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Tax White Paper Task Force
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Dear Sir / Madam

TAX WHITE PAPER SUBMISSION

We refer to the current Tax White Paper and review being conducted by the Tax White Paper Task Force and wish to take the opportunity to provide submissions on issues that are currently hindering private business to meet their commercial objectives.

For over 25 years, Cleary Hoare Solicitors has specialised in providing specialist tax advice to accountants and their private business clients throughout Australia. As such, we consider our Firm uniquely placed to provide comments in relation to the tax impediments facing private business.

Our submission will only concentrate on three facets only, but we offer our services to assist with any aspect of the consultation process.

Division 7A of the *Income Taxation Assessment Act 1936*

Division 7A of the *Income Taxation Assessment Act 1936* is principally an integrity measure, but is one of the divisions of the taxation legislation that impacts negatively on private businesses ability to retain working capital at an effective tax rate if they are structured in anything but a company structure.

In essence it requires a loan or payment from a company to a shareholder or associate of a shareholder, or from a trust that has an unpaid present entitlement to a private company to be an unfranked dividend unless it is repaid prior to the tax return of the entity or subjected to a compliant Division 7A loan under Section 109N. The practical effect of the complying loan is additional tax to be paid by the clients.

Speaking generally, the choice of business or investment structure by private business is driven by flexibility, asset protection and access to tax incentives such as CGT concessions. For these reasons quite often a company will not be a suitable structure for private business clients.

In terms of asset protection, the saying "don't have all of your eggs in one basket" is a wise one to follow, hence the desire of private business clients to separate business assets amongst different structures. For example, to shield assets from risk of the trading entity, other assets such as the business premises will preferably be held in another structure. Quite often the

funding for the acquisition of other business assets in these structures comes from within the client group.

Division 7A currently has a carve out within Section 109K for loans or payments between companies, so using the above example a loan from one of the clients companies to another would not be subject to Division 7A.

However if the client was lending money from a company to a trust for the exact same purposes, in order to comply with Division 7A they would have to enter into a complying Division 7A loan agreement, which would result in additional tax.

What this is in effect is a tax now on the unrealised gains within the other entity. Something which the current Federal Government has said on previous occasions they would not do.

It is our submission to correct this discrepancy that an exclusion be included that deals with loans or payments amongst "family groups" so as to not trigger Division 7A. Returning to our latter example this would allow this amount to be ignored for Division 7A purposes and eliminate taxation on unrealised gains. Appropriate integrity measures could be built into the exclusion to ensure that it applies to business or investment assets only, rather than personal assets.

One further point on Division 7A, as outlined above it can operate as a tax on unrealised gains. The clear example of this is the introduction of Subdivision EA and EB of Division 7A which deals with payments from a trust with an unpaid present entitlement referable to an unrealised gain. Restating the current Federal Governments public position on taxing unrealised gains, this has in effect been introduced by stealth and should be removed.

Small Business Capital Gains Tax Concessions

Currently concessions in relation to the disposal of small businesses which meet criteria can be accessed under Division 152 of the *Income Tax Assessment Act 1997*.

There has been some commentary that these concessions are too generous. What this commentary fails to recognise is that for the vast majority of small business owners, their business is in effect their superannuation savings. They often have limited ability to contribute to superannuation funds themselves as most funds are reinvested in the business or not accessible as they are tied up in debtors, WIP or stock depending on the nature of the business.

The removal of these concessions will unfairly treat these taxpayers and fail to recognise that their businesses are their "super". Furthermore, the current thresholds for accessing the concessions in terms of aggregated turnover or maximum net asset value test have not been changed for many years, and should be reviewed or at the least indexed to inflation.

It is our submission that the concessions in Division 152 should remain considering their objectives and purpose.

Reintroduction of the CGT Trust Cloning Exception

The last area that we would like to make a submission on is the removal of what is commonly known as the "trust cloning" exceptions contained at that time within former sections 104-55(5)(b) and 104-60(5)(b) of the *Income Tax Assessment Act 1997*. ("ITAA 1997"). These sections were amended by Bill No. 19 of 2010 to remove the exception for the majority of trusts from 1 November 2008.

