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**Effective Business Structures for  
Australian Small and Medium  
Enterprises:  
Is the Trend of Adopting Discretionary  
Trusts as a Business Structure  
Counterproductive to the Economy?**



## **Supervisors:**

**Professor Brett Freudenberg**

**Dr John Minas**

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The concept of misuse of trusts throughout history can be found as early as the era of Jerome when he stated in his letter:

***Per fidei commissa legibus inludimus*** (Jerome, *Ep.* 52.6)

**‘by trusts we elude the laws’.**

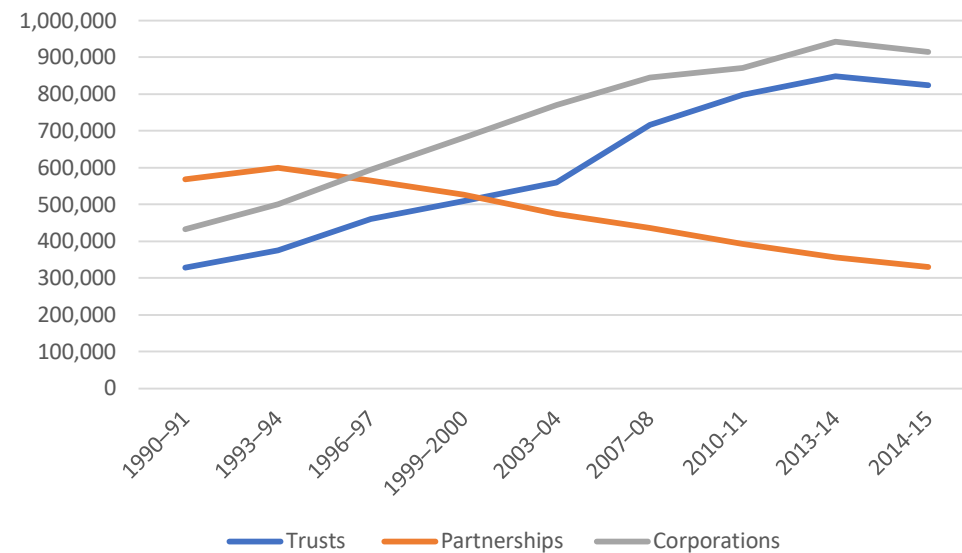
Such perceptions could be still valid with the modern-day trusts.

# Background

- Since the 1970s there has been an increasing trend toward the adoption of discretionary trusts as a business structure by small and medium enterprises (SMEs) in Australia (Cooper, 2013).
- Australia has a distinctive commercial feature, trusts are significantly used to conduct commercial activities.
- The utilisation of trusts is not just restricted to the domain of charitable foundations and deceased estates.
- There were over 800,000 trusts in 2015 (Australian Taxation Office 2018):
  - 266,071 (32%) discretionary trusts from trading.
  - 335,536 (41%) discretionary trusts from investment.
- Expected over 1 million trusts will exist in Australia by 2022 (ATO).

# Background

## Lodgement of Tax Returns - Business



Source: Australian Taxation Office (2018). Taxation statistics, 1990-91 to 2014-15.

