# NEW BUSINESS TAX SYSTEM (ENTITY TAXATION) BILL 2000

## TAXING TRUSTS LIKE COMPANIES

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*TO THE*

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# Introduction

In the terms of reference outlined by the Treasurer, the Business Income Tax Review was directed to pursue the strategy outlined in the New Tax System of reforming the taxation of business entities. At the forefront of the reform process were the key objectives such as improving the competitiveness and efficiency of Australian business, providing a secure source of revenue, enhancing the stability of taxation arrangements, improving simplicity and transparency and reducing the cost of compliance. The realisation of these objectives would, in part, be reliant on redesigning the taxation of collective vehicles and business entities to ensure these vehicles were taxed equally under company tax arrangements.

The reform undertaken by the Government with respect of both the general tax system and business taxation is fully supported by the Australian business community. A major investment in a new tax system was more than clearly warranted because the old tax system was taking us in a direction that was simply unsustainable. It is also understood by business that the process of putting in place such an overhauled system would not be painless and that is why it is necessary that the right perspective to take with tax reform is to focus on the longer-term benefits of such reform.

With the above objectives and longer term focus in mind, the proposed New Business Tax System (Entity Taxation) Bill 2000 in its current form goes against the fundamental principles of uniformity and equity outlined in the Ralph blueprint. The original proposal was to address the inconsistency in the current tax law that results in different business structures being treated differently when conducting similar business activities. However, the new entity taxation proposal concentrates solely on discretionary trusts seemingly narrowing the focus of the new entity taxation regime to a short-term remedy designed to address the issue of tax avoidance. The taxation of only one type of trust structure like companies compromises the long run objectives of improving the competitiveness, simplicity and fairness of the business tax system.

# Integrity and tax avoidance

The new entity regime does not address the issue of taxpayers using non-fixed trusts as a vehicle to avoid paying their fair share of tax. The new rules still ensure that the total income tax on a member's (beneficiary) share of a non-fixed trust's distributed profits will be limited to the member's marginal tax rate. This new regime does not reduce the trustee using his/her discretion to distribute profits mainly to members on low marginal tax rates, particularly, with low-income earning members not likely to pay any tax after receiving a credit for the company tax already paid at the entity level. Such members can use the excess to reduce their tax on other income and if they have insufficient income, they can get a refund of the unused imputation credits further reducing the amount of tax collected.

On the other hand, members whose marginal tax rate is above the corporate tax rate will still prefer all trust earnings to be retained and re-invested as a way to defer paying tax on profit distributions. This is magnified by the fact that unlike current rules applying to tax treatment of trusts, non-fixed trusts will not be under any obligation to distribute their profits (or anything else) to their members, and there will be no tax consequences if they choose not to. (We recognise that the issue of deferral is to some extent addressed by the measure to tax unrealised gains but this determination leads to the inequity of double taxation and reduces the incentive to invest).

To maintain this treatment of non-fixed trusts is completely at odds with ensuring the integrity of the tax system and providing a secure source of revenue. As was recognised in the Ralph blueprint - A Tax System Redesigned:

> *'Tax avoidance represents a serious threat to the integrity of the tax system and to its revenue. It is also a form of a subsidy from those paying their fair share of tax according to the intention of the law to those shirking similar obligations.'*

The attempt to address the issue of misuse of non-fixed trusts as a vehicle to avoid tax does not go far enough. The new entity tax regime has deviated away from the Ralph principle that the tax system should treat all structures in the same manner and taxpayers should not gain any advantage depending on the type of structure chosen.

## *'Profits First Rule'*

Generally, distributions from a non-fixed trust will be treated as coming first from its available profits and then from its contributed capital. This is called the *'profits first rule'*. Available profits of an entity will be measured as the excess of the net assets over its contributed capital. **Section 157-85 (1)** outlines the definition of available profits:

> 'A non-fixed trust's **available profits** at a particular time are:
>
> *Net Market value of assets less Accounting provisions less Contributed Capital less Prior taxed amounts'*

The important element of the profit's first rule is the definition of *net market value of assets* which is defined as:

> 'the difference between the market value of the non-fixed trust's assets and the amount of the trust's liabilities at that time'.

Examining this issue further **Section 157-70** outlines the following:

> 'Available profits are determined at the time a distribution is made. They include the excess of unrealised gains over unrealised losses'.

The implication of this definition is extremely significant from a business perspective, particularly, if for example, goodwill of the entity is included in the net market value of assets, then by definition the entity will always have available profits. Moreover, the decision to include the excess of unrealised gains over unrealised losses in available profits is extremely inequitable, particularly, as capital gains accrued by taxpayers outside of non-fixed trusts are only taxed after the gain has been realised.

