Arthur Andersen
A Member Firm of Andersen Worldwide SC

360 Elizabeth Street
Melbourne VIC 3000

GPO Box 5151AA
Melbourne VIC 3001

Tel 61 3 9286 8644
Fax 61 3 9286 8171
DX 288 Melbourne

Assistant Commissioner
Law Design & Development (Entities)
PO Box 900
Civic Square ACT 2608
CANBERRA

6 November 2000

Dear Sir

Submission – New Business Tax System (Entity Taxation) Bill 2000 Exposure Draft

We welcome the opportunity to comment on the exposure draft of the New Business Tax System (Entity Taxation) Bill 2000 that was released on 11 October 2000.

We look forward to a transparent process for consultation on this proposed law. We expect that all submissions will be publicly available on the relevant web-sites, and we will release this submission publicly.

Arthur Andersen supports the refocus of much of the entity tax rules to relieve the corporate sector of what might otherwise have been a massive compliance task for no or minimal extra Government revenue. However, the exposure draft will also adversely impact many entities through the application of the benchmark rules and will impact many trusts that may fall unintentionally within the definition of a "non-fixed trust" for the purposes of these proposed rules.

Accordingly, we would like to draw your attention to the possible consequences of the proposals which may adversely impact on the genuine non-tax focused activities of many businesses that may unintentionally fall within the new measures. Our purpose in doing so is to enable these considerations to be taken into account in finalising and legislating the Bill and to ensure the measures are effective and workable.

In summary, Arthur Andersen submits, in relation the entity tax definition and operational issues that:

A. In respect of companies as well as trusts, the community needs urgent resolution of the rules for classification of membership interests and debt.

These issues, we understand, are yet to be decided and will have a profound effect on the operation of the entity tax rules.

It is widely known that the issuance of perpetual notes, income securities and other such hybrid securities has resulted in tax uncertainty and the withdrawal of previous tax rulings. This issue was understood to be receiving Government attention which was to culminate in the definitions to be exposed in the entity tax Bill. That resolution has not occurred at this date. It must occur quickly, in order to enable companies and trusts to understand – as they go into the mode of preparing for the entity tax – to have certainty as to the classification of their investors.

B. In relation to trusts and non-fixed trusts, our submissions are:

B1. The definitions of fixed trust and non-fixed trust should be altered to allow for the multiple performance-oriented unit structures which might otherwise cause difficulties with the "vested and indefeasible entitlement" rule.

B2. Loyalty trusts and employee share trusts should be expressly treated as excluded or disregarded trusts.

B3. Restructure relief (covering capital gains tax, state stamp duty relief and Goods and Services Tax), for non-fixed trusts should be introduced when the entity tax bill is introduced to parliament.

B4. That non-commercial loans by members to trusts from members and non-fixed trusts should not be included as contributed capital.

B5. The ability of discretionary trusts to distribute tax-preferred gains (generated prior to entity tax) tax free to discretionary beneficiaries needs to be clearly spelt out, without the limitations on this policy which seem to be creeping in.

B6. The rules for distributions by trusts to members need fine-tuning.

C. In relation to franking issues our submissions are:

C1. The definition of widely-held (not seen by us yet) needs to be drafted correctly to ensure that those entities that are intended to be included within the definition are correctly covered.

C2. Due to the minimal, if any, opportunities for streaming by widely-held entities, the benchmark rules should not apply to these entities.

C3. The exclusions from the benchmark rules need to be refined and expanded. In order to qualify for the exclusion from these rules, a widely-held entity must in the draft bill have only one class of membership interest. We are concerned that this definition of "one class of membership interest" does not adequately allow for many situations and should be reworked to include:

a) express exclusions,
b) a de minimis test and
c) a stronger discretionary override on the part of the Commissioner of Taxation upon application by a taxpayer.

C4. The second benchmark rule demanding that affected entities must frank their dividends to a tolerance within 20 percentage points of the previous six monthly benchmark allows minimal tolerance for very common circumstances. It requires a wider range, and expert exclusions.

C5. The proposal to remove the ability of entities to offset Franking Deficit Tax against income tax is overly harsh and unnecessary. This is especially so for FDT paid before 30 June 2000.

C6. The application of Section 160-145 in relation to deferring franking deficit needs to be clarified as the definition of refund of income tax in section 160-125 is drafted far more broadly than the current section 160AQJC.

C7. The credit rules for franking credits for withholding taxes require some fine-tuning.