We note that an exception was maintained for unit trusts meeting certain criteria by the introduction of Subdivision 126-G of the ITAA 1997, however the vast majority of trusts utilised by small business in Australia are discretionary trusts rather than unit trusts.

The exception contained in the amended provisions had been used for legitimate commercial objectives by small business including estate / succession planning and restructuring purposes. In this letter we set out our submission in relation to the history of the provisions and the reasons why they were previously used by small business clients to meet their commercial objectives.

A brief background:

1. Until the amendment (operative from 1 November 2008), it had been possible to "split" one discretionary trust into two or more identical discretionary trusts, without activating a CGT Event (liability).
2. The ability to do this was supported by paragraph 104-55(5)(b) and 104-60(5)(b) of the ITAA 1997, which are the replacement provisions for sub-paragraph 160M(3)(a)(ii) of the ITAA 1936.
3. The relevant history of the legislation is:
 - 3.1 The capital gains tax provisions were introduced by the *Income Tax Assessment Amendment (Capital Gains) Act 1986* effective from 20 September 1985. Those provisions were expressed to apply to a change in the ownership of an asset;
 - 3.2 Sub-Section 160M(1A) was introduced by the *Taxation Laws Amendment Act 1990* to clarify that a change in ownership of the asset is only considered to occur where there is a change in the beneficial ownership of the asset. This provision has the effect that a mere change of trustee does not cause a change in ownership and is currently reflected in CGT Event A1;
 - 3.3 Until 12 January 1994, it was arguably possible to subject an asset owned by a person to the trusts of a discretionary trust of which that person was the trustee. The reason for this is that, in a discretionary trust, no beneficiary has a right to any assets of the trust fund, with the result that the mere subjecting of an asset to a discretionary trust of which the owner is the sole trustee, did not cause a change in beneficial ownership.
 - 3.4 On 12 January 1994, the then Treasurer announced an intended change to the provisions, to operate from the date of the announcement, to cause the creation of a trust per se over an asset (as described in the previous sub-paragraph) to be a CGT disposal but with some exceptions.
 - 3.5 In implementation of this announcement, *Taxation Laws Amendment Act (No 2) 1994* removed the previous paragraph 160M(3)(a) and replaced it with a new paragraph of which subparagraph (ii) included what has been referred to as the trust cloning exception. The purpose of the exception in subparagraph (ii), as explained in paragraph 6.14 of the Explanatory Memorandum, was to provide that a disposal would not be taken to occur for

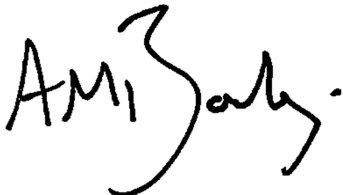
- an asset, although vested upon or transferred to another trust, where it is held under the same trust arrangements;
- 3.6 The essence of that exception was that if the trust being created over the asset is identical to an existing trust over the asset, then a CGT disposal would not occur.
- 3.7 *Obviously, this is because there is no real change in the beneficial ownership of the asset or of a beneficial interest in the asset.*
- 3.8 The CGT provisions were rewritten into the *Income Tax Assessment Act 1997* in which the exception referred to in subparagraph (ii) was incorporated as an exception to CGT Events E1 and E2 in paragraphs 104-55(5)(b) and 104-60(5)(b).
4. The reasons why a person would want to split a trust into two or more trusts (identical) were to attain asset protection or as a part of succession planning (principally, the latter).
5. The fact that this exception has been removed means significant tax cost to private business that operate in discretionary trusts if they are looking to restructure in such a manner. We note the disparity in this approach in that if they were operating in companies or unit trusts they would still have the ability to restructure to meet commercial objectives.
6. An example of the use of splitting trusts (in more recent times called trust cloning) for asset protection purposes is where the trust contains assets which might be subject to risk, eg, business assets, as well as assets which will not ordinarily be subject to risk, eg, investment assets. Trust splitting can be used to set up a new, identical trust with the investment asset then transferred to it thus protecting it from the risks encountered in conducting a business.
7. Another example would be where the trust contains two separate businesses, and the clients want to restructure the businesses so as to protect one from the risks of the other, or to separate them into separate divisions. Again, currently subject to significant tax cost for clients with discretionary trusts, but can be achieved under the legislation for clients operating in other entities.
8. In terms of succession planning:
- 8.1 A person cannot give away in his Will assets owned in a trust, even where the trust is controlled by that person. That is for the simple reason that the person does not own the asset.
- 8.2 The traditional method of dealing with trust assets, upon the death of the controller, was to leave a Letter of Wishes containing "riding instructions" as to the future conduct of the trust, and placing advisors, eg, the controller's accountant and solicitor, in full or partial control of the trust – in the expectation that the client's wishes would be carried out.
- 8.3 This approach was intended to prevent the majority of children attaining control of the trust, and "ganging up" against the minority of the children. *It did not always work.*

