by what is measured but by the purpose for which the measurement is undertaken'.[94]

Therefore, in the case of a discretionary trading trust, reasonable and prudent trustee discretion will be exercised at the end of a 12-month trading period in the absence of a specific provision in the trust deed that allows for the distribution of profit before measurement. In reference to the taxation of trust business income, the same principle position applies in that the derivation of income is determined at the end of an income year.[95] Ongoing family member access to business-generated cash throughout a 12-month trading period is therefore contrary to the nature of the measurement of trading operations, and likely contrary to the law of trusts that relies on trustees to preserve trust property as explained above.

C *Evidence of trustee discretion*

On the basis that prudent and reasonable trustee discretion in a discretionary trading trust is tied to the measurement of trading income at the end of a 12-month period, evidence of the exercise of trustee discretion is likely limited to decisions taken at the end of an income year. While the method, formalities and communication of trustee discretion can be detailed in a trust deed, a number of general principles underpin trustee discretion.

As a starting point, entitlement is premised on separate discretion for each separate beneficiary entitlement,[96] beneficiaries do not have an interest in possession as trading income accrues,[97] beneficiaries do not have a contingent interest in the trust property, [98] beneficiaries have no legal or equitable interest in the trust property,[99] and the decisions of the trustee ought to be recorded in writing. In the case of a corporate trustee, the decision of the board of directors

[94] Graeme MacDonald, 'Matching Accounting and Taxable Profits: Reflections on Gallagher v Jones' (1995) *British Tax Review* 484, 484–5.
[95] See, eg, Dale Boccabella, 'What Should be the Timing Rule for 'Derivation' of Assessable Income by Beneficiaries of Discretionary Trusts?' (2013) 15(1) *Journal of Australian Taxation* 85, 86, 121, 123; John Glover, 'Taxing trust income by "entitlement": The end of the road?' (2014) 43 *Australian Tax Review* 101, 101; RL Deutsch et al, above n 46, 960.
[96] Robert Baxt, Edmund Finnane and Jason Harris, above n 83, 97–8.
[97] *Queensland Trustees Ltd v Commissioner of Stamp Duties (Qld)* (1952) 88 CLR 54, 62–65; *Pearson v Inland Revenue Commissioners* [1981] AC 753, 775, 786.
[98] *ASIC v Carey (No 6)* (2006) 153 FCR 509 [36].
[99] GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 634.

must be kept in formal resolutions and recorded in minutes.[100] Generally, resolutions ought to be kept in ‘a businesslike fashion’.[101]

The practical ongoing access that family member participants have to business-generated cash in a discretionary trading trust to fund their personal expenses is therefore unlikely to be related to trustee discretion, and precedes their present entitlement for income tax purposes.[102] In turn, this gives rise to the question whether there is any other legal basis upon which beneficiaries have an ongoing legal right to cash if they are not employed by the family discretionary trading trust.

VI PRINCIPAL, AGENT OR DELEGATE?

The first argument that a beneficiary may propose to justify their ongoing access to business-generated cash outside of the ambit of trustee discretion is that the trustee acts on their behalf. If that is the case, the beneficiary is able to instruct the trustee as their agent to make payments to them, or in the absence of such an instruction, the beneficiary is entitled to take cash payments as they are the principal owner of the cash which is trust property. This argument is fundamentally flawed from two perspectives. First, in reference to the trust deed, a trustee is bound to act in accordance with the trust deed and it is unlikely that a discretionary trust deed allows anything but the unfettered discretion of the trustee.[103] Second, in reference to the law of trusts, beneficiaries in a discretionary trust have no legal or equitable interest in the trust property and no equity ownership basis upon which they are able to instruct the trustee.[104] Prior to becoming presently entitled to income of the trust estate, beneficiary rights involve little more than to be considered by the trustee and to obtain information about the trust property.[105]

The second argument that a beneficiary may propose to justify their ongoing access to business-generated cash outside of the ambit of trustee discretion is that they act as a delegate to the trustee in taking cash for personal purposes on an ongoing basis if the trust deed allows delegation in the first instance.[106] While trust law requires trustees to act personally in

