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STANDING COMMITTEE ON ECONOMICS

Reference: Tax Laws Amendment (2008 Measures No. 4) Bill 2008

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**SENATE STANDING COMMITTEE ON
ECONOMICS**

Tuesday, 12 August 2008

Members: Senator Hurley (*Chair*), Senator Eggleston (*Deputy Chair*) and Senators Bushby, Cameron, Furner, Joyce and Pratt

Participating members: Senators Abetz, Adams, Arbib, Barnett, Bernardi, Bilyk, Birmingham, Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Bushby, Cash, Colbeck, Collins, Coonan, Cormann, Crossin, Ellison, Farrell, Feeney, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Hanson-Young, Hefernan, Hogg, Humphries, Hutchins, Johnston, Joyce, Kroger, Ludlam, Lundy, Ian Macdonald, Marshall, Mason, McEwen, McGauran, McLucas, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood, Williams, Wortley and Xenophon

Senators in attendance: Senators Bushby, Cameron, Furner, Hurley, Joyce and Pratt

Terms of reference for the inquiry:

To inquire into and report on: Tax Laws Amendment (2008 Measures No. 4) Bill 2008

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Committee met at 1.02 pm

CHAIR—I declare open this meeting of the inquiry of the Senate Standing Committee on Economics into the [Tax Laws Amendment \(2008 Measures No. 4\) Bill 2008](#) Tax Laws Amendment (2008 Measures No. 4) Bill 2008. The bill was introduced into the House of Representatives on 26 June 2008 and is due for a report by 27 August. The bill has three schedules. Schedule 1 of the bill provides relief from the capital gains tax for private health insurance policy holders when their insurer demutualises and converts to a for-profit insurer. Schedule 2 amends the definition of ‘family’ in the family trust election rules to limit lineal descendants to children or grandchildren of the test individual or the spouse of the test individual. It also prevents family trusts from making a once-off variation to the test individual specified in a family trust election. Schedule 3 implements various minor amendments to the law, correcting terminology and grammatical or punctuation errors. This hearing will focus on the amendments in schedule 2 relating to family trust election rules.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may, of course, also be made at any other time.

[1.04 pm]

BROWN, Mr Colin, Acting General Manager, Tax Analysis Division, Treasury

CICCHINI, Mr Raphael, Manager Trusts, Business Tax Division, Treasury

McMAHON, Mr Paul, Manager, Capital Gains Tax Unit, Treasury

CHAIR—Welcome. Do you wish to make any opening comments?

Mr Cicchini—I am here to answer questions on the family trust election changes.

CHAIR—Could you run through for me examples of the test individual and where they might want to vary the status of the trust?

Mr Cicchini—I will just make a couple of comments. The trust loss rules in schedule 2F of the Income Tax Assessment Act 1936 are primarily there to prevent the tax benefits arising from the recoupment of trust losses being passed to beneficiaries that did not bear the economic loss or the bad debt when it was incurred. It does this basically by tracing through the underlying ownership. Many family trusts are discretionary trusts, which means that the beneficiaries may not have a fixed interest, so it will be difficult to trace through their economic ownership in the trust. Therefore, in many cases, they would not be able to meet the standard rules for determining whether they can carry forward and utilise a loss to reduce income tax in later years.

As part of that background, in recognition of that, the rules within schedule 2F provide a special concession to family trusts. That is, if you make an election and specify a test individual, you may carry forward your losses and utilise them without meeting the other rules. Provided that you only distribute to family members or members within the family group, you are not subject to family trust distribution tax, which is charged at the top marginal tax rate, plus the Medicare levy, of 46.5 per cent. So, in essence, this is a concession within the tax law to family trusts. The previous government made amendments in 2007 that varied the operation of those rules and made them more concessional. It allowed various things to happen. This government has reversed two of those measures, one applying, in effect, with a transitional rule.

You have asked when it might affect people. The answer is that the rules currently provide for variations, and they can only be made in two circumstances. One is where there is a family breakdown and the control of the trust changes to the spouse; in that case, they can make a variation. The other rule was, if you met certain conditions, you could change the test individual once, and only once, going forward. Those conditions were about who you had distributed to previously. So to meet the conditions you had to only distribute or confer present entitlement to people who would have been in the family group, had that person always been the test individual. So, in a sense, because the law required you to make the variation with your trust return or within two months at the end of the income year, in theory, no-one should have been able to make that variation for the 2007-08 year. However, these amendments do allow trusts to do that but for the variation to the test individual to only apply for that year.

CHAIR—I think I get that. In terms of restricting the number of generations, do you know how many trusts currently that is going to apply to?

Mr Cicchini—In terms of the restriction, the previous amendments extended the definition of ‘family’ to include lineal descendants. So the previous definition essentially was the test individual, their parent; the test individual, their child; the test individual’s child of a child, so their grandchildren; and a test individual’s brother or sister and their child. The extensions were about lineal descendants of those people. The new definition removes lineal descendants below that level, so it reverts back to the previous definition. In terms of the possible number of trusts that it could affect, we understand that there are in the order of 185,000 to 200,000 trusts that have made family trust elections over the period since the measures were introduced, which I think was around 1998. That means trusts that are potentially affected; that does not mean that all will be affected.

CHAIR—I guess that was my next question. You would not necessarily know, unless you were privy to the—

Mr Cicchini—They are discretionary trusts. Chances are that they do not necessarily have named beneficiaries; they might just say ‘X family’, ‘the family of X’ or ‘the children and the children of X family’. This measure reverses the previous measure.

CHAIR—In that time there was time for 185,000 trusts?

Mr Cicchini—No. The point is that from when the trust loss rules were introduced, around 1997 to 1998, up until now around 200,000 family trust elections have been made.

CHAIR—Do you know how many of them will be affected by this legislation?

Mr Cicchini—No. That information would not be available.

CHAIR—Are you aware of any groups of people who form family trusts—for example, in rural areas or among particularly wealthy individuals? Can you discern a trend?

Mr Cicchini—I do not have available the sort of information that would be required to make that judgement. But I understand that there are in the area of the rural communities. It would mainly be in the farming sector, where the land may be held separately to the business. Certainly, if you are a high-wealth individual you may seek to utilise a trust. But it would not necessarily be because you are high-wealth individual; it might be because you want to segregate and control your assets in succession planning. But I do not have any statistics with me; they would be with the tax office.

CHAIR—I have some follow-up questions, but I might see what Senator Joyce has to say.

Senator JOYCE—As you know—but for the purpose of the *Hansard*—the strength of the trust is that in legal proceedings you cannot find to the detriment of a third party; therefore, it becomes an asset protection mechanism by reason of certain assets such as family properties and rural properties. Basically, the person who lives on them has a right to earn income, but the essence or the nature of it is that there is a belief in families that, if you sell the family farm, it is a curse that you take to your grave. In fact, it is an insult that people use against someone: he or she sold the family farm. So the essence of ownership is, by custom and practice, different with these family properties. With the change now in the structure of lineal descendants so that we now have the antecedent of the person and then two levels of progenitors before it becomes wiped out, does this bring in capital gains tax implications for property that is held in that trust?

Mr Cicchini—Firstly, these rules only apply to a family trust that makes a family trust election. Not all trusts are required to make family trust elections. Some trusts may be fixed trusts, so there may not be a need. These amendments extended the definition of ‘family’ for a very short period—effectively for only one year. That definition will remain for any payments or distributions that are made in that year only. I do not think the amendments themselves directly go to the heart of the capital gains tax regime. My colleague Paul McMahon can talk more about that.

Senator JOYCE—I will be a bit more specific. Are you ruling out any effects on possible capital gains tax consequences by the changes in this Tax Laws Amendment (2008 Measures No. 4) Bill 2008?

Mr Cicchini—I think it is fair to say that if the previous government’s legislation had effects these might reverse that, but certainly none of it was built into the budget estimates for the next three- to four-year period.

Senator JOYCE—So, with the reversal of those effects of what would be the capital gains tax exemptions brought through by the 1998 act, have you modelled the revenue impact on Treasury by widening the net of capital gains tax?