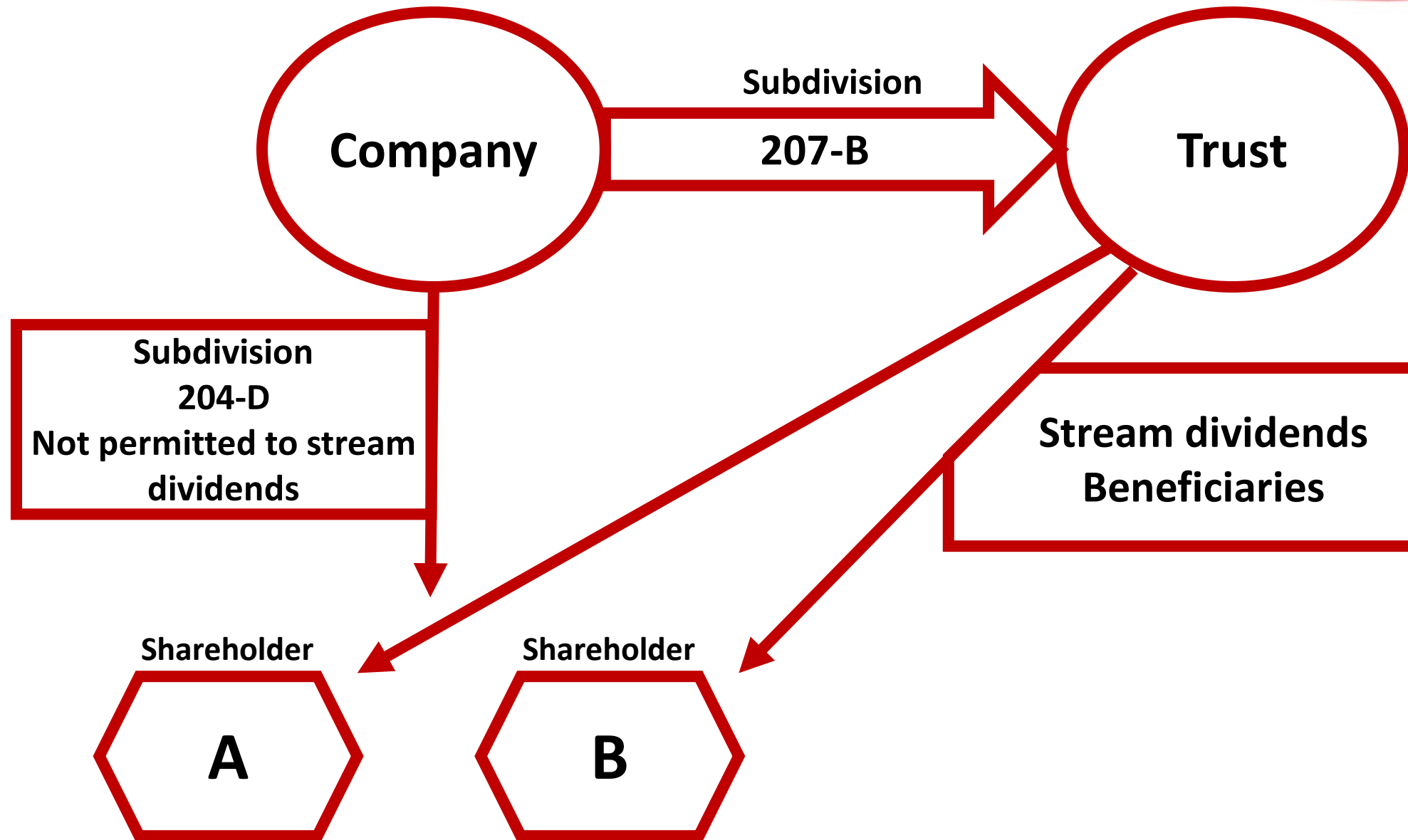
Why do we need a  
**'triage'**  
for business taxation?

