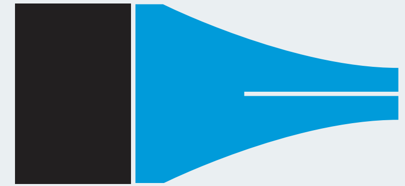
Discretionary trusts reform: let's restart the conversation

by Neil Brydges, CTA, Special Counsel, Sladen Legal



The Labor policy proposal begs the question: should we continue to tinker at the edges or restart the stalled reforms to the modernisation of trust taxation?

Labor released its policy on "discretionary trusts reform" with much fanfare on 30 July 2017. Since the release, there has been a tsunami of commentary in the media. Some of that commentary has been knowledgeable and informed, while some has, to be polite, been less so.

This article seeks to take an apolitical look at Labor's policy proposal and look at whether Labor's focus on trusts should instead restart the conversation on updating and rewriting the trust taxation rules.

The Labor policy is to introduce "a targeted reform to the taxation of discretionary trusts. We will introduce a new standard minimum rate of tax for discretionary trust distributions to mature beneficiaries (aged over 18). Labor will legislate to ensure that discretionary trust distributions to people aged over 18 are taxed at [a] minimum rate of 30 percent from 1 July 2019". Labor's policy will not apply to:

- special disability trusts;
- testamentary trusts;
- fixed trusts or fixed unit trusts;
- cash management unit trusts;
- public unit trusts;
- farm trusts (whatever these may be); and
- public unit trusts (listed and unlisted).

First, without introducing a raft of new anti-avoidance rules to eschew having to rely on Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the proposed measure could be easily circumvented in several ways, including:

(1) a discretionary trust could distribute income to a company owned by family members, the company pays tax at 30%, and pays fully franked dividends to the family members who may be an eligible for a refund of the franking credit; and

(2) a wealthy individual "streams" income to a fixed trust or a fixed unit trust with that income then flowing to family members on lower marginal tax rates.

Second, discretionary trusts are not just used by wealthy individuals — such as the surgeon and the "partner in a top law firm" to use the examples in the Labor policy document — to split income with family members. Trusts are used legitimately for asset protection purposes and in estate and succession planning. Further, as many commentators have noted, one of the major user groups of discretionary trusts are small businesses. While a discretionary trust may be used to split the income from the small business operated through the trust by (say) a husband and wife, the income would also be split if they operated the business as a partnership (although they would have joint and several liability for partnership debts). One may argue that the "cost" of joint and several liability in a partnership justifies the "benefit" of income splitting, whereas with a trust, you get the benefit without the cost. Alternatively, will the policy setting be that Labor's proposed measures only apply to (say) passive income derived by a trust and not to active business income of a (small) business carried on by a trust? In much the same way that farming carried on through a trust (if that is what a "farm trust" represents) has been excluded.

Third, within the excluded classes of Labor's policy, what happens, for example, if a fixed trust is used to split income or a wealthy "Collins (or George) Street" farmer splits income through the undefined "farm trust"?

Trying to avoid — perhaps not the best word in an article about tax — the politics, the Labor policy seeks to address a perceived problem by applying a "band aid" to the existing tax rules. Without a suite of specific anti-avoidance rules and carve-outs, it seems that the measure will not achieve its aim of preventing income splitting by "top income earners", while at the same time, not penalising legitimate users of discretionary trusts. The policy would require significantly more change than, as suggested by Labor, merely amending Div 6AA ITAA36. No doubt there will be "unintended consequences" to use the words of the then Assistant Treasurer in the second reading speech introducing the "Interim changes to improve the taxation of trust income" in the Tax Laws Amendment (2011 Measures No. 5) Bill 2011 (see below).

Surely, there has to be a better way?

Almost 30 years ago, Hill J observed in *Davis v FCT*[1] that "it is quite clear that neither interpretation of section 97 [quantum or proportionate] produces a desirable result as a matter of tax policy and the scheme of Division 6 calls out for legislative clarification, especially since the insertion into the Act of provisions taxing capital gains as assessable income".