Mr Cicchini—I think it is fair to say that there is no exemption. Is that right Paul? I will ask Mr McMahon to deal with the CGT aspects.

Mr McMahon—Could you just rephrase your question, please?

Senator JOYCE—I want to know whether, with the tax laws amendment No. 4 bill, there will be an increase in the capital gains tax take for Treasury.

Mr McMahon—I would think not. Although I do not fully understand the family trust aspects of this bill, it would seem that, if you were just changing the beneficiaries, unless that constitutes a resettlement of the trust—

Senator JOYCE—A deemed transfer or whatever.

Mr McMahon—Or a deemed transfer. It should not be an issue. Really, the legal ownership here rests with the trustee of the trust and there should not be a change in legal ownership at that point. Essentially, as long as there is not a resettlement of the trust through these changes there should not be any capital gains tax implications. But that would be a question for the Australian Tax Office; they would have to look at the circumstances to see whether there is a resettlement of the trust as a result of the reversal of the previous changes.

Senator JOYCE—In that case, I will try to drill down and be even more specific. You might take the question on notice. Let us go through the stage of progenitors. I am using ‘progenitor’ not to be smart but so that I do not have to say ‘son’ or ‘grandson’. But with the son and then the grandson or granddaughter—that second generation after the event—I want to know whether there is a window or an event there that could lead to a deemed capital gains tax event. I would like to know from the ATO about the effect. If they say, ‘Well, no, we can’t see any reason that there would be a capital gains tax event,’ by reason of this legislation that would not have an effect unless, as you say, the nature of the trust is changed. But I am really asking: specifically because of this legislation, is there an event horizon at the second generation after the event that leads to a capital gains tax liability?

Mr McMahon—We can certainly take that on notice. A vesting of the trust has nothing to do with the family trust amendments that are occurring here, which Mr Cicchini has been talking about. But, if there is a vesting of the trust at some later point, that depends on the law of perpetuities in relation to trusts, which vary from state to state, and there could well be or there will be a capital gains tax event. But that issue is different from the one we are talking about here.

In relation to your first question, essentially, I understand this legislation to be saying that you can now get trust losses with respect to a different grouping of beneficiaries. But if you have not changed the beneficiaries of the trust itself then there should be no problem. However, if you would prefer, we certainly could consult with the ATO to see whether there is an issue.

Senator JOYCE—You would not know of a change in beneficiaries at that stage. At two generations you do not know who the beneficiaries will be. Issues might happen within that family that will change the beneficiaries and you cannot anticipate an event that has not occurred and you would have no knowledge of it.

Mr Cicchini—Yes. I take your question. The only way these amendments could affect CGT is if they caused a trust to be wound up earlier than otherwise. We do not really know the answer to that other than to say there may be some incentive in some years time to wind up the trust earlier for various reasons, and one of them could be that you cannot make distributions to the lower levels of the family. But certainly that is an issue to do with the rule of perpetuities. Again, when that kicks in and the trust has to vest in any case, there would be a CGT-taxing point there, and it is a question of whether or not the removal of this extension would cause that to occur, which would be very difficult to estimate.

Senator JOYCE—In this process, the minister has commented on trying to improve integrity and reduce the utilisation of tax losses to lower income tax. Has this mechanism been used in Wickenby cases?

Mr Cicchini—Again, we would not be able to comment on that. That would be a matter for the tax office. Is the question: are trusts involved in Wickenby cases?

Senator JOYCE—Has this been specifically targeted around that? I will be clearer: has this been targeted around Wickenby cases as a means of changing that loophole? If that is the case, is there the capacity to say that they are the sort of people we are targeting, as opposed to owners of other assets who are trying to do everything legitimately, and would there be scope within the legislation to be more specific and to target a certain area than in this more generalised form by changing the definition of ‘family’ in this instance?

Mr Cicchini—I think the point about the integrity concerns is that the trust loss rules themselves are integrity measures, as I mentioned earlier, designed to restrict your ability to utilise losses unless you meet certain rules. When this measure was announced by the current government, it was announced as a savings measure. There was no reference in their policy announcement to Wickenby, and that is really all I can say about that. This legislation implements, in effect, a pre-election announcement that was costed in November under the Charter of Budget Honesty.

Senator JOYCE—Your role within Treasury is the assessment of certain changes in tax laws that will save or cost the government. Is that correct?

Mr Cicchini—My role is to provide advice to the government on policy in relation to the taxation of trusts and other business tax issues and to advise on the costs, but I do not undertake the costings. The area of my colleague Mr Brown undertakes the costings in conjunction with the tax office.

Senator JOYCE—It is a lot of work for \$20 million, \$1 million and \$6 million in the years thereafter. I will put this to Mr Brown. Using a comparative analysis of the intent and effort that is going into this piece of legislation, is Treasury still happy with the forward estimates it has and the estimates and costings of the capital gains tax exemption for non-real property assets for foreign entities and how that is transferring

through now that foreign entities can get capital gains tax exemption on non-real property assets that they own or deal with in Australia? Are you aware of the exemptions that I am talking about?

Mr Brown—I am aware of the exemptions you are talking about. They are a little bit different to family trusts.

Senator JOYCE—I am just using a comparative—for example, the work that has gone into this and how much we are saving here, compared to what we are losing out the backdoor at the moment on that piece of legislation.

Mr Cicchini—They have different policy objectives and I guess the policy is determined by the government. I think a nonresident CGT exemption, in my understanding, was a previous government's—

Senator JOYCE—It was supported by both sides of politics, I might say.

Mr Cicchini—And again, this piece of legislation is fairly short, it is a savings measure and it is just implementing a government decision. So we do not have a view about that.

Senator JOYCE—I will just put that question on notice, because I want to do a comparative analysis between what we are saving on this legislation and what we are losing out the backdoor on the other one.

Mr Cicchini—Again, I think it is a matter of policy that the government is prepared to spend X amount of dollars achieving one policy objective and there will be a cost to the trust loss measures. The cost of that to revenue has been reduced by this savings measure.

Senator JOYCE—I will still put it on notice.

CHAIR—Senator Joyce, Mr Cicchini is trying to tell you that it is a policy measure and he is not—

Senator JOYCE—It is just an issue for costing. I am not asking for a direction on policy. I am just asking what it is costing us at the moment.

CHAIR—Costing to develop the policy?

Senator JOYCE—No; costing the capital gains tax exemption for non-real property assets, such as choses in actions, that is happening by reason of the exemption for non-real property assets for foreign entities.

CHAIR—So you just want to know—

Senator JOYCE—Because I want to compare it to this.

CHAIR—The budget estimate?

Senator JOYCE—We are about to save \$20 million here.

CHAIR—So you just want to know the budget estimate for the other measure. Is that what you are saying?

Senator JOYCE—Yes, at the same time.

Mr Cicchini—If it is in the tax expenditure statement, I am sure we can look that up.

Senator BUSHBY—Before I ask any questions, I probably should declare an interest. I am an MBF policyholder and did receive a cheque in June; also my wife and children are beneficiaries under a discretionary family trust. I am interested in exploring the degree to which you estimate we will save money from this. How have you arrived at the figure of \$20 million over the forward estimates?

Mr Brown—The costing of this represents the reversal of the earlier measure, so it is based essentially on the earlier costing of the changes to family trusts and family trust elections.

Senator BUSHBY—Which aspects of the changes in this bill actually lead to savings and how much? Can you break that down for me—the changes and where they will actually lead to savings?

Mr Brown—The different elements have different potential costs over periods.

Senator BUSHBY—Can you outline those for me?

Mr Brown—The bulk of the cost saving in this measure comes from the reversal of the measure to be able to change the test individual over the forward estimates period. The component that is related to changing the lineal descendants has a different cost over a different time frame. It has a longer term cost, which is larger.

Senator BUSHBY—So that would not be showing up in the forward estimates at this point?

Mr Brown—No. It would show up as a small amount of the cost; it is not a large part.

Senator BUSHBY—Do you have any figures to show or have you done any modelling to suggest how much you will save from that measure in the long run?