C8. The treatment of franking credits for on-market buybacks needs to revert to the RBT recommendation.

C9. The late balancing companies' franking account rules might need transitional rules or elective treatment.

These issues are discussed in detail in the Attachment to this submission.

Should you have any questions concerning the matters raised in this submission, please do not hesitate to contact Trevor Hughes on 03-9286 8282 or Anthony Stolarek on 03-9286 8666 or Alf Capito on 02-9993 6473 for further clarification.

Yours sincerely

Attachment

TAXATION OF NON-FIXED TRUSTS

B1. The definition of fixed trust and non-fixed trust

The definition of fixed trust requires significant attention in our view, because in its current form many unit trusts and indeed widely-held unit trusts would be considered not to be fixed trusts, because their members would not have a complete vested and indefeasible beneficial interest in all circumstances.

We submit that this element of entity tax requires:

a) a clear exclusion of widely-held unit trusts,

b) a recognition that specialist classes of units will exist in widely-held unit trusts to deal with the interests of managers, experts etc., with the rights of those units legitimately being tied to performance of elements of the trust's operations.

We see the need to allow for variable-return arrangements associated with fixed trusts, which would otherwise cause these to be non-fixed trusts. We expressly refer to:

- preferred financing units

- units allotted to managers with performance-oriented distributions

- and other similar arrangements.

B2. Exclusions from non-fixed trust status needed for loyalty trusts and employee share scheme trusts

- Loyalty Trusts

The current drafting of the exposure draft will apply the entity tax regime to loyalty programs that are conducted through a trust structure.

In very brief outline, loyalty trusts are mechanisms whereby credit card companies and other "frequent buyer" programs allow for benefits to accrue to customers using the particular loyalty program. The provider of the credit places monies into a loyalty trust to reflect their commitment to the customers and the monies are used to purchase the customer benefits and rewards.

As you know, the customer rewards are already comprehensively taxed under the Fringe Benefits Tax legislation for employees, and under the rules dealing with non-cash business benefits.

It appears to us that there is a significant risk that these loyalty trusts would be treated as non-fixed trusts, unless within the definition of an excluded trust. Should the legislation apply, loyalty trust programs would be at a severe disadvantage in comparison to other loyalty programs. These rules would potentially result in participants being taxed on distributions of reward points under the profits first rule (section 157-25). This is inconsistent with the ATO's position on loyalty program rewards set out in TR 1999/6 (Payne's case). Participants may also be subject to CGT on distributions of contributed capital. This is not currently the case. Furthermore there is no transitional relief should the trust reorganise its affairs to become a "fixed trust" or company before 1 July 2001.

We submit therefore that there be an express exclusion from the non-fixed trust rules on account of loyalty trusts.

- Employee Share Trusts

There are many employee share trusts which are holders of shares issued under employee share plans, where the trusts might be entitled to dividends or other related rewards, and the distributions of the dividends or gains might be not fixed between the employees of the employer who are beneficiaries of the trust. Reasons for the non-fixed nature of such trusts would include the beneficiaries' interests being subject to restrictions during the earn-in of entitlements under the employee share scheme. Other difficulties would potentially arise in respect of interest free loans to employees to fund their interest in the ESP and also potentially debt forgiveness issues would arise. There will also be significant compliance obligation imposed of the ESP's.

In light of the Government's overall policy to encourage employee share ownership without onerous tax consequences and compliance obligations, we think it is clear that such bona fide employee share scheme trusts should be excluded from the list of non-fixed trusts. (Please refer to our separate submission on this issue, lodged by our Human Capital practice).

B3. Restructuring Relief for existing Non-Fixed Trusts

- A rollover of trusts into companies or partnerships is needed

There is a need for an ability to convert an existing non-fixed to a company or indeed some other entity such as a partnership. This is necessary because the provisions in the Bill will adversely affect some existing trusts.

Given an appearance of attempting to dissuade taxpayers from utilising non-fixed trusts, then provisions need to be inserted that will allow taxpayers who already have non-fixed trusts to "restructure" their affairs at no tax cost.

The proposed restructure relief does not assist non-fixed trusts, whether they wish to "convert" to a company or whether they wish to distribute all the assets to the beneficiaries. In neither case is there any restructure relief.

We submit that the Bill should contain:

a) an unambiguous rollover from an NFT into a company structure (not using the existing CGT rollovers which require retention of the existing trust)
b) an unambiguous opportunity to rollover a trust into a partnership (whether by vesting the trust into a partnership or otherwise).

