Is the Income Tax Treatment of Discretionary Trusts Objectionable?

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Submission not confidential: this submission to ***Re:think - Better tax, better Australia*** is not confidential.

1. Overview, Aim and Constraints

1.1 The Two Broad Views

The ongoing and strong criticism made of the tax treatment of discretionary trusts is that they are predominantly a mechanism for income tax minimisation; tax minimisation of the type not available to other entities and taxpayers. The flexibility of the discretionary trust is identified as the key thing that permits tax minimisation. On the other hand, defenders of the current position assert that all of the discretionary trust's taxable income is being taxed on a current basis (no deferral), and that it is being taxed appropriately in the sense that those entitled to (e.g. presently entitled to, share of net financial benefit) the trust's receipts are taxed.

With respect, the debate rarely goes beyond these general assertions. It is hoped that this submission does go a little beyond what appears at the moment to largely be general assertions on both sides of the debate.

1.2 Aim of this Submission

The key aim of this submission is to undertake an initial comparison in a limited range of areas of the tax treatment of discretionary trusts, with the tax treatment of circumstances outside a discretionary trust where those circumstances are similar to a discretionary trust situation. The latter reference point(s) is justified because the current tax law, either legislation and/or case law, is usually the best reflection of tax policy in a given area.

The article also selects two areas outside the income tax (i.e. social security, family law property pool) as a point of comparison of the treatment of a discretionary trust; that is, the income tax treatment of the discretionary trust with the compared regime's treatment of the discretionary trust.

It is not the aim of this submission to suggest a possible alternative tax treatment of the discretionary trust. A serious debate on this issue should start with the question as to whether there is “anything wrong” with the current treatment. This “anything wrong” question should draw on accepted tax policy criteria, but the main one that should carry most weight is the equity (fairness) criterion.

The debate should only turn to “solutions” should the conclusion be reached that there is “something wrong” with the current treatment. If accepted, this must also mean that criticisms of the “anything wrong” analysis by reference to solutions (most particularly, challenges in implementing various solutions) would tend to be distractions from the real initial point of focus.

1.3 Constraints and Assumption(s)

Given time constraints, this submission is not as comprehensive as the author would have liked. In spite of this, it does raise the key or central issues that may require more detailed analysis.

It is assumed that the reader has a general understanding of the areas raised in this submission (e.g. tax law rules referred to, general law governing discretionary trusts). Given time constraints, the author does not provide comprehensive references to the source of rules referred to in this submission.

2. Justifications often put forward for Continuation of Current Treatment

One justification put forward is that a discretionary trust is a trust, and it is accepted as such under the general law (non-tax law), and that therefore the income tax should be able to apply to it in the “normal” way. This status quo argument would probably also embody, or be augmented by, the idea (mentioned in the trust reform discussion papers) that the tax liability should “follow the money”.

First, it is hard to accept that the presence of a trust by itself closes off the debate. One hardly needs to point out the number of times the income tax law does not accept the “normal” application of the tax law to the general law transaction/entity. In addition, closing off the debate, which is what this justification seeks to do, really means that there is no opportunity to examine the reality of the discretionary trust. Examining the reality of the transaction is what is at the core of the numerous regimes in the income tax where the tax rules are not allowed to operate in the “normal” way.

Secondly, our tax system does not always just “follow the money”. One hardly needs to look too hard to find many examples of this in the income tax system. Some of the more relevant examples of this, to the issue in this submission, are set out in Part 3 below.

Another justification often made for continuation of the current treatment is that a lot of allocations of taxable income of discretionary trusts are included in the assessable income of high marginal rate taxpayers. The suggestion seems to be that tax minimisation is not the key driver for use of the discretionary trust. Of course, many discretionary trust allocations are made to taxpayers on low marginal tax rates in circumstances where the “controller” of the trust or the “contributor” of assets to the trust, are on high marginal tax rates.

Assuming that there is “something wrong” with the current treatment, and assuming that all allocation are made to top marginal rate taxpayers, a failure to open us debate would be tantamount to “outsourcing” tax design to taxpayer practice, and therefore taxpayer voluntariness. Obviously, this is not a sound approach to income tax design.