Mr Brown—The estimates on which these costings were based originally and in this reversal are very much indicative cost estimates.

Senator BUSHBY—Are you talking about the long-term ones from the lineal descendant changes?

Mr Brown—Yes. What I am saying is that the costings are very indicative. There is not a lot of data on which to base an assessment. Things like family trust distribution tax, for instance, is generally something that is not paid rather than is paid. So you cannot use that as a costing base. What you look at is the number of trusts and the likely impact that it would have based on the judgements about the amount of distribution.

Senator BUSHBY—We have had evidence just a few moments ago from Mr Cicchini that this measure is primarily about saving money, and yet with this particular measure that you are changing you have some indicative expectation that you might save some money some time down the track but no actual costings of how much that might be.

Mr Cicchini—There are two components—that is, the two aspects that are being removed.

Senator BUSHBY—I am talking about the aspect of lineal descendants here in terms of that question. I probably was not clear on that. In terms of the change with respect to lineal descendants, Mr Brown says that it is difficult to model an actual figure and there is an indication that down the track we may actually save some money to the Commonwealth budget.

Mr Cicchini—There is an amount included in as part—

Senator BUSHBY—As part of that \$20 million?

Mr Cicchini—I think what Mr Brown is saying is—

Senator BUSHBY—How much is that amount?

Mr Cicchini—There is \$1 million in the first year.

Senator BUSHBY—That is the overall effect of the bill.

Mr Cicchini—Overall, for the two measures, there is \$1 million in the first year.

Senator BUSHBY—Can you break that down into how much is being saved from the lineal descendants and from the other measure? Mr Brown said that the bulk of it was coming from the election measure.

Mr Brown—Yes.

Mr Cicchini—On page 4 of the bill, there are figures across the four years, being \$1 million in the 2008-09 year and then it becomes \$6 million.

Senator BUSHBY—But that is the total sum of the savings, as a result of the bill. I am interested in knowing to what degree the Commonwealth revenues will benefit from this bill specifically out of the changes to the lineal descendants' application.

Mr Brown—The numbers that are in the bill are the estimate of the gain to the Commonwealth.

Senator BUSHBY—Just from the lineal descendants?

Mr Brown—I am sorry; from both measures.

Senator BUSHBY—Exactly; that is right. But are you able to break that up and show me where the financial benefit to the Commonwealth is from making the changes regarding the lineal descendants?

Mr Brown—My recollection of the costing of this is that the lineal descendants, over the forward estimates period, is a very small part, probably around \$1 million.

Senator BUSHBY—\$1 million out of the \$20 million?

Mr Cicchini—Each year.

Mr Brown—Each year.

Senator BUSHBY—\$1 million each year?

Mr Brown—Each year. But that number outside of the forward estimates period would grow. These are integrity measures. The estimates are based around essentially what people will do in circumstances where an integrity measure is weakened and people are able to do more things. We are trying to estimate what people will do—

Senator BUSHBY—But, Mr Brown, in response to Senator Joyce's questions where he was highlighting Project Wickenby and this particular measure, Mr Cicchini said this was an issue about revenue, not about integrity.

Mr Cicchini—The trust loss measures are integrity measures and they limit the scope for utilising losses and transferring the benefits of losses to members outside the family group.

Senator BUSHBY—We have had submissions from various parties, some of whom will be appearing this afternoon, suggesting that that particular change—the change regarding lineal descendants—will have little effect on the bottom line, certainly in the forward estimates. Down the track there may well be some potential effects, but the original reason for the change in 2007 that introduced the greater ability to include further down the lineal descendant path was to actually overcome some practical problems and reduce the complexity in approaching this. If there were good policy reasons for doing it in 2007 and now we are seeing that, in the overall context of the budget, there is very minimal benefit to the Commonwealth revenue, why would you include this particular provision in the bill?

Mr Cicchini—Again I think it is a matter of the government's judgement about the policy considerations, so it is really a matter of policy. We are simply implementing the government's desire and its pre-election commitment. It announced it as a savings measure. So we are not passing judgement on its worth as a measure but rather implementing the government's decision and the government's policy.

Mr Brown—The original measures are estimated to cost \$8 million a year over the forward estimates in 2007, so the costs—

Senator BUSHBY—That was the suite of measures?

Mr Brown—That was the suite of measures. The vast majority of that came from the measures that are being addressed in this bill and that is why the order of magnitude is slightly smaller than in 2007, because some measures which were also expected to have a cost will continue out of that 2007 bill. What we are talking about really is something which was of the same order of magnitude and is essentially a reversal of those earlier measures and the costing was very much based on that reversal.

Senator PRATT—What is the definition of 'spouse' within the definition of 'family'?

Mr Cicchini—The definition of 'spouse' is the current definition of spouse in the Income Tax Assessment Act.

Senator PRATT—So that pertains only to married couples. Is that right? Are de facto couples included?

Mr Cicchini—It would include de facto couples. I am pretty sure that it does not include same-sex couples at this stage and I understand the government did make some amendments to deal with superannuation recently, so I am not sure that it has changed this definition at this time.

Senator PRATT—So you are not sure yet whether the changes to the Superannuation Act definitions will come across the tax laws amendment bill?

Mr Cicchini—I am not from that area, but whatever decisions are taken would flow through; I am just not aware of what the public announcements are on that particular aspect.

Senator PRATT—What about the definition of 'child'? How is a child's parentage currently assessed, for example, if they are created through assisted reproductive technology? Which act defines that parent-child relationship if they are not biologically connected to that parent?

Mr Cicchini—I might need to take that on notice to be a bit more precise.

Senator PRATT—That would be fine, thank you. I appreciate that it is a little bit from out of left field.

Mr Cicchini—We are certainly aware that step-children are covered by the current definition. Previous amendments also made a change that said that a death will not necessarily cause someone to be outside the family; there has to be some other rationale.

Senator PRATT—Are step-children of de facto partners covered?

Mr Cicchini—Yes.

CHAIR—Thank you to Treasury for coming in this afternoon.

[1.39 pm]

CHENG, Mr Julian Christopher, External Representative, Institute of Chartered Accountants in Australia

NOROOZI, Mr Ali, Tax Counsel, Institute of Chartered Accountants in Australia

CHAIR—Welcome. Mr Noroozi, do you wish to make an opening statement?

Mr Noroozi—I thought it might be useful to give a bit of background based on the earlier questions. Family trust election has been an area of difficulty for some time in terms of compliance. In fact, at one stage, the tax office provided an amnesty to allow people to lodge their elections, which at that time required a deadline. Back in November 2004, the institute raised this issue with a number of small businesses and their advisers and put a submission to the then government about the problems that existed and what could be done to remedy them. Three years later, the previous government passed the legislation, which really only attacked the tip of the iceberg. There is still a great deal more reform required in this area. So I guess it was with a bit of regret that we heard the government announce just before the last election that even the little that the previous government had done by way of reform was going to be undone.

However, we have engaged with the current government and that is why, as was mentioned earlier, a number of these measures of the previous government have been retained. It is only two measures, and the current government has been very responsive to the representation we have made. For example, they have made sure that even the repeal of these measures is on a prospective measure, so they won't have retrospective effect. However, I think we need to highlight here that even these two remaining measures create significant difficulties for small businesses and their advisers. I will pass over to Mr Cheng, who has practised in the area, for the detail; but, broadly, it is a bit more difficult for trusts to use losses. They have to pass a number of fairly heavy-duty tests. With a family trust, you usually know that the beneficial ownership is going to remain with that family. For them to pass it, they basically need to make this election. If they make an election that they are a family trust then they do not have to pass through the same number of hoops that they would otherwise. So it is basically about making it simple.

Bear in mind that trusts generally last for 80 years. That is the standard rule of thumb. I think it appeared in the original EM to the bill. These elections are irrevocable, and that is why it is important to allow the extension of the lineal descendant, as it were. Julian will explain this in more detail. This is all that this measure aims to do. I do not believe that this is an integrity measure. As Treasury confirmed, it was seen as a savings measure. However, we have never had the costing that Treasury provided explained to us. We doubt very much if it will save the government any money and, if it does, it will be very little and will be by way of almost a penalty tax, because distributions were made outside the family. At this stage, I will pass over to Mr Cheng, but I might interrupt as we go along.