- 8.4 Obviously, the person who controls a discretionary trust determines who gets the benefit of the trust assets.
- 8.5 Trust splitting or trust cloning had become a useful way to prevent a majority of beneficiaries "ganging up" against a minority: the trust is split into such number of trusts as equals the number of children and either particular assets are moved among the trusts or all of the assets are split evenly (or in other proportions desired by the controller) among the trusts but in both cases subject to the same trust arrangements – thus preventing some children causing others to miss out.
- 8.6 Later, as noted above, on 31 October 2008, the Assistant Treasurer, Mr Bowen, announced that, because of difficulties with the provision *and to bring certainty to taxpayers*, the provision would be deleted!
9. On 31 October 2008, the Assistant Treasurer, Mr Bowen announced that because of difficulties with the provision and to bring certainty to taxpayers, the provision would be deleted.
10. Normally, when there is a change in tax legislation, it is to address a mischief: either a mischief which is detrimental to the ATO/Government or a mischief which is detrimental to taxpayers.
11. All discretionary trusts must terminate within 80 years of commencement. At that time, the trust must be wound up, which will almost always result in the sale of assets; or, alternatively, it will result in the transfer of assets to beneficiaries.
12. In either case, CGT Events will occur and CGT liabilities will arise. This will be the case whether the assets have remained in one trust or reside in a number of identical trusts.
13. Just as transfers of assets owned by individuals, upon the death of those individuals, does not amount to a CGT Event, and therefore, to a CGT liability, the death of a controller of a trust does not give rise to a CGT Event or to a CGT liability.
14. However, when the beneficiary of a deceased sells the asset, CGT liability will arise on any gain in the value of the deceased's assets up to the point of sale. Correspondingly, upon the wind-up of the trust, a CGT Event will occur and a CGT liability will arise.
15. As noted, the use of trust splitting or trust cloning when used primarily for succession planning is to bring more certainty to family members in the administration of the trust following the death of the family patriarch or matriarch. In the absence of the ability to split or clone trusts, the trust would still carry on, under a mixture of a Letter of Wishes and with partial or full control by parties external to the family (eg, advisors), but with less certainty for the family. There is nothing in the traditional method or in the splitting of trusts, in the context of succession planning or asset protection, which involves tax avoidance.
16. Considering the exception built in for unit trusts as part of the amendments in Subdivision 126-G of the ITAA 1997, if the difficulty was with doubts in the requirements of meeting the exception in relation to the trusts being the "same", there is no reason why you could not introduce a provision that is simpler in its operation.

17. This will allow private business taxpayers operating in discretionary trusts to meet their commercial objectives as outlined above, without the impediment of significant tax cost – much like they could if they were to be operating in a company or unit trust.

We thank you for the opportunity of providing this submission. If you have any further queries or require clarification on any parts of our submission please do not hesitate to contact the writer.

Yours faithfully

A handwritten signature in black ink, appearing to read 'AM Bailey'.

Adrian Bailey
Cleary Hoare Solicitors