In the end, the main justifications often asserted for continuation of the current treatment have little or no merit.

3. Comparison with Some Fundamental Features or Principles in the Income Tax

3.1 Irregular and stand-alone mere gifts are not taxed in hands of recipients

This can be expanded to read that: irregular and stand-alone mere gifts are not taxed (e.g. assessable income) in the hands of recipients, and no cost recognition (e.g. deductions) is given for their provision (i.e. the gifted amount is from the giver’s after-tax dollars). The same point can be made if the gift is given through a deceased estate.

This is an entrenched principle of the income tax system. Yet, in spite of this entrenched principle, the trust tax rules do tax the recipient of a mere gift, namely, a beneficiary of a discretionary trust. The beneficiary of a discretionary trust is a recipient of a mere gift because the income allocation has no connection to any income activity of the beneficiary or any property right (e.g. investment) of the beneficiary. The beneficiary, who is made the proper taxpayer by the income tax rules, is a pure volunteer.

It is hard to see how this mere gift conclusion is undermined because of: (a) presence of a trust (b) the fact the donor of the property to the trust did not make or complete the gift (c) the trustee was required to complete the gift and (d) the gifted money did not exist at the time the donor commenced to make the gift.

It is true that the income tax does tax recipients on mere gifts in certain limited circumstances, but these are circumstances where the recipient has been gifted a secure series of receipts, and not a stand alone receipt (e.g. life interest in an income-producing asset, annuity). These situations, which are based on “contractual” and/or property rights are quite different to the discretionary trust situation.

A dividend paid on a dividend access share (DAS) (discretionary dividend share) in a company could also attract the description of a gift. The fact the DAS might have cost its holder $1 does not undermine the gift assertion. However, if the DAS is held by a shareholder that has a real investment in the company, and the DAS is a means of accessing company profits as opposed to accessing them on the real investment, the gift assertion becomes hard to maintain.

But even if the mere gift assertion can be maintained, which is more likely where the shareholder’s only share is a DAS, the income tax law situation re the DAS and the company is quite different to a discretionary beneficiary and the discretionary trust. In short, even only on a quick glance at the Tax Act, the DAS situation opens up the DAS holder and/or the company to a range of anti-avoidance or integrity provisions that need to be “negotiated”. Some examples are: (i) franking credit streaming provisions (ii) franking credit trading provision(s) (iii) dividend stripping measures (iv) un-grandfathering of pre-CGT asset measure and (v) risk of failure of COT re company losses and other tax attributes, but this is less likely if and when exposure draft legislation is enacted and has retrospective effect. The recent AAT case of *Devuba* provides another example (CGT small business concessions).

In the run of the mill discretionary trust where allocations are changed (without effective restriction) to maximize "tax efficiency", the discretionary trust and its beneficiaries have no concerns from similar provisions (i.e. do not exist).

The preference is to treat all mere gifts in the same way. The comments in regard to a DAS are only made to point out that the DAS mere gift situation is very unlikely to be the same as the discretionary beneficiary situation.

3.1.1 Trustee as Agent for Beneficiary

In short, both legally and [perhaps more relevantly] commercially, the trustee is not deriving profits, etc, as an agent for discretionary beneficiaries ultimately allocated trust income. Instead, it is not known who the profits are made for until "after the event". In a fixed trust, it can be accepted that the trustee is deriving profits for a beneficiary with a fixed interest.

The point is that a discretionary beneficiary is getting a gift (mere gift) of money.

3.1.2 Taxing Discretionary Beneficiary therefore is Harsher Treatment than Similar Situations

Some will no doubt argue that the above indicates harsher treatment for discretionary trusts. Viewed narrowly from the perspective of the beneficiary, this would be correct. But, the narrow view mislead. Outside a discretionary trust situation, a donor makes a gift in after-tax dollars. In a discretionary trust situation, the donor makes the gift in before-tax dollars. In both situations, there is only one layer of taxation (one taxing point), therefore, the harshness argument has no little merit.

Gifting an "asset" is usually treated as a realisation of the asset at market value for the giver. The income tax is riddled with market value rules. In short, a donor, when gifting an asset, is treated as having realised the asset at market value. This is either to protect the integrity of the individual as the tax unit, and/or that the act of gifting is an expression of dominion or enjoyment over the asset such that it should be treated as the realisation of the value inherent in the thing gifted.

