Chapter 6

The role of family trusts

6.1 Family trusts are considered important for the operation of many family businesses. Used properly, trusts enable family businesses to use available resources strategically and optimally. However, the committee heard that the existing legislative frameworks across the Commonwealth, States and territories pose challenges for family businesses trading through a trust structure.

6.2 This chapter considers the following three challenges to the effective use of a family trust structure.

- First, some have argued that the rule against perpetuities in State and Territory legislation undermines business longevity.
- Second, concerns were raised with the effect of taxation requirements under Division 7A of the *Income Tax Assessment Act 1936* (the 1936 Act), Division 6 of the 1936 Act, and the capital gains tax provisions.
- Third, some submitters criticised the inclusion of family trusts in the pool of assets available for distribution as part of a family law property settlement.

Trading trusts — overview

6.3 To understand these challenges, it is important firstly to understand the role that family trusts play in the family business sector. The following section provides:

- an overview of the trust structure, and its capacity to be used to facilitate business transactions (paragraphs 6.4–6.11);
- a summary of the use of trusts by family businesses (paragraphs 6.12–6.32); and
- various aspects of current Australian trust law (6.33–6.122).

6.4 The Australian Taxation Office (ATO) defines a trust as 'an obligation imposed on a person or other entity to hold property for the benefit of beneficiaries'.[1] Trusts are typically established by trust deed.[2]

6.5 Trusts are administered by trustees, which may be individuals or corporations.[3] Trustees hold legal title in the trust property and associated income.

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1 Australian Taxation Office, *Guide to the taxation of trusts*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00245963.htm&page=3#P44_3570 (accessed 7 December 2012).

2 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, p. 24.

However, trustees are subject to two strict fiduciary duties. First, trustees must avoid a situation where their own interest may conflict with their duties as trustee. Second, trustees must not take an unauthorised profit from the trust.[4] The trustee may also be a beneficiary, provided they are not the sole beneficiary.[5] Unless otherwise specified in the trust deed, trustees are personally liable to third parties including creditors.[6] Trustees are appointed by, and may be removed by, an 'appointer', which is 'normally the person who has the greatest immediate interest in the affairs of the trust'.[7]

6.6 For beneficiaries, a trust creates an equitable interest in the trust property and associated income.[8] Their interest may be discretionary or clearly defined. Discretionary trusts do not provide beneficiaries definite rights to the income or capital generated by the trust. Their entitlements depend on the trustee electing to distribute income or capital.[9] This contrasts with 'fixed trusts' in which beneficiaries' entitlements to property and/or income is established, in writing, as part of the trust deed. Accordingly, fixed trusts do not provide the trustee discretion to determine the beneficiaries' entitlements.[10] While nominally entitled to the income generated by the trust property, beneficiaries may also be 'personally liable to the trustee to the extent of their interest in the trust'. Accordingly, it has been argued that where trust assets are

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3 Australian Taxation Office, *Guide to the taxation of trusts*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00245963.htm&page=3#P44_3570 (accessed 7 December 2012).

4 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 4th edition, Lawbook Co, Pyrmont, 2007, p. 570.

5 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, p. 24.

6 The Hon Justice Paul Brereton, *A trustee's lot is not happy one: Address to the National Family Law Conference*, 19 October 2010, p. 1, http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/brereton191010.pdf/$file/brereton191010.pdf (accessed 7 December 2012).

7 The Hon Justice Peter Nygh and Andrew Cotter-Moroz, 'The Law of trusts in the Family Court', *Australian Journal of Family Law*, 1992, vol.6, pp 4 and 5, as cited in The Hon Justice Paul Brereton, *A trustee's lot is not happy one: Address to the National family law conference*, 19 October 2010, p. 2, http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/brereton191010.pdf/$file/brereton191010.pdf (accessed 7 December 2012).

8 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, p. 49.

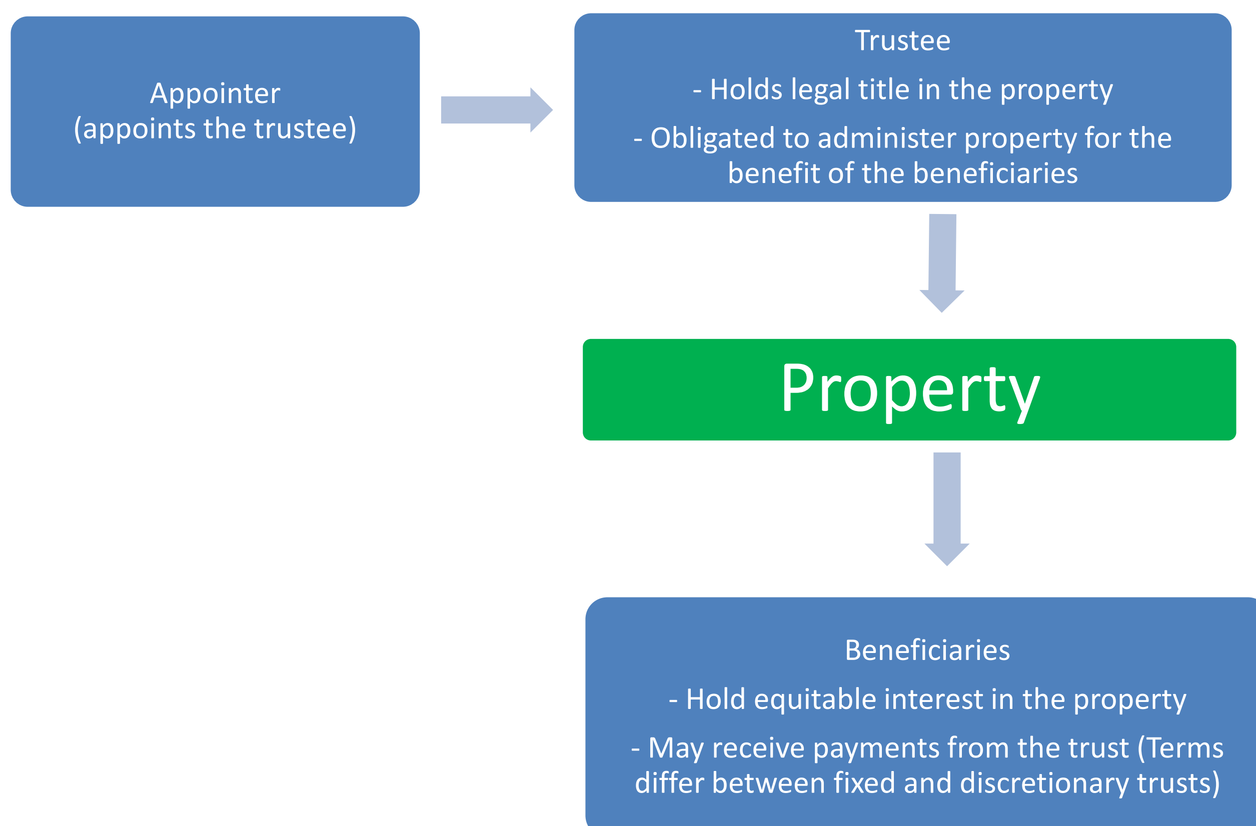
9 Australian Taxation Office, *Guide to the taxation of trusts*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00245963.htm&page=3#P44_3570 (accessed 6 December 2012).

10 Australian Taxation Office, *Guide to the taxation of trusts*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00245963.htm&page=3#P44_3570 (accessed 6 December 2012).

insufficient to repay creditors, beneficiaries may be personally liable to address any shortfall.[11]

6.7 Figure 6.1 shows the basic relationship between a trustee and beneficiaries.

Figure 6.1: The trust structure



The use of trusts to facilitate commercial transactions

6.8 Historically, trusts were used for private arrangements. Their origins lie in medieval English property and succession law. Trusts, or 'uses', were primarily used for estate planning purposes to transfer property to heirs and descendants.[12] However, Trusts were also used to 'circumvent the payment of [feudal] dues'.[13] There was a decline in the use of trusts following the introduction of legislation in 1535 which sought to disrupt the effect of the trust by recognising beneficiaries as the property

11 Philip Lipton and Abe Herzberg, *Understanding Company Law*, 12th edition, Lawbook Co, Pyrmont, 2004, p. 43.

12 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, pp 432–433.

13 Treasury, *Consultation paper: Modernising the taxation of trust income—options for reform*, November 2011, p. 4.

owners for the purposes of levying duties. This legislation prompted the further development of the trust structure.[14]

6.9 The 20th century witnessed a marked expansion in the use of trusts. Trusts 'expanded from being principally a landholding device to instruments of commercial activity'.[15] Accordingly, as academic commentators have noted:

> companies, partnerships and unincorporated non-profit associations do not represent all the structures available for collective action towards a common goal. A commercial enterprise requiring contributions of capital from a number of contributors can be organised as a trust.[16]

6.10 Trusts have retained their traditional role in estate and succession planning, while expanding into other commercial settings. They are, for example, used as investment vehicles (typically known as 'unit trusts'), for charitable purposes, and to prioritise payments to certain creditors.[17] Trusts established for trading purposes, also known as 'trading trusts', hold property for the purpose of conducting business. Trading trusts typically consist of a limited liability corporate trustee holding the business on a discretionary trust for beneficiaries or in a fixed trust for unit holders.[18] Ultimately, businesses that operate through a trust structure will be subject to trust law requirements.

6.11 The legal implications for businesses operating through a trust structure differ to those that operate as a corporation. Unlike a company, a trust is not a legal entity — this means that the trust cannot sue or be sued.[19] Trustees therefore may be personally liable for debts incurred in administering the trust. Beneficiaries, unlike members of a company, have no power to direct the trustee on the administration of the trust unless this power is specified in the trust deed. Trustees of a trust, unlike directors of a corporation, cannot personally guarantee a trust liability.[20]

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14 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, p. 434.

15 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, p. 434.

16 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, p. 20.

17 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, pp 434–435.

18 Gino E. Dal Pont and Donald RC. Chalmers, *Equity and Trusts in Australia*, 2007, p. 435.

19 Australian Taxation Office, *Guide to* the *taxation of trusts*, http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00245963.htm&page=3#P44_3570 (accessed 7 December 2012).

20 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, pp 23–24.

