ENTITY TAXATION

SUBMISSION TO TREASURY

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

2 NOVEMBER 2000

The Institute of Chartered Accountants in Australia
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The Institute of Chartered Accountants

Executive Summary

The Institute of Chartered Accountants submits:

- The non-fixed trusts provisions and the non-commercial loan (member-to-entity) provisions of the *New Business Tax System (Entity Taxation) Bill 2000* should be completely withdrawn. These provisions lead to many significant anomalies and unintended consequences, and provide for a tax system that is not consistent with the taxation of companies.
- The transitional contributed capital provisions are grossly inadequate and unacceptable. In conjunction with the profits first rule, they lead to some gross anomalies that will be unacceptable to many in the Australian community.
- The exceptions to the profits first rule are fair in theory, but the requirements for relief will not always be able to be satisfied, particularly the need to identify prior taxed income in non-fixed trusts.
- Restructure relief for non-fixed trusts should be introduced at the same time, if and when the entity tax bill is introduced to parliament. The restructure relief should cover capital gains tax and GST and should be contemporaneous with State stamp duty relief.
- The definitions of fixed trust and non-fixed trust should be altered substantially. The proposed definition, taken from the trust loss provisions, is inappropriate for the current proposals. In any event, employee share trusts should be treated as excluded or disregarded trusts.
- The requirement that non-fixed trusts make a distribution to members annually, in order to enable individual beneficiaries to claim certain primary production benefits, is overly restrictive and makes no practical or economic sense.
- The interaction between the proposed non-fixed trusts measures, the imputation measures and the PAYG system needs to be fully considered and reworked before the bill is introduced, to ensure there are no unintended consequences. This has not yet been done.
- The interaction between the proposed entity tax measures and the international tax system must be fully examined and considered before the bill is introduced to parliament.
- The imputation measures contain some major anomalies and need to be reworked. These anomalies extend to the benchmarking rules, the record-keeping requirements for smaller businesses and the rules for flow-through of franking credits to beneficiaries of non-fixed trusts that are not family trusts.
- Requiring companies and non-fixed trusts to limit franking rate variations to 20 percentage points each six months is overly restrictive and can impose harsh penalties in unintended circumstances.
- Franking deficit tax, as proposed, is an overly harsh penalty that can not be justified when overfranking tax will not be allowed as a prepayment of company tax.

2 November 2000

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1 Introduction

The Institute of Chartered Accountants welcomes this opportunity to comment, formally, on the Exposure Draft of the *New Business Tax System (Entity Taxation) Bill 2000.* Many of our comments have been made already in informal meetings, electronically and in formal educational seminars and those comments should be treated as part of our submissions as well.

Importantly, we submit that the non-fixed trusts provisions of the exposure draft bill should be completely redrafted to withdraw the profits first rule and the non-commercial (member to entity) loan provisions. These particular provisions lead to many unbelievable anomalies, apart from creating a regime such that the taxation of non-fixed trusts is no longer consistent with the system for taxing companies.

The Institute reaffirms its commitment to the program of tax reform and its willingness to continue its role in the consultative process to help develop legislation that is workable, consistent, simplified and reduces compliance costs.

2 The Definition of Fixed Trust

The proposed definition is taken from the existing trust loss provisions in the legislation. That definition may be effective for that specific purpose, but it can create some unintended and anomalous situations in relation to the intent of the current measures. This point was well recognised by representatives of Treasury and the ATO at the recent workshop in Canberra.

(a) Public Investment Trusts

For example, we are cognisant of several public investment unit trusts that may technically be regarded as non-fixed trusts, even though it would not be intended to bring them within the non-fixed trust measures.

The definition of fixed trust in the draft bill provides that the entity must have fixed entitlements to all income and capital of the trust. For the purposes of the draft bill an entity has a fixed entitlement to the income and capital of a trust where the entity has a fixed entitlement within the terms of Division 272 of Schedule 2F of the ITAA 1936.

