The New Business Tax System

ENTITY TAX EXPOSURE DRAFT
- COMMENTS

CPA Australia

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November 2000

Introduction

As Australia's largest professional body, with 100,000 members, CPA Australia welcomes the opportunity to provide further input on the proposed tax entity regime for non-fixed trusts (NFTs).

CPA Australia is supportive of the Exposure Draft approach to developing legislation. This approach is much more consultative and, hopefully, conducive to allowing Australia to achieve a fairer and more robust tax system. However the comments provided herein are limited given the short time available for comments to be provided. It is difficult to do justice to the task within the time allotted - particularly as tax reform has stretched resources to the limit.

Notwithstanding that we support the process, CPA Australia is vigorously opposed to taxing NFTs as proposed in the Exposure Draft. The draft is full of anomalies and devoid of the high level principles espoused in the Review of Business Taxation Report. The original Unified Entity Regime (UER) high level attributes have been lost in the process and the Exposure Draft now proposes a separate, complex regime for NFTs. It does not provide the horizontal equity originally sought.

In order to address these limitations and in the interests of responsible tax reform, CPA Australia has prepared this submission. We hope to dissuade the Government from proceeding with its current proposal, or, in the event that it persists, that amendments achieve legislation that better reflects the needs of business, especially small business, and is more likely to assist, rather than hinder small business growth and prosperity in Australia.

Furthermore, it is fallacious to believe that the proposal can be implemented within the Government's proposed time frame, that is, by 1 July 2001. If taxpayers are to be given sufficient time to review their affairs to determine what steps they need to take before implementation, at least twelve months from the time the bill receives Royal Assent is needed.

In the interests of furthering the tax reform debate, the submission is also available to the general public via the CPA Australia Internet site, CPA Online, at ***www. cpaonline. com. au***.

Copies are also obtainable from CPA Australia by contacting Paul Drum - Senior Tax Counsel on 03 9606 9701 or via e-mail on drump@natoff. cpaonline. com. Au.

Acknowledgements

CPA Australia would like to acknowledge the contribution made by Ray Cummings, Paul Hockridge Vessna Iskra, Robert Oser, and our many CPA Australia Committee members who provided input into the preparation of this short paper including the members of our Taxation Centre of Excellence, National Tax Practice Committee, and National Public Practice Committee.

We also appreciate the assistance provided by Andrew Goldberger.

Executive Summary

As outlined in this paper, *The New Business Tax System: Entity Tax Exposure Draft - Comments,* the most significant issue for business in the proposed business taxation reforms is the taxation of trusts. Over 450,000 of the total 453,639 trusts in Australia are effectively in the Small / Medium (SME) category. In addition, businesses operating through a trust structure span a huge breadth of industries, ranging from primary production, finance, retail and manufacturing, to health and community services and others.

The Ralph Review identified that the rationale for taxation reform as it affects the small business sector had three major, related components. These are:

- the need for a more consistent, simpler tax system
- the need to reduce operating costs (compliance costs for taxpayers and administrative costs for the ATO) and
- a desire to promote the economic growth of the small business sector.

This Exposure Draft fails to take these fundamental criteria into account and also fails small business and SME's in terms of equity. It discriminates against small business and SMEs, creating an uneven playing field, with entities other than NFT advantaged at the expense of NFTs.

CPAs have argued against the taxing of trusts at the entity level for many years, and this fundamental position has not changed. The recharacterisation of trusts into companies for tax purposes ignoring their legal status has implications which have not been analysed. It behoves the Government to address this issue rather than ignoring it.

The Explanatory Material to the Exposure Draft Bill states that the new regime applying to non-fixed trusts 'will claw back tax preferences generated by a non-fixed trust in a manner consistent with the rules that apply to companies.**'** (paragraphs 1.5 and 1.6). No full explanation has been given what the offending tax preferences are and how the outcome from the new rules will deliver a better system than dealing with specific issues.

Accordingly, CPA Australia is vigorously opposed to the Exposure Draft (ED) on entity tax as currently drafted. However, notwithstanding our position and given that the Government is at this stage still intent on implementing some measures to address certain tax avoidance activities, we make the following recommendations to minimise risk, unintended consequences and compliance costs that will be inevitably associated with these measures should they be introduced.