Family trusts in Australia

6.12 Estimates vary as to the number of family businesses that operate through a trust structure. MGI Australasia found in its 2010 Australian Family and Private Sector Survey that only 12.2 per cent of family businesses operate as family trusts. The vast majority, 80 per cent, are structured as private companies; 5.1 per cent trade as partnerships; and the remaining 1.2 per cent operate as public companies.[21]

6.13 Treasury officials estimated that of the 700,000 discretionary trusts operating in Australia in 2009–10, approximately 225,000 were family trusts. However, Treasury also noted the limitations of the data:

> How accurate that is is difficult to say because it is a self-assessing label. It is just something you tick on your tax return. Some people might misunderstand…[22]

6.14 Anecdotally, family trusts appear to be a common feature of family businesses. Deloitte characterised their use as 'typical':

> A typical family business comprises a corporate operating entity owned by a discretionary trust with both family members and a corporate entity as beneficiaries. For family groups the equity in the corporate operating entity is often the primary investment asset. A trust structure is regularly selected to hold significant long-term investments of family groups for asset protection and succession planning purposes.[23]
>
> MGI Australasia also identified trusts as a prominent feature of the family business sector. Its 2010 survey found that 80.0% of family businesses are structured as private companies and just 12.2% as private trusts, most of which we could presume are family discretionary trusts. At first glance this might give rise to the impression that trusts have a relatively minor role in family business structures.
>
> It is our contention, as experienced family business advisers, that trusts play a much more significant role in the structuring of family enterprises. Whilst there is no definitive data to validate this observation, we can point to substantial anecdotal evidence that supports:
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> - that a substantial proportion of shareholdings in family businesses are held by family discretionary trusts and
> - that regularly “passive” assets associated with the family business, such as land and buildings, are held in family trusts.[24]

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21 MGI Australasia, *Submission* 9, p. 4.

22 Mr Tony Poulakis, Assistant Commissioner, Australian Taxation Office, *Committee Hansard*, 13 November 2012, p. 14.

23 Deloitte Private, *Submission 16*, p. 22.

24 MGI Australasia, *Submission* 9, p. 6.

6.15 Family trusts are typically discretionary trusts.[25] Family trusts differ from other forms of discretionary trusts in that the pool of beneficiaries is limited to family members. Under the *Income Tax Assessment Act 1936*, a 'family' is defined for the purposes of discretionary trusts with reference to the 'test individual'. A person may be a beneficiary of the family trust if he or she is the spouse, parent, grandparent, brother, sister, niece or nephew, or the lineal descendant, of the test individual.[26]

6.16 Alternatively, as Deloitte Private explained, dividends may be distributed to a corporate beneficiary connected with the family—rather than to individual family members—to fund business activities. This mechanism reportedly reduces tax liabilities and reduces the funds available to the business, as the dividends are not subject to higher individual tax rates.[27]

6.17 KPMG suggested that company structures are often complemented by a family trust. Therefore, the data on the number of companies within the family business sector may also include companies that operate in conjunction with a subsidiary family trust:

> The main operating entity employed by family business is a private company. For reasons associated with asset protection and maintaining the family's long-term ownership and control of that capital, many families may own their equity in a business (the shares in the company) through a discretionary trust structure.[28]

6.18 The Australian Taxation Office (ATO) submitted a similar theory:

> On the face of it you might ask why aren't all family businesses or the lion's share using that family trust as the operating entity. The data indicated that it is the lion's share of the company that runs the business. It is fair to say that in some industries, or even in just trying to raise finance, it is easier to do so with a company as long as that is supported by a discretionary trust underneath owning the shares, and that makes a lot of sense to get the advantages of both structures or both entities in your family business structure.[29]

6.19 The chartered accounting firm, Grant Thornton, noted that family trusts are commonly established with a company acting as trustee:

> Companies are often used in conjunction with the family trust, most commonly to act as a trustee of the trust, due to the limitation of liability afforded by a company structure; thereby providing a degree of protection

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25 Grant Thornton, *Submission 18*, p. 1.

26 *Income Tax Assessment Act 1936,* Schedule 2F, ss. 272–95(1).

27 Deloitte Private, *Submission 16*, p. 22.

28 KPMG, *Submission 21*, p. 10.

29 Mr Tony Poulakis, Assistant Commissioner, Australian Taxation Office, *Committee Hansard*, 13 November 2012, p. 15.

> for the business assets which are being held in trust, as well as the personal assets of the family members, which would potentially be exposed should those individuals act in the capacity of trustee. In this situation, one or more family members would normally be shareholders and directors of the trustee company.[30]

6.20 It added:

> [T]he two legal structures most favoured by family businesses in Australia are companies and trust estates, however the most prevalent structure used is the family trust. This is particularly the case for businesses commenced prior to the late 1970's, possibly due to the (then) existence of death duties.
>
> […]
>
> In recent years this writer has seen more family assets being owned in a company structure, which for new businesses is now as prevalent if not more prevalent than family trusts. Despite relative advantages of family trusts…I expect the trend away from family trusts to continue.[31]

The tax minimisation benefits of operating a family trust

6.21 One of the benefits of operating a trust structure is income streaming, whereby certain types of income, specifically franked dividends and capital gains, is diverted to beneficiaries. Income streaming is available to trust beneficiaries but not to members of a company.[32] In evidence to the committee, Treasury identified income streaming and the associated income tax advantages as a principal motive for operating a trust structure:

> I guess the key advantages from a family business perspective of operating a trust relate to the ability to stream income to beneficiaries and to retain the character of that income in the hands of beneficiaries. Neither of those advantages is available in a company structure.[33]

6.22 Academic commentators have also argued that the decision whether to operate as a company or through a trust will be guided by the taxation implications of both structures.[34] Professor Harold Ford, University of Melbourne, Dr Robert Austin, University of Sydney, and Professor Ian Ramsay, University of Melbourne, have

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30 Grant Thornton, *Submission 18*, p. 1.

31 Grant Thornton, *Submission 18*, pp. 1, 3.

32 Mr Hector Thompson, General Manager, Small Business Tax Division, Treasury, *Committee Hansard*, 13 November 2012, p. 14.

33 Mr Hector Thompson, General Manager, Small Business Tax Division, Treasury, *Committee Hansard*, 13 November 2012, p. 14.

34 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, p. 7.

concluded that '[w]hether a company or a trust will be employed will depend on the impact of current taxation legislation in respect of companies and trusts.'[35]

6.23 In its submission to this inquiry, the accounting and advisory firm, Pitcher Partners, emphasised the lure of capital tax concessions in opting to establish a trust structure:

> [T]rusts are often favoured to companies from a tax perspective, as they are able to access capital gains tax concessions that are not available to companies. This can be an important consideration when establishing a family business, as the disposal of the business at a later date will often result in a capital gain.[36]

Other benefits of operating a family trust

6.24 However, several submitters challenged the view that family trusts are established primarily to minimise taxation obligations. They cited broader advantages of operating a trust structure; namely to:

- assist the business to manage succession and related estate planning issues;[37]
- provide a mechanism to retain control of the business within a family;[38] and
- provide asset protection.

6.25 Family Business Australia put to the committee that a family trust structure allows control to be retained within the family and encourages an equitable business governance model:

> The use of trusts, particularly discretionary trusts, plays an integral part in any family or privately held group structure. In essence, any family unit is best described as a "socialist" system where all members are encouraged to be inclusive and treat one another fairly.[39]

6.26 Family Business Australia (FBA) also distinguished between tax avoidance and tax minimisation and emphasised the importance of trusts for protecting family assets:

> The other thing that annoys them [family businesses] is the perception that family businesses use trusts because they want to minimise or avoid tax. They will always want to minimise tax, but they will certainly not avoid

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35 Harold AJ. Ford, Robert P. Austin and Ian M. Ramsay, *Ford's Principles of Corporations Law*, 12th edition, LexisNexis Butterworths, Chatswood, 2005, p. 7.

36 Pitcher Partners Consulting Pty Ltd, *Submission 28*, p. 10.

37 See, for example, Family Business Australia, *Submission 1*, p. 7. This issue is explored in chapter 7 of this report.

38 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 40.

39 Family Business Australia, *Submission 1*, p. 7.

> tax. In fact, the trust structures are there to protect the family assets from business mistakes. I think that there is a lot of misapprehension about things like trusts, and why family businesses embrace them.[40]

6.27 Mr Simon Le Maistre of KPMG also downplayed tax arrangements as a motivator for using a trust structure:

> I often see the tax advantages of family trusts and so forth, but when I deal with my clients, the amount you are talking about with the tax advantages around the income streaming and so forth is really lost in the enormity about what the real issue is here—that is, the more commercial drivers.[41]

6.28 He added:

> [I]n the family trusts we see I still recommend to many of my clients that a vital part of being able to achieve proper estate planning and proper asset protection is the need to keep the business intact for future generations.[42]

6.29 Mr Robert Powell of Grant Thornton, told the committee:

> [T]here has been a huge focus on the tax benefits of trusts and I think that is an overfocus…That is a very minor consideration for families that decide to use trusts in a family business situation. The other issues, in my experience, have more relevance and more prevalence as to why those trusts are set up. Tax is a by-product; it is not the main reason for doing it.[43]

6.30 MGI Australasia argued: 'it is timely to dispel the regularly dispensed myths that family trusts are no more than a tax avoidance measure'.[44] Mr Bill Winter of BW Business Development, similarly, suggested that the perception of family trusts as a tax avoidance mechanism is outdated:

> I had a family trust. When I set up my business with my brother, we were advised to set up a trust for tax reasons back in the 1970s. Obviously, that has changed.[45]

6.31 Deloitte Private conceptualised family business as a broad structure, referred to as a 'family group', of which family trusts are an integral part. Figure 7.2 illustrates Deloitte Private's concept of multiple business ventures conducted by the same family

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40 Mrs Philippa Taylor, Chief Executive Officer, Family Business Australia, *Committee Hansard*, 14 November 2012, p. 35.

41 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 40.

42 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 40.