The types of relief to be provided need to be wide enough to permit maximum flexibility within the constraints of any anti-avoidance safeguards that would be considered necessary to protect the revenue.

- Stamp Duty Problems overcome by "deemed companies" and "deemed partnerships"

We know that the discussions with the States about stamp duty relief for restructures arte proceeding slowly. For that reason we recommend an alternative option be available – a "check the box" rule whereby a trust might be permitted to elect to be taxed as a company or partnership, subject to express limitations on its activities.

We think that such a "deemed company" or "deemed partnership" rule could be developed in a way which would bind the trust. In effect it is somewhat similar to the family trust rules in relation to loss trusts.

This rule could be restricted to non-fixed trusts in existence at 31 December 2000.

We would be pleased to assist to develop such a rollover.

B4. Treating Non-Commercial Loans from Members to Non-Fixed Trusts as Contributed Capital is inappropriate

A major area of concern relates to the definition of distribution arising in respect of non-commercial loans in cases where business proprietors (operating through a non-fixed trust) make interim cash injections into a trust to assist the business, in a business downturn or when additional cash funds may be needed. Such situations are not uncommon in businesses where revenue is seasonal (as in agriculture). In these circumstances, unless the business proprietor charges interest (and makes the loan a commercial loan) or withdraws the relevant cash within 12 months of contributing the funds, he or she cannot withdraw funds when the business has improved. The withdrawal of the funds will be subject to the profits first rule.

In our view, the treatment of non-commercial loans made by members to entities is at odds with the concern of the Review to achieve horizontal equity which, the Review said:

> "requires that *taxpayers in similar situations are taxed in a similar manner* and that transactions of similar economic substance are taxed similarly."(emphasis added)(p15, para 31)

The proposals for non-commercial loans TO trusts would immediately distort horizontal equity as between corporates and non-fixed trusts in the case of member-to-entity loans that are "non-commercial". To make the repayment of such loans subject to a "profits first rule" creates a regime that is inconsistent with the system applying to corporates.

To be able to debt-fund a corporate's business activities with the non-application of the "profits first rule" and yet not be able to do so where the business is operated through a non-fixed trust seems to us highly distortionary.

That proposal is also a fundamental shift in the economic logic that currently underpins the system to the extent that there is a notion that requires a member to "retain" the capital of the non-fixed trust until available profits are exhausted.

The abandonment of the principle of horizontal equity is even more difficult when it is recalled that under the heading of "Promoting equity", the Review, after stating that the issue of equity concerned both horizontal and vertical concepts, said:

> "While both concepts are relevant to designing a business tax system, *horizontal equity is a more central concern.*"(emphasis added)(p15, para 32)

We recommend the development of a proxy for the measurement of a capital amount in a trust, which could be distributed without the imposition of a non-commercial loan rule.

B5. Need for a clean ability to distribute pre-reform tax-preferred income to ALL discretionary beneficiaries

We have great concerns about the comments at para 5.15 of the EM which appears to make the promised continuation of the concessional CGT treatment of different sorts of gains made by NFTs **conditional and dependent** on:

- The distributions being made by a "family trust" (is this restricted to one that has so elected pursuant to the Loss Trust legislation?)
- The distribution being made to members of that family
- Only individuals or family members have ever contributed capital to the trust

We think that this restriction is inconsistent with ALL published writings of the Government and of the RBT[1].

- Our Concerns

Subject to the issues mentioned above, we consider that the Government proposals will not be the end of trusts. While we would have preferred no change, we can accept the policy issues surrounding the broader need for change.

However, we cannot accept the need or policy for any changes to now be made to limit the transitional/concessional rules to trusts that elect to be family trusts. This is overly restrictive and the complexity created appears to exceed the benefits to the community.

For example, the artificial definition of family – while reasonably broad – does have a lot of shortcomings. These are particularly relevant in the context of second and later marriages, and the definition of family here would need work.

Further, in many cases, if a trust distributed outside the ordinary list of beneficiaries in a trust deed, it would constitute a breach of trust exposing the trustee to actions by other beneficiaries.

If such restrictions were introduced as hinted at in para 5.15, Arthur Andersen would consider the legislation to be contrary to the principles announced by Government and accepted in RBT (Appendix C). would find it difficult to support the legislation.