The transaction of a beneficiary in a discretionary trust being allocated income is a non-market value transaction. At first glance it does not appear to be an asset situation (cash only). However, the gifted money will usually represent the return on an asset(s) the donor gifted or contributed to the trust. The return on an asset is an accepted component of ownership of an asset. It is this component that the donor is realising through the power of allocation of the income to the discretionary object. It needs to be remembered that the donor did not "dispose" of the whole asset at the time of the transfer to the discretionary trust.

There would seem to be an element of double taxation, under current law, if the market value consideration rule applied at the time the asset were gifted to the trust by the donor, and then another taxing point when the income from the asset was taxed to the discretionary beneficiary upon allocation to that beneficiary. In other words, the current tax law has already treated the return on the asset as a realisation by the donor.

The double taxation point does not undermine the conclusion that the income allocation to the discretionary beneficiary is a realisation of part of the asset by the donor. The error that may lead to double taxation was to treat the asset transfer as a 100%, transfer of the asset, when, in many cases, it was not. The same point can be made about the asset, less the return on it (i.e. not a transfer).

3.2 For "Some" Tax Purposes, Assets and/or Income thereon remain that of the Donor where Control of Asset maintained and/or Asset or Income could revert to Donor

Many, if not most or all, discretionary trusts involve the transfer of assets to the trust and the retention of control over the assets and the income thereon, by the person(s) who contributed the assets. (Realistically, very few people are going to give away complete control over assets that they have generated through their work and investment). The retention of control is achieved in a number of ways, for example, through: (a) being a trustee or (b) being a shareholder and/or director of the corporate trustee or (c) having a power to remove and appoint trustees.

In an inter vivos trust, the asset contributor is very likely to be an object so that for all practical purposes, the asset contributor has the legal power to allocate the income and the assets to himself/herself and/or family members. It is hard to imagine many discretionary trusts drafted differently. At times, some of the trust income will in fact be allocated to the persons that contributed the assets.

It is true that the exercise of trustee discretions must be made for proper purposes, "all" beneficiaries need to be considered, etc, and that as a result, it may be going too far to say that the controller can have all of the trust income or most of the trust income for a number of years. On the other hand, it is pretty difficult to successfully challenge the exercise of a trustee's discretion. In any event, the controller is in a position to control the allocations of trust income amongst family members.

The following provides a brief examination of three tax areas that apply to situations involving the retention of control over assets (or income), even though the owner has "disposed" of the asset (or income).

3.2.1 Revocable Trust or Power to Alter Trust: s 102(1)(a) of the ITAA 1936

Subsection 102(1)(a) deals with inter vivos revocable trusts or inter vivos alterable trusts. It cannot apply to testamentary trusts. In particular, where a person (trust creator) who has created a trust has the power to revoke or alter a trust so as to acquire a beneficial interest in the income or the property that produced the income, the trust creator may have the relevant income added to his/her taxable income and tax will be paid on it. If s 102(1)(a) applies, the legislation places the tax liability on the trustee, but the amount of tax payable is determined by reference to the creator's tax rate schedule. This clearly suggests it is a surrogate tax on the creator and that the trustee is only paying the tax in a representative capacity for the creator, and not a representative capacity for all potential beneficiaries (which is the ss 99 or 99A situations). Making the trustee pay the tax reflects the fact that the trust creator will not usually be presently entitled to the relevant trust law income, and therefore access to the related funds. Indeed, another beneficiary may have present entitlement to the relevant income.

Subsection 102(1)(a) appears to confer a discretion on the ATO to activate the charging provision therein. As a general comment, one would think that the ATO would only activate s 102(1)(a) where the rate of tax levied on the relevant taxable income under the normal trust rules (i.e. outside of s 102(1)(a)) is lower than that faced by the creator of the trust. Where s 102(1)(a) has been activated, s 102(3) ensures that a presently entitled beneficiary is not taxed on the relevant taxable income. Subsection 102(3) also ensures that the trustee is not taxed under s 99A, if there was a lack of present entitlement over the relevant trust income.

