A Fairer Tax System

Discretionary Trusts Reform

Australians want a fair society, and that requires a fair tax system – one that promotes equality of opportunity, rewards hard work, and drives productive investments in the future of our country.

The vast majority of Australians are pay-as-you-go (PAYG) taxpayers, making a few modest deductions come tax time. Australia's progressive tax system means that the more an employee earns, the greater the share of their income they pay in tax. That's fair for everyone.

While this principle applies to PAYG taxpayers, it does not apply to all aspects of the tax system. Significant tax subsidies and arrangements are available to those with the means to access them. While in many cases these are legitimate and have a valid public policy rationale, in some cases they are solely being used for tax minimisation.

Every dollar of a tax subsidy is a dollar that has to be paid by another taxpayer. Labor wants to change the system so that PAYG taxpayers aren't subsidising the tax breaks of much wealthier Australians.

Labor is committed to ensuring that the tax system is fair for all Australians.

Snapshot – Discretionary Trusts Reform

Discretionary trusts are being used to reduce high income earners' tax liabilities through 'income splitting'.

Income splitting allows high net worth people on top marginal tax rates to reduce their tax bills by apportioning their non-PAYG income, like investment income, to people (usually family members) who face much lower marginal tax rates.

The vast majority of wealth in private trusts is held by the wealthiest households.

Labor is announcing that it will extend the work of John Howard as Treasurer, and apply a minimum standard tax rate of 30 per cent to discretionary trust distributions to beneficiaries over 18 years of age.

This will close a long standing tax loophole, improve tax fairness, and strengthen the budget position.

Labor's plans are well targeted, with 98 per cent of all taxpayers unaffected by the changes.

Australia's two class tax system

The Australian tax system includes a number of subsidies and arrangements that allow high income earners to reduce their tax bill. Access to these arrangements is nearly entirely the preserve of top income earners – those with accumulated savings and investments, and the resources to structure their affairs and side-step the progressive tax system.

Australia has a two class tax system – those that have the financial means to access these generous deductions and subsidies to lower their tax, and those who do not.

Labor supports tax concessions that drive positive and productive policy outcomes, and improve the fairness of the tax system, like a nurse claiming a deduction for their uniform. However, they need to be continually evaluated in the context of budget consolidation and fairness, and whether they continue to achieve the stated policy outcomes.

With Australia's AAA credit rating under threat, and with unprecedented debt recently crashing through the half a trillion dollar mark, greater scrutiny of tax concessions is needed to deliver budget repair that is fair.

The Turnbull Liberal Government refuses to address unfair tax concessions and tax loopholes, instead relying on ordinary taxpayers to shoulder the burden of budget repair. The Government is making ordinary Australians pay more tax, while giving tax handouts to large multinationals and millionaires. It's unfair, it's unaffordable and Labor has a better way.

Labor has led the way on tax reform, announcing a series of reforms to tax subsidies that improve the tax system – achieving better policy outcomes, improving the fairness of taxation, and strengthening the budget position.

Since 2015, Labor has announced:

- Policies to rein in unfair and unsustainable superannuation concessions which are skewed towards high income earners;
- Reforms to negative gearing and capital gains tax concessions – concessions which largely accrue to higher income earners and also help to worsen the current housing affordability crisis;
- Reforms to close debt-deduction loopholes for multinational companies that are shifting profits out of Australia; and
- Plans to cap at $3,000 the amount people can claim as a tax deduction for costs incurred in managing their tax affairs.

Labor is committed to strengthening the budget, and to the ongoing task of improving the fairness of the tax system.

The next steps in tax reform

The current tax settings, in addition to subsidies and deductions, have loopholes that are sometimes exploited to minimise tax. This includes the use of discretionary trusts to minimise tax paid by allocating income to household members in lower tax brackets.

Labor is acting to prevent revenue leakage through these types of activities which erode the integrity of the tax base. Reforming the taxation of discretionary trusts to prevent income splitting builds on Labor's previous commitments to reform superannuation tax concessions, negative gearing and capital gains tax concessions, multinational tax reform and capping the tax deduction available for the costs incurred in people managing their tax affairs.