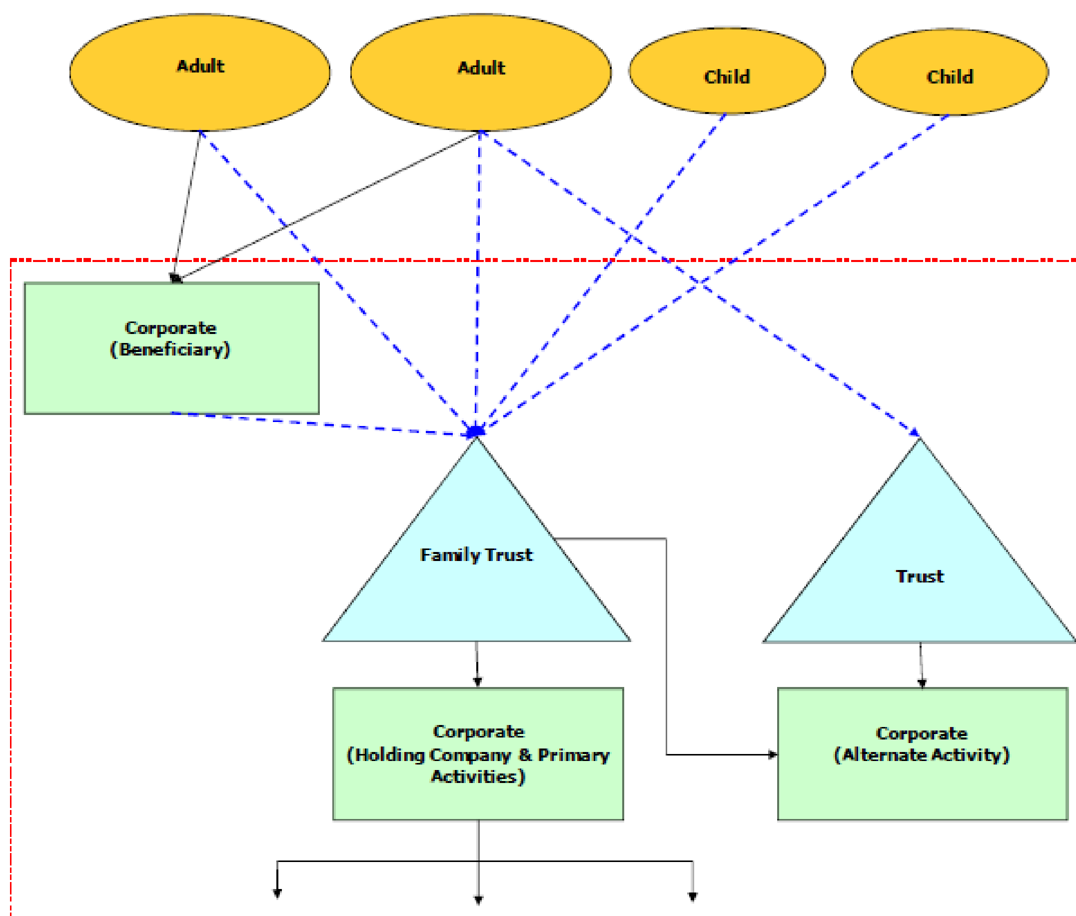
43 Mr Robert Powell, Partner, Grant Thornton, *Committee Hansard*, 14 November 2012, p. 13.

44 MGI Australasia, *Submission 9*, p. 7.

45 Mr William Winter, BW Business Development, *Committee Hansard*, 14 November 2012, p. 42.

being treated tax for purposes in the same way as transactions between subsidiary and parent companies:

Figure 6.2: Family trusts and the family group[46]



6.32 Significantly, the ATO told the committee that the advantages to succession planning, estate planning, asset protection and taxation arrangements are 'consistent generally with what the ATO observes'. The ATO further noted that 'the reasons are not just about tax effectiveness'.[47]

Legislative issues

6.33 The following section discusses a range of legislative matters relating to the operation of family trusts that have been raised with the committee. Specifically, the focus is on the following five aspects of Australian law:

- Division 7A of the *Income Tax Assessment Act 1936*;

46 Deloitte Private, *Submission* 16, p. 24.

47 Mr Tony Poulakis, Assistant Commissioner, Australian Taxation Office, *Committee Hansard*, 13 November 2012, p. 15.

- Division 6 of the *Income Tax Assessment Act 1936*;
- the capital gains tax rules;
- the property settlement rules under the *Family Law Act 1975*; and
- the rule against perpetuities.

Issues relating to Division 7A of the Income Tax Assessment Act 1936

Policy purpose of Division 7A

6.34 The direct purpose of Division 7A is to ensure that private companies cannot make tax free distributions of profits to shareholders and their associates in the form of payments or loans. The provision ensures that disguised or informal distributions of company profits are included in the assessable income of the shareholder or associate in the form of unfranked deemed dividends (trustees can be shareholders or associates of shareholders of the private company).

6.35 However, underlying this is a broader purpose to protect the progressive income tax base. This is necessary because the current corporate income tax rate of 30 per cent is lower than the marginal tax rate for individuals on incomes above $80 000 (on current thresholds) and lower than the general trustee tax rate. Without such rules, individuals and trusts would have an incentive to divert their income into companies to access the lower tax rate whilst still being able to enjoy the benefit of the income.

ATO administrative practice

6.36 Taxation Ruling 2010/3 takes the view that an unpaid present entitlement is capable of amounting to the provision of financial accommodation (a loan) by the private company beneficiary in favour of the trust. The Commissioner's view is that where the funds representing the unpaid present entitlement are not used for the sole benefit of the private company (eg: other beneficiaries of the trust can benefit from the use of those funds by the trustee), the private company has provided the trust with a loan for the purposes of Division 7A. The alternative interpretation would mean that the provisions of Division 7A could easily be avoided through the use of an unpaid present entitlement being used by shareholders to fund private purposes. Accordingly, the view contained in Taxation Ruling 2010/3 is consistent with the policy intent of Division 7A.

6.37 Prior to issuing the ruling, there had been some public statements by the ATO (but no formal advice or rulings) to the effect that unpaid present entitlements would not constitute a financial accommodation by the private company beneficiary.

6.38 Taxation Ruling 2010/3 was finalised following the publication of a draft ruling and a consultation process to gain feedback from stakeholders and raise awareness of the departure from the ATO's previously held view. The ruling took

effect prospectively (from 16 December 2009), to ensure that people who had relied upon the administrative practice were not disadvantaged.

6.39 When Division 7A of the *Income Tax Assessment Act 1936* was introduced in 1998 the ATO took the view that where a trust resolved to distribute income to a company in the same family group and the distribution was not physically paid (that is, it was intermingled funds), the ensuing outstanding unpaid present entitlement was not treated as a loan by the company to the trust and therefore Division 7A did not apply.

6.40 Taxation Ruling 2010/3 stated that Division 7A could apply to unpaid present entitlements involving family companies and other small business. The effect of this ruling and the ATO's change in view is that Division 7A is likely to apply to any trust that distributes income to a company where the distribution is not physically paid. If Division 7A does apply to an unpaid present entitlement, then the trust will be deemed to have received an unfranked dividend equal to the amount of unpaid present entitlement. Tax lawyer Ms Kay Papadopoulos has noted that the unpaid present entitlement will be taxed at the corporate rate in the hands of the company.[48]

6.41 Some have argued that Division 7A of Part III of the Income Tax Assessment Act 1936 inappropriately diminishes the resources available to family businesses that operate through a joint company and family trust structure.[49] The ATO explains the policy intent of Division 7A as follows:

> Division 7A of Part III of the *Income Tax Assessment Act 1936* is an integrity measure aimed at preventing private companies from making tax-free distributions of profits to shareholders (or their associates). In particular, advances, loans or other payments and credits to shareholders (or their associates) are, unless they come within specified exclusions, treated as assessable dividends to the extent that the private company has a distributable surplus.[50]

6.42 Division 7A is intended to disrupt attempts to minimise the tax paid on profits earned by a trust, such as a family business trading through a family trust structure. The ATO explains:

> Subdivision EA [is] designed to ensure that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to an amount of net income in favour of a private company without paying

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48 Kay Papadopoulos, ‘Distributions to company beneficiaries from family trusts and Division 7A’, *Keeping Good Companies*, vol. 62, no. 9, October 2010, pp 562–564.

49 See, for example, Family Business Australia, *Submission 1*, p. 8; KPMG, *Submission 21*, p 10.

50 Australian Taxation Office, *Division 7A—Overview*, http://www.ato.gov.au/businesses/content.aspx?doc=/content/40223.htm&pc=001/003/075/001/001&mnu=44743&mfp=001&st=&cy= (accessed 21 December 2012).

it, and then distributing the underlying cash to a shareholder (or their associate) of the company.

The trust is treated as a notional company and the general Division 7A provisions are modified to determine the amount to be included in the assessable income of the shareholder (or their associate) as if it were a dividend.[51]

6.43 In evidence to the committee, the ATO advised that Division 7A responds to, and is intended to prevent, the following kinds of business practice:

> The ATO identified instances where family trusts were making what we call unpaid present entitlements to bucket companies...What is generally done with the company is that, if the money were retained in the trust, it will be taxed at the highest notional tax rate. If it were made an entitlement to a beneficiary, including a bucket company beneficiary, it will be taxed at the company rate and therefore it is taxed at 30 per cent. It appeared as though this bucket company strategy was being utilised to avoid tax at the higher rate…The ATO, after making this observation, came to the view that the unpaid present entitlements may actually be treated as loans for Division 7A purposes.[52]

6.44 However, KPMG has claimed that Division 7A goes beyond this intent and unfairly captures unpaid present entitlements to a company from a trust:

> The original intent of Division 7A was to be an integrity provision that was aimed at ensuring loans that were in substance distributions of profits from companies to individuals, were caught within these provisions. Hence, Division 7A required that these loans be repaid or a loan agreement with minimum repayments be executed. However, unpaid present entitlements to a company from a trust are not an arrangement to disguise the distribution of profits to family members…There are very few instances where the trust uses the unpaid present entitlement for nonbusiness purposes (such as payment of personal debt).[53]

6.45 PricewaterhouseCoopers submitted that Division 7A 'operates to penalise families'.[54] The FBA contended that the restriction adds unnecessary complications and costs:

> Recent changes, particularly the measures around Unpaid Present Entitlements owing by Trusts to Private Companies after 16 December

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51 Australian Taxation Office, *Division 7A—Overview*, http://www.ato.gov.au/businesses/content.aspx?doc=/content/40223.htm&pc=001/003/075/001/001&mnu=44743&mfp=001&st=&cy= (accessed 21 December 2012).

52 Mr Tony Poulakis, Assistant Commissioner, Australian Taxation Office, *Committee Hansard*, 13 November 2012, p. 16.

53 KPMG, *Submission 21*, p. 12.

54 PricewaterhouseCoopers, *Submission 11*, p. 3.

> 2009 are now unnecessarily complicating family and privately owned business models causing additional compliance and transaction costs at a time when the entire economy is facing challenges.[55]

6.46 In KPMG's assessment, Division 7A can nullify the benefits of operating a family trust.[56] It argued that Division 7A:

- inappropriately lessens the resources available to family businesses. By requiring a loan agreement to be entered into between the trust and the company, there are additional administrative costs.[57] The Division also requires loans to be offered at a higher interest rate than what may be available on the open market.[58]
- limits the capital available to family businesses, as it restricts a family business from financing related family ventures[59]
- triggers a taxing point within a family group structure. Where a trust borrows funds from a company to buy a property and a loan is put in place, the company will be forced to pay a dividend to the family which will be taxed at the differential between the franking credit and the marginal tax rate. As KPMG put it: '…you force a taxing point to repay an artificial loan and that actually pulls capital outside the business'.[60]
- unfairly disadvantages family groups that operate through a trust structure. KPMG advised that the ATO's definition of an unpaid present entitlement has led to a situation where financial distributions between entities in the same family group, for example the transfer of funds from a corporate beneficiary of a family trust to the business' operating entity, are treated as Division 7A loans.[61] Family groups in particular are at a disadvantage because they are forced to pay a taxing point which other groups are not.[62]

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55 Family Business Australia, *Submission 1*, p. 8.

