Your Ref:

12 December 2000

Our Ref: aws:mrm:365

The Assistant Commissioner
Law Design and Development (Entities)
PO Box 900
CIVIC SQUARE ACT 2608
CANBERRA

Dear Sir

NEW BUSINESS TAX SYSTEM (ENTITY TAXATION) BILL 2000 - EXPOSURE DRAFT

I refer to the above Bill and explanatory material and, following my attendance at the Consultation meeting in Canberra on 19 October 2000, make the following comments. I have numbered the paragraphs for ease of reference.

1. **Application of Entity Tax from 1 July 2001**

1.1. This operative date is of considerable concern. The introduction of GST and pay as you go ("**PAYG**") on 1 July 2000 has put enormous pressure on advisors, particularly accountants assisting their clients, in coming to terms with GST and PAYG. Currently the resources of advisors are stretched to the limit in preparation of client's Business Activity Statements. I have heard instances of business people saying their own productive time is now being taken up completing the BAS.

1.2. Whilst I hope these problems will diminish over the next 12 months as we all become familiar with GST, PAYG and the BAS, in my opinion it is unreasonable (and unrealistic) to expect accountants who are already endeavouring to manage these matters to become familiar with the proposed taxation of non-fixed trusts under a completely different regime from 1 July 2001.

1.3. The impact of the profits first rule means that from 1 July 2001 accountants **must** understand what represents "contributed capital" for a non-fixed trust as at 1 July 2001 (ie. opening contributed capital). This is an entirely new concept. I do not see that it is

possible for such a change to be fully understood, particularly on top of GST, PAYG and BAS.

1.4. I suggest the operative date be deferred until 1 July 2002.

2. Prior Taxed Amounts

2.1. The concept of "prior taxed amounts" is relatively straightforward (in theory) and the proposed tax-free treatment appropriate.

2.2. My concern is that the "Liabilities" section of a non-fixed trust balance sheet does not immediately indicate whether any "beneficiary entitlement" credit balance represents a "prior taxed amount" or "contributed capital".

2.3. I understand "non-commercial loans" made to a non-fixed trust on or after 22 February 1999 unpaid on commencement will be included in opening contributed capital. Therefore, repayments will be subject to profits first. If however such post-21 February 1999 credit balance can be shown to be a "prior taxed amount", then the exception to profits first applies.

2.4. The status of pre-22 February 1999 loans to an entity is, I suggest, not as clear. I understand the intent is that such loans (whether "commercial" or not) can be repaid without reference to profits first. Is that correct? If so, how is that result arrived at in the draft Bill?

2.5. Any credit balances to beneficiaries may have arisen over a large number of years, some part of which may well represent "prior taxed amounts", whilst some portion of it may represent cash contributed by the "member" to the trust. I understand a "reconstruction" of such credit balance is required.

2.6. An exercise to reconstruct every discretionary trusts beneficiary entitlements accounts will be considerable. This will place enormous strain on the resources of accounting and legal firms to revisit/reconstruct those balances.

2.7. That reconstruction would however be necessary prior to 1 July 2001 as, in my view, to properly assess the impact of the profits first rule by that date the accountants will need to consider the exact amount that represents "prior taxed amounts".

2.8. In my view it appears likely taxpayers would endeavour to rely on section 170(2) of the Income Tax Assessment Act 1936 to restrict any such "reconstruction" to four years on the basis that there has not been "fraud or evasion."

2.9. Even a four year reconstruction of such credit balances will in my view involve considerable time on behalf of taxpayers and their advisors.

2.10. In my opinion some practical guidance needs to be given as to what is expected of trustees in reconstructing or determining what represent the "prior taxed amounts". There also needs clarification of pre-22 February 1999 loans to non-fixed trusts. As there are only 3 exceptions to the profits first rule (EM paragraph 4.25) it is perhaps

unclear as to how a pre-22 February 1999 loan may always be repaid without resort to profits first.

3. Repayment of Non-Commercial Loan

3.1. A non-commercial loan by a member to a trust, on repayment, will be subject to the profits first rule. To the extent the trust has profits, the loan repayment will represent a distribution of the profits. Will this repayment reduce the loan balance of the "creditor" in the balance sheet of the trust? That is, if the trustee of the trust understood that it was making a payment of principal reducing that non-commercial loan, then to the extent the trust has available profits the recipient will receive an assessable distribution. The recipient may therefore not accept that the payment is a reduction of the principal, but rather akin to interest. On the other hand the trust may well record in it's accounts a reduction in the amount due to the creditor.

3.2. There will need to be a considerable education process for both accountants and lawyers to become aware of the consequences of these non-commercial loan repayments. There seems a great potential for a difference between accounting figures and tax figures. In particular, after some "non-commercial loan repayments" have been made, it may be that the "creditor" in the trust balance sheet for accounting purposes is different from the amount utilised between the trust and "member" for tax purposes. This could cause problems, to say the least.