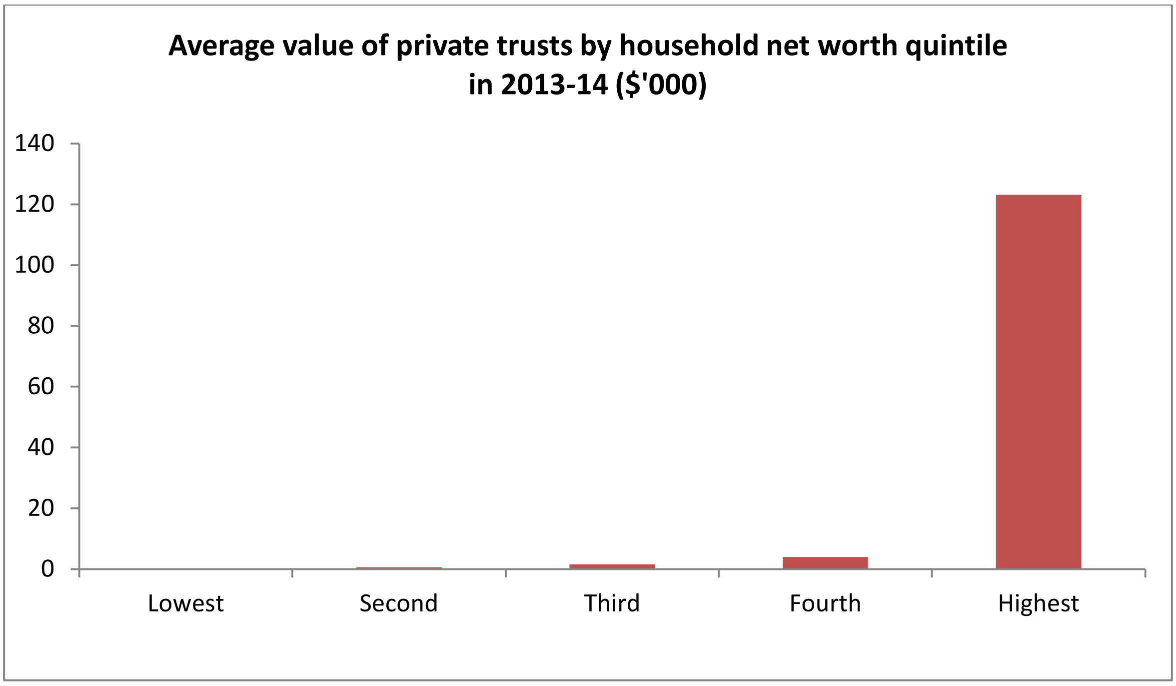
What's the problem?

Trusts are a legal structure that involves a trustee (usually an individual or company), which holds assets for the benefit of other (beneficiaries).

Trusts can be legitimately used by individuals and businesses for several reasons, including asset protection and business succession. However, discretionary trusts also have attractive tax advantages and are used by high-wealth individuals to minimise their tax obligations. As the Productivity Commission stated in its *Business Set-up, Transfer and Closure* report: "*Trusts are inherently complex and opaque structures used to protect assets and potentially minimise tax*".