There is an enormous amount of detail that requires more work or is actually not present at all in the ED – so much so that it is difficult to determine to whom the rules would actually apply. These include fundamental definitions such as Australian resident, fixed trust, excluded trust, qualified person and others. Extensive work is necessary to determine these definitions and it is not considered that this can be achieved in the current proposed timeframe.

In the interest of ensuring open and frank disclosure of ideas, there is merit in making available copies of the submissions received on this ED, and others in the future. This could be done via the Treasury or ATO website, subject to the approval of the participants.

If the Government intends to proceed, then rollover relief will be necessary to enable NFTs to restructure if required.

Also because of the uncertainty and complexity inherent in the entity proposals as expressed in the Exposure Draft, CPA's believe it is incumbent on the Government to release as soon as possible, the Regulation Impact Statement, including the Financial Impact Statement, prepared by the Office of Regulation Review. The Government must demonstrate that the proposals will be of benefit to Australia and, if there is a benefit, state in some detail what that benefit is.

General comments

Australian resident - It has been suggested that this would include some trusts created offshore and a definition would be available later this year. Until this is provided /determined there are significant risks for entities that cannot be fully contemplated.

Available profits - The available profits definition is unacceptable as it will result in the taxing of unrealised gains (anticipated profits), and also these profits may never crystallise.

Also it is not clear what assets and liabilities will be included in the available profits test. For example, accounting records currently often do not include goodwill. Also assets to be disregarded for test purposes should include prepayments, which are not legally recoverable debts. More work needs to be done on the definition to minimise unintended consequences.

Also there are general compliance as well as compliance cost concerns linked to the amount of times a trustee will be required to determine available profits if multiple distributions are made during the course of a year - this should be once per annum only.

Contributed capital - The determination of contributed capital creates some anomalous and iniquitous outcomes on transition. One example of this is the problem of allocating a cost base for pre-CGT assets in trusts on the transition. If a cost base cannot be determined, then there is a zero value for contributed capital purposes which is iniquitous. Even if the cost based can be determined, any increase in value above cost base will be included in available profits and this can result in the distribution of unrealised gains that will be taxable in the hands of the member, whereas if the trustee had actually disposed of the asset and made a distribution from the non-taxable proceeds then the distribution would have been tax free. This is also iniquitous. To overcome this drafting problem it is recommended that pre CGT assets on hand on implementation date should be brought to account at their market value, not at cost base as proposed.

Also the ‘sole purpose’ test (s157-90(1)(b)) needs modification as there are other non-tax reasons why a contribution may be made, the most common being asset protection. Also (i) –(iv) are exclusive tests, that is, if the purpose is for more than one of the reasons permitted in (i)- (iv) then you fail the test. We recommend that ‘sole’ be removed from the test

Complexity - The provisions are complex, and comprehension is not assisted by the fact that they are incomplete. Taxpayers will be faced with significantly increased compliance costs in relation to the NFT regime through the necessity to gain an understanding of the provisions, the record keeping required, including maintaining contributed capital accounts, maintaining franking accounts; determining prior taxed profits; determining available profits; determining the ‘cost base’ of pre-CGT assets by 1 July 2001; and the restructuring wind-up costs associated with some entities.

Drafting incomplete - While we acknowledge that the ED is only a draft, substantial parts are either incomplete or completely absent. Also there are issues of significant substance present in the draft explanatory memorandum (EM) with no corresponding section in the draft bill and vice versa. For example, at para. 5. 15 in the EM it refers to ‘the same family group’. Rules covering this measure are intended to be introduced in a later bill. Significant gaps such as this make it impossible to be able to draw a conclusion on how these provisions are intended to operate and to whom they will actually apply.

There are no specific provisions dealing with the position of non-resident non-fixed trusts and non-resident unit trusts which fail to qualify as fixed. Such entities may have Australian source income which is not exempt under a double tax treaty.

Equity - The proposal is iniquitous as the taxation of unrealised gains and double tax will be consequences of this regime in many circumstances.

