



**Australian Government**

# **Improving the fairness and integrity of the tax system:**

## **Extending the Tax File Number withholding arrangements to closely held trusts, including family trusts**

**Consultation Paper**

October 2009

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## Consultation process

### Request for feedback and comments

The Government is seeking your feedback and comments on the legislative design details of the Government's 2009-10 Budget announcement to extend the tax file number withholding arrangements to closely held trusts, including family trusts. The proposed approach to the legislative changes is outlined in this consultation paper. In particular, comment is sought on any potential unexpected consequences for trustees and beneficiaries of these trusts.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

### Closing date for submissions: 20 November 2009

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## FOREWORD

I am pleased to release this discussion paper on the Government's proposal to extend the tax file number (TFN) withholding arrangements to closely held trusts, including family trusts.

In the 2009-10, Budget the Rudd Government announced important changes to improve the integrity of the tax system and protect Commonwealth revenues. Extending the TFN withholding arrangements will help ensure that beneficiaries of trusts include their share of the trust's taxable income in their assessable income when completing their tax returns.

The measure will also help to improve the efficiency and effectiveness of the Tax Office's income matching system as a means of ensuring that closely held trusts and their beneficiaries comply with the taxation law.

These proposed tax changes will assist significantly and we look forward to receiving the community's views.

A handwritten signature in black ink, appearing to read 'Nick Sherry'.

Senator Nick Sherry  
Assistant Treasurer

## BACKGROUND

1. In the late 1990's the then Government became aware that complex chains of trusts were being used to avoid or indefinitely defer tax. In order to address this issue, it introduced legislation to require a trustee of a closely held trust to advise the Commissioner of Taxation (Commissioner) of certain details about a trust's ultimate beneficiaries and tax-preferred distributions to beneficiaries. Failure to do this, or there being no ultimate beneficiary, rendered the trustee liable to pay an 'ultimate beneficiary non-disclosure tax' at the top marginal tax rate plus Medicare levy.
2. The purpose of that measure was to allow the Commissioner to check that the assessable income of ultimate beneficiaries correctly included their share of trust income and that the net assets of ultimate beneficiaries reflected their receipt of tax-preferred amounts.
3. This measure proved to be very difficult to comply with for some trustees of closely held trusts. Consequently, from the 2008-09 income year, new rules apply requiring that the trustee of a closely held trust report information to the Commissioner in respect of each beneficiary that is itself a trustee entitled to a share of the trust's net income or to receive tax-preferred amounts. The new reporting requirements do not apply in respect of individuals or companies, or to family trusts that have made a family trust election under the Trust loss provisions in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936).

## BUDGET REFORMS

4. On 12 May 2009, as part of the 2009-10 Budget, the Rudd Government announced that, with effect from 1 July 2010, it would extend the current TFN withholding arrangements to closely held trusts, including family trusts, to ensure that the assessable distributions to beneficiaries of those trusts align with the amounts included by those beneficiaries in their tax returns.
5. This approach will assist the Tax Office with its compliance activities to help ensure that beneficiaries of these trusts pay their fair share of tax.
6. The purpose of this discussion paper is to provide interested parties with an opportunity to comment on the design and implementation details of this proposal with a view to achieving this goal with minimum compliance costs.

## CURRENT TAX ARRANGEMENTS

7. Currently<sup>1</sup>, where a beneficiary of a closely held trust is not under a legal disability and they are required to include their share of the trust's net income in their assessable income, they are assessed on that income at the applicable rates of tax. However, through the application of the trustee beneficiary reporting rules<sup>2</sup> to closely held trusts (other than family trusts<sup>3</sup>) the following exceptions arise:

- a trustee that has not provided the tax file number of a trustee beneficiary (or other information as required under Division 6D) may be liable to pay 'trustee beneficiary non-disclosure tax' at the rate of 46.5% on that beneficiary's trust income (to the extent that it has not already been taxed); and
- where a share of the net income is included in the assessable income of a trustee beneficiary and part of it 'comes back' to the first trust, trustee beneficiary non-disclosure tax is payable.

8. The trustee of the trust will ordinarily advise the beneficiary of the amount to include in their assessable income through distribution statements.

9. The current arrangements for TFN withholding rules<sup>4</sup> operate so that if an entity receives a payment of salary or wages or investment income, and they do not quote their TFN to the payer, the payer is required to withhold tax at 46.5% from the payment. The payer is required to remit and report the withheld amount to the Commissioner and the entity will receive a credit for the amount withheld in the calculation of their annual income tax liability.

10. These rules currently apply in a limited trust context<sup>5</sup> where an investor in a unit trust fails to quote their TFN to the trustee.