Mr Cheng—As Ali mentioned, these trust loss rules were an integrity set of rules that were basically introduced to prevent or target trafficking in trust losses. Many discretionary trusts are administered for the benefit of particular family groups. As a concession for those sorts of groups and those types of trusts, the concept of a family trust election was introduced. Essentially, if one of these trusts makes one of these family trust elections, they do not need to pass the same number of tests in order to recoup trust losses for tax purposes, but the downside is that essentially distributions of that trust are confined to members of a particular family group—that is, defined by reference to a test individual.

The definition of a family group essentially covers a test individual and members of the test individual's family. It is this definition of 'family' that is the subject of these proposed amendments. When this definition was originally introduced with the original trust loss rules, it included the test individual, children of the test individual and grandchildren of the test individual. It also extended to brothers and sisters of the test individual but only to the children of those brothers and sisters. So it did not extend down to the grandchildren of those brothers and sisters.

The difficulty here with the definition is that it extends down to only two generations. When you look at the test individual, it covers off their children and grandchildren. But, in practice, as Ali mentioned earlier, a lot of trusts have a typical vesting period of around 80 years. In practice, they can typically cover four generations. The proposed amendment to limit the definition of family is out of line with the expected life span of trusts. What is going to happen going forward is that basically distributions, say, to great-grandchildren or to

subsequent lineal descendants of a test individual will be subject to this penalty tax, which is currently at a rate of 46.5 per cent.

To put all of this in the context of an example, take a family group: you have parents, children and grandchildren. If you make a decision to make one of the parents the test individual then the trust can distribute to their children and to all of their grandchildren, but it can only distribute to children of their brothers and sisters. If you make a choice to make, say, one of the children a test individual, you have the advantage of extending beyond the grandchildren of the parents, but I guess you are limited to the extent that you cannot distribute to all lineal descendants of the children's brothers and sisters.

Our concern is that this proposed amendment to the definition of family to bring it back to what it previously was when the trust loss measures were introduced is limiting and does not really match up with the expected life span of trusts in practice.

Senator JOYCE—I just want to go back through the correlation of the 80-year period for the life of the trust and the generations of family that were formally in the definition of family. In your work as accountants, do you see much evidence of trust losses being affected by these changes? Is it something that you come across once in a blue moon or does it affect a good section of your book? Through your experience as accountants, do you see this as having relevance or is it a very occasional problem?

Mr Noroozi—I do not practise anymore. I have been at the institute for some time but we hear from a lot of our members—in other words, practitioners in the field. As I said, when we made our submission to the previous government back in 2004, it was as a result of so many representations to us. Bear in mind, we are mainly talking here about SMEs—small to-medium sized businesses—and their advisers. As you would know and as this committee would know, the complexity of the tax system is such that sometimes they find it an awful burden to deal with and to comply with. This results in unnecessary errors that cannot be corrected because these elections are irrevocable. The business of choosing a test individual is not particularly easy. If you get that wrong, you are stuck with it.

You asked earlier about how many trusts were involved. According to taxation statistics for the year to 30 June 2006, there were 427,532 discretionary trusts. A large number are affected. My understanding is that it is really the small to medium end of town that is affected. In relation to the previous questions about project Wickenby that you referred to Treasury, I would doubt very much whether this would be a major part or any part at all of these schemes. But, again, that is something we will not know until the tax office declares what they have been doing.

Senator JOYCE—That is probably one of the areas that I am getting at. With over 400,000 trusts, the long-term forecast is that we are going to save ourselves only \$20 million. It seems like an awful amount of work for what is really not a great win.

Mr Noroozi—We could not agree with you more. Perhaps one of the few ways that they might be thinking of collecting money with the family trust distribution tax is if you fall foul of the provision. It is not as if you are trying to do anything dodgy; it is more the fact that you are suddenly hit with these harsh rules. It is a penalty tax rather than a tax that was due and is being dodged, if you like.

Senator JOYCE—I want to focus on a certain issue. Let us say, for instance—as you cannot foresee events into the future—a client comes into my accountancy practice, I set them up with a family discretionary trust; the test individual—a wife or husband or whichever it might be—tells me that they are planning on having kids, blah blah blah, everything is set up in the trust and then, lo and behold, they cannot have kids. Under this current legislation what do they do next, because they have just selected one of themselves as the test individual?

Mr Noroozi—I guess it depends. It can still go sideways; that is my understanding. It does not have to go down, but it can go to brothers.

Senator JOYCE—But only out and down one.

Mr Noroozi—Yes.

Senator JOYCE—So one has to say, 'Well, we'll distribute through your brother or your sister or my brother or my sister,' but I suppose that in itself works on the premise that you are biased towards people who were multiple siblings.

Mr Noroozi—Possibly, yes. But you are right. The current law allows you to go a couple of steps further down, whereas, if the current legislation is repealed, we can only go down two steps, and you can go out and down one.

Senator JOYCE—The current law basically works on the premise—and I do not know the actuaries, but I imagine that it is backed up by the actuarial belief that 80 years is a fair term for one person's life and, although it may incorporate a number of generations within that purpose. Most people now are living to see great-grandkids. That is not unusual at all, as opposed to in the past when grandkids were about as far as people expected to get. So really with this, in its current form, it would be better just to stay in the scheme of—in the definition of 'a family', how many generations would you expect to see in 80 years? In 80 years you would expect to see three or possibly four, as opposed to two.

Senator BUSHBY—Thank you for appearing today and for your evidence. One thing occurred to me while I was sitting here. If you were a small business and were doing very well and you were a very high-income earner, would a family trust under which you distribute to individuals be the best vehicle to run that, or would you be better off getting into a corporate structure and taking advantage of the lower tax rate, as the income gets higher? I am talking about a very high income.

CHAIR—Are you asking for advice, Senator Bushby?

Senator BUSHBY—No.

Senator JOYCE—I can give you an answer, but only for a fee!

Senator BUSHBY—It is relevant to the issue of whether family trusts—

CHAIR—I am sorry, yes. Go ahead.

Senator BUSHBY—are employed by very high-income earners as a tax structure or whether they are a tax dodge.

Mr Noroozi—It depends on your circumstances. You may assume a number of structures. You may in fact choose to have combination. There are other issues such as limited liability, such as asset protection as well as tax consideration. So it is not so easy to necessarily say, but perhaps if I know where you are going with this I might—

Senator BUSHBY—Could I ask it slightly differently then. If you were a very-high-income earner and using a family trust with individuals as beneficiaries, ultimately you are not going to be able to save an awful lot of money in the end because your individuals will end up all paying a top tax rate any way.

Mr Noroozi—That is right. That is—

Senator BUSHBY—For every extra dollar that you earn over a certain point, you will still be paying the top individual tax rate.

Mr Noroozi—I am happy to answer that question. Can I just make one point first: there may be some question over the way trusts are taxed at the moment; should the trust laws and the taxing of them be the way they are? I do not think that is a question for this committee on this legislation at the moment. That question was addressed. There was some talk some years ago as to whether trusts should be taxed like companies and the board of tax addressed that issue. There was long-term discussion—

Senator BUSHBY—I do not want to raise that as an issue.

Mr Noroozi—No, but I am just painting the background. I am not here to defend whether trusts are valid, on this occasion in any event. However, to answer your question, these days you are absolutely right because children, after they receive a certain amount of money—I think it is about \$500-and-something—then get taxed at the highest marginal rate. These days in families both spouses generally work. There is a very minimal way in which you can shift around income to get a better tax outcome. I think the only way perhaps you could do it is if you had children who are over the age of 18 but who are still at university. There are some very minimal—

Senator BUSHBY—But even then you can only give them so much before you start hitting the top marginal tax rate.

Mr Noroozi—Exactly.

Senator BUSHBY—I have another question. You have mentioned that this reduced the complexities for small business. Why do small businesses adopt family trusts? Why do they use them to such a high extent? What are the advantages for small business?

