

How does Labor's 30% tax on discretionary trust distributions interact with the flow-through nature of trusts? (Part 3)

18 September 2017

Here is the third instalment of feedback received from Chartered Accountants ANZ Tax News readers on the ALP's [proposal](#) to deny the graduated personal rate scale to individual beneficiaries of discretionary trusts, imposing instead a *minimum* 30% tax on distributions to adult beneficiaries from 1 July 2019¹.

My earlier Opinion Pieces on this topic were titled:

- Part 1: [CAs seek clarity around farm carve-out from Labor's 30% minimum trust distribution tax and ask: "Why no carve-out for active small businesses?"](#)
- Part 2: [Labor should clarify the carve-outs for discretionary trusts - Testamentary, disability and charitable trusts.](#)

More of your feedback next week.

5. Trusts as a flow-through entity

This week's Opinion Piece highlights the most common question we are getting from CAs about Labor's proposed policy: how does the 30% minimum tax on distributions interact with the flow-through nature of a discretionary trust?

The [policy](#) published on 29 July 2017 is surprisingly silent on the issue.

Why do I say surprisingly?

To answer that requires a brief history lesson.

The current legislative code for streaming franked dividends and capital gains through trusts was introduced in 2011² in response to the High Court decision in [Commissioner of Taxation v Bamford \[2010\] HCA 10](#).



¹ Unless otherwise mentioned, all references to a "trust" refer to a discretionary trust, the only type of trust targeted by Labor's policy.

² [Taxation Laws Amendment \(2011 Measures No 5\) Act 2011](#).

This was a policy decision not taken lightly. It followed an extensive consultation process³, input from the Board of Taxation, and a government consultation paper⁴.

Put simply, the outcome which eventually emerged was that, where permitted by the trust deed, franked dividends and capital gains in the trust could be streamed for tax purposes to beneficiaries by making them 'specifically entitled' to those amounts⁵.

The streaming legislation was accompanied by even more integrity rules⁶.

Overseeing all this back then was Wayne Swan's Assistant Treasurer and Minister for Financial Services & Superannuation, Bill Shorten.

Mr Shorten described the 2011 changes as interim because Labor was "committed to considering issues with the taxation of trusts more broadly as part of its announced update and rewrite of the trust income tax provisions"⁷.

What's my point?

Well, apart from observing that both sides of politics have since shied away from a wholesale rewriting of the trust provisions, there is nonetheless a well-considered policy framework which exists to this day, allowing certain types of concessionally taxed items to flow-through to specifically entitled beneficiaries.

Trust deeds have been drafted on the basis of this treatment and trustee resolutions now diligently record the components of each beneficiary's annual entitlement and distribution.

So when the 30% minimum tax on distributions was proposed, CAs were naturally concerned that Labor was simply seeking 30% regardless of the flow-through tax outcome.

Nowhere is this more concerning to CAs than the tandem structure commonly used for small business and personal investors involving franked dividends.

6. Discretionary trust owning shares in a company – Flow-thru franked dividends

Combining both asset protection and tax planning features, the Scenario 5 structure would be familiar to most readers.

³ Assistant Treasurer and Minister for Financial Services & Superannuation media release No 25, 16 December 2010.

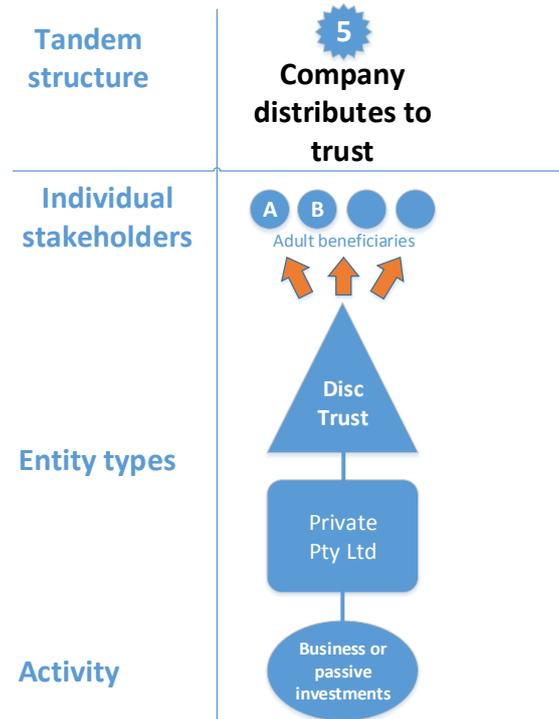
⁴ Improving the taxation of trust income (March 2011)