Subsection 272-5(1) provides that a beneficiary is taken to have a fixed entitlement to the income or capital of the trust where the beneficiary has a vested or indefeasible interest in the income or capital.

From the outset it can be seen that the terms vested and indefeasible impose unintended restrictions on the definition of a fixed trust for the purposes of the draft bill. The case law appears to indicate that an interest is vested where the holder has an immediate fixed right of present or future enjoyment, and an interest is indefeasible where it is not subject to any condition.

This is clearly inappropriate in the context of unit trusts for the following reasons:

- There is uncertainty as to whether an interest is defeasible, where a trustee has a power to redeem units for less than the listed price, or less than the price determined by reference to the net assets of the trust, or where the trustee has a power to issue units at a discount to the prevailing market price (e.g. reinvestment units);
- Moreover, an interest could also be interpreted as being defeasible, where a unit trust deed appropriately provides for a clause which allows for the amendment of the deed, and a change in the unitholder's entitlements;
- Most unit trust deeds provide the responsible entity with a discretionary power to determine the quantum of a distribution to unitholders. Unitholders are usually not presently entitled to a distribution until the responsible entity resolves to distribute an amount to the untiholders. This power is essential because it is the responsibility of the responsible entity to maintain the solvency of the trust. Accordingly, in these circumstances, it would be difficult to conclude that, "from time to time", a unitholder has any fixed entitlements to the income of the trust, or a unitholder has any fixed entitlements in relation to a share of the income of the trust, particularly where that share is not ascertainable until year end, and the quantum of that share is subject to the discretion of the responsible entity;
- Furthermore, it is not uncommon for some unit trusts to accumulate income. The issue that arises in this circumstance is that the accumulated income is effectively being held for the benefit of unitholders who will receive the distribution in the future as opposed to the current unitholders.
- Some unit trusts also have units that have contingent rights and obligations. These units are often issued to managers of the trust as an incentive to encourage the managers to ensure that the trust outperforms its competitors. For example, the rights to receive a distribution from the trustee/responsible entity may be contingent upon the trust achieving a certain level of economic performance. Under the current rules, the existence of such units will result in the trust being treated as a non-fixed trust.
- The definitions in Schedule 2F apply in the context of the trust loss measures. Those measures were anti-avoidance provisions aimed at preventing trust loss trafficking. It is, therefore, inappropriate to apply the restrictive definition in Schedule 2F to the draft bill.

(b) Employee Share Acquisition Scheme Trusts

We are also aware of many employee share acquisition scheme (“ESAS”) trusts that, technically, would be regarded as non-fixed trusts, whereas it is not the intention of the Government to bring them within the ambit of this draft legislation. For example, employee share trust deeds can permit discretionary distributions in the event of employee dismissal or could allow for non-distribution to some members in the event of forfeiture events or failure to meet performance hurdles.

The attached paper outlines the transactions usually undertaken by an ESAS Trust. The Institute considers ESAS Trusts should be excluded from the NFT regime because they serve a purpose – essentially a security purpose – associated only with the acquisition of shares or options by employees in accordance with ESAS Plan documents. There is no discernable mischief with any of the listed activities and accordingly any transfers of shares or options to employee beneficiaries should be treated as if it is a transfer from a bare trust and all other transactions should be taxed, where applicable, under Division 6.

(c) Fixed Trust – Circular Definition

There is also a technical deficiency in the definition of a fixed trust in the Exposure Draft.

A trust is a fixed trust if entities have fixed entitlements to all of the income and capital of the trust: Section 995-1(1) (definition of Fixed Trusts).

An entity has a fixed entitlement to a share of the income or capital of a trust <u>covered by the non-fixed trust rules</u> if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936: Section 995-1(1).

Trusts covered by the non-fixed trust rules are trusts where, at any time during the income year, the trust is a non-fixed trust (unless it is an excluded trust): Section 153-25.

A non-fixed trust means a trust that is not a fixed trust: Section 995-1(1).

The definition of a fixed trust is therefore circular and cannot be satisfied. No entity will have a fixed entitlement to the income or capital of a "trust covered by the non-fixed trust rules" ie a non-fixed trust.