[100] *Corporations Act 2001* (Cth) s 251A.
[101] NE Rento and Rod Caldwell, *Family Trusts* (Wrightbooks, 5th ed, 2014) 87.
[102] *Income Tax Assessment Act 1936* (Cth) s 97; *Harmer v FCT* (1991) 22 ATR 726; 173 CLR 264.
[103] See, eg, Michael Evans, above n 29, 393–4.
[104] GE Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 6th ed, 2015) 634.
[105] See, eg, *Gartside v IRC* [1968] AC 553, 606; *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405, 421–2; Michael Evans, above n 29, 652–4.
[106] Gino Dal Pont and Tina Cockburn, above n 29, 303.

executing the trust,[107] the principle that a trustee may not delegate has all but disappeared in reference to trust legislation in Australia.[108] Notwithstanding, trustee delegation is limited to delegation of the trustee's power, discretion and authority, and requires instruction to their agent. Agents can only carry out or implement the decisions properly taken by the trustee.[109] If trustee discretion in relation to trading activities is best exercised at the end of an income year in reference to the operating results of the trust, any argument that a beneficiary has access to cash in the mean-time based on delegated trustee power is misplaced.

Thirdly, if the trustee appoints an agent in the ordinary course of the business to manage the operations, the agent will be tasked to do what is required of an ordinary prudent man employed to manage a business within the ordinary course of the business.[110] It stands to reason that it is not in the ordinary course of the business to allow the agent or delegate the freedom to take cash from the business operations to pay for their personal expenses outside of the formal avenues of remuneration.[111]

Last, it is worth noting that in the event that ongoing access to cash is regarded as a cash advance of a beneficiary's future entitlement, the trustee is left in a precarious position. There is, after all, no certainty during an income year that the cash advance will be covered by business profits at the end of the income year and available then to be applied for the benefit of any beneficiary at the end of an income year. If cash advances are unsupported by trust income determined at the end of the income year, it is unlikely that the trustee will be able to recover the cash as the beneficiary has already applied the cash to pay for their personal expenses.[112]

To sum up, in reference to the law of trusts, there is a practical disregard of the legal form and nature of a discretionary trust in reference to family member participants' ongoing access to business-generated cash to fund their personal expenses outside of the ambit of employment entitlements. This position draws into question whether access to cash which is unsupported

[107] See, eg, Michael Evans, above n 29, 590–93.
[108] RP Meagher and WMC Gummow, above n 75, 441 [1730].
[109] Andrew S Butler and Nicky Richardson, 'The Trust Concept and Classification' in Andrew S Butler (editor) *Equity and Trusts in New Zealand* (Thomson Brookers, 2003) 58–9; Gino Dal Pont and Tina Cockburn, above n 29, 303; Susan Barkehall Thomas and Vicki Vann, above n 74, 174.
[110] *Fry v Tapson* (1883) 28 Ch D 268, 280.
[111] *Austin v Austin* (1906) 3 CLR 516, 525; *Elders Trustee and Executor Co Ltd v Higgins* (1963) 113 CLR 426, 453; *ASC v AS Nominees Ltd* (1995) 62 FCR 504, 516; *Re Canadian Oil Works Corp* (1875) 10 Ch App 593, 601; Malcolm Cope, *Equitable Obligations: Duties, Defences and Remedies* (Lawbook, 2007) 12 [1.60], 157 [5.170].
[112] RP Meagher and WMC Gummow, above n 75, 451 [1737], 453–4 [1738].

by trustee discretion should be allowed in reference to equity and in reference to the relevant trust acts enforced in the different states of Australia.

VII RELIANCE ON TRUST LAW FOR INCOME TAX PURPOSES

While the law of trusts is conveniently ignored in favour of ongoing access to business-generated cash to fund personal expenses, taxpayers rely on the trust law principle that discretionary trust property belongs to no one and that no one is entitled to trust income until the trustee exercises discretion in order to minimise income tax across a family group.[113] The yet-to-be-determined beneficial ownership over assets in discretionary trusts, based on the law of trust, thus permits flexible and tax efficient income distributions in the interim until vesting occurs. This common practice of income splitting in family discretionary trusts is allowed under income tax law and is highly effective. An analysis prepared by the Parliamentary Budget Office based on ATO data reveals that 'a disproportionate amount of discretionary trust distributions are allocated to people in the lowest marginal tax bracket with little or no work income.' Thirteen per cent of individuals in the lowest income tax bracket received discretionary trust income, a much higher proportion than the number in higher income tax brackets.[114]