## OVERVIEW OF PROPOSED CHANGES TO THE INCOME TAX LAW

11. In summary, the TFN withholding arrangements will apply to the trustees of closely held trusts including family trusts where the trustee makes an assessable distribution to a beneficiary that has not provided their TFN to the trustee. Assessable distribution in this context means:

- the trustee makes a payment from the trust upon which the beneficiary will be assessed; or

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<sup>1</sup> Under section 97 of the ITAA 1936.

<sup>2</sup> In Division 6D of the ITAA 1936.

<sup>3</sup> For the purposes of this measure family trusts refers to the group of trusts defined under section 272-75 of Schedule 2F to the ITAA 1936. The term family trust includes trusts that are covered by a family trust election, or an interposed entity election or wholly owned by the family trust that are not subjected to the trustee beneficiary reporting requirements under Division 6D of the ITAA 1936.

<sup>4</sup> See Part 2-5 of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) and Division 3 of Part 5 of the *Taxation Administration Regulations 1976*.

<sup>5</sup> Through the operation of Subdivision 12-E of Schedule 1 to the TAA 1953.

- the beneficiary of the trust is presently entitled to a share of the income of the trust at the end of the income year and withholding has not previously applied to the beneficiary's corresponding share of the net income of the trust or part thereof.
12. For trusts subject to the trustee beneficiary reporting rules in Division 6D of the ITAA 1936, where an assessable distribution is made to a trustee beneficiary, TFN withholding will only apply to interim distributions made during the income year.
13. TFN withholding will not apply to an amount that is subject to 'family trust distribution tax' (for example, when a family trust makes a payment to a beneficiary outside the family group).
14. The trustee of the trust will be required to submit a number of reports and remit amounts withheld to the Commissioner.
15. A flowchart is included at Appendix A of this discussion paper to provide an overview of the proposed changes. Examples are included at Appendix B to assist readers to understand the provisions.
16. This measure will not apply:
- where tax is payable by the trustee of the trust on behalf of the beneficiaries, such as in the case of minors and foreign resident beneficiaries;
  - to foreign resident trusts (already covered by Part III Division 6AAA);
  - to assessable distributions to entities that are exempt from income tax; and
  - where the closely held trust is a unit trust already subject to TFN withholding rules under section 12-140 or 12-145 of Schedule 1 to the TAA 1953.

## **DETAILED EXPLANATION OF THE PROPOSED CHANGES**

### **TYPES OF TRUSTS COVERED BY THE MEASURE**

17. This measure will apply to closely held trusts including family trusts. A closely held trust is currently defined<sup>6</sup> as:

(a) a trust where an individual has, or up to 20 individuals have between them, directly or indirectly, and for their own benefit, fixed entitlements to a 75% or greater share of the income, or a 75% or greater share of the capital, of the trust; or

(b) a discretionary trust;

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<sup>6</sup> Subsection 102UC(1) of the ITAA 1936.

except where the trust is an excluded trust. The exclusion for family trusts<sup>7</sup> in that section will not apply for this measure.

## **FAILURE OF BENEFICIARY TO PROVIDE TFN TO TRUSTEE**

18. The TFN withholding arrangements will apply to the trustees of closely held trusts where the trustee makes an assessable distribution to a beneficiary who has not provided their TFN, or their ABN, to the trustee. Although specifically excluded from the definition of closely held trust in Division 6D of the ITAA 1936, family trusts will be included in this measure. Whilst the term 'assessable distribution' includes a payment to a beneficiary, it does not matter whether the trustee has actually made the payment.

19. Accordingly, an assessable distribution also includes the situation that occurs at the end of the year of income, where a beneficiary becomes presently entitled to a share of the income of the trust. Where the beneficiary does not quote their TFN to the trustee, the trustee will be required to withhold from the beneficiary's<sup>8</sup> share of the net income at that time. The amount subject to withholding will be the relevant share of the net income of the trust to which the beneficiary is presently entitled, less any interim payments made during the year of income. This will prevent interim payments being subject to double withholding.

20. This means the withholding arrangements will work in a similar fashion to the current TFN withholding rules<sup>9</sup> in respect of investment bodies. The rate of withholding under the measure will be the top marginal tax rate plus Medicare levy (currently 46.5%) in line with other TFN withholding rates.

21. While persons in receipt of various pensions and benefits, including the age pension and disability support pension, are currently exempt from quoting their TFN under Division 5 of Part VA of the ITAA 1936, for salary or wages and investments, they will be required to provide their TFNs for this measure.

22. The inclusion of these persons is necessary due to the discretionary nature of many closely held trusts, including family trusts, and it will reduce the scope for tax abuse using trusts. Failure to include such persons could undermine the effectiveness of the measure.