⁵ Division 6E Income Tax Assessment Act 1936. The requirements to create a "specific entitlement" to a capital gain or a franked dividend are set out at sections 115-228 and 207-58 of Income Tax Assessment Act 1997.

⁶ Division 207 Income Tax Assessment Act 1997, particularly the franking credit trading rules. See also [ATO website](#).

⁷ Para 2.19, [Explanatory Memorandum](#), Tax Laws Amendment (2011 Measures No. 5) Bill 2011.

Scenario 5: Discretionary trust owns 100% of Pty Ltd



Private Pty Ltd either pays tax itself at the relevant company tax rate, or receives franked dividends from its underlying investments in other Australian companies.

Either way, Private Pty Ltd pays a fully franked dividend to its sole shareholder – Discretionary Trust – whose trust deed permits the streaming of the franked dividend component of trust income to specifically entitled beneficiaries assumed to have the following profiles:

- *Beneficiary A* – a high wealth individual whose taxable income exceeds \$180,000. He pays what is commonly referred to as “top-up” tax (broadly, the difference between the **top personal marginal rate** and the company tax rate reflected in the franked dividend component of the trust distribution).
- *Beneficiary B* – is A’s daughter, a university student. She is on a **low personal marginal tax rate** and the franking tax offset resulting from the trust distribution not only negates any income tax, but also results in a tax refund of the unutilised part of the franking tax offset⁸.

For passive investment structures, the discretionary trust could also hold shares directly in listed Australian companies yielding franked dividends.

⁸ See also [ATO website](#).

Labor advisers say flow-through approach stays

Labor advisers have informally indicated that the flow-through of franking credits will continue under their model⁹. If this is correct:

- Labor’s policy document should make this clear, with supporting examples and tax calculations¹⁰.
- Labor’s policy isn’t just about tax. It also has ramifications for the trust’s investment strategy and the weighting accorded to shares yielding franked dividends.
- In determining the quantum and tax composition of each trust distribution, new tax “sweet spots” will develop reflecting the beneficiary’s tax profile, based around the effective (rather than marginal) rate.
- Reduced company franking capability due to current and proposed reductions in company tax rates (or lower corporate taxable income in lean years) may eventually mean the 30% minimum tax on trust distributions has a top-up tax effect for some beneficiary profiles.

7. Other flow-through scenarios

Franked dividends flowing through discretionary trusts aren’t the only issue.

Flow-through treatment of a discount capital gain can also result in an individual beneficiary paying tax on the trust distribution at a rate less than Labor’s 30% minimum. This can be due not only to the “specifically entitled” legislation referred to above, but also because the beneficiary becomes absolutely entitled to the gain¹¹.

Ditto for trust distributions which reflect foreign income tax offset entitlements and small business CGT concessions.

So, this week’s request from CAs is for Labor to:

- Explain, using examples, how the 30% minimum tax model interacts with the various types of trust income or gains whose tax characteristics currently flow-through to beneficiaries impacted by the policy. Particularly urgent is clarification of flow-through franked dividends and individual beneficiary eligibility for the refundable franking tax offset.

⁹ Max Newnham, writing for [The Sydney Morning Herald](#) (12 September 2017) and response to questions posed by Chartered Accountants ANZ Tax Team.

¹⁰ Labor says its policy is based on the Division 6AA (Part III, Income Tax Assessment Act 1936. Section 13, Income Tax Rates Act 1986) regime for taxing the unearned income of children, so the tax calculation may mirror the current [ATO guidance](#). That is, the beneficiary’s taxable income includes two components: the trust distribution and other taxable income.

¹¹ See also [ATO website](#).