Whether income splitting using a discretionary trust is 'fair' is an entirely different question, and one that goes beyond trust law and income tax law, and one that features in contemporary political debate in Australia. In 2017, the Australian Labor Party ("ALP") adopted an aggressive stance on the taxation of discretionary trusts used to conduct family businesses and/or hold family wealth, contending that wealthier Australians are using trusts to distribute income to remain in lower tax brackets. The ALP's proposal is for a minimum 30 per cent flat rate of income tax on distributions from discretionary trusts.[115] Conceptually, this is

[113] NE Rento and Rod Caldwell, above n 101, 135.
[114] Australian Labor Party, *A Fairer Tax System: Discretionary Trusts Reform* (Policy Document, 30 July 2017) 7.
[115] Australian Labor Party, *A Fairer Tax System: Discretionary Trusts Reform* (Policy Document, 30 July 2017) 1, 3–5, 7, 10; Chris Bowen, 'ATO Confirms that Trusts are Being Used to Minimise Tax' (Chris Bowen, Shadow Treasurer, Member for McMahon, Australian Labor Party, Media Release, 1 August 2017) 1, 3; Mike Seccombe, 'Family Trusts and Tax Dodges', *The Saturday Paper* (online), 5 August 2017 <https://www.thesaturdaypaper.com.au/news/politics/2017/08/05/family-trusts-and-tax-dodges/15018552005022>.

diametrically different to the position of the incumbent Liberal Party government, which is that businesses should have the freedom to choose any form suited to their circumstances.[116]

Briefly, the taxation of discretionary trust income is based on the conduit or flow-through principle of taxation that includes an amount in the assessable income of a beneficiary when they are made 'presently entitled' to net income from the trust,[117] failing which the trustee is liable for tax on the remaining net income at a flat rate 47 per cent (in reference to the 2018–19 income year).[118] In the event that the trading trust returns a tax loss, beneficiaries can never be made presently entitled to tax losses,[119] since they bear no trust property risk.

Present entitlement to trust income differs significantly from the general conception of income in the remainder of the Income Tax Assessment Acts that imposes income tax on that which is 'derived' by a taxpayer. Present entitlement to trust income requires no action, exertion, or investment. It does not imply actual receipt, nor does it reflect practical access to economic benefits or cash. Present entitlement can therefore be confined to 'book entries' or trustee decisions that are reflected in income tax returns, without being supported or evidenced by cash receipts. For income tax purposes, income that beneficiaries are presently entitled to flows through the trust to the beneficiaries identified in the trustee resolutions,[120] retaining the original substance of the income using the streaming provisions for capital gains,[121] and franked distributions.[122]

Tax minimisation is classically achieved across the family group by making minor beneficiaries presently entitled to net income of no more than $416 to take advantage of capped tax free distribution to them.[123] Next, other beneficiaries who are tax resident in Australia, who stand under no legal disability and have no other (or limited) source of taxable income are usually made presently entitled to income to the extent that their overall taxable income remains under the income tax threshold of $18,200.[124] This tax planning tool is used

[116] PricewaterhouseCoopers, 'Targeting the Taxation of Trusts – But Should We be Thinking More Broadly?' (TaxTalk–Insights, 14 August 2017); David Leyonhjelm, 'Trust Labor to Spend Too Much', *The Australian Financial Review*, 25 August 2017, 38; Commonwealth, *Parliamentary Debates*, House of Representatives, 8 August 2017, 7666–7 (Michael Sukkar, Assistant Minister to the Treasurer).
[117] *Income Tax Assessment Act 1936* (Cth) s 97.
[118] *Income Tax Assessment Act 1936* (Cth) pt III, div 6.
[119] *Income Tax Assessment Act 1936* (Cth) s 97.
[120] John Glover, above n 95, 101; Commonwealth of Australia, *Modernising the taxation of trust income – options for reform* (Consultation Paper November 2011) 16.
[121] *Income Tax Assessment Act 1997* (Cth) s 115–228.
[122] *Income Tax Assessment Act 1997* (Cth) s 207–58.
[123] *Income Tax Rates Act 1986* (Cth) s 15(2).
[124] *Income Tax Rates Act 1986* (Cth) sch 7 pt I.