23. When the beneficiary submits their income tax return for the year of income, they may claim a credit for any amounts withheld during the year of income.

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<sup>7</sup> Paragraphs (c), (d) & (e) of the definition of 'excluded trust' in subsection 102UC(4) of the ITAA 1936.

<sup>8</sup> Except trustee beneficiaries subject to Division 6D of the ITAA 1936.

<sup>9</sup> Sections 12-140 and 12-145 of Schedule 1 to the TAA 1953.

## TREATMENT OF TRUSTEE BENEFICIARIES SUBJECT TO THE TRUSTEE BENEFICIARY REPORTING RULES

24. For trusts subject to the trustee beneficiary reporting rules in Division 6D of the ITAA 1936<sup>10</sup>, TFN withholding will apply to assessable distributions made to trustee beneficiaries during the year of income as interim distributions.

- TFN withholding will not apply to assessable distributions to trustee beneficiaries determined at the end of the year of income as those amounts are already subject to the 'trustee beneficiary non-disclosure tax' where the trustee beneficiary's TFN is not quoted.
- Amounts withheld from interim distributions to a beneficiary will be available in the first instance as a credit against any 'trustee beneficiary non-disclosure tax' that the trustee may be liable to pay in respect of that beneficiary at the end of the income year. Any credit remaining will be refundable in accordance with the current PAYG withholding framework.

## TREATMENT OF FAMILY TRUSTS UNDER THIS MEASURE

25. A family trust that makes an assessable distribution to any entity within their designated family group<sup>11</sup> will be subject to the TFN withholding arrangements where the beneficiary does not quote their TFN to the trustee.

26. Where a trustee of a family trust makes an assessable distribution to any entity outside the family group, they are subject to 'family trust distribution tax'<sup>12</sup>. Therefore, a trustee of a family trust will not be required to withhold in respect of amounts that are subject to the 'family trust distribution tax'.

## REPORTING REQUIREMENTS OF TRUSTEES

27. The trustee will be required to prepare a report (TFN report<sup>13</sup>) and lodge it with the Tax Office in the approved form to advise the Commissioner of TFNs quoted by beneficiaries during the relevant period, together with other identifying information of those beneficiaries. The trustee will be required to lodge the TFN report with the Commissioner each quarter in line with the current TFN reporting requirements for investments. Following receipt of the report, the Commissioner will confirm that the TFNs quoted are correct. Where they are not correct, the Commissioner will advise the trustee of the correct TFNs or the fact that the beneficiary does not have a TFN. In the latter case, the trustee will be required to treat the beneficiary as not having quoted their TFN.

28. The trustee will be required to report and remit amounts to the Commissioner where the trustee has withheld amounts from assessable distributions in accordance with the requirements of the existing PAYG withholding system. The trustee will need to register for PAYG withholding if not already registered.

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<sup>10</sup> Refer to sections 102UK and 102UM of the ITAA 1936.

<sup>11</sup> Refer section 272-90 of Division 272 of Schedule 2F of the ITAA 1936.

<sup>12</sup> Imposed by the *Family Trust Distribution Tax (Primary Liability) Act 1998*.

<sup>13</sup> Similar to Regulation 55 of the Income Tax Regulations 1936.

29. After the end of the year of income, the trustee will be required to provide beneficiaries with a payment summary showing amounts withheld. This reporting requirement will operate in the same manner as the existing payment summary requirements for TFN withholding for investments<sup>14</sup>.

30. The measure aims to improve the efficiency and effectiveness of the Tax Office's income matching system as a means of ensuring that closely held trusts, including family trusts, and their beneficiaries comply with the taxation law. Accordingly, the trustee will also be required to provide an annual report<sup>15</sup> to the Commissioner in the approved form by 31 October of the following income year or such later time as approved by the Commissioner.

31. Details required on the approved form may include the name of the trust, its TFN, each beneficiary's full name and address, TFN and their respective assessable distributions/withholding payments. Where the beneficiary's TFN is not quoted, the report could also include the amount withheld and, where the beneficiary is an individual, the beneficiary's date of birth.

32. Where a trustee beneficiary has been subject to withholding on its assessable distribution and it has one or more beneficiaries that are presently entitled to the income of the trust, the trustee beneficiary will need to advise the pro-rata amounts of withholding available for its beneficiaries to claim as a tax credit. Where the trustee fails to lodge the report or it contains intentional errors, administrative penalties will apply.

