

Greater fairness and equity in the taxation of Special Disability Trusts

Consultation Paper
August 2009

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Consultation process

Request for feedback and comments

The Government is seeking your feedback and comments on the legislative design details of the Government's 2009-10 Budget announcement to change the tax arrangements applying to special disability trusts. The proposed approach to the legislative changes is outlined in this consultation paper. In particular, comment is sought on any potential unexpected consequences for beneficiaries of special disability trusts.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 31 August 2009

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FOREWORD

I am very pleased to release this discussion paper on proposed changes to the tax arrangements applying to special disability trusts.

Special disability trusts are designed to assist family members to provide care for a severely disabled family member.

In the 2009-10 Budget the Rudd Government announced important changes to ensure that the taxation of special disability trusts is more fair and equitable. In particular, the Government has agreed to extend the capital gains tax main residence exemption to special disability trusts. The Rudd

Government is committed to supporting those in our community with a disability, and their families and carers.

These proposed tax changes will significantly assist and we look forward to receiving the communities' view.

A handwritten signature in black ink, appearing to read 'Nick Sherry'.

Senator Nick Sherry
Assistant Treasurer

BACKGROUND

Special disability trusts (SDTs) were established in 2006 to assist families and carers to make private financial provision for the current and future care and accommodation needs of a family member with a severe disability. SDTs are established in accordance with the *Social Security Act 1991*.

SDTs offer concessions from social security and veterans' entitlements means tests for beneficiaries of the trust and eligible contributors. Immediate family members making gifts to an SDT, who are within five years of the age pension age or older, may access a concession of up to a combined total of \$500,000 from the social security or veterans' entitlements gifting rules. In addition, assets of an SDT up to \$532,000 (current as at 1 July 2008 and indexed annually) do not impact upon the principal beneficiary's ability to access income support payments, such as the disability support pension. Furthermore, income from the trust may also be disregarded for the purposes of the assessing the principal beneficiary's entitlement to an income support payment.

There are a number of requirements under the social security legislation that SDTs must meet:

- There can be no more than one principal beneficiary per SDT and only one SDT per beneficiary, and the beneficiary must be an individual and meet the definition of severely disabled as defined in the social security legislation.
- The assets of the trust must not include any compensation received by or on behalf of the principal beneficiary.
- The funds from the SDT can only be used to pay for the reasonable care and accommodation needs of the principal beneficiary. The Social Security (Special Disability Trust) (FaHCSIA) Guidelines 2008 issued by the Department of Families, Housing, Community Services and Indigenous Affairs provide examples of what are and are not considered to be reasonable care and accommodation costs of the principal beneficiary.

On the wind-up of an SDT, the remaining assets must be dealt with in accordance with the trust deed, which may allow for the assets of the trust to revert back to the donors of the assets.

BUDGET REFORMS

On 12 May, 2009, as part of the 2009-10 Budget, the Rudd Government announced it would ensure that the unexpended income of an SDT is taxed at the relevant beneficiary's personal income tax rates rather than automatically at the top personal tax rate plus Medicare Levy, with effect from the 2008-09 income year.

The Government also announced that it would extend the capital gains tax (CGT) main residence exemption to include a residence that is owned by an SDT and used by the principal beneficiary of the SDT as their main residence, with effect from the 2009-10 income year.

The purpose of this discussion paper is to provide interested parties with an opportunity to comment on the implementation details of this proposal.

Although there may be other types of trusts that are used by families to assist a family member with a severe disability, this paper deals specifically with SDTs and does not contemplate tax changes to other trusts.

UNEXPENDED INCOME TAX ARRANGEMENTS

CURRENT INCOME TAX LAW

The income tax rules for SDTs under the *Income Tax Assessment Act 1936* (ITAA 1936) are not unique and apply to trusts in general. Whether the trustee or the beneficiary of a trust pays tax on the income of the trust depends on a range of factors, including whether the beneficiary is presently entitled to a share of the income of the trust and whether they are under a legal disability.

There is no definition of legal disability within the taxation law. Instead, the common law definition of 'legal disability' applies. The common law definition encapsulates persons who are unable to make decisions on the ground of mental incapacity, such as a minor. A legal disability for taxation purposes should not be confused with other types of disabilities such as a severe physical disability that may qualify a person for social security entitlements, but not place the person under a legal disability for taxation purposes.

The current taxation arrangements applying to SDTs are summarised below.

Beneficiary not under a legal disability and presently entitled to trust income

If the trustee has a power to apply income at their discretion (subject to the requirement that income be used only to provide for the reasonable care and accommodation of the principal beneficiary), and the income of a trust is used by the trustee to pay for the beneficiary's care and accommodation costs, the trustee will have exercised a discretion to pay or apply the income for the benefit of the beneficiary. Consequently, the principal beneficiary will be presently entitled¹ to the trust income under section 101 of the ITAA 1936.