extensively. As explained above, based on 2013–14 ATO data, 13 per cent of all individual taxpayers with taxable income below the tax threshold have discretionary trust distributions, compared to three per cent of taxpayers in all other income tax brackets.[125]

The third step in income splitting usually involves simple tax rate arbitrage points in reference to the marginal tax rates in the tax tables for individuals to make remaining beneficiaries presently entitled to net income to the extent that each beneficiary's taxable income is kept under the top value of the relevant income tax bracket. By way of example, if it is possible to distribute net income to as many beneficiaries as possible up to $90,000 (the maximum dollar value of the third bracket using 2018–19 income tax rates),[126] even when the Medicare Levy is incorporated into the calculation, the effective tax rate applicable to trust distributions of $90,000 is 25 per cent. With a little more planning, it is possible to increase present entitlements to beneficiaries without increasing their effective tax rate above 25 per cent, using the unincorporated small business tax offset applicable to small business entities,[127] if trading is conducted in the trust (capped at $1,000 and likely available to many beneficiaries).[128] On that basis, present entitlements of $96,500 will still return an effective tax rate of 25 per cent, compared to the effective tax rate of 28.1 per cent if the beneficiary had taken the same amount as gross salary. Beyond these steps, income splitting could involve present entitlements to private company beneficiaries in more complex family business structures that are not suited to small family businesses. Notably, the operation of complex anti-avoidance deemed dividend provisions make these ineffective when distributions remain unpaid.[129]

The record of how trust income is distributed (split) for income tax purposes (present entitlements) is limited to trustee resolutions and the income tax returns of the relevant beneficiaries, trust and trustees. In the absence of a default beneficiary in the trust deed, a resolution is income tax effective when it is made before the end of an income year to avoid the position where the trustee is liable for tax on trust net income that no beneficiary is presently entitled to.[130] That said, the earliest date on which a trustee is able to confirm the existence of net income for tax purposes is at the end of an income year. As established above, accounting

[125] Australian Labor Party, *A Fairer Tax System: Discretionary Trusts Reform* (Policy Document, 30 July 2017) 7.
[126] *Treasury Laws Amendment (Personal Income Tax Plan) Act 2018* (Cth) sch 2, pt 1.
[127] *Income Tax Assessment Act 1997* (Cth) s 328–110.
[128] *Income Tax Assessment Act 1997* (Cth) s 328–360.
[129] *Income Tax Assessment Act 1936* (Cth) s 109XA.
[130] RL Deutsch et al, above n 46, 960.

for trust activities involves a systematic process that typically spans the same 12 month period for accounting, recordkeeping and tax purposes.[131]

The determination of income of the trust estate and net income for tax purposes relies on the results of trading operations and is unaffected by cash that family member participants habitually take for personal purposes. The latter is reflected in the trust's balance sheet as a credit entry to bank and, usually a debit entry to drawings or a loan account. Cash withdrawals are concrete identifiable actions when compared to present entitlements, but go unrecognised for income tax purposes.

VIII TRUSTEE DISCRETION ABOUT THE ALLOCATION OF INCOME AND ACCESS TO CASH

Present entitlement to net income for income tax purposes has an imprecise and temporal aspect. The High Court reflected upon the temporal and imprecise nature of present entitlements in *Harmer v FCT*:[132]

> [T]he 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.

From this systematic description, four themes emerge. Firstly, there is an obligation on a beneficiary to disclose their present entitlement to the net income of a trust in their income tax return. Secondly, unless the trust deed determines otherwise, trustees stand under no immediate obligation to make payment to beneficiaries when they become presently entitled to income. Thirdly, if the beneficiary does not demand and receive payment before the end of an income year, their right to do so in the future must be recorded against their name in the records of the trust. Fourthly, present entitlement to net income is framed against the income of the trust estate, but its precise value involves consideration of complex concepts including 'presently

[131] *Income Tax Assessment Act 1997* (Cth) ss 4–10(1), 995–1.
[132] *Harmer v FCT* (1991) 22 ATR 726; 173 CLR 264, 271.