56 KPMG, *Submission 21*, p. 11.

57 KPMG, *Submission 21*, p. 11.

58 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 12.

59 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 40.

60 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 12.

61 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 13.

62 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 12.

6.47 Deloitte Private also commented that 'the application of these rules within family groups can lead to additional costs, uncertainty and perception of inequity'.[63]

6.48 Several options were recommended to address the reported problems with the operation of Division 7A. PricewaterhouseCoopers recommended that Division 7A be reconfigured to not financially disadvantage intra-family transactions:

> We recommend Division 7A be amended so that the rules don't penalise private business borrowing arrangements where either:
>
> - the borrowing entities are entitled to claim an income tax deduction for servicing such debt – an 'otherwise deductible rule'; or
> - the terms relating to such loans are arms' length in nature.
>
> We would also recommend removing the strict requirements that documentation be prepared with certain timeframes.[64]

6.49 Deloitte Private argued that the taxation system should acknowledge and account for the operation of family groups, through 'essentially ignoring' intra-group transactions:

> A cohesive structure for the taxation of family groups would ideally allow for profits contributed back into a business to be excluded from individual tax rate treatment and provide a simple process for calculating group tax payable. Alternatively the introduction of a family tax unit concept would provide the ability to pool income (with or without the use of trusts).[65]

6.50 In support of this proposal, Deloitte Private submitted that such an approach would place family groups on equal footing with corporations. It stated that recognising intra-family transactions would provide the benefits of family groups benefits that are 'enjoyed by corporate groups who have entered the consolidation regime'.[66] Deloitte Private argued that this would be consistent with overseas practice.[67]

6.51 The ATO acknowledged that the inclusion of 'bucket company' loans, that is unpaid present entitlements, within Division 7A 'has been somewhat controversial'.[68] On 18 May 2012, the government announced that the Board of Taxation would be

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63 Deloitte Private, *Submission 16*, p. 23.

64 PricewaterhouseCoopers, *Submission 11*, p. 4.

65 Deloitte Private, *Submission 16*, p. 23.

66 Deloitte Private, *Submission 16*, p. 23.

67 Deloitte Private, *Submission 16*, p. 24.

68 Mr Tony Poulakis, Assistant Commissioner, Australian Taxation Office, *Committee Hansard*, 13 November 2012, p. 16.

reviewing Division 7A, which includes the treatment of unpaid present entitlements.[69] In announcing the review, the government noted that Division 7A has been identified as a 'particularly thorny issue for small business – especially for users of trusts that need working capital to reinvest in their business'.[70] The Board is scheduled to report to Government by 30 June 2013.[71]

Committee view

6.52 The committee acknowledges submitters' concerns with the operation of Division 7A. It recognises the concerns of family business representatives that Division 7A has imposed significant compliance costs for some family businesses. However, the committee also acknowledges that Division 7A was established for the legitimate purpose of ensuring the integrity of Australia's progressive taxation system. Division 7A should not be altered in a way that would expose Australia's taxation system to misuse.

6.53 ATO regulations should achieve an appropriate balance between supporting businesses while maintaining the integrity of Australia's taxation system. There is some evidence that at present Division 7A may not be achieving this balance. The committee therefore recommends the Board of Taxation take account of the evidence presented by the family business sector on the effect of Division 7A on business performance.

Recommendation 12

6.54 The committee recommends that as part of its current inquiry into Division 7A of the *Income Tax Assessment Act 1936*, the Board of Taxation closely review the evidence gathered through this inquiry about the effect of Division 7A on Australia's family business sector. In considering the evidence, the Board of Taxation should consider what measures can be taken to support Australian family businesses, and by extension the Australian economy, while giving due regard to appropriate taxation obligations.

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69 Mr Hector Thompson, General Manager, Small Business Tax Division, Treasury, *Committee Hansard*, 13 November 2012, p. 16.

70 The Hon David Bradbury MP, Assistant Treasurer, 'Board of Taxation to conduct a post-implementation review of Division 7A', Media release 033, 18 May 2012.

71 The Hon David Bradbury MP, Assistant Treasurer, 'Board of Taxation to conduct a post-implementation review of Division 7A', Media release 033, 18 May 2012.

Recommendation 13

6.55 The committee recommends that the government publicly release the Board of Taxation's report into the operation of Division 7A of the *Income Tax Assessment Act 1936*.

Issues arising out of Division 6 of the Income Tax Assessment Act 1936

6.56 The committee heard that the rules in Division 6, Part III of the *Income Tax Assessment Act 1936* (the 1936 Act) that govern the taxation of income of family trading trusts are complex and cumbersome.[72] Division 6, Part III of the 1936 Act establishes the rules to determine the taxation of trust income. This can include the income of family trusts used as a means of operating a family business.[73]

6.57 The final report of the 2009 review *Australia's future tax system* provided the following synopsis of the taxation requirements applying to trading trusts:

> Trusts can be used as an alternative structure for conducting business activities. Trusts are largely taxed on a flow-through basis, with the income of a trust allocated to its beneficiaries based on their 'present entitlements'. However, losses do not flow through to beneficiaries. Where there is income of the trust to which no beneficiary is presently entitled, it is taxed in the hands of the trustee at the top personal income tax rate plus the Medicare levy.
>
> […]
>
> The general rules governing the taxation of trusts rely on a mix of trust law concepts (which mostly derive from case law) and tax law concepts (which derive from case law and statute).[74]

6.58 Reflecting on the development of Division 6 and trading trusts in Australia, academic commentators have noted that trading trusts do not fit easily within the Division 6 framework:

> The assumption on which Div 6 and its antecedents were drafted was that there would be no significant differences between net or distributable trust income and what would be calculated as the notional taxable income of the trustee…Once a business is embarked upon, however, a whole range of discrepancies emerge.[75]

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72 National Farmers' Federation, *Submission 29*, p. 9; PricewaterhouseCoopers, *Submission 11*, p. 3.

73 Treasury, *Consultation paper: Modernising the taxation of trust income – options for reform*, November 2011, pp. 5, 9.

74 Dr Ken Henry et al, *Australia's Future Tax System: Final Report*, 'Chapter B: Investment and entity taxation', December 2009, p. 190, http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-2.htm (accessed 21 January 2013).

75 Antony H. Slater QC, 'Taxing trust income after Bamford's case', 2011, 40 AT Rev 60 at 80.

6.59 The 2009 review *Australia's future tax system* also noted the difficulties of applying Division 6 to trading trusts. The review found that there is a lack of certainty about the concepts underpinning Division 6:

> Differing views on key concepts, such as 'present entitlement', 'income of the trust estate' and 'share', create uncertain tax outcomes for taxpayers, increasing compliance and administration costs.[76]

6.60 Accordingly, the review panel recommended that '[t]he current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application'.[77]

6.61 As the ATO has stated, 'income of the trust estate' and 'share' of income are key concepts necessary to determine income tax liabilities of trusts. However, their meaning is not defined in the 1936 Act. These key taxation concepts were the subject of the 2010 High Court case *Commissioner of Taxation v Bamford & Ors* [2010] HCA 10 (the Bamford case). PricewaterhouseCoopers and the National Farmers' Federation submitted that rather than providing clarity and certainty for businesses, the Bamford case has added further complexity to trust taxation laws.[78] It is evident that the government shares these concerns:

> The recent High Court decision in *Commissioner of Taxation v Bamford* highlighted ongoing discrepancies between the treatment of trust income by trust laws, on the one hand, and by the tax system on the other. Tax outcomes for beneficiaries of trusts often do not match the amounts they are entitled to under trust law and the trust deed. This can result in unfair outcomes as well as opportunities for taxpayers to manipulate their tax liabilities.[79]

6.62 Following the release of the final report of the *Australia's future tax system* review and the High Court's judgement in the Bamford case, the Australian government announced it would 'undertake a process of public consultation as a first step towards updating the trust income tax provisions in Division 6 of Part III of the

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76 Dr Ken Henry et al, *Australia's Future Tax System: Final Report*, 'Chapter B: Investment and entity taxation', December 2009, p. 190, http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-2.htm (accessed 21 January 2013).

77 Dr Ken Henry et al, *Australia's Future Tax System: Final Report*, 'Chapter B: Investment and entity taxation', Recommendation 36, December 2009, p. 191, http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-2.htm (accessed 21 January 2013).

78 National Farmers' Federation, *Submission 29*, p. 9; PricewaterhouseCoopers, *Submission 11*, p. 3.

79 The Hon Bill Shorten MP, Minister for Financial Services and Superannuation, 'Farmers benefit with changes to trust laws', Media release 025, 16 December 2010.

Income Tax Assessment Act 1936 and rewriting them into the *Income Tax Assessment Act 1997'*.[80]

6.63 Where noted, family business representatives shared the view that there is a need to reform Division 6.[81] However, submitters were cautious about the outcome of the review. The National Farmers' Federation argued that, to enable farmers to clearly understand and work within taxation requirements, further reforms following the Division 6 review should be limited. PricewaterhouseCoopers noted with concern the potential for the reform process to introduce additional obligations on trustees.[82]

Committee view

6.64 The committee is concerned that the current operation of the rules in Division 6 is unclear, uncertain and may create unnecessary complexity for Australian businesses. The committee particularly notes the findings of the 2009 review *Australia's future tax system* which claims that Division 6 increases compliance and administrative costs for Australian businesses. The committee agrees that there is a need to review Division 6 to ensure it imposes clear and equitable taxation requirements. The committee looks forward to discussion as to how the operation of Division 6 could be improved, and encourages the government to release a timetable for the introduction of legislation.

6.65 It is apparent that Division 6 is of particular concern for the family business sector. While the exact proportion of the family business sector that operates under a trust structure is currently difficult to quantify, it is clear that family trusts are an established feature of the Australian business landscape. Accordingly, the committee recommends that in developing the draft legislation Treasury meet with representatives of the family business sector. The reform options should achieve an appropriate balance between promoting business interests and the proper operation of Australia's taxation system.

