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Ref: JB/JM/RP/cmb

28 April 2010

Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email: economics.sen@aph.gov.au

Dear Sir/Ms

Supplementary Submission on Tax Laws Amendment (2010 Measures No. 2) Bill 2010 ("the Bill")

Thank you for inviting Peter Riley from this firm to make an appearance before the Senate Economics Committee on 29 April 2010.

Further to our submission on the Bill dated 16 April 2010, we would like to make a supplementary submission with an additional comment on the disconnect between Schedule 1 of the Bill and TR 2009/D8 ("the draft Ruling").

Disconnect between Schedule 1 of the Bill and the draft Ruling

As we pointed out in our initial submission, if the ATO interpretation of unpaid present entitlements ("UPEs") in the draft Ruling is correct, Subdivision EA will have negligible operation and there is no need for the amendments in the Bill.

In this supplementary submission we would like to state our view that:

- on a thorough analysis of the introduction of Division 7A;
- the introduction of section 109UB;
- that provision's subsequent replacement by Subdivision EA; and
- the proposed amendments in the Bill,

it is clear that Division 7A proceeds on the basis that a UPE is not a loan as defined.

We also believe that treating a UPE as a loan would be wrong from a policy perspective. In particular, it would often place a trust with a corporate beneficiary in a worse position than if a business/investment had simply been conducted in a corporate form.

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For example:

Trust A conducts a trading business and, as is often the case with tax payers in the middle market, has a corporate beneficiary ("Company A"). The profits from the business conducted by Trust A are taxed at an average tax rate of 30% - i.e. in the hands of the individual beneficiaries of Trust A and Company A.

Company B is a direct competitor of Trust A - its profits are also taxed at an average rate of 30%.

Both Trust A and Company B are using the cash generated by their business operations as working capital to expand their operations. Accordingly, Company B does not pay dividends and Trust A has left the present entitlement due to Company A unpaid - i.e. in both cases all that has happened is that the maximum possible cash is retained for business use. (We note that this type of arrangement is common amongst our target client base and that the decision to use a trust rather than a company to conduct a business is generally driven by asset protection, business succession and/or estate planning reasons).

If the UPE between Trust A and Company A is regarded as a loan from Company A under Division 7A however, then in order to avoid a deemed dividend being received by Trust A this (deemed) loan will either need to be placed on complying Division 7A loan terms or 'repaid' before Company A's tax return is lodged - i.e. something that is legally not a loan will either (somehow) have to be legally converted into a loan, so that there is actually a loan which can comply with section 109N, or Trust A will (somehow) have to find the funds to repay this 'loan'.

Given that:

(a) both the Trust A/Company A 'group' and Company B are (validly) retaining the maximum possible cash for use in their businesses; and
(b) exactly the same amount of tax is currently payable in both the Trust A/Company A 'group' and Company B scenarios,

we are at a loss to understand what tax 'mischief' (and thus, policy) objective will be achieved by forcing the former to have to 'jump through a number of purely compliance - i.e. non-commercial - hoops' in order to avoid Division 7A applying.

We thus submit that in order to avoid (further) unintended consquences either

(i) a legislative amendment is required to section 109D of the 1936 Tax Act to make it clear that a UPE is not a loan as defined in that section; or
(ii) a reduction is made to the tax rate that applies where a trust accumulates income.

(i) Legislative amendment to section 109D

This amendment, which should have retrospective effect to the commencement of Division 7A, can easily and simply be done by adding two Notes to the end of Section 109D. For example:

> *Note 1: A present entitlement from a trust to an entity, regardless of the length of time that it is unpaid, is not a loan for the purposes of this Division.*
>
> *Note 2: A present entitlement from a trust to an entity can only be converted into a loan for the purposes of this Division by a formal written agreement between the trust and the entity which: (a) evidences the terms of the loan; and (b) is signed by all of the parties to that loan.*

(ii) Reduction in the tax rate that applies if a trust accumulates income

At the current moment the trustee of a trust that accumulates income - i.e. where there is trust income to which no beneficiary is presently entitled - is taxed at 46.5% (unless some extremely limited circumstances exist). To circumvent this "punitive" tax rate our clients have, as can be seen from the example provided earlier in this supplementary submission, invariably used corporate beneficiaries to allow the funds retained in their trusts to bear tax at the corporate tax rate of 30%. That is, at the same rate as if the clients had actually used companies to conduct the businesses.

If the tax rate that applies to income accumulated in a trust is reduced to 30% there will be little, if any, need for trusts to use corporate beneficiaries and the complex Division 7A rules that apply to trusts with UPEs to corporate beneficiaries will <u>not</u> need to be complied with.

Given the widespread use of corporate beneficiaries by taxpayers in the middle market we do not believe that there will be any loss to the revenue if the section 99A tax rate is reduced - i.e. tax that would have been paid at 30% in the hands of corporate beneficiaries will just be paid at 30% by trustees.

Further information

Please do not hesitate to contact either the writer (on 03 8610 5110), Jacci Mandersloot (on 03 8610 5431) or Richard Pegg (on 03 8610 5359) should you require any clarification of our comments.

Yours faithfully
PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

JOHN BRAZZALE
Executive Director