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The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir

Post Implementation Review of Division 7A

We welcome the opportunity to make a submission in relation to the second discussion paper released by the Board of Taxation in respect of the post implementation review of Division 7A of the *Income Tax Assessment Act 1936*.

We comment in relation to the treatment of UPEs and the 'tick the box option'.

Treatment of UPEs – problems with current rules (Q6.2)

With appropriate transitional rules, legislative amendment to include unpaid present entitlements (UPEs) as loans for Division 7A purposes would provide greater certainty.

Whilst legislative inclusion would, on balance, provide greater simplification for the majority of private structures, this will not be the case for those structures with UPEs that are not currently subject to the application of *Taxation Ruling* TR 2010/3. For example, the type of scenario articulated in *Interpretive Decision* ID 2012/74 would become subject to greater complexity following the broad application of Division 7A to UPEs owing to private companies.

The commencement date of a legislative amendment should recognise that there remain various structures with UPEs to which TR 2010/3 does not currently apply. It should also preserve the position of TR 2010/3 by grandfathering UPEs arising prior to 16 December 2009.

Exclusion – Loans to trusts (Tick the box option) (Q6.3)

With appropriate transitional rules, the 'tick the box option' would be effective in addressing issues associated with retaining working capital for carrying on a business in a trust.

Our remaining comments consider certain aspects of the design of a 'tick the box option'.

CGT discount and identifiable intangibles

The proposed limited exception would operate by way of trade off, whereby the trust is able to access the corporate tax rate and in return it would forgo the CGT discount on capital gains arising from assets other than goodwill.

The CGT discount should also be preserved for identifiable intangibles subject to CGT (such as trade marks) that are inherently connected with the business and to which a separate value is not usually attributed on the sale of private businesses.

It should be noted that the restriction of the CGT discount to goodwill and not other intangibles would result in a significant increase in the compliance costs on the sale of many private businesses. This is because CGT assets such as trade marks will usually attract the same CGT treatment as goodwill (e.g. if both are held for more than 12 months) thus alleviating the need to attribute sale proceeds separately to those intangibles. Separate values are usually therefore only required for assets dealt with outside the CGT provisions, such as patents and copyrights, which are less common in many small to medium private businesses.

The valuation process of intangibles, such as trademarks, usually relies upon more sophisticated valuation procedures, such as a return to royalties method. To impose such onerous valuation requirements on private businesses will result in a significant and unnecessary increase in compliance costs.

The retention of the CGT discount on goodwill and identifiable intangibles is important to ensure a trust structure is not disadvantaged compared to those operating through company structures that could benefit from the CGT discount through a share sale.

Importantly, it should be noted that many larger private businesses operating through trust structures find themselves unable to corporatise due to significant cost impediments, such as state transfer duties and the business disruption caused by a change of legal identity. Consequently, those businesses find themselves effectively locked-in to a trust structure and should therefore not be disadvantaged on eventual sale by forgoing the CGT discount that could be available to shareholders of a company.

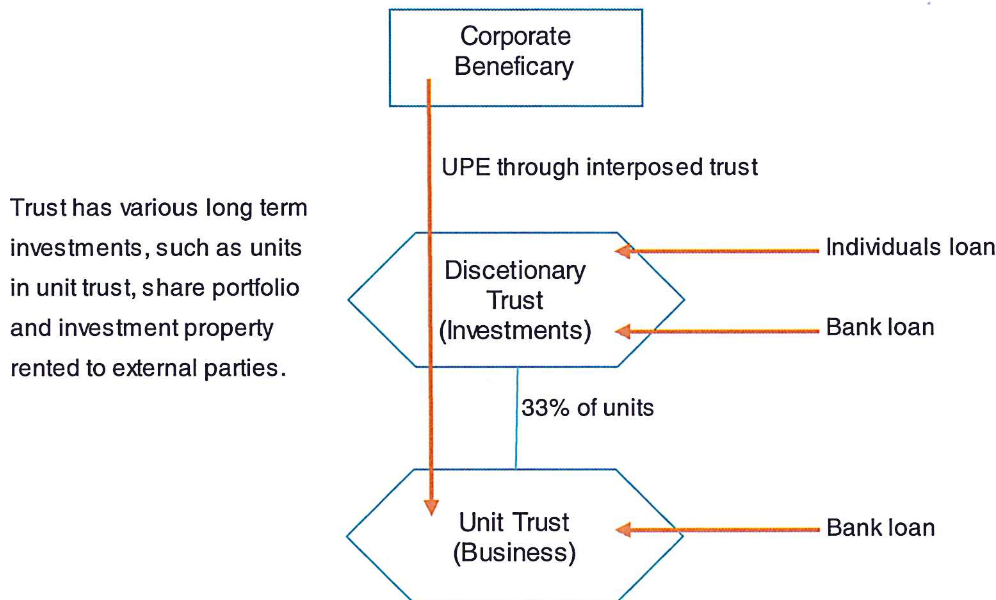
CGT discount for shares in a company and units in a unit trust

