SMSFAdviser

Trust legislation will mean testamentary trusts will need urgent review

By Keeli Cambourne, Deputy Editor SMSF Adviser and Matthew Burgess, Director, View Legal

The newly introduced legislation on the minimum tax on discretionary trusts includes changes which appear to mean every single testamentary trust will need to be reviewed before 1 July 2028, Matthew Burgess, director of View Legal said.

Burgess said the initial proposal was that the minimum 30 per cent tax would apply to testamentary trusts or trusts that can only come into existence on the death of a person under their will.

“Widespread criticism of this ‘death tax by stealth’ saw an announced wind back. The difference between the political rhetoric of the wind back and reality has however been stark ever since,” he said.

“And now the proposed treatment of testamentary trusts is arguably the most serious sleeper issue in the legislation as released.”

On Wednesday 14 October, the Government tabled the Treasury Laws Amendment (Tax Reform No. 3) Bill 2026 and Income Tax Rates Amendment (Minimum Tax on Discretionary Trusts) Bill 2026 with the aim of passing it by November.

The legislation includes:

• Implementing the core components of the minimum tax on discretionary trusts, including a new definition of fixed trusts.

• Expanded options to limit or eliminate restructuring costs for small businesses and others using discretionary trusts.

• Implementing the next tranche of legislation for the Government’s reforms to negative gearing and capital gains tax (CGT).

• Providing transitional relief for excess contributions in the first year of Payday Super.

Treasurer Jim Chalmers said fixed trusts, charitable trusts, special disability trusts and superannuation funds, as well as primary production income and certain income relating to vulnerable minors will all be exempt from the minimum tax. Deceased estates and discretionary testamentary trusts established for genuine testamentary purposes will also be excluded.

“Small businesses and others using discretionary trusts can access rollover relief from 1 July 2027 if they want to restructure, or can make an election for tax purposes to be exempt from the minimum tax, for as long as they continue to make distributions to pre-nominated beneficiaries in line with an upfront nomination,” Chalmers said.

“[The legislation] clarifies the operation of the reforms to capital gains tax for more complex and specific circumstances, including for a range of trust structures. It also includes the definition of a new residential dwelling and exemptions from the limits on negative gearing for affordable and public housing, specialist disability accommodation, operators of retirement villages and residential aged care, and build-to-rent developments.”

However, Burgess said under the legislation testamentary trusts are not in fact excluded from the 30 per cent tax regime and instead, the new rules only exclude "qualifying income of qualifying testamentary trusts".

"Further, for any testamentary trust 'established' (a term conveniently not defined) on or after 1 July 2028, the exclusion applies only if the instrument establishing the trust permits the relevant beneficiary to be an individual; an exempt entity; or the trustee of a special disability trust," Burgess said.

"This drafting approach has a much broader impact than the previous promises that testamentary trusts would be "protected" from the rule changes."

Burgess explained that most modern testamentary trust deeds use wide beneficiary classes and those classes routinely include companies; related entities, including other testamentary trusts; family trusts; corporate beneficiaries; and other entities introduced to preserve tax, asset-protection and succession flexibility.

"Unless every such non-permitted beneficiary is removed before a willmaker dies, it appears what is otherwise currently a standard testamentary trust established from 1 July 2028 risks failing the statutory exclusion," he said.

"The practical consequence is unavoidable. That is, every existing will containing testamentary trust provisions must be reviewed and, where its beneficiary class extends beyond individuals, exempt entities and trustees of special disability trusts, will need to be amended before 1 July 2028 if the intended testamentary trust is to qualify for the exclusion."

He added that the costs of such an update will be "enormous" assuming willmakers are aware of the issue and have the testamentary capacity to make the required changes.

"With an aging population testamentary capacity is a material risk for many families," he said.

"More bluntly, the government's approach is not merely an issue for testamentary trusts drafted after the legislation commences. Any will, regardless of when it was drafted will be caught if the willmaker dies on or after 1 July 2028."

Burgess said the legislation also contains anti-avoidance provisions directed at income injection and property transfers into testamentary trusts.

"Under these rules, the Commissioner may deny the exclusion of a testamentary trust from the 30 per cent tax regime where relevant property entered the trust structure under a 'scheme' having the subjectively determined exclusion-seeking purpose," he said.

"Despite repeated requests for clarity on the mischief intended by the anti-avoidance provisions (given conceptually identical prohibitions were introduced after the 2018 Federal Budget), no insight has been shared by Treasury. Willmakers and advisers should therefore be extremely concerned about the inclusion of these provisions."

The EET: discretion without the discretion

Furthermore, Burgess noted that the Excluded Election Trust regime has been marketed by the Government as an alternative to restructuring.

"The trustee nominates the beneficiaries, or limited eligible charitable classes, who may benefit. The nomination must allocate 100 per cent of income and the newly introduced concept by the Bill of 'non-

income earnings' between them in fixed proportions. Any later corpus entitlement must follow equivalent proportions," he said.

"The practical result is straightforward: a discretionary trust can escape the 30 per cent discretionary trust tax if it stops operating like a discretionary trust."

However, Burgess said, there are several problems which arise with this strategy including that the election is available only for a minimum tax trust existing on 1 July 2028, nominees generally must have been capable of benefiting under the trust on that date and superannuation entities and partnerships cannot be nominated.

"Also, a company can be nominated only if there are no material discretionary elements affecting member rights and nominations generally cannot be varied, other than under narrow death and relationship-breakdown rules," he said.

"Moreover, changes affecting a nominated company or its shareholders may automatically revoke the election, and inconsistent income, non-income earnings, payment or corpus outcomes may also automatically revoke the election. Finally, once revoked, the election cannot be remade."

He noted that for most revocations, beneficiary entitlements for the relevant year are treated as never having arisen. The trustee may then be assessed on all net income under section 99A. A payment failure can have an even more remarkable retrospective effect, with the election ceasing at the end of the second preceding income year.

"There has been a limited Commissioner discretion to waive breaches for certain inconsistencies introduced; a concession taxpayers and their advisers should assume would be rarely exercised give the War on Trusts being waged by BigGov, Treasury and the Tax Office in unison. Furthermore, there is no equivalent discretion for every automatic-revocation event," he said.

"A regime supposedly designed to reduce disruption therefore creates a permanent compliance exercise where an administrative error can become a major tax event; as a point of cross reference consider, for example, the outrageous situation currently faced by all trust operators under the family trust election regime."