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80 The Hon Bill Shorten MP, Minister for Financial Services and Superannuation, 'Farmers benefit with changes to trust laws', Media release 025, 16 December 2010.

81 National Farmers' Federation, *Submission 29*, p. 9; PricewaterhouseCoopers, *Submission 11*, p. 3.

82 National Farmers' Federation, *Submission 29*, p. 9; PricewaterhouseCoopers, *Submission 11*, p. 3.

Recommendation 14

6.66 The committee recommends that as part of the current analysis of options to reform the Division 6, Part III of the *Income Tax Assessment Act 1936* the Department of the Treasury review the evidence gathered through the committee's inquiry into family businesses in Australia and consult with representatives of the family business sector.

Family trusts and capital gains tax

6.67 On 1 November 2008, Division 104 of the *Income Tax Assessment Act 1997* was amended to repeal the exception to capital gains tax events E1 and E2. The exception, commonly referred to as the 'trust cloning' exception, was a key focus of submitters to the inquiry.

6.68 Prior to their repeal, subsections 104–55(1) and 104–60(1) of Division 104 of the Income Tax Assessment Act removed the requirement to pay capital gains tax (CGT) in certain circumstances. CGT is incurred where a trust is created over a CGT asset by declaration or settlement (referred to by submitters to this inquiry as CGT event E1).[83] The trust cloning exception in subsection 104–55(1) removed the requirement to pay CGT in circumstances where the trust was created by transferring the asset from another trust with the same beneficiaries and operating terms. Similarly, CGT is incurred by transferring a CGT asset to an existing trust (referred to by submitters to this inquiry as CGT event E2).[84] The trust cloning exception in subsection 104–60(1) provided that capital gains tax was not incurred if the asset was transferred from another trust with identical terms and beneficiaries.

6.69 Family business advisors submitted that trust cloning was a legitimate, and necessary, business management practice. MGI Australasia argued that trust cloning was a 'valuable mechanism' that provided appropriate business management flexibility and reduced the potential for family conflict to derail the succession process.[85] The Institute of Chartered Accountants Australia submitted:

> One of the means open to family businesses to transfer business assets without triggering a CGT event was the practice of trust cloning…Trust cloning facilitated succession planning, allowing effective control of assets to pass between trusts, within a family group, without triggering a CGT liability.[86]

6.70 On 31 October 2008, the government announced its intention to repeal the tax cloning exceptions. It was further announced that the repeal would take effect on

83 See, for example, Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

84 See, for example, MGI Australasia, *Submission 9*, p. 8.

85 MGI Australasia, *Submission 9*, p. 7.

86 Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

1 November 2008. The trust cloning exceptions were repealed by the *Tax Laws Amendment (2009 Measures No. 6) Act 2010*.

6.71 The Tax Laws Amendment (2009 Measures No. 6) Act also introduced measures to allow limited CGT rollover relief for the transfer of assets between fixed trusts.[87] For family businesses, it is notable that the rollover relief was not designed to be available for the transfer of assets between discretionary trusts. The Explanatory Memorandum (EM) to the Tax Laws Amendment (2009 Measures No. 6) Bill 2009 makes clear that this distinction between discretionary and fixed trusts was intentional and based on the policy perspective that, unlike fixed trusts, it is difficult to establish the ownership of assets held in discretionary trusts:

> [S]o-called discretionary trusts cannot access the rollover. This is because it is difficult to establish, with any degree of certainty, the real underlying ownership of the assets of a discretionary trust. Therefore, it is equally difficult to test whether that ownership has been maintained.
>
> […]
>
> In effect, beneficiaries' interest should be 'fixed'. This requirement is consistent with the objective of ensuring that subsequent changes in effective ownership are subject to appropriate tax consequences.[88]

6.72 In announcing the intention to repeal the trust cloning exception, the Government emphasised that the proposed changes to the CGT rules were necessary to 'help ensure equity and the integrity of the tax system'.[89] As stated in the EM, the trust cloning exceptions were considered to undermine market integrity:

> The trust cloning exception allows the creation of a trust over a CGT asset or the transfer of a CGT asset to an existing trust without triggering a CGT taxing point, provided the beneficiaries and terms of both trusts are the same.
>
> However, this can be used to change ownership of an asset without a CGT taxing point. It potentially allows taxpayers to eliminate tax liabilities on accrued capital gains, undermining equity and the integrity of the tax system.[90]

6.73 The repeal of the trust cloning exception was intended to promote a fair marketplace, by ensuring that changes in asset ownership generally trigger a CGT taxation point:

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87 Schedule 1, Item 9, section 126–220, Tax Laws Amendment (2009 Measures No. 6) Bill 2009.

88 Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 6) Bill 2009, paragraphs 1.29; 1.32–1.33.

89 The Hon Chris Bowen MP, Assistant Treasurer, 'Government abolishes trust cloning tax concession', Media release 092, 31 October 2008.

90 Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 6) Bill 2009, paragraphs 1.4–1.5.

> The repeal of the trust cloning exception is consistent with the policy principle of taxing capital gains that arise where there is a change in ownership of an asset.[91]

6.74 Submitters to this inquiry acknowledged the market integrity principles that prompted the repeal of the trust cloning exception.[92] However, submitters disputed that the use of the trust cloning exception to facilitate family business transfers, and other 'legitimate' business purposes, presented a market integrity risk.[93] The submission of the Institute of Chartered Accountants Australia encapsulated the views put forward in defence of the trust cloning exception:

> The Institute acknowledges that the trust cloning exception was too wide and needed to be narrowed to protect the CGT base. However, we believe that the exception should not have been abolished entirely and should instead have been replaced with narrower provisions, with appropriate integrity measures, to preserve the use of trust cloning for legitimate business purposes (including asset and business protection, business restructuring and succession planning).[94]

6.75 The view that trust cloning is a legitimate means of operating a business was submitted as part of the consultation process on the proposed repeal of the trust cloning exception. For example, at the time of the consultation process the Institute of Chartered Accountants in Australia[95] argued:

> Discretionary trusts are a common conduit structure used by SMEs. Where SMEs operate through discretionary trust structures, outside of either section 104-55(5)(b) or section 104-60(5)(b), there is currently little or no CGT relief for restructuring arrangements.
>
> As demonstrated below, trust cloning is used by SMEs for legitimate family and commercial reasons. It is often used to facilitate asset or business protection and restructuring in cases where there is no change in the economic ownership of the underlying assets.
>
> We are concerned that the proposed removal of the exceptions to CGT event E1 and E2 will not be replaced by any provision allowing CGT relief involving the transfer of an asset from one trust to another. From an SME

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91 The Hon Dr Craig Emerson MP, Minister Assisting the Finance Minister on Deregulation, *House of Representatives Hansard*, 25 November 2009, p. 12776; The Hon Chris Bowen MP, Assistant Treasurer, 'Government abolishes trust cloning tax concession', Media release 092, 31 October 2008; Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 6) Bill 2009, paragraph 1.6.

92 See, for example, Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

93 See, for example, Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 32.

94 Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

95 Currently known as the Institute of Chartered Accountants Australia.

perspective…we submit that a narrower targeted exception should be considered by Government and the Treasury.[96]

6.76 However, as Treasury's response to the consultation process indicates, the Government did not support the view that the transfer of assets that occurs when a trust is cloned is a legitimate business practice that, accordingly, should not incur CGT:

> Most of the submissions on the policy design of the measure to abolish the CGT trust cloning exception opposed abolishing the exception. The submissions argued that there are non-tax reasons for using trust cloning, and uncertainty and integrity concerns should be addressed directly, by legislating a roll-over.
>
> This request is contrary to the policy intent of…the original decision to abolish the CGT trust cloning exception. Although there may be non-tax reasons for the transfer, this does not mean it should not give rise to a CGT taxing point. It is the change in underlying ownership, not the reasons for the transaction, that is the policy reason for a CGT taxing point.[97]

6.77 The EM to the Tax Laws Amendment (2009 Measures No. 6) Bill 2009 indicates that it was anticipated that the repeal of the trust cloning exception would have minimal financial impact. The EM also indicates that it was expected that Australian businesses would not incur significant costs to comply with the new taxation arrangements.[98] Evidence presented to this committee about the financial impact of the repeal of the trust cloning exception was largely anecdotal.

6.78 A number of family business owners spoke of the challenges presented by CGT, and advised that these challenges are preventing the transfer of business ownership to the next generation. Mr Peter Levi, Managing Director, Co-owner, Colorific Australia, argued that CGT limits succession options. Mr Levi advised that while it was possible to transfer the management of the business, CGT effectively prevented the transfer of business ownership:

> Certainly in our own business—we are a 22-year-old business employing around 35 people and I have both sons in the business—to transition control is one thing; to transition ownership is another thing altogether. Without going into details, we have a trust structure, but to transfer part of the business we are subject to CGT issues. We want to retain control of the business, obviously, and ownership within the family. Our two boys are

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96 Institute of Chartered Accountants in Australia, *Submission concerning the proposed abolition of the capital gains tax trust cloning exception*, 8 December 2008, p. 3, http://archive.treasury.gov.au/documents/1448/PDF/ICAA.pdf (accessed 15 January 2013).

97 Treasury, 'Abolishing the capital gains tax (CGT) trust cloning exception and providing rollover for fixed trusts—Summary of consultation process', 2009, p.1, http://archive.treasury.gov.au/documents/1435/PDF/Consultation_Summary.pdf (accessed 15 January 2013).

98 Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 6) Bill 2009, p.7.

> coming up and are effectively managing the business now. One is my second-in-charge—doing a fantastic job—– and they really deserve to have ownership, but we cannot afford to be in a CGT situation.[99]

6.79 Similarly, Mr Graham Henderson, co-owner of a family business and Director, Family Business Australia, commented:

> We have mentioned quite clearly the capital gains tax implications and complexities with regard to transfer of a business to the next generation. Our business is 63 years old, so we will be looking to transition to the next generation and certainly it is part of our succession planning policy, so the capital gains tax is a very important plan for us.[100]

6.80 Family business advisors also provided anecdotal comment on the effect of the repeal of the trust cloning exception. KPMG and the Institute of Chartered Accountants Australia both submitted that the repeal of the trust cloning exception, and the resulting CGT obligations, have undermined the sector's capacity to continue the business into the next generation. KPMG advised that:

> the legislative environment…does not encourage the implementation of planned succession due to the tax impost that could arise as a result of changes of ownership of equity or business assets, during the owner's lifetime.[101]

6.81 KPMG further stated:

> [f]amily businesses are united when it comes to their desire for a simpler and more supportive tax regime, particularly with respect to CGT and inheritance tax. All too often the value created by each generation is almost wiped out by the substantial tax that is imposed when transferring the business to the next generation.[102]

6.82 The Institute of Chartered Accountants Australia advised that with the removal of the trust cloning exception the intergenerational transfer of business ownership triggers a CGT event, which businesses fund within existing business assets. Accordingly, intergenerational transfers can reduce a business' asset pool and therefore it's potential productivity and trading capacity:

> To maintain the viability of the family business sector consideration needs to be given to ways to enable the legitimate intergenerational transfer of

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99 Mr Peter Levi, Managing Director, Co-owner, Colorific Australia, *Committee Hansard*, 14 November 2012, p. 38.

