Stranded assets and stranded beneficiaries – Will there be restructuring relief under Labor's 30% tax on discretionary trust distributions? (Part 4)

25 September 2017

Here is the fourth 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 2019[1].

My earlier Opinion Pieces on this topic were titled:

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 1)
2. Labor should clarify the carve-outs for discretionary trusts - Testamentary, disability and charitable trusts (Part 2)
3. How does Labor's 30% tax on discretionary trust distributions interact with the flow-through nature of trusts? (Part 3)

8. The retrospective argument

Several CAs have pointed to the retrospective aspect of Labor's proposal.

Sure, the proposal only applies to distributions from 1 July 2019.

But the point our members are making is that discretionary trusts are generally a long-term structure. They hold money and CGT assets, the income from which is distributed or applied for the benefit of individuals, sometimes across generations. Vesting may occur years from now.

Deeds have been drafted with great care, and cannot be altered easily. Changes which alter the nature and character of the trust relationship may end one trust and create another over some or all of the original trust property – a resettlement. Disputes can and do arise within families when trust restructuring is poorly managed, or there is perceived unfairness.

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

All of this is governed not by the tax law, but by the terms of each trust deed and a statutory and equity law framework not of the Commonwealth's making[2].

Add to this legal morass other considerations associated with restructuring such as trust accounting, asset valuation, stamp duty and CGT considerations and you get the picture.

Even if Labor was minded to provide some additional restructuring relief at a federal tax level[3], it is difficult to see how all these impediments could be alleviated.

9. Stranded assets – Stranded beneficiaries

As one CA put it, some discretionary trusts and their beneficiaries will be "sitting ducks", unable to do much at all in response to Labor's distribution tax.

The stranded asset scenario will arise where it is impossible, too difficult or too costly to change the discretionary trust arrangement[4].

The stranded beneficiary situation on the other hand will occur where those individual beneficiaries ineligible for any carve-out find themselves "over-taxed" by having their entitlement to marginal rates of taxation withdrawn from 1 July 2019.

By over-taxed, I don't mean paying more tax on their trust distribution than was the case prior to 1 July 2019.

I mean paying more tax than would be the case post 1 July 2019 if the trust income was instead derived directly, or via an interposed entity other than a discretionary trust.

Despite the spin surrounding this measure, not every discretionary trust is endowed with enough wealth to distribute in a way which results in an effective rate for individual beneficiaries at or above 30%.

And of course the yield on trust investments varies from year to year. A 30% minimum tax on distributions diminished because of cyclical downturns hurts.

Whatever the cause, over-taxation outcomes will cause some interesting discussions between the trustee and affected beneficiaries, with funding of the tax liability an obvious agenda item.

Scenario 6 provides an example where an unfair over-taxation outcome occurs.

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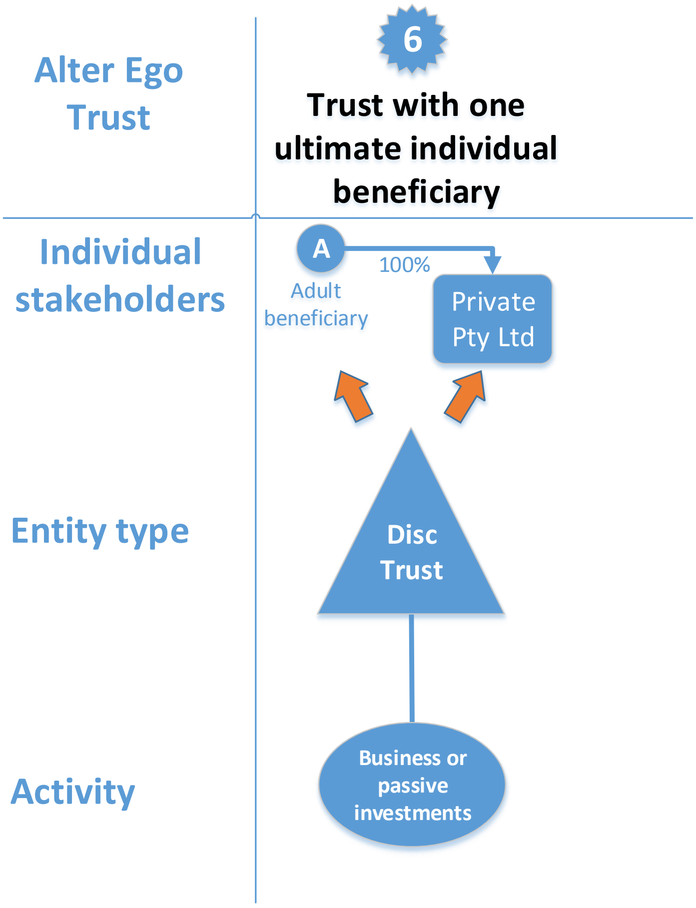
[2] TD 2012/21 contains limited ATO guidance on resettlements which can trigger CGT events. Broadly, the ATO accepts that a change in the terms of the trust pursuant to exercise of an existing power (including an amendment to the deed of a trust), or court approved variation, will not result in a termination of the trust. The ruling notes that the tests for court approved variations differ between the States and Territories.
[3] Bear in mind that Labor hopes its policy will raise $4.1 billion over the forward estimates period to 2021-22 and $17.2 billion over the medium term, based on unpublished work from the independent Parliamentary Budget Office. In terms of its economic credentials, Labor will be wary of granting relief which diminishes the expected tax take.
[4] Labor's policy says 2014-15 Tax Statistics data shows there is more than $590 billion of assets sitting in discretionary trusts.

Scenario 6: Discretionary trust with one ultimate individual beneficiary



This trust was set up for a single person, Mr A, for asset protection or other reasons. Mr A lives modestly on a trust distribution of $87,000 which is all the trust has to distribute for the relevant income year. He has no other income or deductions. Any additional trust income that becomes available in subsequent years is distributed to Private Pty Ltd, a company owned by Mr A. A charity makes up the third, residuary beneficiary.

Applying current income tax rates, Mr A pays $21,562 (including 2% Medicare levy). Under Labor's proposal, the 30% minimum tax on the distribution to Mr A would be $26,100 (add Medicare levy and the total becomes $27,840).

There will be no over-taxation, however, if the trust first distributes to Private Pty Ltd, with the company paying tax at 30% and declaring a franked dividend to Mr A (with a franking tax offset entitlement).

Well-endowed discretionary trusts

Note that well-endowed discretionary trusts whose distributions to high wealth individual beneficiaries already attract an effective tax rate of 30% or more will have little difficulty with Labor's policy.

There may even be relief that a higher minimum rate didn't apply.

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So, this week's requests from CAs are for Labor to:

- Clarify what, if any, restructuring relief will accompany their policy (even if only for a brief transitional period).

- Consider whether a carve-out should be available where, in practice, a discretionary trust provides minimal opportunity for income-splitting benefits (eligibility criteria to be developed, using tracing of beneficial ownership measures proposed by the Coalition government).