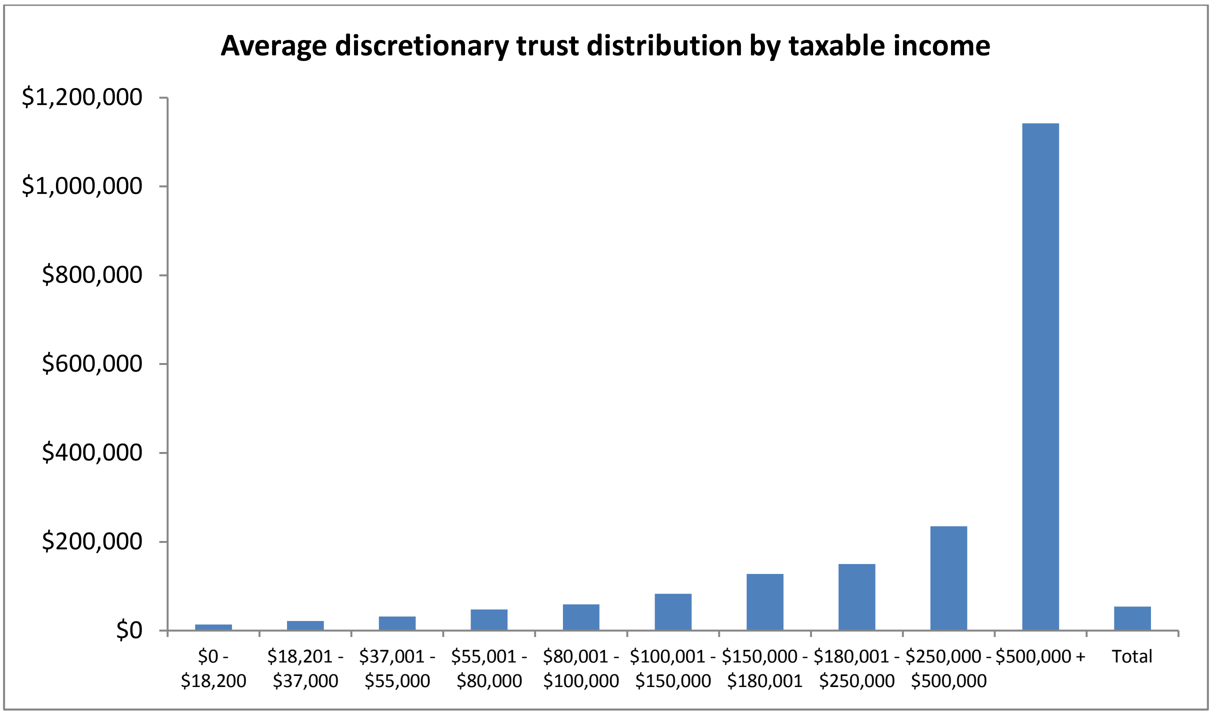
While a trustee must lodge a tax return each year reporting the net income or loss of the trust, most trusts aren't taxed. Instead they are treated as 'pass through vehicles' for tax purposes, so tax only applies when the income is in the hands of beneficiaries. Income distributions from trusts are generally taxed at the individual income tax rate of the beneficiary. Trusts (unlike companies) can also pass through the benefit of the capital gains tax discount, making trusts attractive vehicles for tax purposes.

Wealthy individuals are much more likely to have a trust than low and middle income earners. **The average amount held in private trusts by the wealthiest 20 per cent of households in Australia is more than $123,000, while for the next quintile it's just $4,000.**



Source: Australian Bureau of Statistics, Household Income and Wealth, Australia, 2013-14, Catalogue 6523.0

For discretionary trusts alone, higher income earners are far more likely to have very large trust distributions. Someone earning more than $500,000 has an average trust distribution 21 times that of the average trust distribution for all income earners.



Source: Parliamentary Budget Office, based on 2013-14 Taxation Statistics data[1]

Discretionary trusts are used by individuals and businesses to reduce their tax because income from the trust can be apportioned to beneficiaries on a "discretionary" basis (that is, not in fixed amounts). This allows the trustee to shift income to individuals in lower tax brackets within a family group on a year by year basis. Other structures such as unit trusts or companies do not provide for this flexibility.

As Associate Professor at University of NSW Dale Boccabella has pointed out, "*the income tax treatment of trusts is way out of kilter with the tax treatment of other entities and other taxpayers*". [2]

This practice of "incoming splitting" through discretionary trusts is used frequently by wealthy Australians to minimise their tax. Income splitting allows high income Australians to avoid paying the marginal tax rate that should apply to their income level – something ordinary PAYG taxpayer's can't do.