Excluded trusts – Extensive consultation has taken place on this issue over the last twelve months, but we are uncertain of where this has now got to. CPAs, TIA and ICAA made written recommendations during the consultative process in respect of Everett assignments, constructive and resulting trusts, trustees without a single beneficiary, deceased estates, court trusts and others. A separate submission was also made by CPA Australia on the issue of protective trusts. For completeness and to help ensure these issues have not been lost in the process, copies of both of these submissions are attached for your consideration as Appendicies A and B to this document. (As these submissions were originally made under the cover of the confidentiality agreements in place, these appendices will not be released publicly.)

We also recommend that those NFTs that are prepared to make a family trust election be included in the excluded trust definition, or alternatively treated as fixed trusts for the purposes of the rules. If this is unacceptable, alternative tests that could be used to carve out small discretionary trusts include the proposed STS regime threshold, or the small business CGT threshold. The key arguments for family trusts to be treated as excluded trusts under the entity tax regime are twofold –

> - The proposed provisions are anti avoidance provisions that seem to be targeted at practices identified as undertaken by high wealth families. It is arguable that all other trusts including discretionary trusts used by small business are unintentionally swept up in the proposed application of the provisions due principally to the difficulty of carving out the non-targeted trusts
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> - The major disruption and upheaval that would be created without such an exclusion. Studies of compliance costs all show that small business already bear a disproportionate burden of compliance costs. Reform should be aimed at reducing that disproportionate burden, not adding to it. As the small business sector makes extensive use of discretionary trusts, additional compliance costs associated with the tax treatment of trusts will be concentrated on this sector. As the small business sector is already bearing the highest proportionate costs in relation to the other major leg of tax reform – the GST – it is important that business tax reforms keep additional compliance costs for small businesses to a minimum.

In addition, small business makes a substantial contribution to the Australian economy and employment.

Fixed trust - The proposed definition imported from the 'loss trust' anti-avoidance provisions is untested and is inappropriate in drawing a demarcation line which is fundamental to the entire Draft Bill.

The concept of '*vested and indefeasible interest'* and related concepts are well known but nevertheless imprecise creations of trust lawyers rooted in old equity law. The attempted application of the key definitions to commercial structures used in Australia in the year 2000 will invite confusion and litigation. The approach taken is counter productive in the context of tax reform at a time when Australia is competing in a global economy and is encouraging capital inflows.

In practice, the proposed definition will include many trusts that currently consider themselves to be fixed. This includes many public unit trusts, and the main problem seems to be the 'vested and indefeasible' test in s272-5(1). Previous experience has demonstrated that there are enormous compliance costs associated with determining whether a trust is fixed or not fixed. This was evidenced when the trust loss provisions were introduced. To proceed with the current definition which will now apply to a much larger class of trusts (not only those with prior year losses) will create unacceptable costs of compliance on taxpayers who use trusts.
It is recommended that the definition of fixed trust be modified to overcome this problem and one possible solution would be to ensure that trusts that satisfy the widely held test proposed for CIVs at recommendation 6.21 p. 274 of *A Tax system Redesigned* are excluded or treated as fixed for NFT purposes.

There is also an impending administrative issue arising from the interaction of the self assessment system and the proposed line of distinction between fixed and non-fixed trusts. It is unacceptable to contemplate the prospect that a trustee makes the judgement in good faith that the trust is 'fixed' only to find this treatment under challenge, years later, by the Commissioner of Taxation. Therefore, as a minimum, the relevant Acts should contain provisions which afford the 'reasonably arguable position' protection to trustee taxpayers along the lines of the concept in s284-15 in Schedule 1 of the Taxation Administration Act 1953.

Future of Division 6 - Clarification is needed as to possible changes to Division 6 (ITAA 1936) especially since fixed trusts will continue to be subject to this Division. We consider this aspect of entity taxation should be integral with the proposed changes.

Imputation rules - Although not entirely clear from the ED, it appears that a NFT will be required to make a family trust election to enable beneficiaries to obtain franking credits. This will simply not be possible where the beneficiaries/unitholders are not members of a family group. This must be removed from the legislation as it will give rise to two tiers of tax - once at the trust level and again in the beneficiary's hands. This could result in an effective tax rate of up to 64%.