Where the beneficiary of a SDT is not under a legal disability and is presently entitled to a share of trust income, the beneficiary will be assessed on the corresponding share of the net income of the trust under section 97 of the ITAA 1936 at individual rates of tax.

- The beneficiary would be required to include in their assessable income the share of the trust net income and be taxed on this amount even though the amount of trust income has been used by the trustee of the trust to pay for their care and accommodation costs.
- This raises the issue of what happens if the beneficiary does not have sufficient funds to pay the tax liability. While it is expected that trustees would be able to pay such expenses, there may be some doubts if such tax payments are not specifically authorised under the trust deed and relevant Social Security (Special Disability Trust) (FaHCSIA) Guidelines 2008.

¹ Generally, without the operation of section 101, present entitlement would exist when a beneficiary can claim immediate payment of the income from the trustee.

Beneficiary under a legal disability and presently entitled to trust income

Where the beneficiary of an SDT is under a legal disability and is presently entitled to trust income, the trustee will be assessable on behalf of the beneficiary under section 98 of the ITAA 1936, at either special rates or normal rates depending on the beneficiary's circumstances.

- If the beneficiary has other income, then the beneficiary would include their share of net trust income in their assessable income, be taxed on income from all sources and receive a tax credit for the tax paid by the trustee on their behalf.

No beneficiary presently entitled to trust income

Depending on the trust deed, a beneficiary of an SDT may only be presently entitled to income of an SDT when the income is used to pay for their reasonable care and accommodation costs. A beneficiary of an SDT may not therefore be presently entitled to income of the trust that remains unexpended at the end of the income year (generally 30 June).

- If there is a part of the net income that has not been taxed to the beneficiary or the trustee on behalf of the beneficiary then under section 99A of the ITAA 1936 the trustee will be liable to taxation on that share of the net income of the trust.
- The trustee pays tax on this amount at 46.5 per cent (that is, top rate of marginal tax, plus the Medicare levy) consistent with subsection 12(9) of the Income Tax Rates Act 1986.

PROPOSED CHANGES TO THE INCOME TAX LAW

To ensure that in all cases, the unexpended income of an SDT is taxed at the relevant beneficiary's personal income tax rates it is proposed that the trustee of an SDT be the primary taxing point for the income of the SDT.

Under this proposal:

- the trustee would be assessable on the net income of the trust, whether or not the beneficiary is presently entitled to any part of the income of the trust in the income year (that is, whether or not the trustee has applied any of the income of the trust to pay for the reasonable care and accommodation costs of the beneficiary of the SDT);
- the trustee would pay tax on the net income of the trust as if it were income of an individual (that is, at personal rates of tax).
- the beneficiary would also include the amount of the net income of the trust in their assessable income (but not a tax loss). However, the beneficiary would be entitled to a credit for the tax paid by the trustee. If the beneficiary has no other taxable income, it may be open to the Commissioner of Taxation not to require the beneficiary to lodge a tax return (given that the correct amount of tax would have been paid by the trustee).

To give effect to this outcome, it is proposed that special rules dealing specifically with SDTs established in accordance with the *Social Security Act 1991* be inserted into Division 6 of the ITAA 1936.

There may also need to be special rules to apportion net income in the year that a trust is wound-up, where for example, the remaining assets of the trust revert back to the donors of the assets or where the assets are otherwise disposed and the proceeds distributed in accordance

with the trust deed. A situation could arise where assets are sold and a capital gain is paid to a capital beneficiary. It may be inappropriate to tax the principal beneficiary or their estate on such capital gains.

Example

Mark is the principal beneficiary of an SDT. While he is over 18 years of age he is under a legal disability. The SDT has trust income of \$30,000 (which corresponds to the net income of the trust as calculated under section 95 of the ITAA 1936). The trustee pays \$10,000 in the income year for the reasonable care and accommodation costs of Mark, who has no other income.

Under the current law:

- Mark is presently entitled to \$10,000 of trust income and therefore the trustee of the SDT would be assessed under subsection 98(1) of the ITAA 1936 on \$10,000 of net income at individual rates of tax (i.e. marginal rates of tax). As Mark has no other income, he is not required to lodge a tax return.²
- The remaining \$20,000 is not brought to tax in the hands of the beneficiary or to the trustee on behalf of the beneficiary under section 98 of the ITAA 1936. Therefore, the trustee would be assessed on \$20,000 of net income and would be taxed at the highest marginal rate of 46.5 per cent under section 99A of the ITAA 1936.
- The total amount of tax payable by the trustee on the \$10,000 is \$600 (using 2009-10 income tax rates) and the total amount of tax payable by the trustee on the \$20,000 is \$9,300. Total tax paid under the current tax arrangements is \$9,900.

