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Mr J. Hawkins
The Secretary
Senate Standing Committee on Economics
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Mr Hawkins

Inquiry into Tax Laws Amendment (2008 Measures No.4) Bill 2008
Family Trust Election (FTE) Rules

We refer to your correspondence dated 1 July 2008 inviting submissions for the inquiry into Tax Laws Amendment (2008 Measures No.4) Bill 2008 (the Bill) concerning, amongst other things, the proposed repeal of certain changes introduced by the former government to the family trust election (FTE) rules contained in Tax Laws Amendment (2007 Measures No. 4) Act 2007.

CPA Australia represents the diverse interests of more than 117,000 finance, accounting and business advisers. We are committed to working with governments and their agencies to ensure current and future economic and social policies foster an environment that facilitates sustainable economic growth.

We commend the Federal Government for its decision to allow the test individual of a family trust to be varied for the 2007-08 tax year as a transitional amendment, and for deferring the requirement that the test individual be the person specified in the original FTE until the 2008-09 tax year. We believe that this is a significantly more equitable outcome than the measure originally announced in the 2008-2009 Federal Budget which required family trusts to retrospectively revert back to the test individual under the original FTE from the 2007-2008 tax year.

We also acknowledge that the Government had earlier determined to retain a number of technical improvements to the FTE provisions amended in Tax Laws Amendment (2007 Measures No. 4) Act 2007 which were the subject of our earlier correspondence to the Assistant Treasurer.

Nonetheless we remain concerned with the proposed repeal of the provisions allowing the variation of a test individual (albeit in very limited circumstances) and extending the lineal descendants of a family group beyond two generations.

CPA Australia believes that the introduction of these measures addressed various anomalies arising from the operation of the FTE rules, and that neither of these amendments should be repealed as currently proposed under the Bill.

We note that the most recent publicly available statistics *(Taxation Statistics -2005/06)* disclose that there were at least 427,532 discretionary trusts who lodged income tax returns in the year ended 30 June 2006, and that many of these trusts will be adversely impacted by the repeal of the above amendments.

We are particularly concerned with the proposal that from 1 July 2008 the definition of a family's lineal descendants be effectively capped to the grandchildren of the test individual or that individual's spouse. In our view such a limitation effectively amounts to a de facto inheritance tax, adds significant complexity to the tax law and is wholly inconsistent with trust law, commercial practice and the objective of reducing the compliance burden on taxpayers.

The repeal of these provisions will produce some inappropriate outcomes. For example, assuming each generation of a family outlives the previous generation, once the test individual's grandchildren die, any distribution of income or capital by the trustee will attract Family Trust Distribution Tax at 46.5%. This would be the case irrespective of whether the distribution represented:

- Accumulated income that has already suffered tax at 46.5% in the hands of the trustee (resulting in an effective tax rate of 71.4%);
- A gain on sale of an asset acquired pre-CGT (which would otherwise be tax-free);
- A gain on sale of an asset acquired post-CGT (which would otherwise be taxed at a maximum rate of 23.25%); or
- A distribution of ordinary income that would otherwise be subject to tax at the beneficiary's marginal rate of tax.

In all cases the distribution would be to existing or future generations of the family of the test individual, being beneficiaries who qualify as such in accordance with the usual terms and duration of family discretionary trusts.

Moreover, the limited definition of a 'family group' was originally introduced as part of the trust loss recoupment rules but was later inappropriately applied as an anti-dividend streaming measure under the dividend imputation provisions. In our view, it is inequitable that franking imputation credits can only be distributed to a limited range of beneficiaries and not other lineal descendants such as great-grandchildren which may become objects of the discretionary trust over its normal lifespan.

Further support for the retention of both of the above amendments is set out in the accompanying attachment.

Finally, we reiterate our earlier contention that the amendments legislated in 2007 only partly rectified inequities associated with the FTE provisions, and that further amendments are required to ensure that various anomalies and compliance costs can both be appropriately reduced.

Should you have any questions on the above, please do not hesitate to contact Mark Morris on (03) 9606 9860.

Yours sincerely

Geoff Rankin FCPA
Chief Executive Officer

Enc

Specific comments on the proposed repeal of recent changes to the family trust election (FTE) rules

Overview

Various technical amendments were made to the FTE rules in Tax Laws Amendment (2007 Measures No.4) Act 2007 (the Act).