entitled',[133] 'specifically entitled',[134] 'absolutely entitled',[135] and 'vested and indefeasible right',[136] which are separately defined in income tax law. As a result, notional present entitlements to lower the aggregate income tax burden across a family group is common and permitted within the confines of income tax law, albeit that it has necessitated a complex legislative response that entails high compliance cost.[137]

The complex debate about the differences between income of a trust estate based on accounting principles, and net income for income tax purposes have resulted in many trust deeds being amended so that income of the trust estate is more closely aligned to the income tax conception thereof, and modern trust deeds follow the same income tax-based approach to define income of the trust estate. Present entitlement and allocation of income of the trust estate has thus become more closely aligned.[138]

Regardless of the basis of the definition, the exercise of trustee discretion to allocate income of the trust estate to beneficiaries must be accounted for against their names in the accounting records of the trust as part of the trust balance sheet. As explained above, in the event that family member participants take cash generated by the trust to fund their personal expenses, these are also accounted for in the balance sheet, often in drawings or loan accounts. In both cases, the accounting characterisation of their cash possession is misplaced.

'Drawings' are not defined in the *Income Tax Assessment Act 1997* (Cth),[139] or the *Income Tax Assessment Act 1936* (Cth),[140] and play no part in determining the tax burden associated with a discretionary trust operations. Drawings are relevant to established ownership rights and reflect present entitlements to future profits suited to sole traders and partnerships. Sole traders and partners have the freedom to take business-generated cash based on their proprietary rights, albeit that it reduces their capital invested until the end of an income year when trading profit is added to their capital accounts.[141] Based on trust law, beneficiaries of a discretionary trust

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133 *Income Tax Assessment Act 1936* (Cth) s 97.
134 *Income Tax Assessment Act 1997* (Cth) s 115–28.
135 *Income Tax Assessment Act 1997* (Cth) s 106–50(1).
136 John Hyde Page, 'CTP Custodian and the effect of trustee recoupment rights on the taxation of beneficiaries' (2011) 40 *Australian Tax Review* 165, 167–8.
137 Commonwealth, *Modernising the taxation of trust income – options for reform* (Consultation Paper November 2011) 2, 39–42; Commonwealth, *Taxing trust income – options for reform* (Policy options paper, October 2012) 8, 17, 21.
138 See, eg, Anna Ziaras, above n 35, 72–6.
139 *Income Tax Assessment Act 1936* (Cth) s 995–1.
140 *Income Tax Assessment Act 1936* (Cth) s 6(1).
141 Floyd A Beams et al, above n, 45, 537; Phillipa Greig et al, above n 45, 91, 142.

do not have present entitlements to future profits, and no ownership interest prior to the trustee exercising discretion (as explained above). As such, taking cash generated by the trading trust to fund personal expenses throughout a year is unsupported by trust law and unrelated to drawings.

Turning next to the characterisation of cash appropriations as a loan advanced to a beneficiary, this approach implies indebtedness on the part of the beneficiary to the trust. From the beneficiary's perspective, accounting standards define liabilities as present obligations to sacrifice *future* economic benefits,[142] and presuppose a contract with an implied promise to repay an amount.[143] Neither characteristic is present in beneficiary access to trust cash to pay for their personal expenses.

Nevertheless, it is common in discretionary trusts to use drawings and loan accounts, and to offset cash receipts and present entitlements to income against these, and to consolidate present entitlements of minor beneficiaries against drawings and loan accounts of their parents. While the overall income tax burden of the family is determined in respect of present entitlement, it is more likely that the cash taken by beneficiaries is a better reflection of the economic benefits that flow to them from the trust.

IX Access To Cash v Unpaid Present Entitlements

While it is entirely possible that beneficiaries could have access to more cash than what they are presently entitled to, based on trustee discretion, the position in many small family businesses that use a discretionary trust is quite the opposite. Family members are unlikely to demand all their present entitlements in the form of cash, as cash funds are required as a source of working capital for the business operations of the trust.

