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9 May 2014

Post-Implementation Review of Division 7A of Part III
of the Income Tax Assessment Act 1936
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email only: taxboard@treasury.gov.au

Dear Sir/Madam

Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936

Cleary Hoare Solicitors welcomes the invitation to provide comment and feedback in relation to the second discussion paper of the post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936*, released for public comment on 25 March 2014.

For over 20 years, Cleary Hoare Solicitors has specialised in providing specialist tax advice to accountants and their SME clients throughout Australia. Division 7A has a direct impact on many, if not all, of these clients. As such, we consider our Firm uniquely placed to provide comments in relation to the discussion paper.

1. First of all, we note that in paragraph 4.12 of the discussion paper that the use of trusts as active trading entities is described as "controversial". This is a disappointing comment for the Board to make in the discussion paper and tends to indicate that there is a bias against trusts, perhaps due to a misguided understanding of why they are used as trading entities, and have been since the early 1970's. Very simply, the commercial reasons for using trusts are:

   1.1 Properly structured trusts can be an extremely effective asset protection mechanism in our increasingly litigious business environment.

   1.2 A trust can have flexibility that a company cannot; this is especially relevant for small businesses as they can often involve the entire family working as an enterprise.

   1.3 Trusts are simple to form and do not require ongoing maintenance costs.

   1.4 Operating within a trust structure is often much simpler than operating within a company for small business. The trustee's roles are outlined within a potentially simple trust deed as compared to a company which requires compliance with the *Corporations Act 2001*. The flexibility as to the distribution of income and capital without the expense of dealing with ASIC is an additional advantage for small businesses which often have smaller margins.

1.5 Banks and other financial institutions are comfortable dealing in trust structures.

2. We now make submissions in relation to some of the Questions raised in the Discussion Paper.

Paragraph 4.16 and 4.17 and Question 4.1 of Appendix B

3. At paragraphs 4.16 and 4.17 of the discussion paper and question 4.1 of Appendix B the paper raises whether business accumulations should be taxed at a company tax rate irrespective of the structure chosen. We submit that this is beyond the scope of the review paper and due to its significant complexity would delay the review process which has been ongoing since 2011. This is in effect a return to the "profits first" rule proposed in the "entity taxation" system floated in 1998 and eventually rejected in 2001 after significant discussion.

4. In fact revisiting the matter was rejected recently by both the Treasurer and then Assistant Treasurer during a press conference held on 19 November 2013 where both stated that they had "scar tissue" from the attempt to tax trusts as Companies in 2000 and 2001. A transcript from that press conference can be found at http://jbh.ministers.treasury.gov.au/transcript/018-2013/?utm_source=TaxVine+2&utm_campaign=54adce6fd5-TaxVine_43_11_7_2013&utm_medium=email&utm_term=0_3c674f2dde-54adce6fd5- .

Question 4.4

5. In question 4.4 the Board sought comments on the proposed formula for calculating the distributable surplus and the exclusion of unrealised gains from this formula. It is our submission that the formula is consistent with the intended operation of the provisions, it would be easy in practice to implement and effectively addresses the potential for double taxation. As such it should be implemented including the exclusion of unrealised gains.

6. In that respect it is important to remember that when initially introduced as Division 7 it was based on permanent transfers of value, much like the current proposal. Unrealised gains were excluded from calculations within the provisions relating to companies. With the later introduction of Division 7A, and in particular Subdivision EA, this intention to exclude unrealised gains was "overlooked" and this position should be rectified.

Question 4.6

7. In relation to deemed dividends question 4.6 asks whether a deemed dividend should be frankable, and if so in what circumstances. It is our submission that where a deemed dividend has arisen this dividend should be fully frankable if the requisite franking credits are available. The net result would be identical to as if the client had taken a dividend rather than an arrangement which ended with the deemed dividend. In many circumstances deemed dividends arise through the shareholder of a family business being not properly acquainted with the operation of Division 7A due to its significant complexity or for reasons outside their control they are unable to meet

minimum interest payments. For reasons for equality amongst taxpayers, they should not be penalised by legislating that the dividend be unfranked. As a practical example to illustrate this, consider the situation where a shareholder has a loan subject to Division 7A where for reasons outside their control they have the inability to repay the said loan. Under the legislation this should and does become a deemed dividend and currently unfranked. However contrast that with a situation where rather than take a loan, they had taken the amount initially by dividend and utilised the franking credits. In the alternative they would at least have access to the franking credits for tax previously paid by the entity and should continue to do so, deemed dividend or not.

Question 6.1

8. At question 6.1 the Board sought comments on whether the proposed terms and conditions for Division 7A loans could be simplified. We submit the following:

8.1 Statutory rate interest should be set at the start of the loan and fixed. This reflects the commercial reality that many loans in the business environment, especially where fixed against real property, are done on a fixed interest basis.

8.2 The statutory rate of interest suggested is the Reserve Bank of Australia's indicator lending rate for small business variable overdraft. Currently for the 2013 year this is 10%. The Board's own research in paragraph 5.31 indicates that an appropriate rate of interest should be set at 9%. It indicates that the RBA indicator lending rate is too high; we submit that the interest rate should be set at the 9% figure indicated by the Board's research.

8.3 The remainder of the suggested terms are reasonable, however the existing compliant 25 year loans should be allowed to continue and protected under legislation consistent with the view proposed elsewhere that the Commissioner's period of review should run from the last milestone payment date rather than being open-ended.