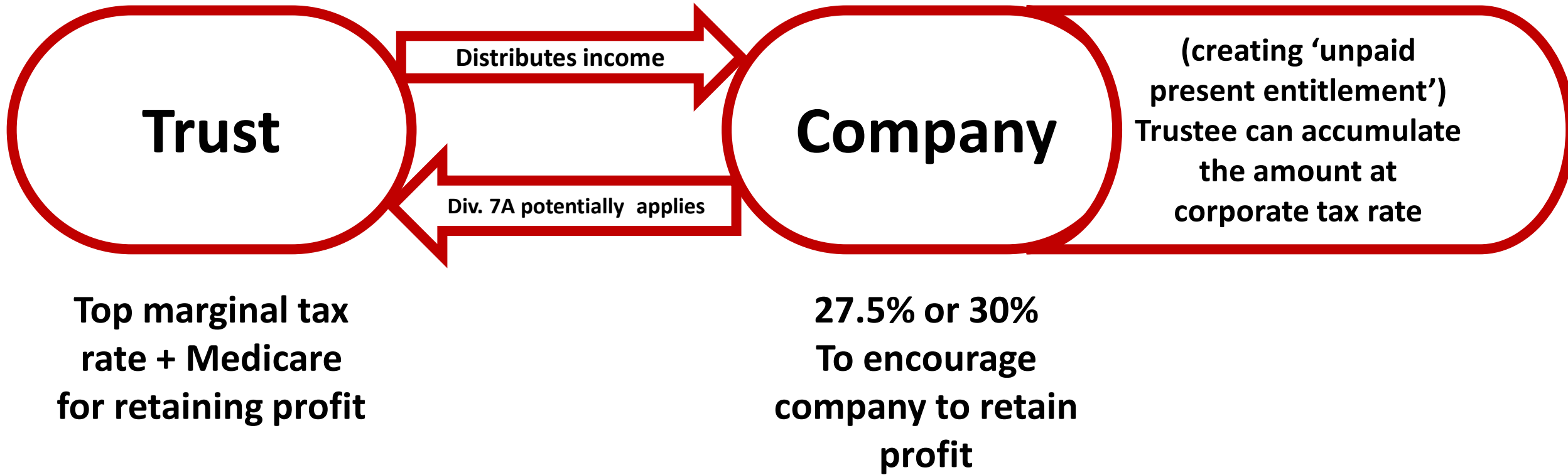


# Issues

- Tax neutrality can be breached by tax advantages that are available to certain SMEs but not to others (Burton, 2006): an entity with a structure that facilitate income splitting - trusts can benefit from income splitting which is not available to sole traders or wage earners.
- The issues and concerns are related to the interactions and the contradictions associated with taxing income depending on its classification and on the legal structure of the business.
- Differences and applications in the provisions could give rise to a significant complexity for businesses.
- Open opportunities for taxpayers to manipulate their tax liabilities.







# Research Gap

- Holub studied the utilisation of public unit trusts in Australia during the 1980s.
- Freudenberg (2013) explored the important considerations regarding the formation of businesses.
- Trad and Freudenberg (2017) explored the factors considered when a business structure is chosen for a small business.
- To date there is a paucity of empirical academic research exploring the reasons why Australian SMEs have been so proactive in utilising discretionary trusts.

## Research Questions:

1. What are the reasons for Australian SMEs for the adoption of discretionary trusts compared to other business structures?
2. What are the implications derived from the adoption of discretionary trusts by Australian SMEs compared to other business structures?