The definition of a fixed entitlement should be amended to read:

> "an entity has a fixed entitlement to a share of the income or capital of a trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936".

3 The Profits First Rule

The profits first rule is possibly the most difficult proposition to accept in the proposed treatment of non-fixed trusts, since it now represents a major departure from the taxation of any other entity in Australia. The Treasury attempted to have such a concept introduced in Australia in 1996. At that time, the Government rejected the proposal. The Government has again rejected the proposal for companies and fixed trusts. We submit that the Government should, once again reject the current attempt to introduce such a concept into Australian tax law.

Without the profits first rule, it would be unnecessary to have the proposed rules for non-commercial loans from members to trusts. These non-commercial loan provisions create some of the worst anomalies in the draft bill and, even for these reasons alone, should be withdrawn.

There are further difficulties in relation to some of the exceptions to the profits first rule. Exceptions to the profits first rule include:

- A distribution from a prior taxed amount. The trustee will have the option of distributing any "prior taxed income" in the trust, such as income taxed under Section 97, 98, 99 or 99A, prior to distributing under the profits first rule;
- A distribution on termination of a membership interest; and
- Distributions that satisfy some of the transitional asset rules, such as out of gains on disposal of pre-CGT assets, discount capital gains on sales of pre-23 December 1999 assets and exempt gains that satisfy the small business active asset test.

Under the Government's original proposals, such transitional asset distributions would have to be made in the year in which the gain was realised (sometimes impossible). In the consultative process, this impossibility was pointed out, together with a request to be allowed a period after year-end in which to make the distribution. The draft now allows the distribution to be made in the 12 months after year-end, but it no longer allows the distribution to be made in the same year as when it is realised. This is anomalous and has been pointed out during the further consultative period. It is believed Treasury considers this is a drafting error.

The proposal to allow an exception from the profits first rule for prior taxed amounts assumes that prior taxed income can be identified accurately in the accounts of non-fixed trusts. That is a wild assumption that will rarely be able to be satisfied. For example, a trust that has been in existence for many years may have several elements that have been pooled under the category of "trust corpus" or some similar description in the accounts of the trust. This could be made up of prior taxed income, prior untaxed income, trust settlements, capital gains, revaluations, and so on. Further, there may have been withdrawals from the corpus in any year and it would be impossible to determine whether the distributions were out of prior taxed income, capital gains or settlement sums. This proposal is fair in theory, but it will be impossible to implement in the majority of cases due to the lack of appropriate accounting records going back to the commencement of the trust.

The other possible anomaly, coming from the definition of prior taxed amount, relates to income that is never taxed in the trust because of permanent or timing differences. This could include accumulated capital gains realised before the introduction of capital gains tax in 1985. It seems that if ever this is distributed after 1 July 2001, it will become fully taxable in the hands of beneficiaries. Trustees will therefore be inclined to consider distributing these amounts in full before 30 June 2001 in order to avoid the potential tax cost of any subsequent distribution.

For those who:

- are not fully advised; or
- do not take the appropriate action in sufficient time; or
- do not have the funds available to make such a distribution; or
- would be faced with substantial stamp duty, CGT and GST costs of making a distribution of assets,

the future tax cost could be very damaging, especially to small businesses.

(a) Further Anomalies

In addition to several anomalous situations already mentioned above in relation to the profits first rule and prior taxed income, the draft bill contains many other anomalies. These are due to the combination of the profits first rule, the contributed capital rules, the non-commercial loan rules and the available profits rule.