Mr Cheng—Basically trusts are used for a number of reasons. One of them is, for example, asset protection reasons and also flexibility of distributions to obviously members of the family group, particularly a family that a trust is administered for the benefit of.

Senator BUSHBY—The people who set up family trusts, including farms and small businesses—what percentage of family trusts would actually be set up for the purposes of running a small business?

Mr Noroozi—That is probably difficult. Treasury might be able to answer. That might be a better question for them. They might have better statistics than I do.

Senator BUSHBY—In your understanding, do many people set up family trusts for purposes other than running a small business?

Mr Noroozi—You might set up a family trust for a number of reasons. It might not necessarily be for a small business, but you do see them a lot in conjunction with small businesses.

Senator BUSHBY—Especially rural small businesses, yes. You mentioned earlier that one of the advantages of the legislation that was passed last year was that it made it easier for small businesses to carry forward losses and to deal with those in an appropriate manner, but you suggested that there were a number of hoops that they would have to go through if that legislation had not been passed.

Mr Noroozi—I am sorry; I may have misled you. I was saying that, for trusts generally to utilise their losses—forget family trusts for a minute; just trusts generally—there are a number of hoops they have to go through. The rationale is that the underlying individuals or whoever, taxpayers, who incurred the loss should be able to also recoup it—the same individuals. However, with family trusts, because you know that the beneficiaries are usually members of the same family, there is a presumption that the same people that incurred the loss will also be—this is putting it very simply and perhaps not accurately. Basically with election to be a family trust, as soon as you are—

Mr Cheng—It confines the group of people to whom the trust can distribute.

Senator BUSHBY—But in the absence of the election, could a family trust do what other trusts have to do and go through and prove and pass it down?

Mr Noroozi—Yes.

Mr Cheng—It would, yes.

Senator BUSHBY—So, ultimately, if this bill were passed and put into law and a family trust still wanted to try to claim those losses and were prepared to jump through the hoops, the savings to Treasury might not be there.

Mr Noroozi—Yes. Part of the reason why this family trust election has become so all-important is because initially they may have just been dealing with trust losses. Other things are hanging off it now such as franking credits and the like. So it is probably used for more than it was initially intended to be.

CHAIR—Thank you to the Institute of Chartered Accountants coming in.

[1.59 pm]

LEIBLER, Mr Mark, Senior Partner, Arnold Bloch Leibler

CHAIR—Welcome. Do you have an opening statement?

Mr Leibler—I would like to make a few remarks; thank you. I think Senator Joyce really put his finger on the problem when he asked about capital gains tax. Despite the fact that there is no direct relationship between this legislation and the capital gains tax, the reality is that it is likely going forward that capital gains are going to be brought forward because people are going to want to vest their trusts because, as you run into grandchildren or great-grandchildren who are no longer beneficiaries rather than paying penalty tax on distributions you may want to vest the trust in relation to beneficiaries who are still alive and who comply. So I think it is a point that is very important to make.

The other thing I would like to say is this. I believe it is very important for incoming governments to carry out their election promises. If that is all that this were about, I am not sure that I would have come to give evidence to this committee. The issue is, however, that commitments are based on advice from Treasury in relation to tax saving. The changes we are talking about here are likely to have wide-ranging ramifications for many—I think it is half a million-plus—trusts which have reported total business income in, I think, 2005 of something in excess of \$215 billion. We are not talking about a small group of privileged taxpayers. There are countless thousands of small business people who use family trusts which have elected to be family trusts and which have test individuals.

It is important to note that, when the government or the then opposition opposed this legislation back in 2007, it did not do so as a matter of principle; it was a question of priorities. If I can just remind you of what Chris Bowen said—and I am quoting from *Hansard* of 13 August:

This is not a matter of attacking the government and saying, for example, that family trusts are a complete rort or that family trusts should be closed down. This is about priorities. We do not believe that expanding the operation of family trusts and making them available to more people—more lineal descendants such as great nieces and nephews and great-great nieces and nephews, for example—should be a priority for government.

Dr Emerson, also on the same day, said:

We do not think that this is a priority and therefore think that the money could be better spent elsewhere.

You will notice the focus on lineal descendants. We were talking then apparently about a savings of revenue of \$8 million per annum. I do not believe that those two gentlemen would necessarily have made those remarks or opposed that bill in relation to the lineal descendants issue had they been here and heard for the first time what this committee heard from the Treasury people this morning.

I was going to come here and I was prepared to stake my own reputation on the fact that \$8 million or \$6 million per annum, insofar as it relates to the lineal descendants issue—the other issue I really do not know—was a complete nonsense to begin with. You will be hearing from Pitcher Partners afterwards, but I have seen some work that they have done and they have actually worked out that family trust distribution tax on average to the year 2005-06 was just under \$1.5 million. The idea that even \$1 million per annum would be saved in relation to the lineal descendants issue is a complete and total nonsense.

It is important to understand how important this issue is. You have two brothers in a family trust carrying on a business. They have to nominate a test individual. They take one of them, so the grandchildren of one of them are okay. Only the nieces and nephews are okay for the brother. In other words, the brother can only include his children—his grandchildren are not included. This is not about tax avoidance; this is all about getting rid of totally unfair anomalies. It is not something, by the way, which is impacting on revenue today, but it is an important structural issue which will be important as you go down the lines with the generations. I guess, if the cost to revenue is illusory, at least in relation to the lineal descendants issue, all I can say is that I believe the ALP should be quite comfortable in at least taking that element out of this bill.

Fundamentally, that is what I came here to say. I was going to do a whole song and dance, I must confess, about the costings, but I did not have to, because Mr Brown said it all. One of the problems is that we have been speaking to Treasury, we have been speaking to the government and they have refused to give us the costings. We asked for a breakdown of the costings. We asked, 'How did you arrive at this figure?' They refused to tell us. This is the first time, coming here before this committee, that we have heard about the costings.

I might remind you, Madam Chair, that you were a member of this committee when the government passed the legislation back in August 2007, and this committee, as far as I know, recommended—and there was no dissenting or minority report—the original legislation which introduced these changes. That highlights the fact that we are talking about an issue of priorities, not an issue of policy. If we are talking about priorities and if it could be demonstrated that the basis upon which the decision was made to reverse the legislation—namely, the savings to the revenue—at least in relation to the lineal descendants issue, was totally misconceived, I think there would be a basis for, hopefully, this committee recommending this aspect at least.

All my instincts tell me that there is not going to be much revenue savings in relation to the revocation of elections as well. But I am totally focused on this because it is long term, strategic, structural, just fundamentally wrong and there is no revenue involved. I do not know where Treasury got the figures from. I would venture that even \$1 million per annum is way over the top.

CHAIR—Were you in discussions with the previous government when they introduced the bill in 2007?

Mr Leibler—I was actually part of the confidential discussion that took place with Treasury in relation to the introduction of this bill.

CHAIR—So you are arguing passionately for the lineal descendants aspect to be changed.

Mr Leibler—Correct.

CHAIR—Given that you say there are no revenue implications, why is it so critical?

Mr Leibler—It is critical in terms of moving forward. People look to future generations. They look to their children, they look to their grandchildren and they look to their nieces and nephews. In other words, people are setting up structures for the long term. Senator Joyce put his finger on it. These people have to start thinking clearly about either paying penalty tax or capital gains tax somewhere down the line—certainly not within the period of the forward estimates, if we cannot get this right. It is one thing to delay introducing this piece of legislation and having difficulties getting it up. Having gotten it up, to take it out now is just a tragedy. It does not make any sense. If I had known previously what Mr Brown said to this committee today, I would have made a very valiant effort to talk Chris Bowen out of this. I am not sure how focused he is on the disparity between the estimates on the so-called \$1 million on the one side and I guess \$5 million for the revocation. When you think about that for a moment, I do not understand why one could even contemplate proceeding with this legislation, as it impacts on the lineal descendants issue.

I do not think the legislation should be proceeded with at all, but I am also conscious of the fact that you have an incoming government that made promises. It was an issue of priorities. There was a revenue savings issue. But that does not apply to the lineal descendants issue. That is my point. Fortunately, I do not have to stake my reputation on it, because Mr Brown said all that was needed to be said this morning, for the first time.