In its simplest form, it involves someone on a high income tax rate (e.g. the top marginal rate) distributing investment income through a discretionary trust to beneficiaries that face lower marginal tax rates (for example, non-working family members), therefore reducing the overall amount of tax paid. Trust income can be distributed to family members of the person creating

[1] Does not include primary production income. Discretionary charitable trusts, deceased estate trusts, testamentary trusts and distributions to people with a disability are excluded from the analysis

https://theconversation.com/using-family-trusts-to-minimise-tax-is-on-the-nose-so-why-are-policy-makers-silent-47277 the trust including their husband or wife, parents, grandparents, siblings, children and nephews or nieces.

Because normal PAYG salary and wage incomes can't flow through discretionary trusts the vast majority of taxpayers don't have access to these special arrangements.

Income splitting example

Sam is a surgeon and is married to Melissa who doesn't work. They have two adult children who attend university and who also don't work. Sam earns $500,000 a year from his work income which he pays PAYG tax on at the top marginal tax rate.

Sam and Melissa have a discretionary trust which generates $54,000 in income from their investments.

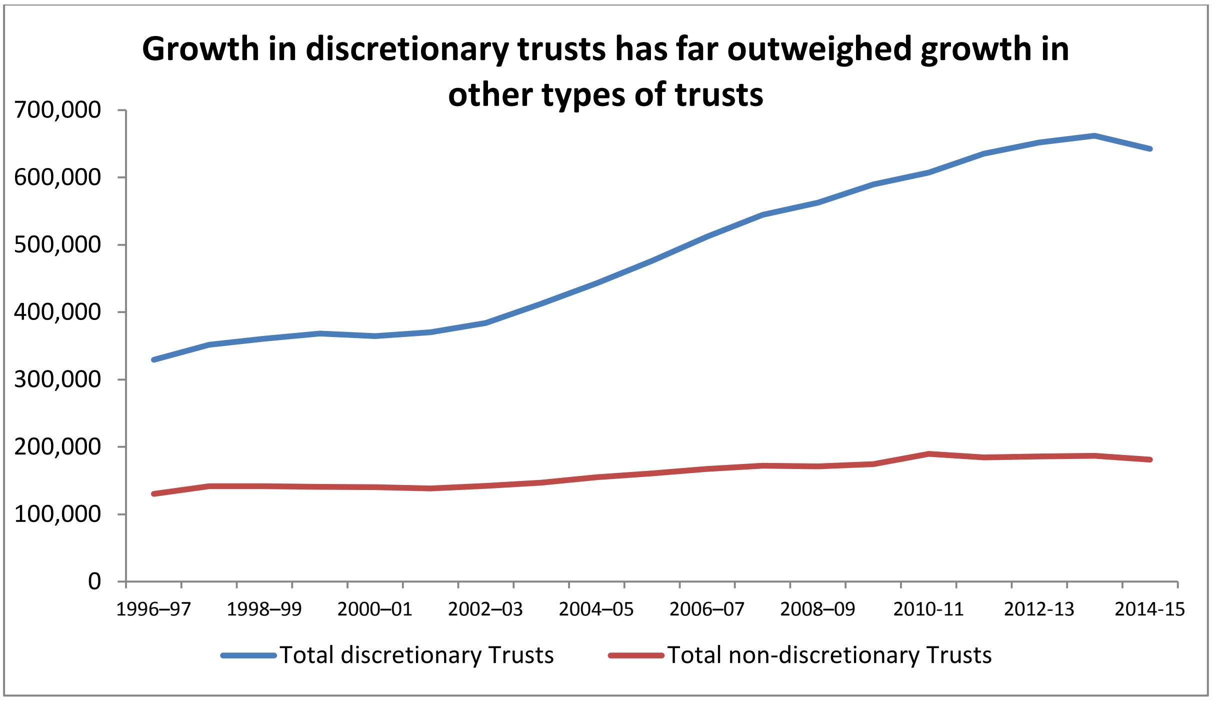
On advice of their accountant, they attribute $18,000 to Melissa and $18,000 to each of their two children, who all pay no tax on their distributions because they have no work income and remain under the tax free threshold.