The 20% benchmarking rule proposed for dividend franking is unrealistic, and fails to take into account how the market operates. This point was covered effectively by the CTA at the consultations on 19 October 2000 and CPA Australia are supportive of their comments and suggested solution.

Imputation and benchmarking rules – a special rule will be needed for liquidations – or is this expected to be covered under s160-85 (Commissioner's discretion?)

s160-E - The issue of distribution statements (also as outlined in the draft EM at 7.150 -154 inclusive) needs to be revisited. Business owners often draw down amounts from trusts during a year that are offset against year end profits when determined. The work required to satisfy this criterion is quite onerous, and the costs of compliance of multiple distribution statements throughout a year is too high. It will result in non-compliance in many circumstances, with penalties applicable under the Tax Administration Act 1953. It is recommended that sufficient time be allowed after the end of an income year to enable the relevant distribution statements to be completed, say up until one month prior to the final lodgment date for taxpayers who self prepare their tax returns.

s157-55 - the 12 month distribution rule needs clarification.

s157- 20 (c) type distributions are not frankable according to the draft; see s160-32 p82. However it is not understood what is the policy reason behind this decision, and it is unnecessarily harsh. It is recommended that these distributions (should they ever arise) also be frankable.

Loans to members - The non-fixed trust regime essentially replicates Division 7A in relation to loans made by trusts. Submissions were made in relation to Division 7A problems and anomalies when it was introduced. These problems/ anomalies still exist, and they will be replicated in the NFT provisions. These anomalies need to be fixed as part of tax reform, not expanded to a broader class of taxpayer entities.

Non-commercial loans by members - The definition of contributed capital together with the application of the profits first rule can have extremely harsh operation in relation to treating loan repayments as a dividend. While it is acknowledged that there has been a softening of the application of these proposed loan rules (up to 24 months to repay from the time the loan was made in some circumstances) it seems to presume that the member wants to be repaid as soon as possible. This fails to recognise that member loans are a common source of long term business financing for many family businesses.

Profits first rule - The wide definition of available profits can have the effect of creating double taxation in some circumstances. For example, taxing distributions while an NFT has unrealised gains via the operation of available profits rule, and later when the NFT actually crystallises the gain and that gain is taxable to the NFT. The provisions should be amended to eliminate any double taxation.

Also it is unlikely that an entity that is a going concern will ever be able to access contributed capital. Or put another way, a going concern will have to wind up operations before a member could access contributed capital. This is enormously harsh and unacceptable especially when compared to the rules that apply to companies who are able to do a share buyback or a fixed trust which may issue an unfranked distribution that reduces a member's cost base. This needs to be modified to enable access to capital.

Prior taxed amounts - The definition of prior taxed amounts should be amended to include CGT concessional amounts realised before commencement of the non-fixed trust regime.

Qualified person - This relates to the simplified imputation system. Currently there are definitions of qualified persons in the existing income tax provisions while the expression is yet to be defined in the bill for imputation purposes. Presumably this is because the existing definitions, if adopted for the purposes of the simplified imputation system, will result in double tax on income in some cases as franking credits will be unable to pass through to all members. This is grossly iniquitous and it is essential that franking credits be allowed to flow through to members who are not qualified persons.

Regulation Impact statement – As a result of the uncertainty and complexity inherent in the entity proposals as expressed in the Exposure Draft, CPA's believe it is incumbent on the Government to release as soon as possible, the Regulation Impact Statement, including the Financial Impact Statement, prepared by the Office of Regulation Review. The Government must demonstrate that the proposals will be of benefit to Australia and, if there is a benefit, state in some detail what that benefit is.

Restructuring taxpayers affairs - Notwithstanding the reasoning in the Ralph Report under the heading of *Rollovers out of an entity taxed like a company* [page 482], that

'…special rollovers for discretionary trusts to encourage restructuring before transition to the new system are unnecessary.',

CPA Australia urges the Government to rethink this approach. It is recommended that the proposed legislation adopt a flexible and encouraging policy position for the restructuring of non-fixed trusts. This is dealt with further below.

