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Our Ref: AMB

23 May 2014

Review of Tax Impediments to Small Business
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

By Email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of Tax Impediments to Small Business

We refer to the current review of Tax Impediments to Small Business being conducted by Treasury and the opportunity to provide submissions on issues that are currently hindering small business to meet their commercial objectives.

For over 20 years, Cleary Hoare Solicitors has specialised in providing specialist tax advice to accountants and their small business clients throughout Australia. As such, we consider our Firm uniquely placed to provide comments in relation to the tax impediments facing small business.

Our submission will only concentrate on one facet, but as stated in our previous letter of 14 April 2014 to the Board of Taxation offering our services to assist with the consultation process, we are more than happy to assist in any aspect of the consultation process.

The 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 effect of the exception is similar to demerger relief available to companies:

   4.1 Demerger relief allows an asset of a company group held in a subsidiary to be split off out of the company group to the ultimate owners (shareholders in the head entity) with those owners having the same rights in the subsidiary with the same kind of interest (company shares or trust interest), the same proportion of interests in the subsidiary and the same proportionate market value of ownership interests;

   4.2 Similarly, the trust exception allowed assets of a trust to be split off into a separate trust to be held under the same trust arrangements for the beneficiaries (ultimate owners) of the original trust having the same rights.

5. 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).

6. The fact that this exception has been removed means significant tax cost to small 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.

7. 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.

8. 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.

9. In terms of succession planning:

   9.1 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.

   9.2 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.

   9.3 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.*

9.4 Obviously, the person who controls a discretionary trust determines who gets the benefit of the trust assets.

9.5 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.

10. Developments leading to the removal of the exception:

10.1 The ATO, initially, appeared comfortable with the operation of the exception.

10.2 The ATO then started making announcements about some of the difficulties that might emerge in demonstrating that the two trusts were identical.

10.3 It has also become the practice for advisors to seek private rulings as to the identicality of the trusts. This seems to have caused an increased workload for the ATO, with extended delays in provision of the rulings.

10.4 In 2008, in Adelaide, at the National Conference of the Taxation Institute of Australia, the then Second Commissioner, Mr Bruce Quigley, stated that:

10.4.1 The intended effect of the provisions was to simply allow a change of trustee without effecting a CGT Event.

10.4.2 Nonetheless, the ATO accepted that the wording was wider than that.

10.5 Mr Quigley was wrong when he said that the intention of the provisions was to simply allow a change of trustees without a CGT Event occurring: that provision already existed (Subsection 160M(1A)), and, further, the purpose of the provisions was to recognise the continuance of the law as it previously was, namely, that the creation of a trust over an asset, or the vesting of an asset into a trust, will not be a CGT Event (previously a CGT disposal) where there is no change in beneficial ownership, but with some limitations. A change of trustee is only one example of an event which does not lead to a change in beneficial ownership.

10.6 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!

11. 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.

12. *In this case, there is no mischief to address: only a difficulty in application of the provision by the ATO (administrative difficulty, at worst) and, as noted, a failure of the ATO to understand the history and purpose of the provisions.*

13. 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.

14. 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.*

15. 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.

16. 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.

17. Further, on death of an individual owner, a pre-CGT asset becomes a post-CGT asset in the hands of the beneficiary. Similarly, a pre-CGT asset in a trust, when passed to a beneficiary, becomes a post-CGT asset in the hands of a beneficiary. More to the point, as the years progress, there are fewer pre-CGT assets to be considered.

18. *Put simply, there is no mischief in these processes.*

19. 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.*

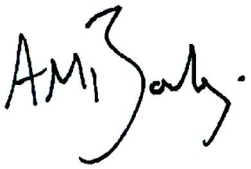
20. Considering the exception built in for unit trusts as part of the amendments in Subdivision 126-G of the ITAA 1997, if the difficulty was with doubts in the requirements of meeting the exception in relation to the trusts being the "same", there is no reason why you could not introduce a provision that is simpler in its operation.

21. We suggest that one option is a provision that provides for the exception where the beneficiaries of each trust are the same and, to borrow from the demerger provisions, have equivalent rights namely the same type of interest (discretionary, unit or fixed interest), same percentage entitlement to distributions of income and capital and voting power (if relevant) and same proportionate market value.

22. This will allow small 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 would be pleased if you would give this submission full consideration.

Yours faithfully



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