This represents a tax saving of $14,460 had the investment income been attributed to just Sam and Melissa in equal proportions, and a tax saving of $25,380 had the investment income instead been part of Sam's normal PAYG salary.

As with other tax subsidies and deductions, access to discretionary trusts and income splitting is generally only accessible to wealthier Australians that have been able to accumulate passive investments such as shares and property. In contrast, low and middle income earners who go to work and struggle to pay their weekly bills typically do not have large passive investments outside their superannuation accounts, nor the resources to pay boutique tax advisers and accountants.

This is why a Shorten Labor Government will reform the taxation of income from discretionary trusts to reduce income splitting, improve the fairness of the tax system, and to strengthen the budget.

There has been significant growth in discretionary trusts, with their numbers nearly doubling since the late 1990s to over 642,000 discretionary trusts in Australia today. This growth is in stark contrast to the lower growth in non-discretionary trusts where the same tax minimisation and income splitting opportunities don't exist.



Source: Taxation Statistics, 2014-15 data

The most recent 2014-15 Tax Statistics data shows **there is now more than $590 billion of assets sitting in discretionary trusts, nearly double the amount of assets a decade ago**[3]. More and more income flowing through discretionary trusts allows for more tax minimisation and income splitting, activities which erode the tax base and put more of the tax burden on ordinary workers in the economy.

"Both super and negative gearing seem to be in the firing line one way or another. That leaves you with the third leg of the tripod which is discretionary trusts. It's an area that will be more and more in focus"[4]

Bob Deutsch, Tax institute Senior Tax Counsel, Adjunct Professor of taxation at UNSW

"the income tax treatment of discretionary trusts is "way out of kilter" with the tax treatment of other entities and other taxpayers"[5]

Dale Boccabella, Associate Professor of Taxation Law, UNSW

"The family trust structure has been utilised frequently for artificial tax avoidance purposes"

"Trusts are widely regarded as the most providing the most effective means of splitting family income for tax purposes"

Reform of the Australian tax system : draft white paper, 1985

[3] Taxation Statistics,Trusts,2014-15

[4] http://www.smh.com.au/national/whatever-you-do-dont-mention-the-trusts-20170406-gvf2pk.html

[5] https://theconversation.com/using-family-trusts-to-minimise-tax-is-on-the-nose-so-why-are-policy-makers-silent-47277

"Wealthier individuals with access to legal and accounting advice can target particular investments and structures to take advantage of differences in tax treatment – and thus minimise the amount of tax they pay The rest of the community subsidises the wealthy investor"