## **APPLICATION OF THE MEASURE**

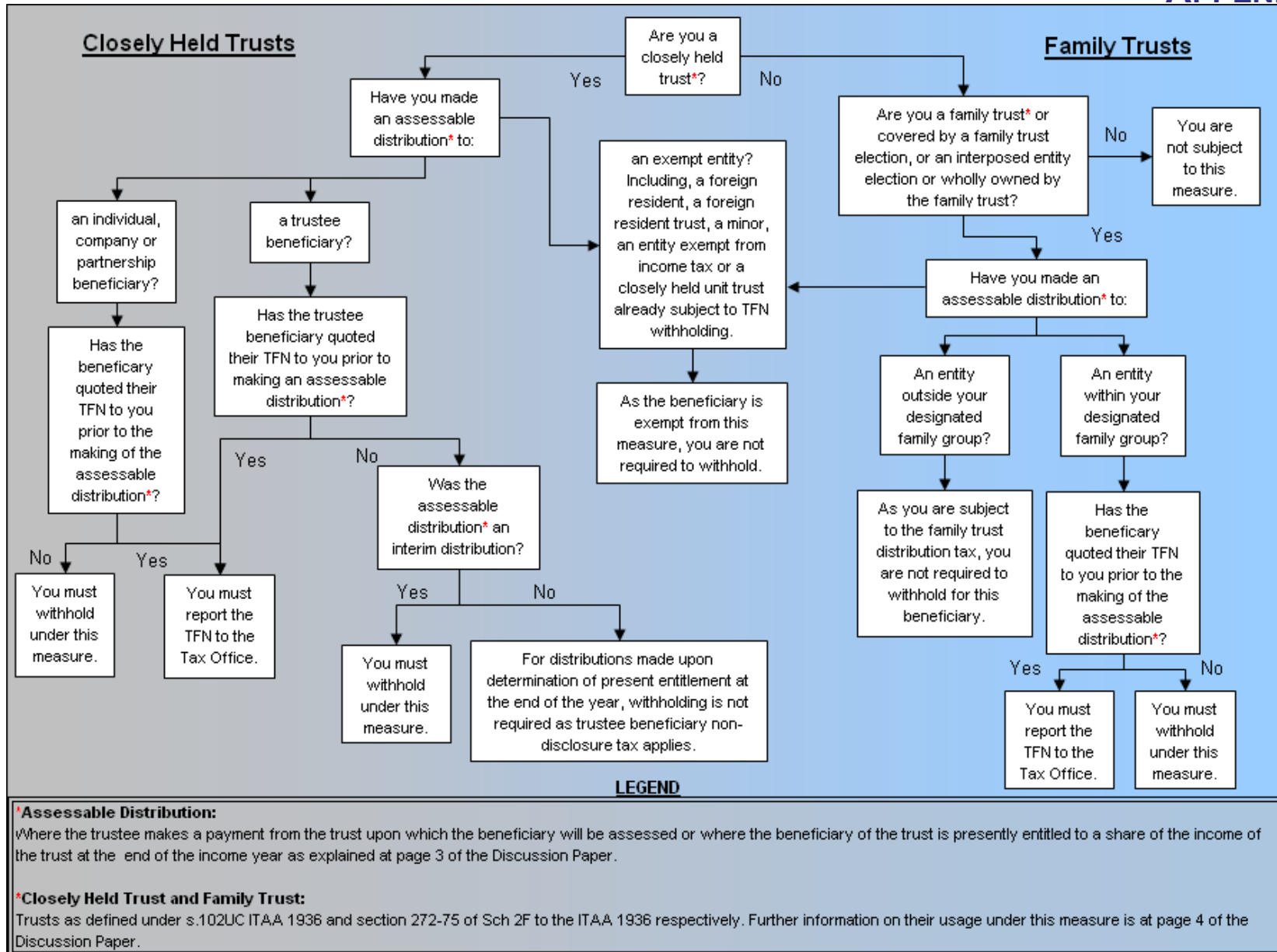
33. The measure will apply to assessable distributions made on or after 1 July 2010 in respect of assessable income derived by a trust for the income year 2010-11 and future income years.

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<sup>14</sup> Under section 16-155 of Schedule 1 to the TAA 1953.

<sup>15</sup> Similar to Regulation 56 of the Income Tax Regulations 1936.







## APPENDIX B

### **Example 1 Effect of measure on an individual beneficiary of a closely held trust**

Michael is a beneficiary of a closely held trust who is not under a legal disability and is a resident of Australia. At the end of the income year he is presently entitled to \$1,100 of trust income, but because of additional tax deductions claimed by the trust, Michael is only required to include \$1,000 in his assessable income for the year. Therefore, the \$1,000 is an assessable distribution. Michael has not provided his TFN to the trustee.