If Mark was not under a legal disability, he would be required to include \$10,000 in his assessable income for the year and be liable to tax on that amount. However, the total tax paid would be the same, that is \$9,900.

Under the proposed tax changes:

- The trustee of the SDT will be assessed on both the applied income and the unexpended income (that is, the entire \$30,000) at individual rates of tax and be required to remit tax to the Tax Office. The Trustee will pay \$3,600 tax (based on 2009-10 income tax rates).
- Mark would be required to include \$30,000 in his assessable income and be assessed on that amount at his marginal rate of tax. Mark would also get a credit for the tax paid by the trustee. As Mark has no other taxable income the amount of the tax assessed to Mark will be offset by the amount of credit for the tax paid by the trustee.
- Total tax payable under the proposed tax changes will be \$3,600 which is \$6,300 less than would be payable under the existing tax law.

If Mark had income of \$12,000 from other sources, he would be assessed on \$42,000. The tax payable (using 2009-10 tax rates) on that income would be \$6,450. The credit for the tax paid by the trustee would be \$3,600 (tax payable on \$30,000) leaving Mark to pay \$2,850.³

2 Refer to section 100 of the ITAA 1936.

3 Example does not include calculation of Medicare Levy or the low income tax offset for simplicity.

CAPITAL GAINS TAX MAIN RESIDENCE EXEMPTION

CURRENT CAPITAL GAINS TAX LAW

The CGT main residence exemption allows a taxpayer to disregard a capital gain or capital loss that is made when the taxpayer sells the main residence, provided certain conditions are met.

Section 118-110 of the *Income Tax Assessment Act 1997* (ITAA 1997) sets out the basic requirements that must be met for a dwelling (or an interest in a dwelling) to qualify for the CGT main residence exemption. These provisions require that the taxpayer claiming the exemption be an individual and that they have an ownership interest in the main residence. Failure to satisfy these requirements results in the loss of the main residence exemption.

In a simple case, capital gains and capital losses will be disregarded if the dwelling is used only as the taxpayer's main residence throughout the period of ownership. However, if the dwelling is used for producing assessable income, such as renting a spare room, a partial main residence exemption applies. In this case, the taxpayer realises a proportionate capital gain or capital loss based on the area and time used to produce the income.

In the case of an SDT, the main residence exemption requirements are unable to be satisfied. This is because the trustee of the SDT owns the dwelling and is responsible for claiming the exemption, but the dwelling is the main residence of the disabled beneficiary. In addition, the terms of an SDT will typically mean that a disabled beneficiary is not absolutely entitled to the assets of the trust.

PROPOSED CHANGES TO THE CAPITAL GAINS TAX LAW

Under the proposal, the trustee of an SDT will be able to disregard a capital gain or capital loss where a CGT event happens in relation to a dwelling that is used by the beneficiary as their main residence, to the extent that would be allowable if the beneficiary was able to own the dwelling directly.

To give effect to this outcome, it is proposed to modify Subdivision 118-B of the ITAA 1997.

Example

Fay Pty Ltd is the trustee of an SDT established for Jack, who is a disabled adult. Jack currently lives with his parents but wants to move to another town to be closer to his friends. In late 2009, Jack's grandparents transfer a substantial amount of money into the SDT.

On 1 January 2010, Fay Pty Ltd as trustee of the SDT, purchases a dwelling for the benefit of Jack. The dwelling is located on a one acre block. Settlement occurs on 10 February 2010.

Jack moves into the dwelling on 1 March 2010, which is the date that it was first practicable for him to move into the dwelling. The dwelling is not used to produce assessable income.

However, some years later Jack's health deteriorates requiring him to be located closer to medical facilities.

To facilitate Jack's move, the trustee of the SDT sells the dwelling and purchases another dwelling closer to the medical facilities.

Under the current law:

- The main residence exemption will not be available as the dwelling is not owned by Jack, who is residing in the home. The dwelling is owned by Fay Pty Ltd as trustee of the SDT. Jack is also not absolutely entitled to the dwelling, due to the terms of the trust deed. Therefore, the main residence exemption requirement that the dwelling be the main residence of the individual owner claiming the exemption is unable to be satisfied.
- Had Jack owned the property, or been absolutely entitled to the property, he would be entitled to the main residence exemption.

Under the proposed changes:

- The main residence exemption will be available as the dwelling, owned by the trustee, is Jack's main residence. The trustee will be able to disregard any capital gains or capital losses arising on the sale of the property.