The principle reflected in s 102(1)(a) is that where a person has the power to gain or regain beneficial ownership of an asset that he or she “contributed” to a trust or to the income from the asset, he or she should be taxed on the relevant income. It is submitted that the idea expressed in s 102(1)(a) is that capacity or the power to regain beneficial ownership of what was [originally] the person’s assets is being treated as equivalent to “ownership”. Given the widely accepted principle that the income tax only taxes those who beneficially own income, s 102(1)(a) is a legislative endorsement that in a revocable trust situation, the creator is in a position sufficiently close to beneficial ownership to have a taxable capacity.

The legislature has restricted its attribution of ownership to the creator of the trust to just the taxable income flowing from the asset. It has not extended attribution of ownership to the asset itself because, under a revocable trust or alterable trust situation, satisfying the criteria in s 102(1)(a) is very unlikely to negate the occurrence of a CGT event. Therefore, the creator would no longer be treated as the owner of the asset for CGT purposes, even though he or she retains the power to regain beneficial ownership of the asset. In one sense, the legislature’s position is inconsistent. But, it does not change the assertion made above in regard to taxable income flowing from the asset.

Many inter vivos discretionary trust situations involve a similar situation to that meeting the criteria in s 102(1)(a). That is, the family controller or principal, who was the contributor of assets, has the capacity or power to gain or regain beneficial ownership of trust income or assets housed in the discretionary trust. Indeed, it is difficult to see the difference in the two situations. In the s 102(1)(a) situation, the power to revoke or alter the trust is expressly given to the creator. In the discretionary trust situation, the power is not expressly given to the controller. Rather, the power is contained in the general provisions of the trust deed dealing with income and capital allocations (power of appointment) and/or through the controller holding the relevant office(s) and/or having the power to remove those that do have the power to appoint income and capital.

It is true that s 102(1)(a) has become largely ineffective through the simple device of ensuring the trust creator is not the person vested with the power to revoke or alter the trust (i.e. use of nominee creator). The legislature has not responded to this planning strategy. While the principle underlying the text of s 102(1)(a) is not undermined, the legislature’s failure to make s 102(1)(a) more effective, does suggest a weak commitment by the legislature to the principle underlying s 102(1)(a). It is submitted though, the fact the ATO has a discretion to not apply s 102(1)(a) where the criteria are satisfied, does not undermine the principle underlying the text of s 102(1)(a).

3.2.2 Short-Term Property Income Transfers: s 102B(1) of the ITAA 1936

The idea in s 102B(1) is that the transfer of a right to receive income from property as a gift is only respected (or taken to have occurred) for income tax purposes if it certain that the right will subsist for seven-years or more. If the right will or may terminate within seven-years, the transfer is taken never to have occurred for all purposes of the Tax Act (which includes the CGT regime). That means the transferor (not the transferee) is assessed on the income from the property, and no CGT event would have occurred re the "transfer".

Subsection 102B(1) can apply whether or not the transferor intended that the right would cease to exist within the relevant period; the test focuses on legal rights and probabilities. However, s 102B(1) clearly applies where the transferor expressly retains a right to terminate the right to receive income within the seven-year period, whether or not such a termination actually occurs.

The idea underlying s 102B(1) seems to be that where the transferor has not completely relinquished the capacity or power to claim their income back, or has not completely alienated their right to the income for seven-years or more, the legislature considers it appropriate to continue to recognise the "transferor" as the proper taxpayer. Like s 102(1)(a) (revocable or alterable trust), the principle expressed in s 102B(1) is that capacity or the power to regain beneficial ownership of the relevant income is, in addition to other situations, being treated as equivalent to "ownership". Given the widely accepted principle that the income tax only taxes those who beneficially own income, s 102B(1) is another legislative endorsement that a transferor, in an s 102B(1) situation, is in a position close to beneficial ownership. Unlike s 102(1)(a), in the s 102B(1) situation, the legislature has provided for the attribution of ownership to the transferor for all purposes of the Tax Act. This means the transferor also remains the owner of the right to receive the income (not separate from underlying property) for CGT purposes.

