Assistant Commissioner
Law Design and Development (Entities)
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Dear Sir

Taxing Trusts as Companies

I am under more pressure to attend to clients needs than I have ever experienced in my professional life of 36 years, but I feel I must comment on the proposals for the taxation of trusts as companies and associated provisions.

I am convinced that the consequences of the proposed legislation have not been fully thought through and the huge overkill will add more areas in which it is almost impossible for a taxpayer to properly comply with the law or where the taxpayer will be seriously disadvantaged – by innocently becoming involved in ‘deemed’ transactions and/or because of the load of compliance obligations being placed on the taxpayer.

Two huge problem areas already created for ordinary business taxpayers are Division 7A and the UB statements. But these are not the issue at present.

As an example of my concerns about the new legislation I offer the following scenario – which will apply to numerous taxpayers in business. I point out that this is only one example of how the law will hurt people, and I could easily provide countless similar scenarios.

The taxpayers operate a successful business and have an opportunity to expand, but they need additional funding to move to the next stage. The banks will not finance the new business, and the old business is also fully geared. To establish the new business, the taxpayers use some of their personal funds – e.g. from the sale of a holiday cottage, cancellation of an insurance policy, inheritance or the like.

The new business later becomes successful and is making profits in addition to the original business. The taxpayers would now like to take their money out of the businesses and buy a holiday cottage to replace the one they previously owned or could have owned had they not gone into the new business. The bank will now provide replacement finance, so the business borrows the funds and the taxpayers take back their original capital to buy the holiday cottage. There might even be surplus money in the business itself.

Unfortunately, under the proposed new system, the taxpayers will have to think about the tax consequences of taking back their own money. If goodwill has been generated by either of the businesses, it is likely that the money taken out will be taxable on the basis that it represents the ‘realisation’ of the increased value of goodwill. To avoid this, the taxpayers will have to pay for taxation advice and valuation fees to determine the exposure to income tax. If they do not incur these costs, the cost in terms of additional income tax is likely to be much greater. Even if the goodwill value has not increased, the value of other business assets such as land and buildings could have increased and the result will be the same.

Although dismayed by the fact that they must pay tax on getting their own money out of the business, they decide to pay the tax and enjoy the remainder of their life – in part through the use of the holiday cottage.

Unfortunately again, there is a downturn in the economy and their businesses are no longer as profitable as they were when they bought the holiday cottage and eventually, they decide to sell the business. They receive only the tangible asset value for their businesses and goodwill is of no value. They are not naïve enough to think that they might get back some of the extra tax they had to pay on the unrealised goodwill when they refinanced to buy the holiday cottage.

This is a simple case. In fact, one small amount might be put into a business and withdrawn for personal reasons on more than one occasion – e.g. the money is loaned to a child of the taxpayers who subsequently repays the loan a year later. The money is then used as temporary finance (it might even be anticipated that it is permanent finance) for the business. The second child then needs money and the money is withdrawn again a year or two later. On each occasion the money is withdrawn, income tax could be payable if the value of the assets of the business reflect an unrealised profit. I regard such a result as simply unfair, and the costs of assessing the tax position each time as totally unreasonable.

I appreciate that the Ralph Report and the Australian Taxation Office would prefer that people borrowed money from the banks for every cent of personal expenditure and paid tax on any money whatsoever that comes out of the business, but it is not fair or reasonable in the minds of my colleagues. My clients are not aware of what it means yet, and they will be completely bemused and devastated when it affects them.

I urge the legislators to take more time to consider what they are doing to small businesses and hopefully to see this proposed new law for what it is – extremely complex in its application, extremely difficult for taxpayers to remain aware of at all times and extremely harmful if they get it wrong.

Yours faithfully

L A Cook
12 December 2000