Senator BUSHBY—Thank you for your evidence; it is a very good submission. It led me to ask some of the questions I asked. I am pleased that I have removed the need for you to stake your reputation.

Mr Leibler—Me too.

Senator BUSHBY—I apologise for stealing your thunder as well. I am interested in exploring further the issue of lineal descendants. In practice, what would actually happen if this bill were passed? If you had a small business that you were operating and you got to a point where you needed to hand on to grandchildren or somebody further down the line, what actually would happen to the business?

Mr Leibler—First of all, it has not happened yet, as you would appreciate, because this legislation has only been in effect for some 15 years, so we are looking to it starting to happen perhaps in the not too distant future. A number of things can be done. It may be possible—going back to Senator Joyce—to vest the trust. There could be some capital gains tax issues, but maybe there will not be. There are ways around this. What one can do, for example, is to distribute the funds to a particular beneficiary who can then later on make some adjustment in another way. But it is very awkward, it is very anomalous, it is not how you put together a good piece of legislation and it has nothing to do with tax avoidance.

Senator BUSHBY—We had some evidence in one of the submissions that it would amount to an inheritance tax. Can you see that happening?

Mr Leibler—I do not think it is productive to overstate the issue. The reason I am here is that I am incensed about the lineal descendants issue because there are no cost savings and it does not make sense.

Senator JOYCE—I was trying to bell the cat, trying to draw this into where I believe we are going to run into problems. As you have said, you will have a choice between reorganisation of a trust or a penalty tax. Therefore, there will be a deemed transfer of an asset; there will be asset transfers and possible gains tax windows that will come into play. You also brought into clear focus that what is going to happen now is that a range of your clients will come trouncing back into the office and you will have to say to them, ‘Look, we’re going to have to reassess where we are with our tax and the structure that we have set you up under.’ No matter what the savings are, the outlay in accountants’ fees is more than going to cover any savings in the economy. I can see that they are the only people who are going to get big benefits from this. It is funny that all of us here today are accountants. I just do not see what the purpose of this legislation is. If they truly are worried about possible—really, in the scope of things—minimal savings, this will lead to a major reorganisation of a lot of people’s affairs.

Mr Leibler—It is good for the accountants and lawyers.

Senator JOYCE—It is brilliant for the accountants and lawyers. To put it in the *Hansard*, for the 400,000 to 500,000 trusts we have with an excess of \$200 billion in assets floating around and for whatever their forward savings are—\$1 million or \$4 million or something like that—how much do you think will be paid out in accountancy fees to try to reorganise all this?

Mr Leibler—I have no idea. I must say that in my experience there was only one time ever that the government made changes to so-called simplify the system that actually cost the accountants and lawyers money and that was when they abolished inheritance taxes.

Senator JOYCE—Probate.

Mr Leibler—Every other change has involved further complication, more work for professionals, and it is the same with this. To me, it sort of stares out at you, when you look at this legislation, that the lineal descendants issue does not make any sense. There is no revenue in it. All it will do is create complications and anomalies. I hope that the government can be persuaded to change its mind at least on that issue.

Senator JOYCE—You would also have the issue that in 1998, when dealing with an asset structure, you liked things to hang around for a while. Otherwise, you structure people into certain entities with the belief that they are going to be there in some form of perpetuity and you listen openly to the political discussion on both sides of the fence so that you can clearly say to people, ‘I think if we go down this path, you’re going to be there for a while.’ But this thing has found its way back into the statute books and now it is going to create unnecessary paperwork and unnecessary costings, because all those people who came in after 1998 to structure things in a certain way are going to have to come back to the office again.

Mr Leibler—Yes.

Senator JOYCE—Can we just go through this, because it is important for the *Hansard*. I know that accountants talk about things and we lose people a bit. Trusts are not something that just popped up last year; trusts have been around for hundreds of years and have been a very competent and widely used structure, mainly for asset protection. How would you see the use of trusts—so that people do not think they just—

Mr Leibler—First of all, the beauty of trusts is that no-one owns anything. If you have children, it enables you during your lifetime to make distributions, to allocate assets to different family members, instead of saying, ‘I am going to keep it all myself and devolve it by will.’ It is not such a big income tax saving nowadays for the very simple reason that, if you are under age, you are taxed at the maximum marginal rate in any event. With most of my clients that run trading businesses, there might be a trust owning the shares underneath, but they are run by companies because the 30 per cent corporate tax rate is still better than 46 per cent or whatever it is—the maximum marginal tax rate.

That reminds me: I was interested to hear your question on Wickenby, but one thing I would guarantee you is that, for people who are using trusts overseas for those purposes, the last thing on their mind is to worry about making trust elections.

Senator JOYCE—That is right.

Mr Leibler—You can be absolutely sure of that. But trusts are accepted. They involve estate planning going forward. You have people who set up trusts in their will so that they can look after the subsequent generation and so that they do not have to give everything to underage people or sometimes even older people. It is a family planning vehicle. Income tax is not a big issue with family trusts nowadays.

Senator JOYCE—In fact, would you suggest that one of the big drivers of trusts—or it was when I was in that field—was asset protection?

Mr Leibler—Asset protection has always been a big factor and, when you see what is happening nowadays, it is becoming a bigger factor day by day.

Senator JOYCE—So, if asset protection is the mechanism that gets it into there, the legislation should look at the reason that people go into trusts, which is asset protection. What this will do is force them back out of trusts. With half of marriages—whether it is your son or your daughter—ending in divorce, that becomes one of the major drivers. The biggest fear in accountancy, I always found—and I do not know whether you have experienced it—is not the fear of going broke; it is the fear of whatever I work for being diminished in the future by a party that I have not yet met through the unfortunate reality in the world that 40 per cent of marriages end in divorce.

Mr Leibler—Yes.

Senator CAMERON—Thank you for participating in this master class on family trusts. I am interested in your comment about a \$1.5 million distribution of an asset of base of \$215 billion. When does this distribution actually rise from under one per cent? It must rise eventually.

Mr Leibler—Are you talking about the family trust distribution tax?

Senator CAMERON—Yes.

Mr Leibler—No.

Senator CAMERON—No, not the tax; the actual distribution.

Mr Leibler—What distribution are we talking about?

Senator CAMERON—I thought you said that there was some—

Mr Leibler—No. I said that there was an average of—I meant to say; maybe I did not make myself clear—about \$1.5 million revenue per annum from the family trust distribution tax. That is the penalty tax.

Senator CAMERON—That is fine. I misunderstood.

CHAIR—As there are no further questions, thank you for coming in this afternoon.

Mr Leibler—Thank you.

[2.19 pm]

BRAZZALE, Mr John, External Representative, Taxation Institute of Australia

CHAIR—Welcome. Do you have an opening statement that you wish to make?

Mr Brazzale—I did have, but my thunder has been stolen by my colleagues from the Institute of Chartered Accountants and Mr Leibler. Perhaps I can just summarise and reiterate the comments of Mark Leibler. Trusts in this day and age are a legitimate vehicle in which to run business and to hold family assets for all the reasons of asset protection, business succession, family protection of assets in the instance of marriage breakdown and the like. Tax is very much an incidental part of the use of trusts. There are so many anti-avoidance and integrity measures around trusts that any benefit of tax is pretty much a secondary benefit to many of the other commercial drivers.

CHAIR—Senator Bushby, do you have any questions?

Senator BUSHBY—I am reasonably comfortable, actually. I think most of the questions have been asked today and the answers have been given.

CHAIR—Senator Joyce?

Senator JOYCE—I will not let you off easily! Mr Brazzale, we need to convey through the *Hansard*, I think, how this affects your segment of clients. It is such a dry topic. Would you be able to convey, for the purpose of the *Hansard*, the sort of typical client that would come in and form themselves into a family trust but then have to contend with this legislation—without any real benefit to the nation by raising revenue for what it is deemed to be about—and the sorts of problems you would have and how you would have to drag them back in.