The choice of a seven-year threshold period necessarily involves a degree of arbitrariness. It does however indicate that the legislature requires a "significant degree of permanence" before being prepared to treat the "gift as complete" for tax purposes, and thereby be satisfied the transferor does not have the power to regain control of the income.

Many discretionary trust situations will involve 100%, or close to 100%, passive property income situations. In a discretionary trust situation, the principal or family controller has the right to not make income allocations to others in subsequent years. In other, words, making income allocations to objects (beneficiaries) in one year does not mean that those beneficiaries can demand an allocation in the subsequent year, let alone for seven-years, the threshold period set for "owned" income entitlements in s 102B(1). And, the family controller can regain the income from the property in subsequent income years by appointing to himself/herself.

In light of the above, the treatment of the discretionary trust situation does not sit well with the legislature's approach in s 102B(1). Both involve gift situations. Subsection 102B(1) requires security of income entitlement for the transferee (and therefore no chance of the income reverting to the transferor) for at least seven-years in order for the alienation of income to be effective and for the transferee to be taxed (and transferor not taxed). Yet, no such requirement is imposed in the discretionary trust situation; not even a two-year period of income security for the discretionary object.

With the introduction of the CGT regime, it is likely that very few transfers of rights to receive income from property for nil consideration are occurring, unless of course the underlying property (source of income) is a pre-CGT asset. Accordingly, the role of s

102B(1), as a matter of practice, is probably very limited and will become more limited as more assets become post-CGT assets with the passing of time. But, it is not clear why this undermines the principle or policy expressed by the legislature embodied in s 102B(1).

3.2.3 Lack of Control over Legally Owned Income: s 94 of the ITAA 1936

The normal rule is that a partner in a partnership will include a share of the partnership's taxable income in their assessable income (based on their interest in partnership profits), and it, along with other taxable income, will be taxed at their marginal rate of tax. The test under s 92(1) as to whether a partner in a partnership shall include an amount in their assessable income is whether the partner has an individual interest in the partnership profits. An individual interest, it is submitted, will depend on the terms of the partnership agreement but it basically means ownership.

Where however, through one of three circumstances, the partner does not have real and effective control and disposal of that taxable income (profits really), s 94 will apply to charge the taxpayer "further tax" on his or her share of taxable income. The effect of the further tax is that the taxpayer (partner) will be charged the top marginal rate of tax on the taxable income from the partnership over which he or she does not have real and effective control and disposal of. It is clear that s 94 assumes, or proceeds from the basis, that the partner who does not have real and effective control, etc, has included the taxable income over which he or she has no control over, in his or her assessable income under s 92(1). That seems to indicate that a partner can, at the same time, have: (a) "ownership" of partnership profits so as to satisfy s 92(1) and (b) not have real and effective control, etc, over the same profits.

The fact the partner without control over the partnership income is not being taxed at their marginal rate of tax invites the conclusion that the legislature is not really taxing that partner, even though as a matter of tax law, the partner is the entity the ATO will seek out for payment of the tax. From there, one would think that a provision like s 94 would require the identification of the person who does have real and effective control of the income, and tax that person at their marginal rate on that taxable income. This would seem the appropriate course given that lack of control over income is the basis for not taxing the ostensible earner of the profits. Indeed, the former version of s 94 effectively did tax the controller of the income at their marginal rate of tax.

However, the current s 94 does not impose tax at the marginal rate of the controller of the income. Instead, it levies tax at the top marginal rate of tax. On the other hand, the legislature may have made the assumption that most s 94 situations would involve a controller of income who is on the top marginal rate of tax. (It is likely this assumption also underlies the tax rate schedule faced by children and that faced by trustees on retained trust income). On the basis of this working assumption, the controller of the income is being taxed at their marginal rate of tax. If this working assumption is not the basis for levying the top marginal rate of tax, the basis may be simply to discourage this type of tax planning.

It is widely accepted that many discretionary objects allocated income under discretionary trusts have no control over the income allocation made to them, and no power to use the funds allocated on a current basis. Yes, it is true that on a legal rights approach, the trustee has made the allocation in such a form that satisfies the deemed present entitlement concept in s 101 of the ITAA 1936 (and/or the case law concept of present entitlement). And, it is also true that a beneficiary loan account may have been established or increased because of the allocation. In the end though, it is submitted that many discretionary objects have little if any control over, or power of disposition over, income allocations made in their favour. If this is the case, the situation appears very similar to that which s 94 is directed at in the partnership context. Indeed, it is hard to see the difference.