If the Government is concerned about particular abuses of a general measure available to discretionary trusts, then we recommend specific targeted measures limited to the potential abuses, rather than creating a thicket of protective rules that apply to **every non-fixed trust** in **every circumstance** and would add **major complexity** to the rules.

---

[1] In "A New Tax System", the announced Government Policy in respect to taxing trusts like companies was that a key feature of the system would be (page 113):
"Transitional arrangements to avoid an inappropriate impact on existing trusts …The transitional arrangements need to recognise the difference in the current tax treatment of the tax-preferred income of discretionary trusts and fixed trusts. With discretionary trusts, tax –preferred income can at present be distributed tax free to individual beneficiaries (p.113)…transitional conversion of tax-preferred income into contributed capital would maintain the current treatment of that income with both types of trusts" (p114)
and then proposed the specific rules for continuation of the concessional treatment.

The RBT, in "A Platform for Consultation", stated that there would be "transitional arrangements for trusts with a view to preserving the existing tax treatment of tax-preferred income earned by trusts prior to the commencement of the new entity tax system, and of future capital gains on existing assets" (para 19.39)
This covered such things as gains on pre-CGT assets, the indexation on post-CGT assets, and the then existing 50% goodwill exemption. Paragraph 19.41 gave an example of a mechanism to ensure that beneficiaries of NFTs would not be subject to CGT on any such capital distribution. It was clear at that stage that all such concessional gains would continue to be able to be extracted from NFTs without any CGT issues.
The RBT Recommendation 12.13 is that "if, as a consequence of the exercise of a discretion by a trustee, contributed capital is distributed to an object of the trust, it is [not] taxable in the hands of the discretionary object…"
The RBT document, at page 439 reiterates approval of the basic principles in "A Platform for Consultation" regarding continuing the effective concessional treatment of the various sorts of capital gains. Discussing Recommendation 12.5, it specifically refers to the exceptions to PFR being "intended to ensure that individuals receive the same treatment in some important respects in relation to existing assets held in trusts".
At no stage is it suggested that eligibility for the continuation of this treatment will be affected by whether or not the trust is a family trust and by reference to who has ever contributed capital to the trust.

B6. Rules for Distributions to Members Need Fine-tuning

The basic rule in section 156-20 provides that a non-fixed trust "makes a distribution to you if you are a member of the trust and the trust distributes money or other property to you." This definition does not clearly outline the treatment of the following:

- provision of services by a non-fixed trust to a member for less than full consideration
- making an asset available for use by beneficiaries for less than full consideration

- Use of Residence

In relation to the latter, the RBT recommended that the use of a main residence by beneficiaries and private use of other trust assets should be specifically excluded provided the beneficiaries could meet certain criteria.

We read the proposed definition of a distribution in the non-fixed trust rules as not applying to such arrangements but this is not clear. Under the basic rule it would not involve a distribution of money or property; nor would it amount to a distribution benefit under s.156-75. Clarification is therefore required on whether the private use of assets would amount to a distribution under section 156-20. This should be covered in the law or at least in the EM.

- Forgiveness of Debt

Forgiveness of debts owed to trusts by beneficiaries will also amount to a distribution under the proposed section 156-90. In this regard proposed subdivision 960-GA sets out the circumstances in which a debt will be taken to be forgiven by the trust. Subsection 960-195(7) provides that a debt (or part thereof) is taken to be forgiven if the creditor is a non-fixed trust and a reasonable person would conclude (having regard to all the circumstances) that the creditor will not insist on the debtor paying the debt.

This provision is intended as a catch-all provision and is very open ended. Furthermore, the EM does not provide any guidance as to when this provision will apply.

We recommend fine-tuning of the provision or clearer development of guidelines in the law or EM.

THE IMPUTATION SYSTEM

C1. Definition of widely-held needs to be improved

As currently drafted, section 160-50 excludes from the benchmark rules only those entities which are widely-held, and which have one class of membership interest.

In the current exposure draft no definition has been disclosed of "widely-held". We submit that it is necessary at a minimum to ensure that:

- subsidiaries of widely-held entities are themselves treated as widely-held;
- entities which are joint venture companies of multiple publicly listed and widely-held entities are treated as widely-held.

We are very concerned that, for example, a company which is owned three ways, equally by shareholders being an Australian superannuation fund and two Australian companies should be able to be treated as widely-held [this is not a factual example but is presented purely to illustrate the issue].