For example:

- Any form of distribution out of pre-CGT asset revaluation rules must be treated as a taxable distribution, even though a distribution out of realised pre-CGT reserves would be exempt.
- Distributions out of trusts that are treated as having available profits only because of unrealised gains on post-CGT assets will be treated as being taxable distributions, even though the gain has not been realised and may never be realised.
- Distributions out of trusts resulting from marriage breakdown settlements may be treated as taxable distributions, whereas existing law provides for CGT rollovers in such situations.
- Distributions out of discretionary trusts out of the original settlement sum could always be a taxable distribution as the beneficiaries will not have any contributed capital attributed to their membership interests.
- Distributions out of accumulated tax-free income (gains on pre-CGT asset sales, timing or permanent differences between tax and accounting income, etc) will always be subject to the profits first rule, since they do not fall within the definition of prior taxed amounts.
- The most difficult-to-understand issue is where a family member makes an interest free loan to a non-fixed trust to assist the business of a family member and the loan is repaid. In this case, the loan repayment will be treated as a distribution of available realised or unrealised profits under the profits first rule.

These anomalies arise only because of the proposed imposition of a profits first rule and the proposed imposition of the non-commercial loan rules as an anti-avoidance measure, to prevent circumvention of the profits first rule. As a result, they will operate effectively as a form of gift or wealth tax, which is hardly likely to be acceptable to the community. An alternative view is that such treatment amounts to a de-facto taxation of gains on pre-CGT assets and a tax on unrealised post-CGT gains.

Therefore, the reality is that the smart, well-advised businesses will continue to be unaffected by these proposals and only the unwary, the ill-advised or the ones not intended to be taxed will be caught up by these measures.

4 Primary Producers

The Government has decided to allow access to averaging and farm management deposits benefits for individuals who are members of non-fixed trusts that carry on a primary production business. Members of non-fixed trusts that carry on a primary production business will be taken to carry on that business themselves. However, there is one major proviso, namely that the member must receive a distribution from the trust in the income year. Why this proviso was included is not known. However, it is considered to be totally unreasonable, given that several trusts carrying on primary production businesses do not make profits and can not always make distributions. Further, the combination of these measures with the imputation system and the PAYG system means there is a real disincentive to make a distribution of any kind in the first year of operation of this entity taxation system for non-fixed trusts.

5 PAYG and the Entity Tax Regime

The lack of any detail on the inter-action between the Pay As You Go (PAYG) measures and the proposed entity tax regime has raised concerns that the practical mechanics for collecting tax from NFTs has not yet been fully thought through within the ATO and Treasury.

There are several important questions that need to be clarified, including:

- the PAYG obligations which will apply to NFTs in 2001/2002;
- the ability to generate imputation credits in NFTs during 2001/2002 (in order that franking credits may be passed out to members in that year);
- how the ATO intends to establish a PAYG instalment rate for NFTs (if data from beneficiary returns is not taken into account, there is a fear that NFTs will be issued with an unrealistically high rate);
- concessions for incorrect PAYG instalment rate variations by NFTs during the transitional years;
- whether beneficiaries will continue to be able to use the GDP adjusted notional tax method for paying PAYG instalments;
- the future of section 45-280 (Schedule 1, Taxation Administration Act 1953) after 1 July 2001. The Institute seeks confirmation that member PAYG instalments on NFT "basic rule" distributions will only be payable when the distribution is paid or credited, as is currently the case with company dividends.

There is also growing concern amongst practitioners at the PAYG issues that will arise where "corporate tax entities" move into the proposed consolidated tax regime from 1 July 2001.

Attempts to discuss these issues via the ATO's PAYG Working Party have so far met with the response that they cannot be discussed until the relevant legislation is released. The Institute strongly suggests that it is time the external representatives on the PAYG Working Party were given an opportunity to work with the ATO on a workable transition to the second phase of the PAYG instalment regime, which commences on 1 July 2001.

6 The International Aspects of Entity Tax

The Explanatory Memorandum (para 1.40) indicates that further work is being done on the international tax aspects of the entity tax legislation. The Institute fears that - in the rush to have the legislation introduced to Parliament – this important aspect of the new regime will not be given the attention it deserves.

This has been our experience on previous occasions (such as when the transferor trust and Foreign Investment Fund, or "FIF", legislation was introduced), and it is increasingly apparent that few resources within the ATO are now allocated to international tax issues.

