Targeting the Taxation of Trusts – but should we be thinking more broadly?

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In brief

The taxation of trusts, and the legitimacy of their use, is again in the spotlight.

The Labor party has called for the introduction of a minimum 30 per cent tax rate for discretionary trust distributions to mature individual beneficiaries as part of its plans to improve our tax system so that it is fair to all Australians.

This policy announcement would likely have an adverse impact on many private and family groups who legitimately carry on business through discretionary trusts.

In detail

Imposing a minimum 30 per cent tax rate on trust distributions to mature individual beneficiaries will have a negative cash tax impact for many private and family groups who operate their businesses through discretionary trusts.

Consider the following example of a family business which operates through a discretionary trust.

Assume the business has an annual turnover of AUD2 million, makes a 10 per cent return on those earnings and distributes AUD100,000 to each parent. Their current individual marginal tax rates are well below the standard minimum 30 per cent tax rate Labor is seeking to impose. As no tax refund appears to be available for the differential, this will result in significant additional tax costs for many family business owners. Some may be forced to move away from the use of trust structures – but at what cost?

The taxation of trusts (not just discretionary trusts) has been the subject of much debate and consideration over the last decade. The complexities of these rules is widely acknowledged together with the need for a wholesale re-write of the provisions.

The current interim trust streaming rules introduced in 2010 are complex and confusing. To impose a minimum tax rate on certain distributions can give rise to additional compliance costs and make the rules difficult to navigate.

The private and family business sector faces a number of tax issues which are peculiar to them and which often leave them facing an uneven playing field when compared to their larger corporate competitors.

In any tax reform discussion it is important to understand what makes the private and family business sector unique.

Discretionary trusts by their nature are attractive to the private and family business sector as they provide a level of flexibility which other business structures do not. In comparison, corporate shareholding structures strictly limit who can access underlying business profits. This can be very restrictive for private and family groups especially when it is time to pass assets and control on to the next generation.

The intergenerational transfer of the ownership of business assets is typically a once in a lifetime decision and an issue unique to private and family groups. One hurdle to the implementation of an orderly succession plan for private companies is the capital gains tax and other transfer taxes that may arise upon the transfer, redemption and / or issue of shares held in the family company.

In order to enable the private and family business sector to take a more active and competitive approach to the management of their business, private companies should be given a degree of flexibility to issue, redeem and transfer shares within their family group. Only if non-family group members become involved should any tax implications arise, irrespective of whether there is actually a cash realisation at that point. Similarly, private companies should be afforded the ability to make dividend payments to selected individuals, provided payments are limited to members of the shareholder's family, thereby reducing the need to alter shareholding structures.

Let's move the tax reform discussion beyond targeted measures and start giving the private and family business sector what it needs – reduced complexity, growth, and a level playing field with large business to ensure private businesses remain competitive.

The takeaway

Underlying Labour's policy announcement is the concept of fairness – improving our tax system so that it is fair for all Australians. However, the proposed changes to the taxation of discretionary trust distributions appears to discriminate against family business owners operating through discretionary trusts by adding costs and reducing the ability of the engine room of the economy to help our country's economic growth.

The overriding objective for any tax reforms involving the private and family business sector should be that of simplification so that smaller taxpayers are provided with a better experience in meeting their income tax obligations. The proposed changes are unlikely to achieve this objective – instead they will likely add another layer of complexity to an area of law which is already difficult to navigate. PwC believes there is a clear need for comprehensive tax reform, but it needs to be done the right way.

Targeting trusts in isolation will not the inequality conundrum. Will taxing distributions from trusts at a flat rate solve, or even partially solve, the inequality issues in our society? Hardly. Will using the levers at our disposal to incentivise those who are disadvantaged economically to build businesses, help them employ people and contribute to our overall prosperity in a balanced way? Absolutely.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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