We would like to be involved with any consultation on this matter ahead of a definition being promulgated, to ensure that it does not operate capriciously or adversely to your intentions.

C2. Widely-held entities should be excluded from the benchmarking rules

We understand the rationale of the benchmarking rule. However we believe that the practical application of the benchmark rules requires adjustment.

In particular, it is our strong submission that there should be a general exclusion from the benchmark rules for all entities that satisfy the definition of a "widely-held entity", **irrespective of their having more than one class of membership interest.**

Due to the inherent nature of widely-held entities (particularly those with no concentrated ownership) there is minimal, if any scope for these entities to stream dividends or manipulate their franking account in a way that is contrary to the principles of the imputation system. There is already more than adequate legislation to ensure that dividend streaming is not undertaken by widely-held entities in the existing legislation (for example, the 45 day rule, sections 45A, 45B and 45C and Part IVA) and in the new specific anti-streaming rules proposed in the exposure draft (Subdivision 160-D).

Accordingly, the requirement for widely-held entities to comply with the proposed benchmark rules places an unnecessary burden on these taxpayers for little, if any, increase to Government revenue. In our view, this requirement is also inconsistent with the original policy objectives behind the benchmark rules.

Thus we submit that the additional requirement for a widely-held entity to have only one class of membership interest to be excluded from the benchmark should be removed.

C3. Definition of one class of membership interest needs attention

Even if there was (for widely held entities) a single class of membership interest rule (which we disagree with) the rule needs to be refined and improved.

In order to qualify for the exclusion from the current draft benchmark rules, a widely-held entity must have only one class of membership interest. Membership interests in a trust form a class if they all carry strictly identical rights to distributions by the entity. Membership interests in a company form a class if the interests have the same, or substantially the same, rights.

We are concerned that this definition does not adequately allow for **many long-standing situations** such as:

- non-participating membership interests (that is interests with no rights to dividends or interests that have theoretical rights to dividends however it can be demonstrated that these rights have never been exercised);
- employee share scheme shares issued to employees;
- "golden shares" issued for purposes of retention of control;
- performance shares issued to management companies, where the dividends are performance-based;
- tracking shares in companies designed to track elements of a company's performance;
- financing shares issued to bankers and financiers (very common historically);
- possible rights in relation to shares such as partly paid shares, rights and options over shares which are not unusual in the Australian context – and which are not associated with dividend streaming;
- stapled securities issued within the same entity that carry differing rights – and which are not associated with dividend streaming.

We submit that there need to be:

a) **express exclusions for the above situations so that the above mentioned interests do not, in themselves, cause a widely-held entity to fall within the benchmark rules;**

b) **a de minimis test (for example to cover a small number of shares which may, on their own, disqualify the company from satisfying the one class of membership interest requirement); and**

c) **a stronger discretionary override on the part of the Commissioner of Taxation to permit a departure from the benchmark rules.**

In relation to this last point, it is stated in subsection 160-85(1) that the Commissioner's powers to permit a departure from the benchmark rules may only be exercised in extraordinary circumstances. In our view, there are many instances which may not be considered "extraordinary" but which are justifiable in permitting a departure from the benchmark rules. For example, a company may have one separate class of shares that theoretically has full rights to dividends yet in practice, are never distributed dividends as these shareholders are no longer contactable or known by the entity. This class of shares cannot, however, be eliminated, because the shares have not been sold by the shareholders and they can not be contacted in relation to their shareholding. In this instance, the circumstances justifying a departure should be sufficient to warrant a departure from a benchmark percentage.

Accordingly, it is our strong submission that a stronger discretion be granted to the Commissioner to permit a departure from the benchmark rules in circumstances that may not be "extraordinary" but are commercially justifiable.

The Commissioner should also expressly consider the entity's intention of no dividend streaming when exercising his discretion.

C4. BENCHMARK RULE 2

4a. Benchmark rule 2 is excessively restrictive

The second benchmark rule demanding that affected entities must frank their dividends to a tolerance within 20 percentage points of the previous six monthly benchmark allows minimal tolerance for very common circumstances.

We submit that:

a) the 20% tolerance needs to be broadened beyond the current proposed 20% (the 20% threshold is not a recommendation of the RBT);

b) there should be some carve-out introduced for manifestly non-dividend-streaming situations;

c) the discretion available to exceed the variation with the approval of the Commissioner needs to be made more accessible – instead of being limited to rare non-recurring extraordinary circumstances as currently proposed.