Tax Reform: Not a New Tax, A New Tax System, 1998

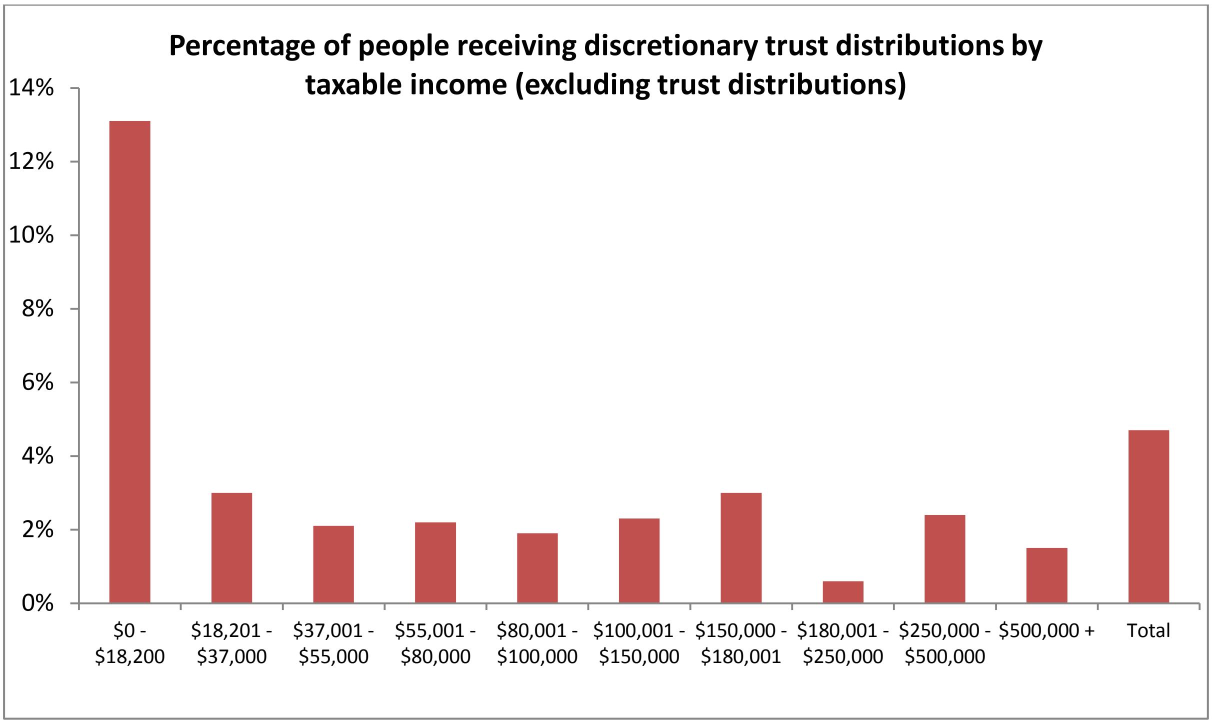
Evidence of income splitting

Analysis of taxation statistics demonstrates income splitting is prevalent in the Australian tax system.

While discretionary trusts are predominately used by wealthier Australians, distributional analysis from the Parliamentary Budget Office (PBO) based on Australian Taxation Office (ATO) data shows that a disproportionate amount of discretionary trust distributions are allocated to people in the lowest marginal tax bracket with little or no work income (i.e. those earning $0-$18,200). These are likely to be non-working members of the family such as spouses and adult children in tertiary education.

The data shows that 13 per cent of individuals in the lowest income tax bracket receive a discretionary trust distribution, which is much greater than for people on other higher incomes.

This indicates that **a significant amount of income is being shifted from the wealthiest individuals to those earning little or no other incomes (for example, non-working members of the family such as spouses and young adults in full time study) to reduce the amount of tax paid.**



Source: Parliamentary Budget Office, based on 2013-14 Taxation Statistics data

Many distributions from discretionary rusts are only *notional* in the sense that they occur on a computer in an accountant's office, rather than being handed over to beneficiaries who are members of the family.

Is anything currently being done to prevent income splitting and tax minimisaton through Trusts?

Income splitting was addressed in part back in the late 1970s and early 1980s by then Treasurer John Howard. The introduction of Division 6AA to the *Income Tax Assessment Act 1936* addressed inequities in the tax system created by individuals distributing income to minors (i.e. those aged below 18).

Division 6AA is essentially an anti-avoidance provision which penalises parents distributing income to their children. Division 6AA deems that income distributions to dependents including from trusts are taxed at a penalty rate of tax, currently the top marginal tax rate (45 per cent). Division 6AA exempts some children from this penalty rate of tax such as those with disabilities and those in full time work.[6]

DIVISION 6AA

"the new system applicable to income of dependent children will apply to the taxable income, whether derived directly or through trusts, of children under the age of 18 years at the end of the year of income"

John Howard, *Income Tax Assessment Amendment Bill (No. 6)* 1979, Second Reading speech, Thursday, 22 November 1979

"The reality is that these measures will effectively curb the ability of many people in the community to minimise taxation liability significantly through the use of family trusts"

John Howard, Speech in Parliament, Thursday, 27 March 1980

While this legislation addressed income splitting to minors, income can still be diverted to other family members to minimise tax, such as stay at home spouses or adult university students who are not yet in full time work. Labor's proposal effectively extends the principle of John Howard's original reform to other beneficiaries of discretionary trusts.