The trustee must withhold from the \$1,000 assessable distribution at the highest marginal tax rate plus Medicare Levy (currently 46.5 per cent). Therefore, the trustee is required to withhold \$465. When the trustee makes the subsequent payment of the \$1,000 distribution, it will not be subject to TFN withholding, as the withholding will have already applied when Michael became presently entitled at the end of the income year.

Michael can claim a credit for the tax withheld (\$465) in his annual income tax return. If Michael has a marginal tax rate of 31.5 per cent (including Medicare levy), he would be liable to pay \$315 on the assessable distribution. In effect, he would be entitled a refund of \$150 of the amount withheld after he lodges his return.

### **Example 2 Effect of measure on partnership beneficiary of a closely held trust**

A & B partnership is a beneficiary of a closely held trust, (Z trust) and it is a resident of Australia. A & B partnership is presently entitled to \$20,000 of trust income and its share of the trust's net income is also \$20,000. A & B partnership has not quoted its TFN to the trustee of Z trust.

Therefore, the trustee of Z trust must withhold \$9,300 from the A & B partnership's assessable distribution. The withholding tax credit amount will flow through the partnership to the partners with their share of the income of the partnership. The partners will be able to claim their respective share of the amount withheld in their individual tax returns.

### **Example 3 Treatment of beneficiaries of a closely held trust subject to Division 6D**

The Kovic trust is a closely held trust. Its beneficiaries include LC Pty Ltd, the Webb trust and the Quade trust (which are also both closely held trusts). All three beneficiaries fail to provide their TFNs/ABNs to the trustee of the Kovic trust. During the income year the Kovic trust makes interim distributions of \$100 to each of the beneficiaries. The distributions will form part of the trust's net income for the year and therefore they are assessable distributions and the trustee of the Kovic trust must withhold \$46.50 from each payment.

Upon determination of present entitlement at the end of the year of income, the trustee of the Kovic trust advises the beneficiaries of their share of the net income, which equates to \$300 each. As the trustee has already withheld from the interim distribution of \$100 to LC Pty Ltd during the year, the trustee must not withhold again on that amount. Therefore, the trustee is only required to withhold \$93.00 (46.5 per cent) on the balance (whether or not it is paid). LC Pty Ltd will be able to claim a credit for the amounts withheld (\$46.50 and \$93.00) from its assessable distributions in its income tax return.

As the Webb trust and the Quade trust failed to quote their TFN to the trustee of the Kovic trust, the trustee is unable to provide a correct TB statement to the Tax Office at the end of the income year. Consequently, the Kovic trust will incur the 'trustee beneficiary non-disclosure tax' in respect of the Webb and Quade trusts' share of the net income of the trust. The trustee is not required to withhold at the end of year as the 'trustee beneficiary non-disclosure tax' takes precedence.

The amounts withheld during the year in relation to the Webb trust and the Quade trust are credited against the respective trustee beneficiary non-disclosure tax liabilities payable by the trustee of the Kovic trust.

#### **Example 4 Treatment of individual beneficiaries of a family trust**

Olga, as the trustee of the ABC family trust, has made a family trust election. The beneficiaries of the trust include Bella, Michael, Simon and Lindsay. All of the beneficiaries are members of the family group except Simon. Both Simon and Lindsay have failed to quote their TFN to the trustee before the trustee makes an assessable distribution.

When the trustee makes an assessable distribution to Simon, the distribution is subject to the 'family trust distribution tax'. As that tax takes precedence over the TFN withholding, the trustee is not required to withhold in relation to Simon's distribution.

The trustee will be required to withhold from an assessable distribution to Lindsay.

As Bella and Michael have quoted to the trustee their TFNs, no withholding will be required from assessable distributions to them.

#### **Example 5 Treatment of trustee beneficiary of a family trust**

At the end of the income year, the trustee of the Evans family trust is presently entitled to a share of the income of the Bell family trust and is required to include \$10,000 in its assessable income. The trustee of the Evans family trust has not quoted its TFN to the trustee of Bell family trust. Both trusts are in the same family group so 'family trust distribution tax' is not applicable. Interim distributions of income have not been made during the income year.

Therefore, the trustee of the Bell family trust must withhold \$4,650 from the amount that the Evans family trust is required (under section 97 of the ITAA 1936) to include in its assessable income. The trustee of the Evans family trust will be able to claim back the amount withheld in its tax return, if that trust is liable to pay tax on that income.

However, where the beneficiaries of the Evans family trust are presently entitled to the income of that trust they are required to include their respective shares of the net income of the trust in their assessable income and will be entitled to a credit for their respective shares of the amount withheld by the Bell family trust.