In our view, the discretion given to the Commissioner to vary the benchmark contained in section 160-85 is excessively restrictive. In fact, it is expressly stated that the Commissioner may only permit a departure from the benchmark rules in extraordinary circumstances.

In our view, there are many instances which may not be considered "extraordinary" but which are justifiable in permitting a departure from the benchmark rules. For example, a company that has been unprofitable for many years may begin to earn profits and wish to distribute fully franked dividends in that year. In this instance, the circumstances justifying a departure may not be unforeseeable and beyond the control of the entity (they may have instigated a large marketing policy or incentive offer to generate the profits), yet they should be sufficient to warrant a departure from a benchmark percentage. In another situation, an entity may be able to demonstrate to the Commissioner that it has widely fluctuating profits over a number of years and has demonstrated no intention of dividend streaming in their dividend policy.

In reverse, an entity may be paying fully franked dividends in one year due to the availability of sufficient credits. In the following year, there may simply be a large permanent or timing difference that results in a tax loss for that year. The entity would then be unable to frank the dividend at the same level, yet the rules only permit a reduction of the franking rate of 20 percentage points.

4b. Carve-out from benchmark

Accordingly, in our view benchmark rule 2 should be amended to permit entities to vary the franking rate between years, with no restrictions, where there is no evidence of dividend streaming. This could be demonstrated in a "bright line" way by demonstrating that the same shareholders continued without trading among the shareholders.

We recommend a carve-out such as "continuity of same shares test" being useful here (for those entities which remain subject to the benchmark after our other recommendations), with a threshold of say 50% continuity of shareholders and absence of dividend streaming giving entities an as-of-right ability to exceed the benchmark.

4c. Stronger ATO Relieving Discretion

In the event that this submission is not acted upon, we strongly recommend that a stronger discretion be granted to the Commissioner to permit a departure from the benchmark rules in circumstances that may not be "extraordinary" however, are commercially justifiable. The Commissioner should also expressly consider the entity's intention of no dividend streaming when exercising his discretion.

C5. Franking deficits tax

5a. Removal of offset of franking deficit tax against entity income tax must be reconsidered

The draft bill proposes that all corporate tax entities will be subject to Franking Deficits Tax ("FDT") if there is an overfranking of a distribution. FDT is currently creditable against income tax but from 1 July 2001 it is proposed that this credit will be removed. The stated policy behind this change is that this is in recognition of the greater access to imputation benefits through refunds of excess imputation credits and to prevent the reinstatement of tax preferences.

We submit that this proposal requires correction. In our view, the policy of offsetting a prepayment of entity tax (that is, FDT) is completely unrelated to the policy behind the refunding of excess imputation credits. In principle, there is no difference from the current system where taxpayers are able to fully utilise funds against other tax payable or in the case of discretionary trusts would not be allocated excess credits.

We would like to know the costing of this proposal and whether it is indeed necessary to fund the refundability of excess franking credits. Particularly when allied to the requirements of the benchmark regime, the non-creditability of FDT can be seen to create a trap for corporates – a permanent disadvantage.

We reject the proposition that the deferred payment of FDT in some way disadvantages the revenue as compared with a dividend-recipient's ability to claim franking benefits, and that this can be used as a driver for this proposal. The payment of FDT arises shortly after the end of a relevant year of income and thus the cash disadvantage to the revenue in present value terms is minimal.

We suggest that any disadvantage to the revenue in respect of FDT is more than offset by the large amount of company and (soon) entity tax paid in advance of dividends being paid to members.

It is difficult to see how, in comparing the current tax system with the proposed tax system, that allowing FDT to continue to be creditable would result in reinstatement of tax preferences.

This proposed measure is extremely harsh and unjustified given that FDT is essentially a prepayment of income tax and that penalty tax (Franking Additional Tax of 30%) already acts as a deterrent to companies against excessively overfranking dividends.

Accordingly, we strongly submit that FDT should continue to be creditable against income tax. This submission is consistent with the policy that FDT is not, in itself, a penalty and is by its inherent nature a prepayment of tax.

Should this recommendation not be acted upon this is a significant change for companies already within the dividend imputation system and transitional measures need to be carefully considered.

Notwithstanding that the transitional rules will be included in a later Bill, we wish to ensure that at a minimum they allow for the offset to continue where the franking deficit tax paid (but not yet utilised against company income tax) was due to the payment of a franked dividend on or before 30 June 2000 (ie. prior to the introduction of excess franking credits being refundable to shareholders).