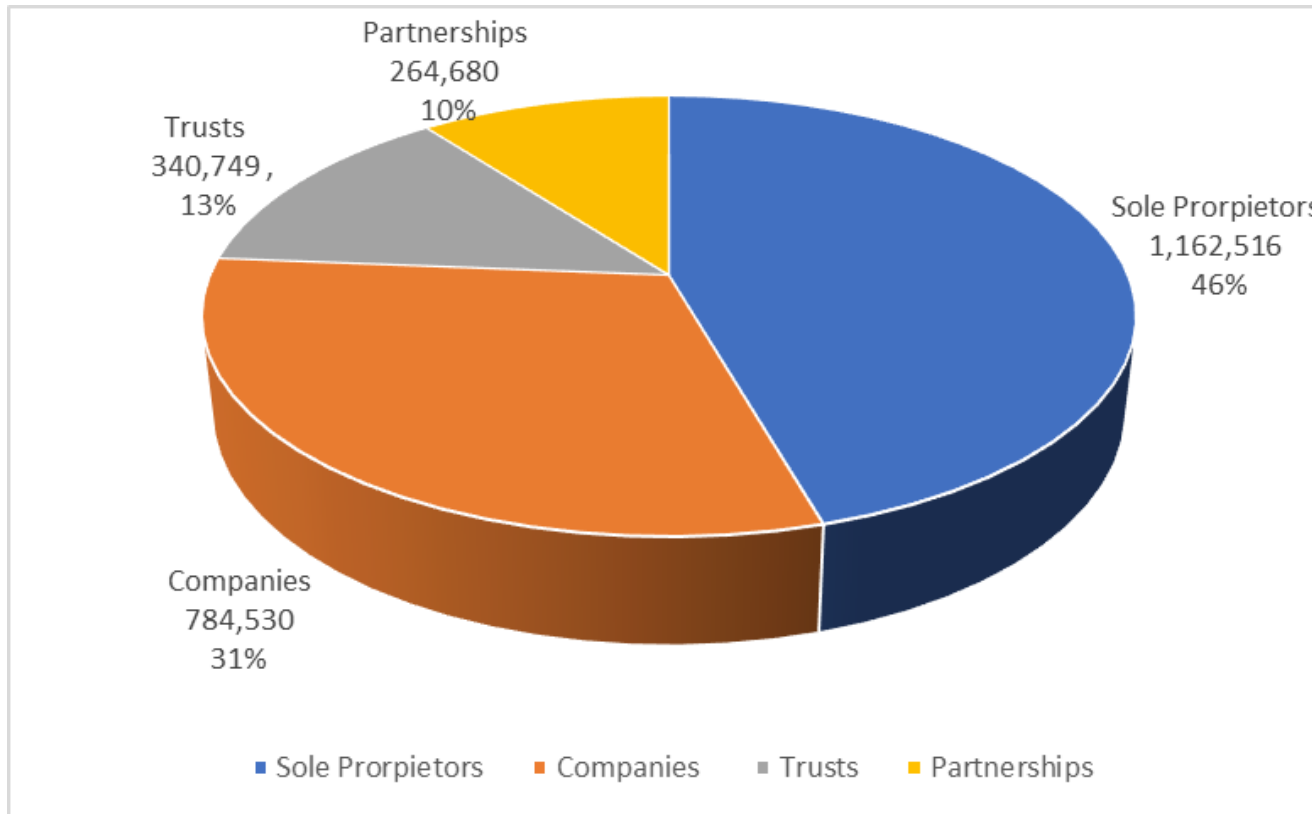
## The Aim of this Research

- To determine the reasons behind the utilisation of discretionary trust by Australian SMEs compared to other business structures; and what are the possible implications of such choice?
- To investigate whether discretionary trusts provides commercial attributes that are more beneficial than other business structures.

# The Importance of SMEs in Australia

- Estimated 2,238,299 SMEs during 2016–2017, representing over 99% of businesses in Australia (ABS 2018).
- SMEs account for 67% of employment, and around 57% of GDP.
- Approximately 61% of trading businesses are non-employing, and are generally operated by family members.

# Business Structures Used by SMEs



Source: Australian Taxation Office (2018).

# Attributes of Discretionary Trusts in the Commercial Arena

1. **Asset protection:** Property can be protected from the claims of creditors in the event of insolvency.
2. **Flexibility in distribution of income:** in selection of beneficiaries and the amount distributed to them, in the most tax effective manner, to accommodate to their changing needs.
3. **Not a taxable entity:** Distributed income retains its pre-tax character as flows through a trust (CGT discount s115-C ITAA97; and franked dividends) – trustee can engineer most tax-effective distribution of business income between beneficiaries.
4. **Estate planning:** Trust property is not owned by any beneficiary and cannot be passed by a beneficiary's will. Trust assets, can be passed to the next generation by appropriate consideration of the appointor provisions (in the trust deed).



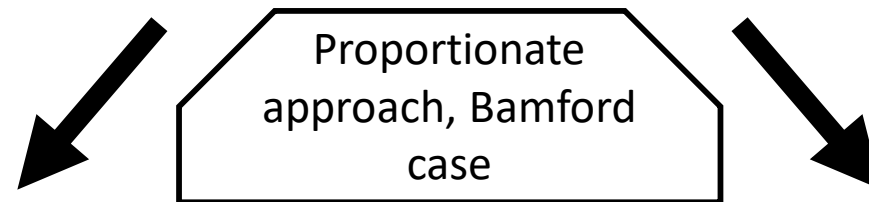
## Issue with Trusts

1. There would be no issue if:

(Distributable) Trust income = (Taxable) Net Income

2. Whenever trust income does not include all statutory income (defined by trust deed) – when trust derives capital gains and/or franked dividends → Issue

### Trust income $\neq$ Net income



#### **Net income < trust income**

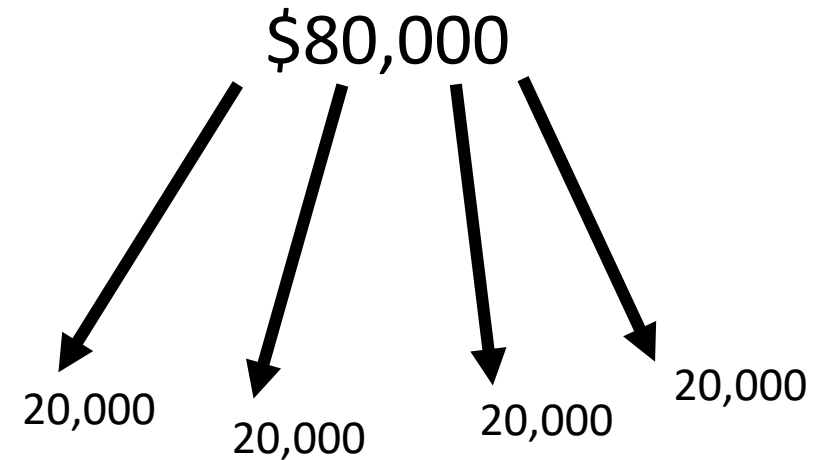
Result on some of the income not being taxed

#### **Net income > trust income**

Unfair tax outcome for beneficiaries (tax liability on income not received).