Question 6.2

9. At question 6.2 the Board sought comments on whether it would be a greater simplification to clarify that all unpaid present entitlements are loans for Division 7A purposes. Although this is a simple solution, it is an incorrect interpretation of the law. Our submission is that the correct interpretation on Unpaid Present Entitlements are as follows:

9.1 In relation to the nature of the Unpaid Present Entitlement ("UPE"):

9.1.1 They generally arise out of the appointment of income by the trustee of a discretionary trust in favour of an object of the trust.

9.1.2 The result of the appointment is that a new trust arises (whether or not the trust deed provides for this), the essential features of which are:

9.1.2.1 The trust property is the appointed income.

9.1.2.2 The beneficiary is the income beneficiary.

9.1.2.3 The trustee is the trustee of the "appointing trust".

9.1.3 Under this new trust, the trustee is under a fiduciary obligation to hold the trust property (the money) for the benefit of the income beneficiary.

9.1.4 Equity treats the beneficiary as the owner of the money.

9.2 There is an important distinction in that being the owner is different from being a creditor.

9.2.1 It is often commercially important to distinguish between these two concepts, eg, for the purposes of:

9.2.1.1 The relevant statutes of limitations.

9.2.1.2 The insolvency of the "appointing trustee".

9.3 Statutes of Limitation:

9.3.1 These are intended to set time limits within which aggrieved persons can sue to enforce their rights.

9.3.2 They operate against rights in personam, eg, choses in action.

9.3.3 They do not extinguish ownership.

9.3.4 It follows from this and the nature of a UPE that the statutes of limitation cannot extinguish the rights of the unpaid beneficiary in respect of a UPE, given that equity treats the beneficiary as owning the property the subject of the appointment, ie, the money.

9.3.5 This is obviously different from the position of a creditor, who can be restrained, under the statute of limitations, from suing.

9.4 Insolvency of the Trustee:

9.4.1 An unpaid beneficiary is not confined to proving as an unsecured creditor.

9.4.2 The unpaid beneficiary is entitled to "ownership" of the "New Trust Property", ie, the amount of the income appointed by the trustee of the main trust in favour of the beneficiary.

9.4.3 Pursuit of these ownership rights involves the principles of tracing.

9.4.4 Whilst some of the text books refer to tracing as having some "common law history", it is generally accepted that its foundations reside principally in equity.

9.4.5 The principles of tracing recognise that the beneficiary is the owner of the property – in this case, the money representing the income appointed by the trustee of the discretionary trust which becomes the trust property of the New Trust.

9.4.6 Tracing enables the beneficiary to trace that money into property in which it has been converted – as if the beneficiary actually owns the converted property or part of it.

9.4.7 The trust fund of the New Trust (the money representing the UPE) has been converted, generally, into part of the "Main Trust Fund".

9.4.8 This conversion arises from the mixing of the two Trust Funds, namely, those of the "appointing trust" and the "New Trust".

9.4.9 In the context of tracing, it does not matter whether this mixing occurs permissibly (pursuant to a power in the trust deed) or impermissibly (in the absence of a power in the trust deed: in the absence of such a power, the duty of the trustee is not to mix funds).

9.4.10 Whilst the principles of tracing are complex, equity will generally recognise that the beneficiaries of all trusts have an interest in the Mixed Fund, proportionate to their contributions.

9.4.11 If, for example, the amount of the appointed income was $100,000.00, and the amount of the trust fund of the "main trust", including the appointed income was $1,000,000.00, then equity will normally treat the beneficiary of the New Trust (the income beneficiary) as having a 10% interest in the Main Trust Fund, ie, the Mixed Fund.

9.4.12 The very existence of the right of tracing, however complex it may be, arises out of ownership of the relevant property recognised in equity.

9.4.13 It does not arise out of a creditor/debtor relationship.

9.4.14 The property in question is the money represented by the appointment of income (the unpaid present entitlement) which has been mixed with the Trust Fund of the Appointing Trust.

9.4.15 Delay by the beneficiary in enforcing its rights in respect of the UPE does not equal:

9.4.15.1 The relinquishment of ownership; or

9.4.15.2 A change in the relationship from that of owner to that of creditor/debtor.

9.4.16 A change in relationship, in relation to the UPE, from one of owner to that of creditor would require the "getting in" of the Trust Fund of the New Trust (the appointed income) and then "dealing" with it, eg, by way of making a loan to the "appointing trust".

9.4.17 Alternatively, it would normally require documentation documenting the "getting in" and the "lending" as if those events had occurred.

Question 6.3

10. At question 6.3 the Board sought comments in relation to the proposed limited exception for the retaining of working capital for carrying on of the business in a trust.

Whilst we agree with the idea of an exemption period we make the following submission:

10.1 Any existing arrangement should remain in force unless an election is specifically made.

10.2 Any asset that meets the definition of an "active asset" for small business concession process should have access to the discount capital gain, rather than just allowing it for goodwill. "Active asset" should not be contingent on whether the taxpayer meets the small business concession requirements but based on the definition of active asset within the legislation. This change will reduce the chances of arbitrage on goodwill values and also restrict the discount capital gain to active business assets rather than passive assets which encourages businesses to invest in productive assets.

10.3 We further submit that there should be the ability for the taxpayer to revoking the election should circumstances change and the trust be able to cash flow any unpaid present entitlements to corporate beneficiaries in the later years.

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

Yours faithfully

Brett Hart
Cleary Hoare Solicitors