100 Mr Graham Henderson, Director, Family Business Australia, *Committee Hansard*, 14 November 2012, p. 43.

101 KPMG, *Submission 11*, p. 7.

102 KPMG, *Submission 11*, p. 15.

> businesses without tax impost constituting a significant drain on the sector's resources and potential growth.[103]

6.83 KPMG also advised that CGT resulting from succession inappropriately erodes a business' asset base:

> We note that the CGT consequences create an unnecessary cash flow burden to family groups when looking to transition their business. So much so, that the tax consequences may outweigh the benefits and the parents may instead choose to dispose of their interest to third parties, or alternatively do nothing.[104]

6.84 KPMG further advised that the removal of the trust cloning exception exposes family businesses to poor business practices, such as including the business among the assets to be distributed as part of a deceased estate. KPMG noted that such transfers do not attract CGT while, with the repeal of the trust cloning exception, transfers during the life of the current generation are liable to CGT. Accordingly, it was argued that 'it is important for policymakers to look at offering the same concessions in life as we do in death.'[105] Treasury confirmed that CGT is not payable for assets transferred as part of a deceased estate.[106]

6.85 The committee was also advised that the removal of the trust cloning exception has increased the risk of family conflict and the difficulty of managing the succession process.[107] MGI Australasia submitted:

> [I]n our experience the results of this has not been to raise additional CGT revenue, but rather has meant that family members, particularly siblings, have chosen to share control of family discretionary trusts with all the potential for conflict that entails and the resultant damage that this brings to both business and family.[108]

6.86 The committee did not receive statistical data to support the view implicit in this anecdotal evidence that the repeal of the trust cloning exception is resulting in the closure or downsizing of family businesses.

6.87 Family business advisors advocated for amendments to the current CGT requirements. MGI Australasia called for the trust cloning exception to be

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103 Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

104 KPMG, *Submission 11*, p. 16.

105 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 14.

106 Mr Paul McMahon, Manager, Small Business Tax General Unit, Treasury, *Committee Hansard*, 13 November 2012, p. 12.

107 See, for example, Mr Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 40.

108 MGI Australasia, *Submission 9*, p. 8.

reinstated.[109] Similarly, but not identically, the Institute of Chartered Accountants Australia recommended the committee 'give consideration to the merits of reinstating a narrow version of the previous tax cloning exception'.[110] KPMG effectively recommended the reintroduction of the trust cloning exception. However, the recommendation was nuanced as it was founded on the argument that family businesses should not incur additional costs for adopting smarter business practices and the concept that a family business is one part of a broader family group:

> [I]n order to encourage the longest term sustainability of family businesses, it is recommended that the CGT treatment the intergenerational transfers of interests in a business to their family members should mirror the CGT treatment of an asset passing to a beneficiary through a deceased estate.
>
> Alternatively, the transfer of the family's ownership interest in a family business to another member of the family should not be regarded as the change in ownership tantamount to a disposal.[111]

6.88 PricewaterhouseCoopers submitted that discretionary trust should be afforded the same opportunities as fixed trusts, recommending the introduction of a rollover mechanism to allow family discretionary trusts to disregard any capital gains resulting from the transfer of individual's assets to the trust. It was argued that this would not undermine the integrity of Australia's taxation system as a 'Family Trust election is an integrity measure that penalises those trusts that provide benefits to non family members'.[112]

Committee view

6.89 The committee appreciates the views of the family business advisors and family businesses who spoke of the effect of the repeal of the trust cloning exception. It is evident that among the family businesses that operate under a trust structure the repeal of the trust cloning exception is an ongoing concern, and has required changes to business practice. Given the evidence that CGT implications may be impeding the innovation and planning of family businesses' succession arrangements, this matter should be considered in the next five years as more data becomes available. The committee further notes that similar concerns were raised at the time the legislation to repeal the trust cloning exception was drafted. The Government's response to these concerns is compelling. The Government's current view is that there are sound policy reasons for all transfers of business assets to equally be subject to CGT laws.

109 MGI Australasia, *Submission 9*, p. 8.

110 Institute of Chartered Accountants Australia, *Submission 25*, p. 5.

111 KPMG, *Submission 11*, p. 16.

112 PricewaterhouseCoopers, *Submission 11*, p. 2.

CGT and the sale of farms

6.90 The committee received some evidence that selling the family farm to the next generation would not trigger a CGT event, whereas CGT would be payable in selling a non-rural business to family members. Mr Donald McKenzie, formerly of KPMG, told the committee:

> Whilst these have been mitigated with some stamp duty concessions—for example, family farm roll-over and small business capital gains concessions—they still need to be reviewed as there is still stamp duty payable on property used in family businesses other than farms transferring from one generation to the next, other than by death.[113]

6.91 This issue was put to the ATO for its response. The ATO explained that:

> …the tax laws currently do not have any great distinction between whether you are in business as a farmer or in any other business in the sense of transferring assets and that sort of thing…
>
> …if you want to sell business assets in certain ways and you want to, say, then use those proceeds to, say, put into super or to acquire other assets then there are rollovers that prevent CGT events occurring. I am not familiar with the concession you are alluding to…

Family law property settlements

6.92 Concerns were raised with the inclusion of family trust assets and income in the pool of property available for distribution as part of a family law property settlement. Mr Robert Powell, Partner, Grant Thornton Australia, shared the view that trusts may be established to protect business assets. Mr Powell advised that historically trusts were created to isolate business assets from the assets that may be subject to property orders under the *Family Law Act 1975*. The committee was informed that sustaining the business through a family breakdown is an issue of some significance to family businesses:

> My experience with the businesses I have worked with is that a lot of those families, particularly the patriarch and the matriarch, are terrified that the children will marry badly and their relationships will break down and that the family's business assets will be under attack from ex-partners, ex-spouses. That is something that keeps them awake at night. That is a driving reason why a lot of businesses protect the assets within a trust structure.[114]

6.93 However, the committee was advised that following recent developments in family law case law, trust assets, and by extension a family business, may no longer be immune from the financial consequences of family breakdown:

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113 Mr Donald McKenzie, *Committee Hansard*, 21 January 2013, p. 10.

114 Mr Robert Powell, Partner, Grant Thornton, *Committee Hansard*, 14 November 2012, p. 13.

> If a trust is in control of those assets, technically speaking no one in the family directly owns anything. I will say though that there have been more and more family law challenges to that concept. I do not think that proposition holds as much water as it used to. I think there is a greater tendency for the courts to see through a trust and I would say that a lot of trusts are formed with the intention of protecting their assets but they are not necessarily operated in a way that actually provides that protection.[115]

6.94 Accordingly, Grant Thornton predicted 'a trend away from family trusts' as a form of asset protection.[116]

6.95 Implicit in this advice is the view that the family law system is eroding, or has the capacity to undermine, the stability and profitability of the family business sector. However, there are also policy reasons why it may be appropriate for business assets to be taken into account in family law proceedings. Mr Peter Strong, Executive Director, Council of Small Business Australia, noted that all parties who have contributed to a business, whether in a formal or informal capacity, should have their contributions acknowledged in the event of a family breakdown:

> I also agree with you on that issue about getting a share of the results of the business. If someone has been putting in time and effort in doing the books and a whole range of other things and that is not recognised in a formal sense, we need to step back and recognise it for reasons of superannuation. If they do split up, they should get a proper and fair share of what they put in. It is an issue that we need to look at.[117]

Committee view

6.96 Family law matters are outside the mandate given to the committee under the *Australian Securities and Investments Commission Act 2001*.[118] The committee did not receive any evidence from family law experts such as the Commonwealth Attorney General's Department or the Family Court of Australia and the Federal Magistrates Court. Nor did the committee receive evidence from advocates for family members experiencing family breakdown such as the Women's Legal Service or the Lone Fathers' Association. Evidence was provided purely from a business perspective.

6.97 The committee understands that it is an established principle of Australia's family law system that the family courts may have regard to assets or income held on trust. The High Court of Australia has confirmed that trust assets and income may be treated as the property of the parties to property proceedings under the Family Law

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115 Mr Robert Powell, Partner, Grant Thornton, *Committee Hansard*, 14 November 2012, p. 13.

116 Grant Thornton, *Submission 18*, p. 3; Mr Robert Powell, Partner, Grant Thornton, *Committee Hansard*, 14 November 2012, p. 15.

117 Mr Peter Strong, Executive Director, Council of Small Business Australia, *Committee Hansard*, 13 November 2012, p. 28.

118 *Australian Securities and Investments Commission Act 2001*, s. 243.

Act.[119] Accordingly, beneficiaries' entitlements may be included in property settlements. Discretionary trusts, such as family trusts operated for business reasons, may be subject to family law property settlements regardless of the purpose for which the trust was established or the time at which the trust was created.[120]

6.98 The committee is aware of academic debate about whether business assets held in a discretionary trust may be inappropriately subject to family law property proceedings.[121] However, as the High Court has noted, 'the question whether the property of the trust is, in reality, the property of the parties...is a matter dependent upon the facts and circumstances of each particular case including the terms of the relevant trust deed.'[122] The committee notes that the High Court has held that:

> [w]here property is held under such a trust by a party to a marriage and the property has been acquired by or through the efforts of that party or his or her spouse, whether before or during the marriage, it does not…necessarily lose its character as property of parties to the marriage because the party has declared a trust.[123]

6.99 In the absence of compelling evidence to the contrary, it would appear there are sound reasons for including trust assets in family law property settlements. It is also evident that the family courts have broad access to trust assets; and therefore property settlements may affect other forms of trusts. The ambit of the Family Law Act is broader than discretionary trusts used as a vehicle for operating a family business. If changes were to occur to the family law system to appropriately isolate business interests, any unintended consequences that would prevent a fair and equitable distribution of property should be avoided. Accordingly, any amendments would need to be carefully considered.

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119 *Kennon v Spry* [2008] HCA 56. A useful summary of the case is provided in High Court of Australia, Public Information Officer, '*Kennon v Spry*', Media release, 3 December 2008; the Hon Justice Paul Brereton AM RFD, *A trustee's lot is not a happy one – Address to the National Family Law Conference October 2010*, 19 October 2010, http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/brereton191010.pdf/$file/brereton191010.pdf (accessed 18 January 2013).