Mr Brazzale—Before I answer that question, I reiterate the comments of Mr Leibler that, in respect of the lineal descendants, I do not see these measures raising anywhere near the amount of revenue that perhaps our friends from Treasury—

Senator JOYCE—Can you just drill down on why it will not, for the *Hansard*?

Mr Brazzale—It will not because, without the extension of the family group down to lineal descendants, most trusts will continue to operate within the parameters that they are currently operating within. They will continue to distribute to children, grandchildren, nieces and nephews. Sure, they will be precluded from distributing down a further generation to great-grandchildren—which, from my perspective, as a matter of policy is a great pity and a tragedy, but that is all it is. It will be many, many, years before trusts will hit a position where the only surviving beneficiaries that are able to receive distributions might be great-grandchildren. At that point in time, the trust will restructure and perhaps vest rather than incur a penalty tax. All these measures and the revenue estimates are predicated on the collection of a penalty tax, which will be the last thing that happens, other than through inadvertent error.

Senator JOYCE—Can you explain what you would do when you had a choice between vesting or collecting a penalty tax and, as that event horizon occurs, how you would be advising your clients?

Mr Brazzale—Obviously you would look closely at the circumstances that arise in each case. If it is an option of incurring a penalty tax, you may simply not do it. It might be cheaper simply to vest the trust and begin again.

Senator JOYCE—What exactly happens when you vest a trust—for the purpose of the *Hansard*?

Mr Brazzale—To vest a trust, you need to dispose of all the trust's assets, so you may trigger a CGT liability on those assets. There will be other assets that might still be pre-CGT assets that were acquired in trusts pre-September 1985. At some point in time, when they are passed out, they will be passed out tax free but will become post-CGT assets.

Senator JOYCE—Post-1985 assets in the vesting of the trust will become realised and out they will go, and therefore you will have an event horizon for capital gains tax purposes.

Mr Brazzale—Correct.

Senator JOYCE—Has that event horizon changed by reason of this legislation?

Mr Brazzale—It will force that change ultimately, yes.

CHAIR—Do you have any feel for the distribution of family trusts between rural and urban areas, for example? Do you see any particular area where family trusts are especially used?

Mr Brazzale—In my professional capacity as an adviser, family trusts are set up for a range of reasons. One is to operate trading businesses, mainly from the point of view of asset protection but also for business succession—being able to pass that business on. I guess many clients see the establishment of a business as a family asset and what they would dearly like is to pass that business on through the generations to their children and grandchildren. Many businesses commence that way; trusts are the most appropriate vehicle for doing that. They are also used extensively as asset investment vehicles for that same reason—that many families see investment in assets, particularly those that grow in value, as being family assets and assets they would like to pass on to the various generations through a trust.

CHAIR—When you talk about asset protection, is that also used when, for example, someone is sued or something like that and they want to put their family assets away so that they are protected?

Mr Brazzale—Correct.

CHAIR—Thank you.

Proceedings suspended from 2.27 pm to 2.51 pm

O'BRIEN, Mr Donald Geoffrey, Adviser, Family Business Australia

POWER, Mrs Genevieve, Director, Family Business Australia

CHAIR—Welcome. I have been, I have to say, fairly thoroughly through the arguments with the previous three witnesses and Treasury, and we have been concentrating pretty much on the lineal descendant part of the bill. Would you like to make an opening statement?

Mr O'Brien—I am here today representing Family Business Australia and, in particular, Philippa Taylor, who lodged a submission on behalf of Family Business Australia. I mentioned to Genevieve that you probably would have discussed all of the technical issues before we arrived, given the people who preceded us today.

I guess the issue from our perspective—this is probably what we want to articulate here today—is that Family Business Australia represents typically the group of people who are going to be most affected by the change to the legislation or the proposed change to the legislation, particularly in relation to lineal descendant. Family Business Australia represents members who are taxpayers and who typically use family trust structures to conduct their businesses. Family trust structures are legitimate mechanisms for conducting business in Australia and they have been for generations now. If individuals who are in the space that family business operate in turn up to their accountant and ask for advice, they are more than likely to be advised to enter into or to conduct their business through a trust structure. There are obviously certain advantages to using trusts in terms of both commercial and potentially tax reasons as well, but they are mainly in relation to matters of policy that have been ruled on over a number of years.

Family business is typically multigenerational, so the clients that Family Business Australia represents are multigenerational businesses. You really do have people involved from a number of generations—from cradle to grave, from cradle to grave. In those circumstances, you will come across a lot of situations where just to limit the lineal descendant argument or to make the change that is currently proposed to lineal descendants is going to be disadvantageous to family groups, particularly family trusts, because there are wider family issues and much larger families involved in businesses.

We think that the change that was made back in 2007 is a reasonable change. I do not want to get into the issue of costings, but I am not sure that there are the tax savings to be expected from making this change. That is anecdotal from our discussions and my experience in family business over a long period of time.

CHAIR—Questions?

Senator PRATT—Will these changes change the kind of advice that you give to clients?

Mr O'Brien—That is an interesting question. Obviously, any legislative change changes the advice you give clients because—

Senator PRATT—But is it a matter of saying, 'Well, a family trust might not be for you,' as a result, or will they still be an effective way, for the people you would expect to manage assets, to do so in that way?

Mr O'Brien—If the legislative change proposed is made, that will not be the death knell of family trusts, but it certainly will make it more difficult for intergenerational, should I say, continuation of businesses rather than disposal of businesses. It is intergenerational continuation that is going to be affected by this proposed change.

Senator FURNER—You have made the comment that business is multigenerational. How would you describe that? Is it two or three generations or greater?

Mr O'Brien—I think it would not be unreasonable, particularly in some of the rural areas, to find businesses in Australia that have operated now for almost 100 years. Looking at some of the changes that are being proposed, for example, if you were the nominated individual, your nephew's son would be someone who was outside your family group. I would have said that there are many instances where those kinds of intergenerational issues arise.

Senator JOYCE—Family trust arrangements—you would see a pretty strong involvement of that, especially in rural property. Would that be a fair comment?

Mr O'Brien—Correct.

Senator JOYCE—The reason for that is—and for the record I am involved in one myself—that you really do not know who is actually going to end up with the farm. My brother was on the farm, he has gone down to Sydney and now the question is who is going to take over. I am married with kids. These sorts of things can

change overnight because you do not really have ownership of the asset; you have the right of use of the asset and the asset basically lives in perpetuity in that family for whomever—daughter, son, granddaughter, grandson, grand niece, the person who says, ‘I commit myself to that asset.’ Then you get to live there in the big old house, but you do not get to sell the asset and put the proceeds in your pocket. That is generally the custom and practice of how it works.

Mr O’Brien—Agreed.

Senator JOYCE—Trusts would be involved basically by reason of reinforcing that custom and practice through the belief of asset protection, that third parties cannot inflict their will on that lineal descent of the asset.

Mr O’Brien—I would agree with that.

Senator JOYCE—One of the problems with this is that we are now bringing forward a possible vesting date or, alternatively, you can pay the penalty tax, which changes the whole structure of the asset and the whole structure and nature of exactly what you are doing. You do not want to vest the asset; the asset is to go on in perpetuity.

Mr O’Brien—If you get to a situation where you would have to make a distribution to a person outside the family, then you would potentially need to look at strategies for disposition of that asset outside of the group or outside of that family. That might not crystallise an immediate issue—because, if the asset has been owned for a significant period of time, it may be a pre-CGT asset—but, effectively, you could be converting a pre-CGT asset to a post-CGT asset.

Senator JOYCE—Exactly.

Mr O’Brien—That is not a good scenario.

Senator JOYCE—That leads me to my next question. I imagine that you would have a fair few families involved in trusts with pre-1985 assets, especially property.

Mr O’Brien—Substantially.

Senator JOYCE—The property has probably been there for donkey’s years.

Mr O’Brien—Yes.

Senator JOYCE—This unnecessarily takes it towards taking a pre-1985 asset to a post-1985 asset; therefore, it becomes an element that is up for discussion in regard to capital gains tax.

Mr O’Brien—This actual amendment does not do that of itself, but—

Senator JOYCE—But it can lead to that.