It should be noted that the failure to have an s 94 equivalent is not limited to discretionary trust situations; the failure extends to all trust situations (and company situations). This includes fixed trusts. Accordingly, one may not assert an anomaly on this lack of control point solely by reference to the discretionary trust situation.

(It is likely that the degree to which a taxable beneficiary lacks control over their trust income allocation is grossly understated).

4. Under Some Legislative Regimes outside the Income Tax, Assets and Income thereon remain that of the Donor where Control of Asset maintained and/or Asset or Income could revert to Donor

Two examples from outside the income tax have been chosen, namely, the social security area and the family law area. A fuller discussion would make reference to other areas of the general law that apply to discretionary trusts. The validity of references to these areas of the law is, of course, debatable in a discussion focusing on the appropriateness of the income tax treatment of discretionary trusts.

4.1 Asset Test and Income Test for Assets held in Discretionary Trusts: ss 1207-1209K of the Social Security Act 1991

In terms of legislation, rules in the *Social Security Act* 1991 (and the Veterans' Entitlements Act 1986) are not part of the income tax. However, the social security system (and the income support component of the veterans' affairs system) can be seen as closely related to, or even the other side of, the income tax. Or, as other commentators have said, Australia's social security system is really a negative income tax; a negative income tax because money does not come into the government, it goes out. The two systems, income tax and social security, both deal with economic capacity. The income tax requires a contribution when a person has sufficient economic capacity, and the social security system provides a contribution to a person when they are in need. But need arises when the person does not have sufficient economic capacity. Thus, the case that the attitude of the legislature in the social security area should carry some weight when examining the merit of the rules under the income tax is a fairly strong one.

The assets and income tests are a measure of a prospective pensioner's capacity to provide for himself/herself. Up until 2002, assets held in a discretionary trust could not be counted as any person's assets when determining the level of assets under the social security assets test. This reflected the discretionary trust rule that no one beneficially owned the assets in a discretionary trust until the trustee had made an appointment of capital to an object (i.e. ownership of the assets was suspended).

From 2002, the social security law was changed. From then on, assets held in a discretionary trust can be counted as assets of a person under the assets test if: (a) the assets in the trust are "controlled" by the person (control test) or (b) the person gifted the assets to the trust (source test). Only one of these tests needs to be satisfied in order that the discretionary trust is treated as a controlled private trust, which in turn would mean that the assets in the discretionary trust would be attributed to the relevant controller or the person who was the source of the assets, for the purpose of the asset test.

There are various alternate criteria by which a person can satisfy the control test, and there can be more than one controller. The following are examples where a person will satisfy the control test: (a) person is the appointor of the trust so that he or she can remove or appoint the trustee (b) person can vary the trust deed or veto decisions of the trustee (c) person had the power by exercise of a power of appointment or revocation, etc, to obtain the beneficial enjoyment of the capital or income of the trust (d) person was able to control the application of the capital or income of the trust or (e) the trustee was accustomed or under an obligation or might reasonably be expected to act in accordance with the directions or instructions of the person.

There is a suggestion that the discretionary trust will not be a controlled private trust of the person who gifted the assets to the trust if he or she has relinquished control of the trust. While possible, one doubts there will be many situations where this will occur.

The key point is that a person who has control over assets of a discretionary trust and/or who contributed those assets is effectively being treated as owning the assets and the income thereon for social security purposes. There are no rules in the income tax that seek to attribute ownership of assets and/or income to a controller of a discretionary trust or the person who contributed assets to the discretionary trust. Put shortly, the appearance that the "controller" of the assets in the discretionary trust is a non-owner is not tolerated under social security law. Yet, on the same facts that would attribute ownership to a controller of the discretionary trust under social security law, the income tax law does not contemplate attribution of ownership to a controller. Instead, the income tax does not depart from the suspended ownership or non-owner position that applies under trust law.