120 *Marriage of Johnson* (2000) 155 FLR 44 at 50–52 per Warnick J, as cited in Dal Pont and Chalmers, *Equity and Trusts in Australia*, 2007, p. 525.

121 See, for example, the Hon Justice Paul Brereton AM RFD, *A trustee's lot is not a happy one – Address to the National Family Law Conference October 2010*, 19 October 2010, http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/brereton191010.pdf/$file/brereton191010.pdf (accessed 18 January 2013); McCullough Robertson, *Assets of the family trust not necessarily a risk on a family breakdown*, http://www.mccullough.com.au/icms_docs/126467_Structuring_-_14_June_2012.pdf (accessed 18 January 2013); Norton and Smailes, *Discretionary trusts, their treatment by the Family Court, and possible tax issues*, http://www.nortonsmailes.com.au/newsletters/discretionary-trusts-and-their-treatment-by-the-fa/ (accessed 18 January 2013).

122 *Kennon v Spry* [2008] HCA 56, at 57 per French CJ.

123 *Kennon v Spry* [2008] HCA 56, at 65 per French CJ.

6.100 The committee is charged with monitoring the operation of Australia's corporations legislation.[124] It is a principle of this legislation that Commonwealth law and policy should promote market integrity and stability.[125] The anecdotal evidence provided to this committee indicates that individual businesses can be affected by family law property settlements. However, the evidence has not demonstrated that this is a market stability issue. The committee acknowledges the concerns of family businesses about the family courts' access to trust assets. However, the case for legislative amendment has not been made.

The rule against perpetuities

6.101 In addition to concerns with the operation of the Commonwealth law, family businesses and family business advisors also expressed strong concerns with the rule against perpetuities, which is operative in States and Territories. The rule against perpetuities prevents property being indefinitely held in trust. The committee was informed that the rule is of long-standing.[126] However, submitters were uncertain of both its origins and the reasons for which it was established.[127]

6.102 The committee understands that the rule has its origins in the 1682 decision of Lord Nottingham in the *Duke of Norfolk's Case*.[128] The case established the principle that '[n]o interest is good unless it must vest if at all not later than twenty–one years after some life in being at the creation of the interest'.[129] Effectively, this requires trusts to cease operating no later than 21 years after the death of a specified person. This requirement reflects the traditional use of trusts for estate planning purposes. As outlined in the 1993 Northern Territory Law Reform Committee's report into the operation of the rule against perpetuities:

> [t]he rule of law known as the rule against perpetuities is one of the rules developed by English courts to restrict dispositions of property which might tie up land or wealth indefinitely or for too long a time. The rule developed in the late 17th century, when family settlements were often made with the intention of keeping property within the landed families from generation to generation and to protect family fortunes against profligate heirs and their

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124 *Australian Securities and Investments Commission Act 2001*, s. 243.

125 *Australian Securities and Investments Commission Act 2001*, s. 1.

126 See, for example, Mr Donald Hugh McKenzie, Private capacity, *Committee Hansard*, 21 January 2013, p. 17.

127 See, for example, Mr McKenzie, Private capacity, *Committee Hansard*, 21 January 2013, p. 17; Mr Robert Powell, Partner, Grant Thornton Australia, *Committee Hansard*, 15 November 2012, p. 15.

128 Queensland Law Reform Commission, *The law relating to perpetuities accumulations*, Report No.7, 24 May 1971, p. 2.

129 Law Reform Committee of South Australia, *Relating to the reform of the law to perpetuities*, Report No. 73, 8 November 1983, p. 2, citing *Grey on Perpetuities* and *Cadell v Palmer* (1833) 1 Cl. & Fin 372; E.R. 956.

> creditors. These settlements effectively prevented the sale or mortgage of land over substantial periods of time. The courts thought it necessary to place some restraint on schemes that tied up land 'in perpetuity'.[130]

6.103 Australian courts have also supported the rule against perpetuities, recognising that it 'performs a useful social function in limiting the power of members of generations passed from tying up property in such a form as to prevent its being freely disposed of in the present or the future'.[131]

6.104 The application of the rule against perpetuities differs across the states and territories. One jurisdiction, South Australia, has repealed the rule.[132] The rule was abolished in 1996[133] following a 1983 review by the Law Reform Committee of South Australia, which held that the rule had led to 'stupidities' and 'unbelievable results' and was ill-suited to the modern business and taxation environment.[134] Accordingly, South Australia adopted a legislative scheme that permits beneficiaries of trusts operative for 80 or more years to apply for court orders that the trusts be disbanded.[135] It follows that a trust may continue operating should the beneficiaries agree to its continuance.

6.105 A similar approach has been adopted by other common-law jurisdictions. In December 2010, the Law Reform Commission of Nova Scotia released its report *The rule against perpetuities*. The report notes that in addition to South Australia, legislation to abolish the rule has been adopted in Saskatchewan, Ireland and several US states and Caribbean nations.[136] However, the report also notes that '[a]bolition has not proven universally popular.'[137]

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130 Northern Territory Law Reform Committee, *Report on the rules against perpetuities and accumulations*, Report No. 15, October 1993, p. 3.

131 *Nemesis Australia Pty Ltd v Commissioner of Taxation* (2005) 225 ALR 576 at [24] per Tamberlin J, as cited in Dal Pont and Chalmers, *Equity and Trusts in Australia*, 2007, p. 512.

132 *Law of Property Act 1936*, s. 1.

133 Law of Property (Perpetuities and Accumulations) Amendment Act 1996 (SA).

134 Law Reform Committee of South Australia, *Relating to the reform of the law to perpetuities*, Report 73, 8 November 1983, pp 4 and 12.

135 *Law of Property Act 1936*, s. 62.

136 Law Reform Commission of Nova Scotia, *The rules against perpetuities—Final report*, December 2010, pp 22–23.

137 Law Reform Commission of Nova Scotia, *The rules against perpetuities—Final report*, December 2010, p. 29.

6.106 The rule continues to operate in all Australian states and territories other than South Australia.[138] In general, the States and Territories have modified the operation of the rule with effect that a trust can be in existence for no more than 80 years. In the Northern Territory, a trust instrument may specify either 80 years from the date on which the trust was established or the traditional period of a 'life in being plus 21 years'.[139]

6.107 Reviews conducted by the Northern Territory Law Reform Committee and the Queensland Law Reform Commission provide insight into the reasons for the rule's continued existence. Reporting in May 1971, the Queensland Law Reform Commission held that the rule 'remains a necessary aspect of a soundly based system of property law'.[140] Similarly, reporting in 1993, the Northern Territory Law Reform Committee concluded that it is fair and equitable for the law to 'limit the remoteness of vesting'.[141]

6.108 There is consensus among Australian jurisdictions that it is inappropriate to apply the rule to superannuation trust funds and charitable funds. In jurisdictions where the rule applies, legislation expressly excludes superannuation trust funds and trusts established for charitable purposes.[142] The exclusion is also supported by Commonwealth legislation, which expressly provides that the rule against perpetuities does not apply to trusts operated by superannuation entities.[143] Similarly, in South Australia, a court may not order the disposition of property held in superannuation trust funds or charitable trusts.[144]

6.109 Some international reviews have noted with concern the perpetuity rule's implications for commercial transactions. Recommending that the rule be abolished, in 1982 the Manitoba Law Reform Commission stated: '[t]hat commercial interests should be subject to any perpetuity rule is misconceived'.[145] Similarly, reporting in

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138 *Law of Property Act* (NT), Part 11; *Perpetuities Act 1984* (NSW); *Perpetuities and Relations Act 1985* (ACT); *Perpetuities and Accumulations Act 1968* (VIC); *Perpetuities and Accumulations Act 1992* (Tas); *Property Law Act* 1969, Part XI (WA); Property *Law Act 1974*, Part 14 (QLD).

139 *Law of Property Act* (NT), s. 187.

140 Queensland Law Reform Commission, *The law relating to perpetuities accumulations*, Report No.7, 24 May 1971, p. 3.

141 Northern Territory Law Reform Committee, *Report on the rules against perpetuities and accumulations*, Report No. 15, October 1993, p. 3.

142 The 1971 Queensland Law Reform Commission report—*The law relating to perpetuities and accumulations*—provides an overview of the policy reasons for excluding superannuation funds.

143 *Superannuation Industry (Supervision) Act 1993*, s. 343.

144 *Law of Property Act 1936*, s. 62.

145 The Manitoba Law Reform Commission, *Report on the rules against accumulations and perpetuities*, Report 49, 12 February 1982, pp 41 and 60.

2000, the Law Reform Commission of Ireland concluded that the rule should be abolished.[146] In reaching this conclusion, the Commission was concerned with the effect of rule on commercial transactions.[147]

6.110 Concern is also shared by jurisdictions that have elected to retain the rule against perpetuities. Reporting in 1998, the Law Commission (England) recommended precise legislative drafting to enable commercial transactions to be excluded from the operation of the rule against perpetuities. The Commission's recommendation was based on the view that 'as a matter of general principle transactions of a commercial character should be excluded'.[148]

6.111 Australian jurisdictions share the concern that the rule against perpetuities may adversely affect commercial transactions. Commenting in 1976, the New South Wales Law Reform Commission held that the rule should not affect commercial arrangements:

> It could be argued…that the rule has its origin in family settlements and to derive from it a general concept applicable to commercial transactions is wrong…We agree. In our view, the rule against perpetuities serves little purpose when applied to arrangements which are essentially of a commercial nature.[149]

6.112 Nearly two decades on, the same reasoning is evident in the 1993 report of the Northern Territory Law Reform Committee. Citing the 1976 New South Wales Law Reform Commission's report, the Northern Territory Law Reform Committee likewise concluded that 'the rule against perpetuities serves little purpose when applied to arrangements which are essentially of a commercial nature'.[150]

6.113 However, despite the view that the rule against perpetuities is unnecessary, and indeed problematic, in a commercial context, neither the Australian nor the international reviews expressly considered trading trusts. The New South Wales Law Reform Commission and the Northern Territory Law Reform Committee recommended express legislative exclusions for options to acquire an interest in

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146 The Law Reform Commission, *Report on the rule against perpetuities and cognate rules*, 2000, p. 98.

147 The Law Reform Commission, *Report on the rule against perpetuities and cognate rules*, 2000, p. 47.

148 The Law Commission, *The rules against perpetuities and excessive accumulations*, 1998, p. 91.

149 New South Wales Law Reform Commission, *Report of the Law Reform Commission on perpetuities and accumulations*, Report No. 6, 26 August 1976, p. 61.