5b. FDT Paid Prior to 30 June 2000 must be fully creditable against company tax

The Bill proposes an end to the offsetting of FDT on the basis that there is greater access to imputation benefits through refunding excess imputation credits from 1 July 2000.

However, a harsh result is achieved where the franked dividend giving rise to the FDT was paid prior to 30 June 2000, **and therefore was not subject to these new refund rules in the hands of the recipient shareholder**. The shareholders are not entitled to excess franking credit refunds and the company is not entitled to offset the FDT against future company tax (for example where the company has not had a tax liability for the year ended 30 June 2000).

In addition, many taxpayers in this position will have recorded the "prepayment of company tax" associated with the FDT offset amount as an asset in their balance sheets. Without transitional relief, these companies and their shareholders will suffer a loss that will in effect be retrospective.

Accordingly, it is our submission that when the transitional measures are released, they should be included in the final legislation in a manner to avoid any retrospectivity relating to existing FDT offset entitlements.

C6. Franking debits and refunds of income tax

The proposed section 160-145 essentially provides that if a franking deficit would have arisen, but does not because of the payment of tax that is refunded in the following year (within 3 months of the end of the previous year), the franking debit is treated as having arisen in the previous year. The purpose of this provision is to replace the current provision relating to deficit deferral tax. However the proposed section 160-145 is drafted far more broadly than the current section 160AQJC which applies only to refunds of company tax instalments.

Section 160-145 would appear to apply to not only cases where a revised upward estimate of the PAYG rate instalment is made but also to the case where there is no variation downwards of the instalment. The application of the section to amended assessments and to refunds also needs to be clarified as the definition of refund of income tax in section 160-125 is any amount of refund which is in whole or in part a refund of an amount refunded or applied to satisfy the entity's liability to pay tax.

Accordingly, we strongly submit that this section is re-examined and if necessary is drafted to align more closely with the current section 160AQJC.

C7. Imputation Credits for Foreign Withholding Tax

7a. Requirement for 100% subsidiary of single resident company is too restrictive

Section 160-165 proposes a credit for foreign tax withheld in a chain of entities where an Australian entity receives a distribution from a foreign corporate tax entity and they are both part of the same chain of entities. The term "chain of entities" is defined at paragraph 160-165(5) and includes only the Australian entity receiving the distribution and foreign corporate tax entities which are 100% subsidiaries that is wholly-owned, directly or indirectly by the

Australian tax entity. There is no provision to include an Australian resident tax entity which is in turn a 100% owned subsidiary of a foreign subsidiary of a second Australian resident tax entity. This scenario is unusual but becoming increasingly common with the global merger of companies to form business combinations which have an Australian company taking over the operations of a foreign company with an Australian subsidiary.

7b. Credit for Australian withholding tax also

There appears to be no policy reason why the concession to convert foreign withholding tax to franking credits should not extend to Australian withholding tax. In the case of an Australian subsidiary in a chain of entities with interposed foreign subsidiaries, the distribution has borne Australian withholding tax. It would seem that there is as strong an argument that this Australian tax should be converted to imputation credits in the same way as if the tax was withheld in a foreign jurisdiction.

Accordingly, we submit that this section be refined to extend the concession to Australian withholding tax.

C8. On-market Buy Backs

The exposure draft legislation has maintained the existing franking treatment for on-market buy-backs. A franking debt will arise calculated by reference to that part of the buy-back price that is not debited to share capital.

The RBT had identified that the current treatment of on-market buybacks led to a wastage of franking credits, and recommended that in an on-market buyback the company would be entitled to a capital loss for the "taxed profits" component of a buyback, and no debit to franking account. It is disappointing that these RBT recommendations have not been adopted.

To explain:

1. An on-market buy-back now and in the future is treated in the hands of the investor as a CGT transaction, with no franking component.
2. From the viewpoint of the company buying back its shares there is currently no franked dividend but there is a debit to franking account.

We think this creates an asymmetry and a permanent disadvantage to the buying-back company. We see no reason for non-acceptance of the RBT proposal.

C9. Late-balancing company transitional rules for franking

We see the proposed argument of franking years and income years as leading to some transitional issues for publicly listed companies in this situation, as it might cause abrupt changes of dividend policy and outcomes.
We wonder whether this measure might be staged or become optional for listed entities.