## Example: Net Income > Trust income

- Net income of trust estate = \$100,000
- Beneficiaries are presently entitled to a share of the income of trust estate.
- Trustee distributes \$80,000 equally to four beneficiaries.



Under the proportionate approach each beneficiaries will be taxed under s97 on \$25,000 (25% X 100,000), Even though they only received \$20,000 each.

- **Cost to government:** at least \$2 billion in lost tax revenue annually (Boccabella, 2017).
- **Multi-million family-run businesses** use trust structures to avoid tax - Aged care sector: exploiting public funding, and compromising the quality of care provided to the elderly and the vulnerable. (Ward, 2019).

## **1 July 2017, Tax Avoidance Taskforce:**

- Most if not all wealthy groups adopt multiple trusts and companies within their structures (ATO, 2019).
- Discretionary trusts are the most common structures, trust income accounted over \$340 billion in 2013-14 (ATO, 2019).

## The key findings of the commissioned report:

❑ **The differences** in the **definitions of income** under trust law and tax law are being manipulated and exploited → \$1.2 billion to several billions some of used techniques:

➤ **Distributions** < income of the trust - beneficiaries are taxed on their share of the net income of the trust - at a concessional level or even insolvent. Resulted amounts from the mismatch are distributed to other beneficiaries in the following years, without being taxed.

➤ The specific use of **loss-making entities**, 'bucket' companies, or combination of trusts and companies as beneficiaries. on average 22% were distributed to loss-making company beneficiaries.

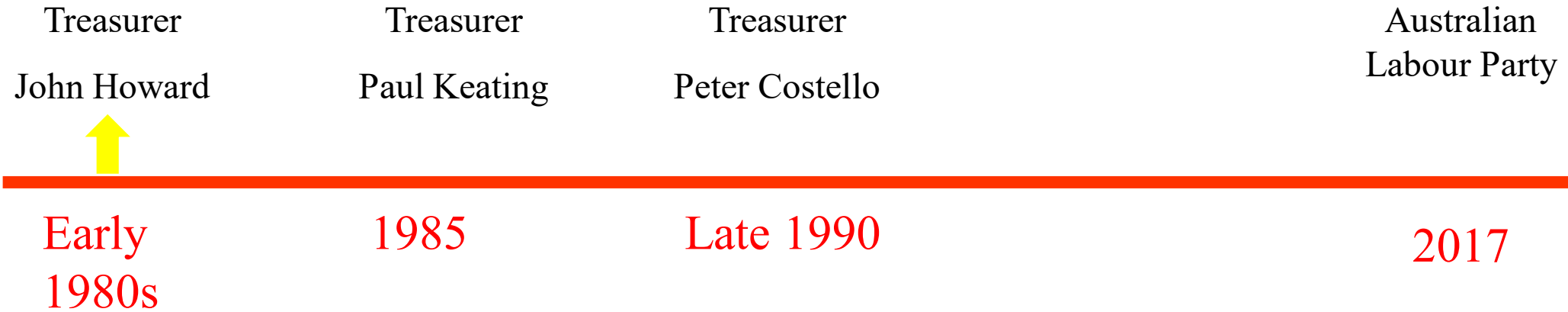
❑ **Complex distributions:**

➤ **Chains of trusts:** to create difficulty for ATO to identify the key beneficiaries to assess.