3.3. The legal problems in drafting a non-commercial loan agreement where repayments of "principal" may be assessable under profits first baffles me at the moment! How much "principal" is outstanding after a "profits first" repayment?

4. "Distribution" and Guarantees

4.1. I refer to the example 3.3 to the Explanatory Memorandum at page 37. In my view that is not an appropriate situation for a "distribution" to arise (ie. the taxable "distribution" to Kia of $100,000). I suggest it be reconsidered.

5. Debt Forgiveness – Debt/Equity Swap

5.1. Section 960-195(5) appears to create an amount being "forgiven" by simply refinancing to pay out an existing creditor. Is that the intent? I suggest this subsection needs to be revisited. I understand from the consultation meeting on 19 October 2000 that that subsection is to be revisited.

6. Rollover Relief Pre 1 July 2001 – Stamp Duty

6.1. There is a very real need for urgent stamp duty consultation with the various States/Territories. Whilst the Entity Tax Bill proposes certain rollover relief for income tax/capital gains tax, unless there is concurrent stamp duty relief then the advantages in seeking the tax rollover relief will be significantly reduced. It may be that in fact no entities seek to restructure because of the stamp duty cost.

6.2. Certainly at the moment there could not be any reason for any entity to restructure since there is uncertainty as to whether the entity tax changes will take effect, and if so from when. Even if the Entity Taxation Bill is passed so that it is operative from 1 July 2001, any stamp duty cost associated with the restructure will need to be considered. The time available to give adequate consideration to all aspects of a restructure is obviously diminishing each day. This again is strong reason for deferring the operative date.

7. Fixed Trust – Depends on "Fixed Entitlement"

7.1. The proposed Entity Taxation Bill applies only to non-fixed trusts. This depends on the definition of "fixed trust" which in turn requires examination of "fixed entitlement".

7.2. The amount of case law that has considered the concept of "vested and indefeasible interest" indicates this concept is far from certain, and in my view gives rise to enormous problems.

7.3. An examination of both the trust loss rules (Schedule 2F) and the Explanatory Memorandum to those trust loss rules is necessary in order to gain any understanding (to the extent that is possible) of what is intended to represent a "fixed entitlement".

7.4. Subsection 272-5(2) of the Income Tax Assessment Act 1936 (adopted in the Entity Tax draft Bill) causes me some concern. It relates to a unit trust (in particular, an unlisted unit trust), where units may redeemed or issued for a price "determined on the basis of the net asset value, according to Australian accounting principles, ……" The mere fact the units are redeemable or further units may be issued "does not mean the person's interest … is defeasible."

7.5. Paragraph 13.11 of the Explanatory Memorandum to the trust loss provisions states "Subsection 272-5(2) is not intended to disturb the ordinary meaning of "vested and infeasible interest" in any way except in accordance with its terms. Thus, if an interest is vested and indefeasible ignoring subsection 272-5(2), it will be a fixed entitlement."

7.6. What then is the intention behind 272-5(2)? I have had it put to me that if units may be redeemed or issued based on a different redemption/issue calculation (or price), then the interest **must** be defeasible. I do not agree with that view. In my view, the section is not stating an interest must be defeasible where the issue/redemption is based on a different calculation. The Explanatory Memorandum at paragraph 13.11 in my opinion supports my interpretation. Subsection 272-5(2) is "not intended to disturb the ordinary meaning in any way except in accordance with its terms". So why have that subsection?

7.7. Furthermore, what does it mean to have reference to "net asset value, according to Australian accounting principles"? Particularly if Australian accounting principles record assets at historical cost! Must assets be revalued to current market value when considering this "interest not defeasible" subsection?

7.8. The variety of trusts that exist is enormous. They are not all inter vivos trusts put in place simply to minimize tax! Some, for example, date back to the early 1900's with income distributed to children and remoter issue, and ultimately there are numerous capital beneficiaries. The application of the proposed non-fixed trust rules, based on

whether a person's interest is "vested and indefeasible" is in my opinion likely to create enormous problems. The concept of vested and indefeasible is an extremely difficult legal concept that will give rise to problems.

7.9. For example, is it anticipated that (say) a "marriage settlement" created in the early 1900's, that provides for income being paid to a number of children, grandchildren and then capital to vest to great grandchildren will be caught by the non-fixed trust rules or by fixed trust rules? There are various scenarios of death of certain "beneficiaries" in such trust (ie. "contingencies") which in turn affect the rights of certain beneficiaries.

7.10. Whilst the examination of all trusts to determine whether all income and capital has beneficiaries with a "vested and indefeasible interest", and therefore whether Entity Tax applies, may be extremely fruitful for legal practitioners, I do question the wisdom of introducing rules that are based on such a vague concept.

7.11. Whether a test could be introduced based on the discretion or ability for the trustee to determine whether to distribute income and/or capital amongst a range of beneficiaries would be more appropriate seems, in my view, to be worth considering.