Non-fixed trusts that are used for private purposes rather than for income producing purposes must be retained as vehicles to protect assets. The taxation of unrealised gains will force taxpayers utilising non-fixed trusts for the legitimate purpose of protecting assets, having to restructure and use alternative vehicles, incurring substantial costs. Also, business would suffer cash flow difficulties in having to come up with the income needed to pay tax on assets that may have appreciated but have yet to realise any value. Further, the proposed legislation requires that available profits need to be determined at the time of each distribution, requiring a valuation to be undertaken. This certainly does not recognise the practical constraints of taxpayers having to value assets.

Including net unrealised gains in available profits, creates an anomaly in that for individuals who sell assets after 22 December 1999, only 50 percent of capital gains will be taxed, with the result that the highest rate of tax for individuals will effectively be 24.25 percent on realisation. But if assets are held within the trust then the reduced tax rate on capital gains is not available to the member because any unrealised gain is deemed to be out of profits first and taxed at the member's marginal rate. In fact, the inclusion of unrealised gains under the *profits first rule* will especially hurt taxpayers because once the capital gain is realised outside of the trust it will result in double taxation.

The proposed legislation reduces the incentive to invest because the sale of assets by the trust will result in the taxation of the capital gain, even though the unrealised gain has already been taxed in the member's hand - this is double taxation. Furthermore, it is more than likely that the assets held by the trust will depreciate over time but there is no mechanism within the proposed legislation that allows members of the trust to rightfully claim this loss against their taxable income.

The taxation of unrealised gains does not occur anywhere else in the business taxation system and in its current form gives rise to double taxation.

## *Restructuring*

The introduction of the new entity taxation regime may force taxpayers to restructure away from non-fixed trusts to a new business entity structure. The draft Bill does contain some transitional measures and relief for certain entities that restructure in the period prior to the commencement of the non-fixed trust regime. These measures allow for rollover relief for asset transfers by:

- a fixed trust to a company; or
- a widely-held company to a widely-held fixed trust, where the underlying ownership of those assets does not change.

There is also the availability of rollover relief from non-fixed trusts to fixed trusts with no capital gains tax implication. However, there are currently no rollover relief provisions contained in the Bill pertaining to the restructuring of non-fixed trusts to partnerships. This is an important equity and cost issue for taxpayers as they try and determine which vehicle best suits their business.

This issue presents some difficulty for the Commonwealth Government, particularly, as the stamp duty for restructuring is a state levied tax, which places doubt on whether the states would agree to relief without sufficient compensation to eliminate it. However, whilst rollover relief does need to be examined further, it does not need to be ongoing and should be implemented for a determined period to help business' transition to the New *Business* Tax System.

## *Administrative Issues - Loans*

The inclusion of repayment of non-commercial loans and guarantees of loans to be included in available profits for distribution compromises the principle of ensuring greater consistency in the taxation of entities while purporting to minimise compliance and restructuring costs. Companies are not subject to the provisions associated with repayments of non-commercial loans and guarantee of loans. Non-commercial loans are a vital tool to aid primarily small business in continuing operations or just staying afloat. In most cases non-commercial loans are legitimate dealings between family members, provided to the trust interest free to ensure the on-going operation of the business. Under the Government's proposal, the repayment or guarantee of a loan would be treated as a distribution of profits, which would create a form of gift tax.

## *Conclusions and Recommendations*

The Australian Chamber of Commerce and Industry (ACCI) does not support the proposed entity tax arrangements contained in the draft exposure. The new arrangements do nothing to improve the integrity of the tax system and compromise the long run objectives of improving the simplicity, fairness and competitiveness of the tax system.

The taxation of entities should return to the principle outlined in the Ralph blueprint that the tax system should treat all structures in the same manner and taxpayer should not gain an advantage depending on the type of structure chosen. While we understand that the special needs of widely held trusts and collective investment vehicles could have been addressed, the new regime does nothing to address the issue of equity and goes against the objective of developing a unified entity taxation system.

The new regime also compromises the objective of ensuring greater growth and productivity and may reduce the incentive for higher rates of investment. The importance of facilitating productive international investment has not been addressed under the new entity tax regime.

Business will also have to contend with increased administrative complexities particularly, with determining profits under the newly introduced *profits first rule* and use of non-commercial loans. These issues will have a significant impact on business operations and cash flow position and in some cases will force business to seek alternative vehicles to carry on operations adding to the cost burden.

*Recommendations:*

1. The principles of uniformity and equity contained in the Ralph blueprint must be maintained and the inclusion of:

   → *profits first rule*
   → treatment of non-commercial loans

   which are causing a divergence between the new regime and current treatment of companies must be addressed.

2. With the estimated number of trusts (based on lodgement figures 1998-99) equalling 460,000 (280,000 of which were non-fixed trusts), a more comprehensive cost-benefit analysis or regulatory impact statement should be attached to the draft to better indicate or evaluate the impact on taxpayers from the transition to the new regime.

3. A greater commitment by Treasury and the Australian Tax Office (ATO) to a comprehensive education program should this legislation be enacted.