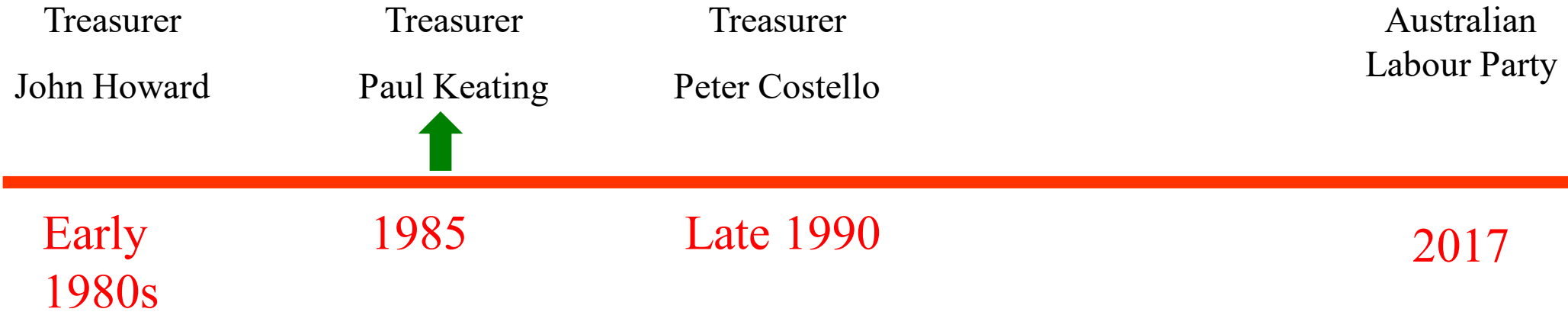
➤ **Interlinking trusts:** whereby at least two trusts make each other presently entitled [Distributions from trust A to trust B more than doubled over a three-year period: \$21 billion (2012) to \$50 billion (2015)].

❑ **No register of trusts** in Australia. Lodgement of trust tax returns is voluntary; no requirements to provide or maintain constitutive documents of the trusts or other trusts' relevant information.

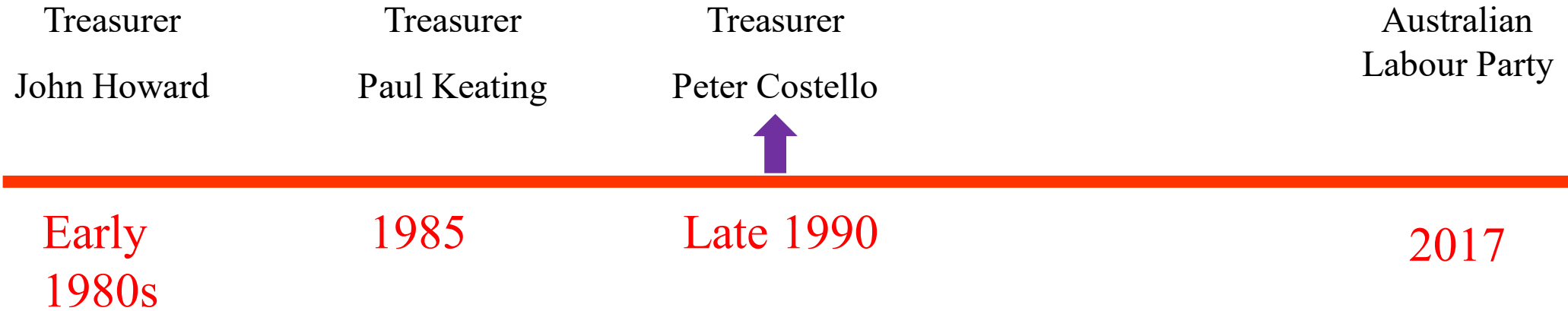
❑ **Significant issue for international transparency.** The lack of information and the difficulty in identifying the beneficial ownership of trusts; can create an international concern in combating money-laundering, terrorist financing and other threats to the international finance system.



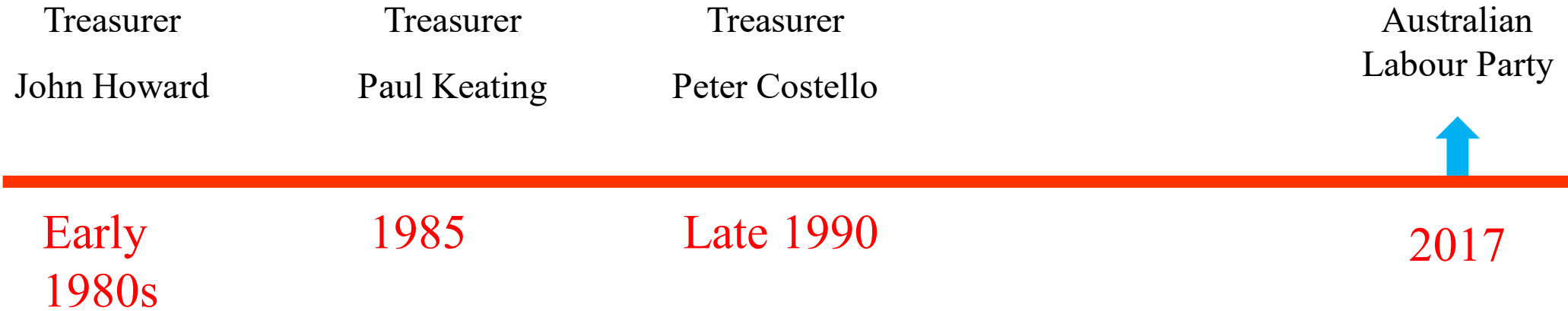
The Treasurer John Howard, announced reforms to trust to curtail the issue of income splitting and to curb the income distribution to dependent children. However, under the current rules income can still be diverted to other family members on a lower/no income.