The equation is simple but effective. If beneficiaries do not demand their full entitlements, cash theoretically required to meet their claims remain available as a source of working capital, avoiding (at least in part) external debt financing and the cost of debt, assuming they will get access to debt in the first instance given limited access to external funding resources for small

[142] Australian Accounting Standards Board, *Framework for the Preparation and Presentation of Financial Statements* (Australian Accounting Standards Board, March 2016) [91].
[143] Arthur Athanasiou, 'Accounting for UPEs' (2014) 48(9) *Taxation in Australia* 534, 534.

business generally.[144] The unpaid present entitlements of individual beneficiaries are therefore collectively applied as 'self-generated funds to help finance a business'.[145]

Under these circumstances, the question may rightly be asked why the beneficiaries were made presently entitled to so much of the income of the trust estate in the first instance, if the business effectively retains a portion to fund working capital. The answer lies in income tax law that imposes a high rate of tax on the trustee on that part of net income that no beneficiary is presently entitled to. A trustee's liability for tax will be funded from trust property, reducing the pool of cash available for working capital purposes. Making beneficiaries presently entitled to such net income does not change the source of funding used to settle their taxes as beneficiaries will demand the cash to do so from the trustees, based on their indefeasible vested right to income of the trust estate to which they have been made presently entitled. But the efficacy of the process lies therein that aggregate beneficiary tax liabilities is lower than that of the trustee, and as a result, more cash is preserved for working capital purposes. Beyond the smaller trust cash outflow when profits are taxed in the hands of the beneficiaries, it is also in the family's best interests in the long run if beneficiaries do not demand all their entitlements. Doing so will have a negative impact on the cost of borrowing, reducing the overall profitability of the family business.

The extent to which present entitlements are left unpaid to fund working capital in discretionary trusts is evident from 2014 Board of Taxation discussion papers that proposed taxing retained trust earnings used to fund working capital at corporate tax rates, commonly referred to as the 'tick the box' election. Though never adopted, the proposal received significant support, particularly from accounting bodies and professional advisory firms, as the same commercial decisions to retain profits in a company would then apply in trading trusts.[146]

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[144] See, eg, Jess H Chua et al, above n 6, 1109–1110; The Tax Institute, Submission to the Board of Taxation Discussion Paper: Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936, 27 March 2013, 6-7. Taxation Institute of Australia, Letter to Assistant Treasurer Hon Nick Sherry, 'Australian Taxation Office ruling on Division 7A loans: trust entitlement' 18 June 2010, 13; Parliamentary Joint Committee on Corporations and Financial Services, above n 6, 188, 194, 196–7; Tim Mazzarol and Delwyn Clark, above n 15, 254.

[145] Taxation Institute of Australia, Letter to Assistant Treasurer Hon Nick Sherry, 'Australian Taxation Office ruling on Division 7A loans: trust entitlement' 18 June 2010, 13.

[146] Commonwealth, *Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (Second Discussion Paper, March 2014) 30; BDO, Submission to the Board of Taxation Second Discussion Paper: Board of Taxation Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936, 9 May 2014, 1; KPMG, above n 2, 6–7.

X CONCLUSION

This paper presented a clear picture of the underlying social construct of a family business that underpins family members' access to business-generated cash to pay for their personal expenses. While ownership rights and employment entitlements may justify some access to cash, in many family businesses, not all family member participants have ownerships or employment rights, but they nevertheless have access to business-generated cash.

This position is pronounced in discretionary family trading trusts. The trust property belongs to no one and beneficiaries are not formally employed, yet they operate the trust and take business-generated cash to pay for their personal expenses before trustee discretion is exercised. Access to cash can also not be justified in reference to principle, agent or delegate status. It is thus so that there is a practical disregard of the essential legal form of a discretionary trust to enable ongoing family member access to cash, highlighting the unanswered question whether discretionary trusts are suited to conduct family business using this approach.

In contrast, the paper explained how family members rely on trust law to justify income splitting to minimise income tax across the family group. The outcome of these notional distributions to beneficiaries for income tax purposes, results in another set of problems: the misclassification of access to cash prior to trustee discretion as drawings or loans, and notional present entitlements often bear little resemblance to access to business-generated cash. In fact, in most small family businesses, there is significant pressure on the family to generate cash for working capital purposes, to retain complete family ownership and to avoid debt. The value of business-generated cash they take is thus likely limited, and a better indicator of their access to economic benefits from the trust. Regardless, the latter plays little part in their income tax position. The resulting inconsistencies between access to cash, taxable income and accounting records underscore the continued and contemporary debate that regulatory reform of discretionary trading trusts is long overdue and necessary in Australia.