150 Northern Territory Law Reform Committee, *Report on the rules against perpetuities and accumulations*, Report No. 15, October 1993, p. 18.

property, such as an option to renew a lease.[151] The reports do not analyse the effect of the rule on trading trusts. Internationally, the Law Reform Commission of Ireland focused on 'future easements, options to purchase land with third parties involved, options to purchase shares, [and] nominations and powers of advancement under pension schemes.'[152] The Commission did not consider the rule's effect on businesses that operate through a trust structure. The Law Commission (England) did refer to family trusts and arrangements between family members. However, the analysis is focused on contracts between members of the same family and does not expressly consider family trusts used as a means of conducting a business.[153]

6.114 Reflecting the concerns of the 1983 South Australian inquiry into the rule against perpetuities, submitters argued that the requirement that trading trusts should cease to operate after a specified period is unsuitable in the modern business context. Submitters noted that the 80 year limit may not reflect the longevity of family businesses. Mr William Noye, National Leader, Family Business Services, KPMG, noted that 'there are certainly examples in Europe where families have gone on for 200 or 300 years owning particular businesses'.[154] Mr Donald McKenzie, a former partner of KPMG, also highlighted that the termination of the trust may not coincide with the planned termination of the business:

> It seems a bit illogical…The issue is that, should that disadvantage somebody who is just going to continue on the business on the day after it vests–the same way they were running the business the day before it vested.[155]

6.115 Further, it was submitted that, rather than facilitating a robust private sector, the forced vesting of trading trusts will arbitrarily limit business growth.[156] In support of this argument, three significant business costs were identified. First, PricewaterhouseCoopers submitted that the rule against perpetuities restricts prudent business and asset management:

> The 80 year limit on trusts can also impact business decisions and structures before the trust is terminated. If a family is to acquire a major asset and their trust is already 50 years old, it would be unwise of them to place that

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151 New South Wales Law Reform Commission, *Report of the Law Reform Commission on perpetuities and accumulations*, Report No. 6, 26 August 1976, p. 61; Northern Territory Law Reform Committee, *Report on the rules against perpetuities and accumulations*, Report No. 15, October 1993, Appendix F, p. 18.

152 The Law Reform Commission, *Report on the rule against perpetuities and cognate rules*, 2000, p. 47.

153 The Law Commission, *The rules against perpetuities and excessive accumulations*, 1998, p. 92.

154 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 14.

155 Mr Donald McKenzie, Private Capacity, *Committee Hansard*, 21 January 2013, p. 17.

156 See, for example, PricewaterhouseCoopers, *Submission 11*, p 3.

> asset in the existing trust–a vehicle with just 30 years remaining. This will prompt the creation of a new structure to hold the asset, further complicating the family's financial structure and increasing the cost of managing their assets.[157]

6.116 As Mr Paul Brassil, a partner at PricewaterhouseCoopers, informed the committee: '[o]ne would not even today sensibly put newly acquired assets into a family trust that has only 30 or fewer years left in it'.[158]

6.117 Second, the committee was advised that the rule against perpetuities will place a significant taxation burden on family businesses. Capital gains tax implications were commonly cited; the present generation will be required to finance the accumulated CGT of multiple generations. Mr Noye submitted that 'it is almost like a ticking time bomb from a family business perspective…there will be, if you like, a triggered CGT event'.[159] PricewaterhouseCoopers provided the following explanation of the CGT implications:

> The termination of a trust can have a serious impact on families and family businesses. When a trust is dissolved, assets must be transferred to a different owner. If the value of the asset is greater than the cost, it precipitates a Capital Gains Tax (CGT) event for the beneficiaries, who may be forced to find up to 46.5 per cent of the assets' value without a liquidity event. This forced tax point can threaten the viability of the family business.[160]

6.118 Mr Brassil alerted the committee to additional tax implications:

> [T]he states are treating the transfer of those assets out of the trust as being a matter that involves ad valorem stamp duty. So 5½ per cent, or more, of the market value of the asset potentially gets hit for stamp duty.[161]

6.119 Third, it was also evident that family businesses will incur additional costs to restructure the business. When asked to comment on the significance of the family trading trust for the Australian economy, Treasury officials commented that any change in business structure entails significant cost:

> If you have a business that has worked in a particular model or framework for a period of time there are costs potentially with respect to any sort of change to structures. There are potential costs to taxpayers and businesses

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157 PricewaterhouseCoopers, *Submission 11*, p 3.

158 Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 31.

159 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 13.

160 PricewaterhouseCoopers, *Submission 11*, p 3.

161 Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 31.

> from those changes. The observation of why would particular structures be important to the broader economy are [that they are] the structures that businesses are currently operating under.[162]

6.120 As alluded to in Treasury's comments, it was argued that the rule against perpetuities will adversely affect the broader Australian economy. As PricewaterhouseCoopers submitted, '[t]rusts have become such a part of the Australian business fabric that even government I think is quite happy that they are here to stay.'[163] Family business advisors and representatives argued that the effect of the rule against perpetuities on family trading trusts is an 'issue we are increasingly starting to face'.[164] Estimates varied about when the 80 year timeframe for family trusts will expire. As Mr Noye acknowledged, the vesting date will differ for each family trust.[165] However, in general it was estimated that the effect of the rule against perpetuities will become acute in the next 10 to 20 or 20 to 30 years.[166] For example, Mr Donald McKenzie predicted that by 2030, 50 per cent of family trusts will vest.[167]

6.121 Accordingly, family business representatives and advisers strongly advocated for the government to address the concerns raised with the rule against perpetuities.[168] Mr McKenzie called for governments to be proactive in addressing the effect of the rule for trading trusts:

> 2030 might be a little bit of a stretch – it might be 2040 – but it is coming and all I am sitting here and saying is 'Let's get ahead of the game; let's have a good look at this now; let's sort it out so that we do not sit there'.[169]

6.122 It was further argued that the rule against perpetuities should be repealed. Mr Brassil told the committee that 'it is high time to challenge the 80 year rule'.[170] Mr Le Maistre concurred:

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162 Mr Hector Thompson, General Manager, Small Business Tax Division, Treasury, *Committee Hansard*, 15 November 2012, p. 15.

163 Mr Paul Brassil, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 31.

164 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 47.

165 Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 13.

166 Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 31; Mr William Noye, National Leader, Family Business Services, KPMG, *Committee Hansard*, 16 November 2012, p. 14.

167 Mr Donald McKenzie, Private Capacity, *Committee Hansard*, 21 January 2013, p. 17.

168 See, for example, Mr Donald McKenzie, Private Capacity, *Committee Hansard*, 21 January 2013, p. 18.

169 Mr Donald McKenzie, Private Capacity, *Committee Hansard*, 21 January 2013, p. 17.

170 Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 32.

> I cannot see any practical reason why that needs to continue to be in place. From a policy perspective, if you are looking to continue to grow and expand these businesses and have the generational transfer going forward is, I think that is something else which we really should be actively contemplating repealing.[171]

6.123 The effect of the rule against perpetuities was also noted by academic advisers, who held that, as a general principle, rules that are not relevant in the modern context should not be retained. As Professor Mary Barrett, Professor of Management at the University of Wollongong, argued:

> I am inclined to think, if nobody can remember why it was there and if it is holding people back, it is probably a 'cat at the temple door' kind of situation—it was part of the ritual once but nobody can remember why. Maybe it happened by accident and it does not seem to help any longer.[172]

6.124 Similarly, Dr Chris Graves of the University of Adelaide Business School, told the committee:

> [I]f there is a consensus that there are still some advantages of structuring a family in business through using trust structures as opposed to company structures, then it would appear that this arbitrary limitation of 80 years—if you have an artificial time period which is imposing costs which otherwise could be avoided—is obviously something that is serious to look at.[173]

6.125 In support of abolishing the rule against perpetuities, it was submitted that permitting family trading trusts to continue in perpetuity is in line with the opportunities available to family companies.[174] PricewaterhouseCoopers argued:

> When companies exist in perpetuity – and we are all comfortable with that – why would a trust need to end? Whatever historical reasons there were for them to have a life, I challenge them in the current climate and I see downsides.[175]

Committee view

6.126 Australia's legal system should support a robust economy and commercial certainty. While largely anecdotal, there is evidence that the rule against perpetuities has the counter effect. The committee notes with interest comments by the Manitoba

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171 Mr Simon Le Maistre, Partner, KPMG, *Committee Hansard*, 14 November 2012, p. 47.

172 Professor Mary Barrett, Professor of Management, University of Wollongong, *Committee Hansard*, 15 November 2012, p. 40.

173 Dr Chris Graves, Business School, University of Adelaide, *Committee Hansard*, 15 November 2012, p. 40.

174 See, for example, Grant Thornton, *Submission 18*, p. 3.

175 Mr Paul Brassil, Partner, Private Clients, PricewaterhouseCoopers, *Committee Hansard*, 15 November 2012, p. 32.

Law Reform Commission that the rule against perpetuities is 'yesterday's device for solving yesterday's problems...its day, certainly in this province, is done'.[176] The committee has received evidence supporting this view. The marketplace has evolved while the rule against perpetuities has substantially remained since it was first articulated. The rule against perpetuities is an example of Australia's legal system not keeping pace with developments in the business sector.

6.127 The effect and broad scope of the rule against perpetuities warrants further investigation. Given that the rule is likely to require family trading trusts to vest in the coming decades, it is necessary that prompt attention is given to the concerns raised by submitters to this inquiry. It is essential that State and Territory governments consider whether the rule continues to be appropriate for Australia's modern economy. Accordingly, the committee recommends that the Council of Australian Governments, or its relevant Ministerial Council, inquire into whether the rule can be abolished in each jurisdiction, or whether its scope can be limited to appropriately exclude all commercial arrangements.

Recommendation 15

6.128 The committee recommends that the Council of Australian Governments, or its relevant Ministerial Council, inquire into whether the rule against perpetuities can be abolished in each jurisdiction, or whether its scope can be limited to appropriately exclude commercial arrangements. In undertaking this review, the Council should consider how many trading trusts are likely to be affected in the next two decades. It should also consider the effect that abolishing the rule against perpetuities in South Australia has had on trading trusts operating in the State.

6.129 If the Council determines that it is not appropriate to abolish or amend the rule, the committee recommends that it should actively engage with the business sector to alert trading trusts to the financial implications of the vesting requirements.

176 The Manitoba Law Reform Commission, *Report on the rules against accumulations and perpetuities*, Report No. 49, 12 February 1982, pp 41–42.