Treasurer Paul Keating, announced that trading trusts would be taxed as companies - This proposal was in response to draft White Paper on the reform of Australian Taxation System - purpose to curb the avoidance of the two-tiered taxation of company income; as the government was concerned about the increase use of trusts for new ventures instead of using companies.

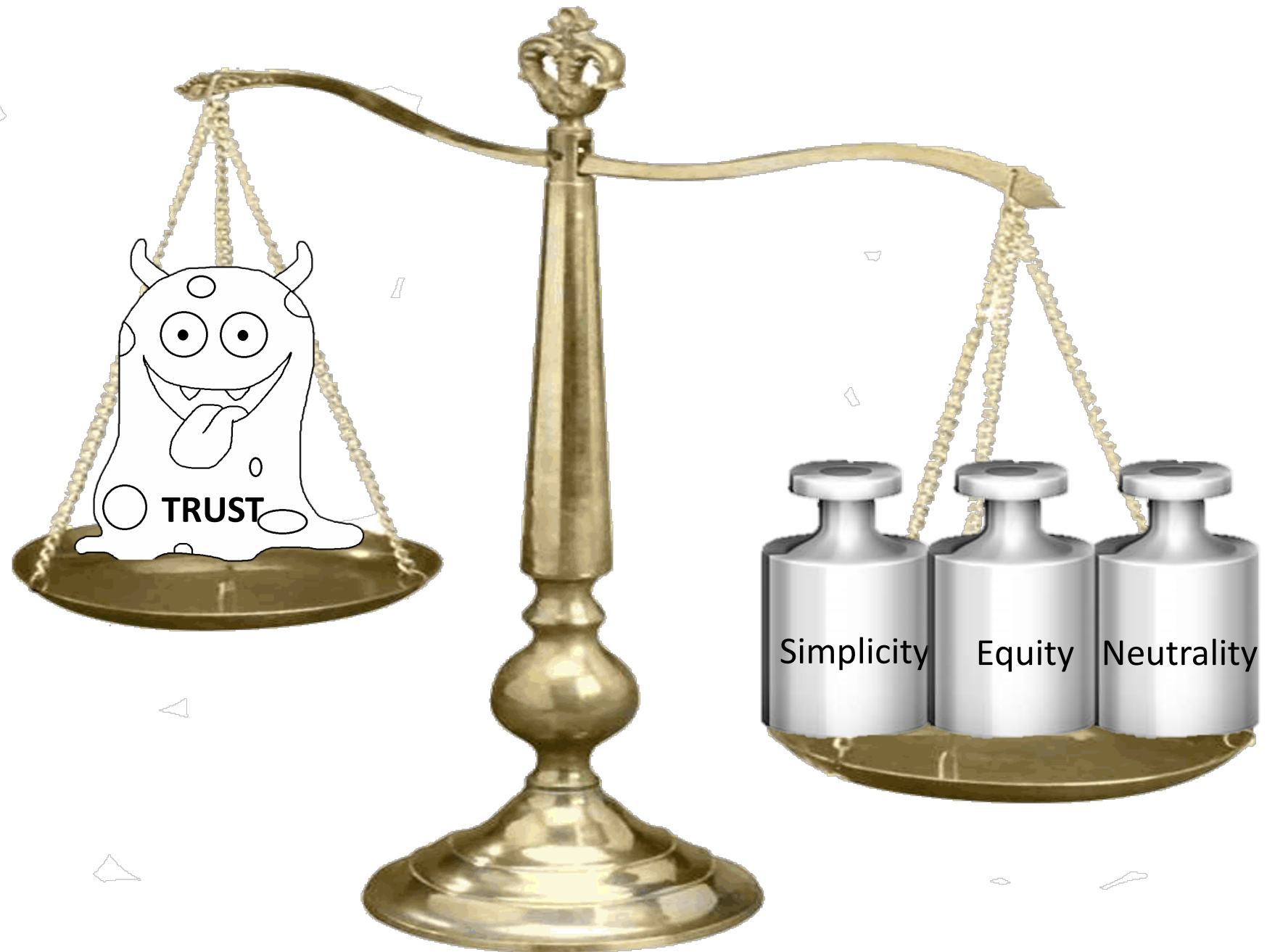


Treasurer Peter Costello proposed to tax family trusts like companies ( A New Tax System). The aim was to achieve a greater consistency in the taxation of entities and to reduce compliance and restructuring cost.



Recently, the Australian Labour Party announced that they will introduce a 30% tax on distributions from discretionary trusts if they win the 2019 federal election.



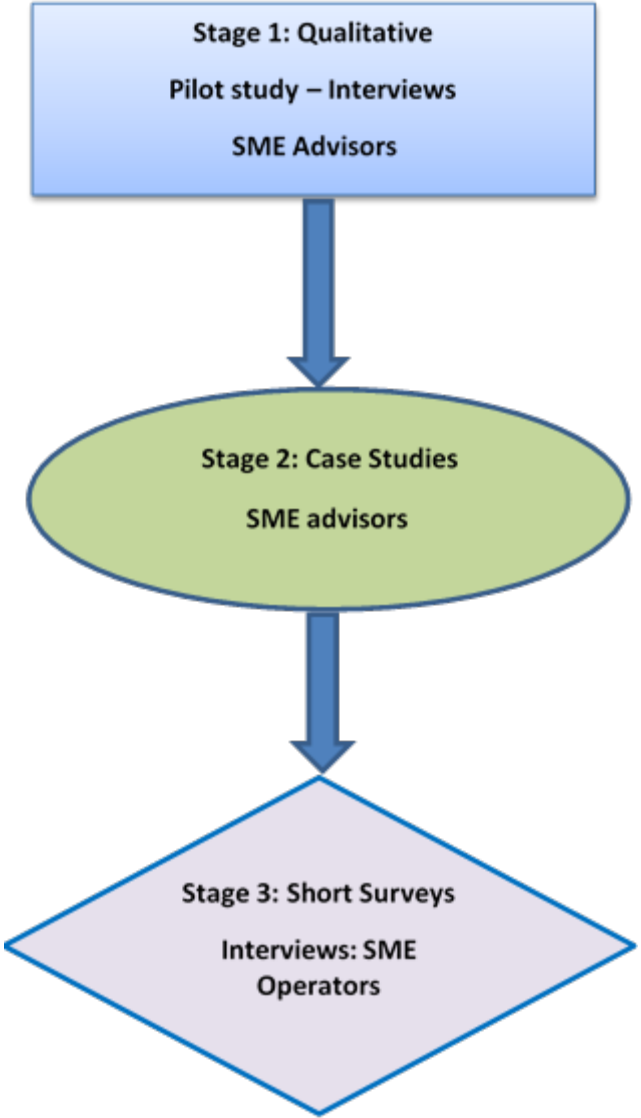


# Research Methodology

This research project is based on:

Scholes and Wolfson's theory (1992) suggests that the structure choice is a trade-off between tax and non-tax costs, with firms likely to choose a business structure that minimise these costs.

Research Design



# Research Methodology

- A mixed-method approach of both qualitative and quantitative methods.
- The combination provides a better understanding of the research issue than either of each method alone (Creswell, 2017).

- **Three stages:**

## **Stage 1: Pilot Study-Interviews: (10 SME advisors)**

- Foundation for the proposed case studies in stage two.
- gain understandings of the factors that lead to the choice of business structure.

## **Stage 2: Case study interviewing SME advisors (40 participants)**

- 3 different mock client scenarios (new business).
- 3 different mock client scenarios (established business).

## **Stage 3: SME operators (40 participants)**

- **In-depth interviews**
- **Surveys**

**QUESTIONS?**