Following consultation with the Government it is currently proposed that the two of the above amendments will be repealed effective from the 2008-2009 year being:

- the ability to make a one off variation to the test individual specified in the original FTE subject to certain conditions being satisfied; and
- the extension of the definition of a family group to include any lineal descendant of a nephew, niece or child of the test individual or a test individual's spouse.

CPA Australia believes that the above measures should be retained to address some of the long standing inequities associated with the application of the FTE rules. Whilst we should emphasise that these changes only rectified certain anomalies, we believe they should be retained to ameliorate anomalous outcomes and reduce compliance costs.

Further arguments in support of the retention of these measures are set out below.

Variation of the test individual specified in a FTE

A key amendment arising under the above Act was to permit the test individual in a FTE to be varied, on a once only basis, where the new test individual was a member of the original test individual's family, subject to the condition that no conferrals of present entitlement to (or distributions of) income or capital of the trust (or an interposed entity) have been previously made outside the new test individual's family group. In broad terms, this means that a new test individual could be substituted for a previous test individual provided that the relevant trust would have retrospectively complied with the substitution.

One of the issues that was raised with the previous government in this context was the view of the Commissioner of Taxation that the test individual cannot be a deceased person. This means that when a test individual dies, any new trust established by the relevant family which is required to make a FTE or an Interposed Entity Election (IEE) would have to nominate another person as the test individual. In turn, this would mean that a range of ordinary dealings between the two trusts which act for the benefit of the same family would be at risk of incurring penal Family Trust Distribution Tax (FTDT).

As detailed in earlier submissions to the previous Government, considerable complexity arises where an inappropriate person is selected as the test individual by family businesses especially from an estate planning and succession perspective. Accordingly, we believe that families should be saved some of the severe consequences which can arise from nominating the wrong family member as the test individual.

The above change introduced in response to these submissions was sensible, modest and entirely appropriate. The ability to vary the test individual can only be done once and there is a further limiting safeguard in the requirement that the trust must have effectively observed this variation retrospectively.

We therefore cannot see how the Government's revenue or policy interests are served by repealing this amendment.

Broadening the definition of 'family' to include lineal descendants

The above Act also expanded the definition of family group to include any lineal descendant of a nephew, niece or child of the test individual or the test individual's spouse.

This amendment was an extremely important one for the small business community in order to remove an imposing and arbitrary intergenerational restriction on trusts that have made a FTE.

It is difficult to see a policy justification for placing a generational limit on trusts that have made a FTE. Most trusts typically have a life span of 80 years, which will commonly span four generations. In our view there is no compelling reason why two generations should be sliced off the normal lifespan of a trust. Indeed, this

limitation has always seemed to be the most perverse and inequitable penalty for discretionary trusts that merely sought to claim tax losses or bad debts, or to pass on the benefit of franking credits to their beneficiaries.

The inclusion of the lineal descendant rule assisted affected taxpayers to resolve one of the major difficulties with the FTE and IEE process, which is to nominate the most appropriate person having regard to issues of equity between generations, without unduly limiting the lifespan of the trust.

Prior to the above amendment, the definition of a 'family group' stopped at the grandchildren of the test individual and at the children of the siblings of the test individual (i.e. nephews and nieces). Consider the dilemma of applying this test where there is an existing family with living (elderly) parents, children and grandchildren. If one of the parents is nominated as the test individual, the lifespan of the trust will be limited to the lifespan of the grandchildren (if FTDT is to be avoided). Alternatively, If one of the children is nominated, the lifespan of the trust may be longer (on the assumption that children generally outlive parents), but the descendants of their siblings will be disadvantaged since only one generation beyond the sibling can benefit from the trust without incurring FTDT.

We fail to see any policy basis for the previous restrictions on the definition of 'family' and strongly argue that the amendment extending the range of lineal descendants be retained.

We also note that the removal of this provision would also unduly penalise a considerable number of taxpayers who have set up structures (and selected test individuals) over the past year on the basis that the new lineal descendant rule would apply in the future. In these circumstances the reversal of this rule will be highly inequitable especially for family businesses which have incurred significant costs complying with the amended provisions.

Conclusion

To conclude, CPA Australia believes that the above amendments are important and necessary changes to the law to rectify former inequities and remove unduly burdensome restrictions and compliance obligations imposed on SME taxpayers. These amendments fall short of those which we believe are appropriate, but nonetheless, they are of significant benefit to many small business taxpayers and we strongly support their retention.