To say that these changes were required because the social security regime should only assist those in need is not a contribution to the current issue. It is hard to see the difference between: (i) giving the impression that one lacks economic capacity to look after themselves (and therefore not and (ii) giving the impression that one lacks economic capacity to contribute to the public revenue.

4.2 Divisible Property Pool, Etc, on Relationship Breakdown: ss 75(2) and 79(1) of the Family Law Act 1975

It must be conceded that the closeness of the relationship between the income tax and the social security system is not present in the case of the income tax and family law property division. However, the family law property break up situation does share some goals with the income tax, namely, that equity is, in the broad sense of that term, an important feature, and that financial capacity is a central part of both regimes.

The short point is that assets held in a discretionary trust can be taken into account in the process of dividing property between separating spouses even though, on trust law principles, neither party to the marriage breakdown has a beneficial interest in the assets held in the discretionary trust. There are two avenues by which assets held in a discretionary trust can be taken into account when deciding on the final division of the pool of assets (property).

First, the assets of a discretionary trust could be held to be "property of the parties to the marriage or either of them": s 79(1)(a). Every case will depend on its own facts, but the cases make it clear that where a person has the capacity to control the income or capital allocations of a discretionary trust so that allocations could be made to the person, the discretionary trust's assets will be property of that person for s 79(1)(a) purposes. This can be the case even where the person is not the trustee of the discretionary trust, provided that he or she is the appointor of the trust and thereby has the power to change the trustee. The presence of a corporate trustee will not be sufficient on its own to prove a lack of control. Instead, the court will look to see who controls the corporate trustee. Even where a party is not a beneficiary but has the capacity to become a beneficiary, and from there obtain an allocation of income, will be sufficient to make the discretionary trust's assets relevant property within s 79(1)(a).

In certain circumstances, one needs to be cautious with the notion of "property of the parties to the marriage or either of them" because, from the reasoning of some judges in *Kennon v Spry* [2008] HCA 56, this notion can be satisfied even where: (a) spouse A contributed the assets to the discretionary trust (b) spouse A is the sole trustee of the discretionary trust, but not within the class of objects and (c) spouse B is within the class of objects of the discretionary trust (and no more). In this situation, there may be some difficulty in referring to spouse A as a controller of the assets of the discretionary trust in the sense the word has been used, for the most part, in this submission (i.e. power to regain ownership of assets and/or income housed in the discretionary trust).

Secondly, if the assets do not come within property of a party to the marriage, etc, s 75(2)(b) may permit assets held in a discretionary trust to be counted as a "financial resource" of one of the parties to the marriage. If this is the case, that financial resource may be taken into account in adjusting the initial property division. Again, every case will depend on its own facts, and care needs to be taken with general propositions. However, it is very likely that the assets of a discretionary trust, or part of them, will be a financial resource of a party if the person has benefited from discretionary trust distributions in the past and/or has a legitimate basis for expecting to benefit from distributions in the future.

Putting aside the situation outlined from *Kennon v Spry* and similar situations, the family law property rules re assets held in discretionary trusts is in direct conflict with the income tax treatment of the discretionary trust. Again, the appearance that the "controller" and/or contributor of the assets in the discretionary trust is a non-owner is not tolerated under the family law rules. Yet, under the income tax, the suspended ownership or non-owner position is tolerated.

5. Conclusion

This submission has focused on a very small number of selected areas where the income tax treatment of a discretionary trust was compared with the tax treatment of analogous situations outside of a discretionary trust. Further examination of the Tax Act needs to be undertaken in order to make a fuller comparison that would allow a more secure conclusion to be reached (e.g. scope of the "application of income principle", scope of principle that returns on assets are taxed to owners of assets, features of transactions where diversions of income are not accepted for tax purposes, extent to which control over an asset is treated as analogous to ownership throughout the Tax Act).

However, in spite of the limited coverage of this submission, the submission has identified some areas that involve central aspects of the income tax, where the tax treatment of discretionary trusts does involve departures from the tax treatment given to analogous transactions outside of the discretionary trust. In addition, the quite divergent treatment of the discretionary trust in the social security area and (less importantly perhaps) the family law area compared to the income tax treatment only serves to add to the perception that the income tax treatment of discretionary trusts is somewhat anomalous.

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