Labor also previously provided funding in the 2013-14 Budget to improve compliance against people who use trusts for tax avoidance purposes.

[6] Under the current Division 6AA, nil tax is paid on the first $416, 68% rate applied on income above this level and 47% rate applied to all income above $1,307.

What will Labor do?

Labor will make the tax system fairer by making it harder for wealthy individuals to minimise their tax through income splitting, extending the tax reform work of the 1980s and 1990s.

Labor will do this through 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 minimum rate of 30 per cent from 1 July 2019.

This means that distributions from a discretionary trust will incur a minimum rate of 30 per cent, instead of the current arrangements where tax can be paid at a much lower rate (or no tax at all if below the tax free threshold) if income is split amongst beneficiaries in low tax brackets.

In circumstances where the minimum tax rate on discretionary trust distributions is lower than what would be paid under the normal marginal tax scales, the higher rate would apply.

A 30 per cent minimum tax rate is less punitive than John Howard's reform of penalising income distributions to minors at the top marginal tax rate. A 30 per cent rate strikes the right balance between ensuring a fair amount of tax is paid on all trust distributions, while also aligning it with the rate for passive investment companies which also face a 30 per cent rate of tax.

Income splitting example

John is a partner in a top law firm. John has a spouse who doesn't work and two children who attend university and don't work. He earns $500,000 each year from his membership of his partnership which he pays PAYG tax on at the top marginal rate.

John has a discretionary trust because in addition to his partnership distribution. His discretionary trust receives a percentage of the profits from his law firm at the end of each financial year.

This year the discretionary trust receives an additional $210,000. Because John is on the top marginal tax rate his accountant advises him that he distribute the $210,000 equally amongst the three non-working members of the family, where $70,000 is given to each.

Under the current tax arrangements, this would give the family members a tax bill of $47,100, a $51,600 tax saving compared to the income tax John would have paid at the top marginal tax rate.

Under the new arrangements, if John distributed the $210,000 in the same quantities to his family, each $70,000 trust distribution would be taxed at the new minimum rate of 30%, which would result in a tax bill of $63,000, an increase of $15,900 compared with the current tax rules.

The policy is well targeted to address tax minimisation through income splitting. **These reforms will not affect 98 per cent of all individual taxpayers in Australia, with virtually all the revenue**

raised from people receiving trust distributions who have little or no other work income. The PBO estimates this will affect 318,000 discretionary Trusts.

Consistent with John Howard's reforms, similar exemptions will apply for distributions to mature beneficiaries under the new arrangements, including people with disabilities, to ensure that people suffering real hardship are not affected by the changes.

Labor's policy will only apply to discretionary trusts, and thus will <u>not</u> apply to non-discretionary trusts such as:

- Special disability trusts
- Testamentary Trusts (Deceased estates)
- Fixed trusts
- Cash management unit trusts
- Fixed unit trusts
- Public unit trusts (listed and unlisted)

Labor's policy will also not apply to:

- Farm trusts; and
- Charitable and philanthropic trusts

Implementation

Labor will consult with the Australian Tax Office, Treasury and tax experts on the implementation of this policy. Labor will also provide $55 million per year to implement these reforms, to ensure that the policy intent is achieved, and also to bolster the ATO's current trust anti-avoidance activities.

The new resources would help ensure that the new rules are applied and enforced effectively. The funding will also be used by the ATO to consider and resolve any unintended consequences of the tax reforms, ensuring the reforms have the intended effect.

These changes build on Labor's previous announcements to increase the transparency of these tax structures, including Labor's commitment to a publicly accessible registry of the beneficial ownership of Australian legal entities, including trusts. The Government is consulting on a beneficial ownership register, but has carved trusts out from the current consultation process.

The independent Parliamentary Budget Office has costed this policy. At the next election, the PBO estimates it will raise $4.1 billion over the forward estimates period to 2021-22 and $17.2 billion over the medium term.

	2018-19	**2019-20**	**2020-21**	**2021-22**	**Total**
Total financial impact (UCB)	-15	945	1,495	1,695	**4,120**