Mr O’Brien—it can lead to a situation where you may be forced to dispose of an asset.

Senator JOYCE—Yes. Of itself, it does not become an event horizon for turning pre-CGT assets—

Mr O’Brien—But I do not think that you are drawing too long a bow, no.

Senator JOYCE—Yes—pre-1985 assets to post. This legislation by itself does not do that, but you are heading towards the door where they say, ‘What are you going to do? Are you going to pay the penalty tax?’ When your brother’s son or daughter ends up with the asset and says, ‘What do I do with it, Uncle Don?’ you would say, ‘Well, you’re sort of stuck. You’ve got a problem now because you can’t go any further; you’re stuck with it.’

Mr O’Brien—Potentially, yes.

Senator JOYCE—If the government’s suggestions are correct about what they intend to get from this piece of legislation, do you think it is an awful amount of work for what is really not very much money at all—in fact I would suggest it is even less than what they have put in their forward estimates?

Mr O’Brien—I think the amendments made in 2007 were reasonable. I think they were reasonable; they were commonsense. It is not as though there is a major tax avoidance issue associated with all of this. That is not the situation. I just think they were recognising that perhaps the rules, as they were, were too restrictive and were just removing some of those restrictions, as opposed to close a loophole. I do not see this as closing a loophole.

Senator JOYCE—I will try to cast a light on the size of this loophole that they are closing. We are talking about their saving \$1 million and \$6 million for each year in the three financial years thereafter. Let us say I

am Barnaby Joyce from New Zealand and I set up my entity in New Zealand, although I might live somewhere else, and I buy a hotel for \$100 million as a nonreal property asset based on the profits that the hotel makes—more so than the value of the real estate. Let us say that I hold it for a couple of years and then sell it for \$200 million and that the hotel is down the street here in Canberra and my entity is based in New Zealand. It is a nonreal property asset with a value derived predominantly from its cash flow potential more than from its real estate, so, as a foreign entity, how much capital gains tax do I pay in Australia after making that \$100 million profit?

Mr O'Brien—That is a question from left field.

Senator JOYCE—I can give you the answer.

Mr O'Brien—You can give me the answer?

Senator JOYCE—It is zero.

Mr O'Brien—Yes, I was about to say it would be zero.

Senator JOYCE—So, as a non-real property asset and as a foreign entity, I do not pay any tax in Australia. If I do it through New Zealand, which does not have capital gains tax, I am not going to pay any in New Zealand anyhow. I am just basically going to walk down the street with the money in my pocket, and why wouldn't I? It is a piece of legislation that was supported both by the coalition, of which I was a member—although I did not vote for it—and the Labor Party. They both voted for it. To me, that is a major loophole. Yet we are chasing an apparent loophole that is going to get us \$1 million in 2008-09 and \$6 million in each of the three financial years thereafter. In a nation with government expenditure of over a \$1 billion every working day, that is not a lot of money for a lot of work.

Mr O'Brien—I am 47 now and I have been doing tax since I was 18, and I would not regard what they are looking to do here as a major loophole.

Senator JOYCE—However, it does involve between 400,000 and 500,000 trusts. So the people who will make—and good luck to us—

Mr O'Brien—Are you talking about lawyers and accountants again?

Senator JOYCE—Lawyers and accounts—

Mr O'Brien—We always get bashed!

Senator JOYCE—are going to make an absolute squillion out of this because everybody is going to have to trot back into the office and redo everything, which I imagine is going to cost a lot more than \$1 million in the next year and \$6 million every year after. I think the fees from that will be exorbitant.

Mr O'Brien—Certainly there will be lawyers rubbing their hands together in glee.

Senator BUSHBY—Thank you for attending today. Most of the comments that you have made so far seem to relate to the changes that are made to the lineage side of things.

Mr O'Brien—Yes.

Senator BUSHBY—Do you have any comments on the election side of it as well?

Mr O'Brien—There has been a lot of legislative change around the family trust election. You will recall that changes were made. The legislation has been very confusing. When I say 'confusing', I mean it has not been well understood by the constituency that it most affects—that is the way I would put it—over a period. It is a bit like the division 7A legislation, which was not well understood by its constituency either.

Senator BUSHBY—It is still not.

Mr O'Brien—It is still not; that is probably correct. To answer your question directly, I do not see a particularly significant mischief involved again in giving a once-off opportunity to make an election or to correct an election that may not have been the best choice at the time.

Senator BUSHBY—Yes. So, although you see issues with that side of it, the main reason that you are sitting here today is because of the lineage side of things. That is what really prompted you to put in the submission and turn up today?

Mr O'Brien—I am representing FBA.

Senator BUSHBY—I am sorry, yes.

Mr O'Brien—But it is certainly the lineage issue. If you were to rate both the issues in terms of importance, I think you would certainly rate the lineage issue of higher importance.

Senator BUSHBY—We had Treasury here earlier this afternoon. Would it surprise you to hear that Treasury gave us evidence—I do not think I am misrepresenting it—that basically said that this measure is a savings measure and it is being introduced to put more money into Commonwealth revenue.

Mr O'Brien—I have read the EM.

Senator BUSHBY—They confirmed that. But when asked how much of the projected savings are coming from the lineage side of it, they were unable to give an exact figure but suggested it would be no more than \$1 million a year of the \$6 million a year. We also subsequently heard evidence from other people this afternoon who, in their view, suggested that it might be a lot less than \$1 million. Would it surprise you, given your concerns on that side of it, how little money they are actually raising from that particular part of this bill or projecting to save?

Mr O'Brien—Can you repeat the question?

Senator BUSHBY—What is your view of the fact that it appears that the whole point of introducing this bill is to put more money into Commonwealth revenues, yet the particular part that deals with lineage is going to put very little into Commonwealth revenue?

Mr O'Brien—From my experience, without having done any Treasury costings or having access to any of that material, my anecdotal view would be that it was slightly Shakespearian: much ado about nothing.

Senator BUSHBY—Having read the explanatory memoranda, as you said you have, do you think that the impact that this change will have on members of the Family Business Australia group is justified at all by the degree of savings that the Commonwealth will achieve?

Mr O'Brien—I am sorry; is the change justified by the degree of savings?

Senator BUSHBY—Particularly given the impact that it will have on your members.

Mr O'Brien—I agree. I do not think it is justified, if I understand your question correctly.

Senator BUSHBY—Yes, given that the stated reason for actually introducing the bill is to put more money back into Commonwealth revenue. We hear that that amount is going to be small, if anything at all, yet it is going to have a huge impact on your members.

Mr O'Brien—Correct.

CHAIR—Just to wind up, Mr O'Brien, what comprises the membership of Family Business Australia?

Mr O'Brien—It has 1,700 family businesses.

CHAIR—Is that around Australia?

Mrs Power—Yes.

CHAIR—Is the head office here in the ACT?

Mr O'Brien—No, it is actually in St Kilda Road.

Mrs Power—It is in Melbourne. It is a growing constituency. We have been operating for 10 years but, effectively, only for the last seven or eight years. It is a growing constituency of families that now have six and seven generations. So the test individual is an important element as well.

CHAIR—Essentially, you deal with those businesses that are set up on a family basis.

Mr O'Brien—Correct.

Mrs Power—One of the things with the test individual is that—and I refer to Senator Joyce's example—the families of today are smaller and, therefore, you may well find yourself in the position where you do not have any direct lineal descent. Your children may choose either not to marry or not to have children or they may not be able to have children, but you may well have nieces and nephews who are perfectly willing to take on the family farm or the family business.

Senator BUSHBY—What would be the options be at that point, under the legislation as proposed?

Mrs Power—Some people have already chosen, as their test individual, an election that would prevent them from doing that transfer, referring to what you—

CHAIR—Do you have rural businesses as well urban businesses in your—

Mrs Power—Yes.

CHAIR—Do you have any idea of what the split-up would be?

Mrs Power—No, I do not.

CHAIR—Fair enough. It is often hard to distinguish, in fact. As there are no further questions, thank you very much for coming in this afternoon.

Committee adjourned at 3.12 pm