Rollover relief - Rollover relief should be extended to NFTs and it was welcoming to see that this was on the agenda at the recent consultative forum. Such rollover relief should enable NFTs to roll into fixed trusts or companies or allow trusts to be wound up and assets distributed to beneficiaries with their tax attributes intact. This is discussed further later in this paper.

Slice rule - The slice rule should apply not only to termination of membership interests on termination of a non-fixed trust, but also to termination of a membership interest on repayment of a non-commercial loan.

State duties relief
It is disappointing the Government has made no announcement on its negotiations with the States for duty relief to facilitate restructuring under the transitional rollover proposals. CPA Australia has been advocating State duty relief on restructuring since the release of the RBT report on 21 September 1999. This was one of the RBT's recommendations and also adopted by the Government. Again we submit that it is essential that the Government introduce arrangements to enable the cost effective restructuring of entities, particularly trusts, prior to the introduction of the entity tax bill. It has been argued that the States have been reluctant to grant concessions to date. If this is the case we submit that the Government consider funding the States for revenue lost from State duties during the interim. Relief from State duty in these circumstances is the responsibility of the Government and should not be a cost to business.

Timeframe - The commencement date of 1 July 2001 will not give adequate time for many taxpayers to review their structures. Taxpayers will need appropriate time to understand any new proposed restructuring rules in order to make informed decisions. The time limit allowed ignores legal and commercial realities in bringing non-fixed trusts into an entirely new taxing regime. Therefore it is critical that the 1 July 2001 implementation date be deferred until at least 1 July 2002, or twelve months after the completed legislation receives Royal Assent.

This extension request is compelled by the Government's delay in releasing the Exposure Draft, and it should be noted, in an incomplete form. The Ralph Committee's Report and initial draft legislation was released as long ago as July 1999. The Government's inability to work to a reasonable timetable should not be made into a punishment for taxpayers.

Specific issues

- s156-20 (1)(a) and (c) - 'the basic rule' - the question arises as to whether these separate events could lead to double tax on the same income. If there is a distribution as a result of crediting under para (1) (c), a subsequent payment of the amount previously credited needs to be excluded from para (1)(a). Arguably at present there could be a doubling up. The previous credit that gets reduced by payment may represent a membership interest and therefore may not be consideration for the subsequent payment for purposes of s156-25(1) as a result of S 156-25(2). The subsequent payment may therefore also be a distribution without any reduction for the previous credit as representing consideration.

- There appears to be a duplication between s156-20 and the following subdivisions in that the exclusions in subdivision 156-D do not apply to s156-20. For example, loans which are intended to be excluded e. g. if they comply with minimum repayments (s156-125), a loan from NFT to NFT(s156-110) and other exclusions, are only excluded from 156-75 and not from 156-20.

- Similarly superannuation contributions could be distributions under 156-75.

- Loans within family trust group - the exclusion under 156-110 is limited to loans between a NFT to another NFT. However it does not apply where the latter NFT on-lends to another NFT. The interposed entity provisions (Subdivision 156E) may apply. It is very common in family groups to have one family trust act as a banker in which those family trusts in the group with a cash flow surplus deposit funds and those requiring funds borrow from the banker trust. The provisions as they stand will be unworkable for a family group and will impose a significant compliance burden. Where family trust and interposed entity elections have been made, there should be no restrictions on inter trust loans as long as the funds remain with a family trust within the group. It is also difficult to assess the full impact of these provisions without the release of the proposed consolidation rules.

- Retrospectivity/exclusion for prior distributions credited and lent back - it is not clear from the provisions the extent of exclusions for pre - 22 Feb. '99 loans. For example, where a trust realised a pre '85 capital gain and distributed the gain to a beneficiary before 22 Feb. '99, the amount credited to the beneficiary should be excluded from the proposed profits first measures. The clear intent of the RBT final report was that the measures in relation to both realised and unrealised gains distributed and credited before 22 Feb. '99 and lent back to the trust should be excluded from the measures, see page 461-462 of *A Tax System Redesigned*. However it is not clear from the provisions how this is or will be achieved.

- s153-25 imposes a 'once a NFT, always a NFT' rule which is harshly inflexible. An alternative would be to enable a FT to remain an FT except where in a year it failed the FT test, then it was out for that year, or something similar.