8. Non-Fixed Trusts and Division 152 CGT Relief

8.1. It appears some of the Division 152 CGT relief is intended to form part of contributed capital of a non-fixed trust. Therefore, upon realisation by a non-fixed trust of an asset that obtains the benefit of Division 152 relief, the "available profits" will not be enhanced to the extent of the CGT relief. However, a distribution by the entity will still be subject to the profits first rule, except if the entity is wound up or terminated in which case the slice rule applies.

8.2. In my view there needs to be clarification as to all the circumstances in which the Division 152 CGT relief applies and can pass through in tax-free form to "members". I understand there are still rules being drafted in relation to the family group provisions and distributions to family members. I refer to paragraph 5.15 of the explanatory material to the Entity Taxation Bill. These proposed rules need to be released as soon as possible.

9. Child Maintenance Trusts/Testamentary Trust

9.1. I understand both child maintenance trusts and testamentary trusts are not intended to be "excluded trusts". Therefore they will be subject to entity taxation if they are "non-fixed".

9.2. As a separate taxable entity, will there need to be a means of identifying (or "labelling") a distribution from such trust since, as I understand it, it is intended that an infant beneficiary of a child maintenance trust or testamentary trust will be taxable at ordinary resident rates rather than the penalty regime applicable to infant beneficiaries of inter vivos trusts? In particular, since under entity taxation a "distribution" from such a trust is simply a "distribution" (whether from income or capital), is there a need to in some form "identify" the income as coming from a child maintenance trust or

testamentary trust? I have not given detailed consideration to this but raise it as an issue to consider.

10. Profits First Rule

10.1. This rule still causes anomalies. For example, consider a primary production partnership that makes losses. The land on which that primary production partnership is carried on happens to be owned by a discretionary trust (for asset protection and succession planning purposes), basically representing the same family group as comprise the primary production partnership. The land on which the partnership is conducted has appreciated in value since acquisition.

10.2. If the trustee of the trust borrows money and pays that to the partnership at "non-commercial" rates then, as the value of the land will have increased, it would seem to give rise to a taxable "distribution" to the partnership. This however simply (in my view) represents a loan of funds from the trust to the members in order for the partnership to continue to trade. Under entity taxation, as a "distribution", that "loan" amount (to the extent of available profits) will absorb the partnership losses. Whilst there may be means around this problem (eg. the partnership borrows the further funds utilising security/mortgage provided by the trust), it may also be that the provision of the guarantee could be caught as a distribution pursuant to the guarantee provisions of the draft Entity Taxation Bill.

10.3. The problem is caused by the profits first rule which does not always achieve an appropriate or fair result. I am not yet convinced the profits first rule is the only means of rectifying current perceived deficiencies.

11. Calculating "Available Profits"

11.1. The available profits are basically (pursuant to s.157-85) calculated as follows:

- net market value of assets, less
- accounting provisions, less
- contributed capital, less
- prior taxed amounts.

11.2 At the Explanatory Memorandum paragraph 4.17 it is stated that non-fixed trusts may rely on their accounting records to determine whether a distribution is wholly from available profits. However, the accounting records will almost always not disclose any internally generated goodwill. Furthermore, very rarely will accounting records for a "family/discretionary trust" show the current market value of land and buildings, or for a share portfolio (except for trading stock).

11.3 Subsection 157-85(3) states that if the Commissioner considers the "accounting records significantly undervalue the net market value of it's [ie. the trust's] assets," then the Commissioner may substitute the value the Commissioner considers is appropriate. Ascertaining the "market value" of assets when they have not been realised on the open market is another extremely vague and imprecise matter. For example, intellectual

property such as trade marks, patents, copyright and designs, whilst they may have a value which is determined when those assets are sold, in an unrealised form the "market value" can span a very large range. It is easy to see the non-fixed trust rules giving rise to a plethora of tax cases based on valuations.

12. **Distribution of Asset Revaluation Reserve**

12.1. It seems to me one of the main driving forces behind the proposed profits first rule and the taxation of non-fixed trusts is to stop discretionary trusts revaluing their assets and making a capital distribution from asset revaluation reserve. That has ceased as of 22 February 1999 in light of the Commissioner's announcement and proposed entity taxation for non-commercial loans.

12.2. I suggest consideration be given to legislatively stopping discretionary trusts from making a capital distribution from, or associated with, any asset revaluation but rather only permitting any such capital distribution to be made on realisation of assets. Is there then a need to have a profits first rule? Further, in that situation is there then any need to tax the non-fixed trust as a separate entity at all?

The above are only brief comments in relation to some issues arising from the exposure draft Bill. There are numerous other issues of which I understand various other submissions will be made. In particular the Taxation Institute of Australia will be making other submissions on numerous other areas of the exposure draft Bill.

If you would like to discuss any of the above please do not hesitate to contact me.

Yours faithfully
COWELL CLARKE

Per:

A W SINCLAIR