Former Treasury Secretary, Ken Henry, in his 2010 review of the Australian tax system commissioned by the Rudd Labor Government, stated that the "general trust tax rules are complex and give rise to uncertainty. Accordingly, those rules should be rewritten and updated". In December 2010, Bill Shorten (during his time as Assistant Treasurer) announced that the government would conduct a public consultation process as the first step towards updating the trust income tax provisions in Div 6 ITAA36. In 2012, the then Assistant Treasurer, David Bradbury, announced that, following further consultation, the trust taxation rules would

be modernised with effect from 1 July 2014 (originally 1 July 2013). A “policy options paper” was released by Treasury in October 2012 outlining two possible options for trust tax reform, although the government did not announce its preferred option. With 1 July 2014 having come and gone, the reform agenda appears to have stalled (although Div 276 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), allowing managed investment trusts to elect out of Div 6 with effect from 1 July 2015, has been legislated).

Against this background of a (stalled) process for reform of the trust taxation rules, the High Court handed down the decision in *FCT v Bamford* in March 2010.[2] In 2011, in response to the *Bamford* decision, the parliament passed the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth) that included the “interim changes to improve the taxation of trust income” by amending Subdivs 115-C and 207-B ITAA97 and inserting new Subdiv 6E into the ITAA36.

To say the interim changes complicate an already complex area is an understatement. Further, there appears to have been unintended consequences (something that the Assistant Treasurer warned about in the second reading speech) arising from the interim changes. In particular, how Div 6 and Subdiv 115-C interact with Div 855 ITAA97 which deals with capital gains and foreign residents. By way of refresher, s 855-10 ITAA97 states that a foreign resident can disregard a capital gain or capital loss from a CGT event if the CGT event happens in relation to a CGT asset that is not taxable Australian property. Section 855-40 ITAA97 gives a similar outcome for foreign residents owning CGT assets through fixed trusts.

Prior to the interim changes, anecdotal evidence suggests the ATO view was that the exemption under s 855-10 may have applied when foreign residents received a distribution of a capital gain, not being from taxable Australian property, from a discretionary trust.[3] Following the interim changes, the ATO position is that s 855-10 does not operate to disregard a capital gain not being from taxable Australian property when the foreign resident is distributed the gain by a discretionary trust.[4]

That ATO position may well be correct given the drafting of Div 6, Subdiv 115-C and Div 855. Nonetheless, nothing in the explanatory memorandum for the interim changes suggested that there was a change of approach with regards to Div 855 and discretionary trusts. Surely such an outcome runs contrary to the objective of Div 855 that foreign residents disregard capital gains (or losses) from CGT assets that are not taxable Australian property (the “statutory source” rule for capital gains) and the principle behind Div 6 that non-residents are not subject to Australian tax on trust income that does not have an Australian source? This must be an unintended consequence of the interim changes.

These anomalies, and the complexity of trust taxation, raise the question, why make further (complicated) changes to an already complex system? Surely a better approach would be to re-start the process of modernisation of the rules for taxing trusts. Division 276, for better or worse, provides one alternative to the current system.

As part of this process, questions such as those raised by the Labor policy could be addressed. However, to do so runs the risk of politicising a series of reforms that is long overdue. Restarting the modernisation process could be approached on a bi-partisan basis while the political debate around the Labor policy proposal continues. The re-write could be in a manner where a Subdivision within the rewritten rules could be “turned on or turned off” depending on the outcome of the political debate.

As individuals, we will all have views on the underlying policy correctness (or otherwise) of the Labor proposal, as tax professionals, we will also engage in debate and consultation around the technical issues the proposal may cause. However, in the author’s view, the debate around Labor’s trust policy should be seen as an opportunity to restart the conversation around the stalled reforms to the modernisation of trusts. As a closing comment, perhaps we can reflect on the words in 2011 of the then Assistant Treasurer in the second reading speech introducing the “Interim changes to improve the taxation of trust income”:

> “The broader review of the trust income tax provisions remains the primary focus for the government. This will simplify the system, rewrite the rules and give more certainty to the many thousands of small businesses and farmers who use trusts.”

Lest we forget.

Neil Brydges, CTA
Special Counsel
Sladen Legal

References

1 *Davis v FCT* (1989) 86 ALR 195 at 230.
2 *FCT v Bamford* [2010] HCA 10.
3 See, for example, PBR 76868.
4 See, for example, PBR 1012445302143.