- Franking credits and PAYG - Transitional measures will need to be implemented to ensure a trust has franking credits at the end of the first year of the entity regime. This was first raised by CPA Australia in a consultative forum on, among other things, excluded trusts in late 1999. To date we have not seen any further developments in this area. The consequences of not implementing same are that at the end of year one an entity will have distributable profits but no franking credits to flow through to beneficiaries/members.

Restructuring taxpayers' affairs

Rollover relief for NFTs

As a general observation, we note that the transitional restructure relief in the ED imposes 2 conditions, namely, that tax values should be the same before and after the transfer is completed and that 'proportionality' should be likewise satisfied, before and after. The 'proportionality' condition is unnecessarily restrictive in the context of encouraging rather than restricting adaptation to the new regime. The Government should encourage the restructuring of non-fixed trusts into companies if the policy is to treat non-fixed trusts as though they were companies.

At the consultations held on 19 October 1999 a paper was distributed considering a number of issues relating to rollover relief to ensure that changes in trust deeds in response to the proposed entity tax rules would not trigger a trust resettlement.

This would relieve the trustee from the CGT liability that would normally arise in such circumstances. However, it was also recognised that 'normal tax rules would have applied where interests in the trust were altered as a result of the deed changes – that is, cancellation of a discretionary interest and replacement with a unit would generate a taxing point for the discretionary object. '

The consultative forum sought to explore the case for developing a wider form of relief for both trustees and members where the necessary restructures are permitted under trust deeds and trust law.

CPA Australia is most supportive of the introduction of rollover provisions to minimise the impact of the introduction of the NFT entity regime. It is submitted that this rollover relief at the Federal level is necessary not only for CGT, but also other asset rollovers (for example trading stock) and GST. The well understood issue of state duty relief has already been commented on earlier in this paper.

The ED has no specific provision to deal with the transition of non-fixed trusts which are carrying forward unrecouped tax losses including capital losses. Assuming there is no intention of causing the forfeiture of tax losses, this should be clarified in a way which secures full protection for the trustees of loss trusts.

Some of the possible additional relief proposed at the recent RBT meeting included:

- 'Enabling rollover relief where a NFT changes its deed to become a fixed trust before 1 July 2001' – we are supportive of this proposal but the date will need to be pushed out to enable sufficient time for taxpayers to make the necessary changes

- To be 'Modeled on the attributes of the other entity restructuring relief outlined in the exposure draft' – we submit that the transitional rollover relief should be extended to allow rollover from a NFT to any of the following:
    - a fixed trust
    - a company
    - an individual
    - a partnership or
    - a joint venture.

- 'No CGT liability for members as a result of the cancellation of membership interests in the NFT and replacement with a membership interest in the fixed trust - agreed but also include companies, individuals, partnerships and joint ventures.

- 'Original cost base for the membership interest transfers to the new membership interest' – agreed, and pre 23 December 1999 status retained on new membership interests required – this is a serious flaw in the current rollover rules from a fixed trust to a company and this must be changed also.

- 'Pre-CGT status of the trust's assets and of membership interests is maintained' – supported.

- 'Acquisition date for interests in the fixed trust is the date of resettlement' – supported.

- 'Restrictions on the allocation of membership interest' - it is suggested that the family trust election approach would go a long way to assisting the majority of trusts in small business – but not all – there would be some losers.

- 'Relief for restrictions involving fixed trust and companies is conditional on there being no proportionate change in underlying ownership' – again the family trust election approach could assist small business, but not all would qualify.

Rollover relief for companies to fixed trusts and fixed trusts to companies

- S125-10(1)(b) – the rule for companies to have at least 300 members now appears to be redundant given that the CIV regime is not proceeding. This should be changed otherwise it creates an extra obstacle for companies that wish to convert to fixed trusts.

- Under s125-30(1) (p136 of the draft bill) there is a short window of opportunity to effect certain rollovers We submit that there is no good policy reason why there is a time limit on this rollover provision. Accordingly it is submitted that the rollover access under this provision be open - ended.

- The proposed requirement to wind up an entity within 6 months on CGT rollover as per s125-30(2) is unachievable and also needs to be extended to at least 12 months.