It is assumed that when paragraph 6.38 of the discussion paper refers to “shares in a business” it is referring to shares in a company that runs a business. On this basis, it is appropriate to ensure that trusts that have chosen the limited exception are able to continue to access the CGT discount in respect of that part of the share value representing the goodwill (and other intangibles)

Additionally, this same treatment should be extended to the sale of units in a unit trust that carries on a business.

Transitional rules for trusts choosing the limited exception (interposed entities)

The following illustration depicts a common structure where a business is conducted by a unit trust and the business is reliant on reinvesting profits at the corporate tax rate for working capital in order to remain competitive:



In the above diagram, the arrows show the sources of finance for the unit trust (business) and discretionary trust (passive investment). The discretionary trust is the entity used to accumulate all passive investments for a family. One such asset is units in a unit trust in which it holds 1/3rd of the units and other family groups hold the remaining interests.

Applying the limited exception to this case, it would be necessary for both trusts to 'tick the box' in order for the unit trust to have continued access to the UPE amount for working capital purposes.

However, this illustration highlights that it would not be an appropriate outcome for the discretionary trust to no longer have access to the CGT discount on investments funded primarily from loans from individuals and bank borrowings. This is especially the case where the structure and all those investments were established prior to 16 December 2009.

Therefore, existing assets held by trusts choosing the limited exception should continue to be eligible for the CGT discount. This allows private groups to make informed structuring decisions for future investments (i.e. they could use another trust without a UPE owing to a company) whilst preserving the appropriate outcome for existing investments.

Should the Board determine that there may be integrity concerns with allowing trusts to defer 'ticking the box' until shortly after buying new assets, thereby gaining unintended access to the CGT discount, it is suggested that a fixed commencement date apply to all trusts. This would be consistent with allowing taxpayers to make informed decisions for new investments whilst

preserving the CGT discount for existing investments. Such a date should be a future date or if it is to be a retrospective date, certainly not before 16 December 2009.

Ability to revoke choice

Given the life of a trust may span multiple generations of a family, it is submitted that it may be possible to establish a basis upon which a choice could be revoked without compromising the integrity of the trade off (i.e. access to company tax rate and loss of CGT discount).

This may be, for example, on commencement of a new tax year, where at the end of the prior year all loans from a private company (including UPEs as deemed loans) have been fully extinguished.

In that case, the trust could be eligible to revoke the choice and as a result:

- the CGT discount could apply on assets acquired prior to originally making the choice (or a fixed commencement date) as well as assets acquired after revoking the choice.

- the CGT discount would not apply to assets (other than goodwill and intangibles) acquired after making the choice (or the fixed commencement date) and before revoking the choice.

This would then allow family groups to continue to use a pre existing trust for future investments after use of a corporate beneficiary has concluded. The historical tracking of choices made and revoked could be administered in a similar way to family trust elections and interposed entity elections, by way of disclosure on the cover of trust tax returns.

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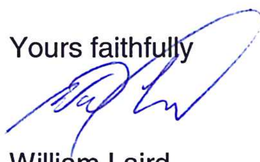
Should you wish to discuss any of the above comments, please do not hesitate to contact me on 07 4639 5067.

Yours faithfully



William Laird
Principal