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Dear Sir / Madam

MODERNISING THE TAXATION OF TRUST INCOME

Cleary Hoare Solicitors welcomes the invitation to provide comments and feedback in relation to the Consultation Paper “Modernising the taxation of trust income – options for reform” dated November 2011.

For over twenty years Cleary Hoare Solicitors has specialised in providing legal advice to accountants and their SME clients throughout Australia. Many of these clients either own businesses or investment assets within trusts due to their attractiveness from an asset protection standpoint and taxation flexibility. As such we consider our firm uniquely positioned to provide comments in relation to the Consultation Paper.

Firstly it is our view that the decision in Commissioner of Taxation v. Bamford [2010] HCA 10 did not cover fresh or untested ground, but merely confirmed the existing case law in relation to the treatment of income under Division 6. An application of the law before the decision would have led to the same result. Despite this, it seems popular to interpret the decision as a call for a reform of Division 6.

Whether such reform of Division 6 is necessary or not, the fact remains that reform of Division 6 is being considered and we wish to make comment on that reform.

It is our view that if any reform is undertaken, it is submitted that the patch model described should be sufficient to address the issues raised in the consultation paper in a manner to provide certainty to the taxpayer in relation to the term “income of the trust estate” for tax purposes. It ought to be possible to provide a suitable definition that will align the term with trust law using tax concepts for income, exempt income and non-assessable non-exempt income.

In making that submission, if the patch model is adopted the following comments are made:

1. The “patch” in Division 6 should be as unobtrusive as possible. The temptation to introduce substantial new concepts within the amendments needs to be resisted. Recent experience with the amendments contained in Taxation Laws Amendment Act No.5 of 2011 relating to streaming of franked dividends and capital gains has shown that the introduction of new concepts within the existing Division 6 has led to more

uncertainty and confusion rather than more certainty for taxpayers. Although we understand the time constraints imposed on the drafters of that legislation, it's interpretation could be at best described as confusing and an example of something that does not simplify the operation of Division 6.

2. The use of the patch model will mean the least change for taxpayers utilising trusts and reduce compliance costs to those taxpayers. Most trust deeds that we see contain both an equalisation clause and a re-classification clause as discussed in paragraph 3.3 of the Consultation Paper. If the concept of income of the trust estate for tax purposes is better defined within Division 6 (including notional amounts), further changes should not be necessary for taxpayers due to this change alone.

We make the following further submissions in relation to issues raised in the paper:

3. There is a suggestion in the paper that a reclassification clause within a trust deed can give rise to manipulation by trustees being able to reclassify income as capital. In our view such a reclassification from income to capital would not be possible even if the deed purported to give the trustee power, as income could not be reclassified as capital. The ability to reclassify the "other way" is a necessary requirement as some receipts that would normally be capital for trust law purposes are treated as income by the legislation.
4. Section 99A should be amended so that the tax rate applied is the same as Section 99 – i.e. the trustee taxed as if it were a separate taxpayer. In our view this would result in two simplifications for taxpayers:
 - 4.1 If there is a miscalculation or amount not distributed then the amount of tax levied would be on that amount rather than at the marginal tax rate.
 - 4.2 From a business or investment perspective, this would allow the trustee to accumulate income for working capital purposes without being subject to the marginal tax rate from the first dollar. This would reduce the chances of manipulation as the trustee can accumulate income at lesser rates than those currently imposed by Section 99A for working capital purposes. It is our experience that the vast majority of clients are using corporate beneficiaries because the actual "cash" is simply not within the business – it is either tied up in debt or WIP for example. This is an example of legislators not understanding the nature of small businesses cash flow positions.
5. If Section 99A were amended in this manner, Section 109XA could be adjusted so that payments or loans from a trust referable to accumulated income in the trust be treated in the same way as payments or loans by the trust in respect of which there is an outstanding entitlement to a corporate beneficiary.
6. An amendment should be made to the legislation so that there is a definite amendment period for trustees of four years of the later of the due date or actual lodgement of the tax return.
7. Whatever approach is adopted, the legislation should contain provisions dealing with the extension under the law for trustees to make decisions in relation to distributions of income after the end of the tax year but before the tax return is lodged to avoid the current situation where trustees of trusts operating businesses or holding equity interests in other entities that they do not control are unable to accurately ascertain

what the taxable income of the trust will be. We acknowledge that this may require amendment to some deeds.

Thank you for the opportunity to provide these comments and we are happy to be involved in any other further consultation. If you require any further clarification on the issues raised and our views on them please do not hesitate to contact the writer.

Yours faithfully

A handwritten signature in black ink, appearing to read 'B. Hart', with a stylized flourish at the end.

Brett Hart

Cleary Hoare Solicitors