Offshore trusts are currently subject to some of the most complex tax law ever enacted in this country. Few within the ATO and the professions have any grasp of their operation, and even those that do find the legislation incapable of practical application, particularly to offshore discretionary trusts. These problems were recognised in the Ralph Report, which recommended limited changes to the foreign source income rules for trusts pending a comprehensive review of the rules (see Recommendation 20.7).

The Institute strongly urges the Government to act upon the key recommendations of the Ralph Report in this area. In particular, the Institute supports the removal of the deemed present entitlement rules for foreign trusts (Recommendation 20.8).

The Ralph Report recommendations dealing with the application of the transferor trust measures (Recommendation 20.10) need to be developed into legislation. The legislation needs to be capable of application. It must not create exposure for Australians before they have any opportunity to gain access to the trust funds necessary for them to pay their tax liabilities in this country. (For example, children who are discretionary objects of an offshore NFT should not have any exposure to tax until they have the actual ability to access trust funds and pay their tax.)

The proposed amnesty for winding-up foreign trusts (Recommendation 20.11) should proceed, but its design needs to have input from practitioners who understand the practical difficulties faced in winding up closely held family trusts located offshore. The lack of such involvement led to the failure of the previous "concession" which accompanied the introduction of the transferor trust rules.

The Institute also notes that the proposed legislation will create a hybrid tax entity, which will be treated differently in the offshore jurisdiction. Overlaying entity tax concepts in CFC and FIF legislation should not add to the burden of Australian taxpayers pursuing legitimate business and investment operations offshore. The efficient operation of our tax treaty network will be jeopardised by ill-thought attempts to quickly change accepted notions of residence, source, and the tax treatment of dividends contained in our double tax treaties - simply to cater for bureaucratic concerns over NFTs.

Finally, the Institute notes that there are unitised trust structures offshore that are unlikely to satisfy the strict provisions defining fixed trusts currently contained in the draft legislation. Many unit trusts - both in Australia and overseas - give the trust manager discretionary powers (eg to treat redemptions as distributions of income in some cases), as well as an ability to issue units for below market value in certain circumstances. Exposing such trusts and their Australian investors to the vagaries of the entity tax rules is simply too ridiculous to contemplate, given that we already have a complex FIF regime. We understand that representatives of the unit trust industry will be making submissions on these and other issues affecting the industry.

7 Simplified Imputation Provisions

The changes to the imputation system, contained in Schedule 2 of the Exposure Draft Bill, are said to produce a simplified system. We submit that this is far from the truth. The proposed rules include some measures that will seriously impact businesses, some of which have not been announced as part of the introduction of the measures.

(a) Benchmarking Rules

We understand and accept the proposition of the RBT that some form of benchmarking rule is *prima facie* required in order to restrict the scope for unreserved streaming of franking credits. We understand that the benchmark is to some extent the price to be paid for relaxation of the existing "45 Day Rule" in relation to franked dividends and it is easing potentially to a five-day or fifteen day rule. Nevertheless, we believe that the policy implications of the benchmark rule have not been fully thought through and require amendment.

We understand that the Ralph Committee proposed Benchmarking Rule 1 so that public companies could set a franking rate at the beginning of a year and not have to continually update the rate each and every time there were changes to their franking accounts. We accept this logic.

However, that logic does not extend from one year to another. Benchmarking Rule 2 means that corporate tax entities will not be able to vary their franking benchmark from the end of one year to the start of another by more than 20 percentage points. The benchmark rule demands that affected entities must frank their dividends to a tolerance within 20% of the previous six monthly benchmark [draft Sec 160-80]. However, there is minimal tolerance allowed for unusual circumstances. Treasury has explained that this measure is designed to prevent streaming of distributions between different members at different rates. However, there may be very genuine reasons why the potential level of franking may change by more than 20 percentage points between franking periods.

The discretion given to the ATO to vary the benchmark contained in sections 16-38A(3) and 160-85 is excessively restrictive, and in fact expressly restricts the ability for successive applications. The situations below illustrate how absurd it is to restrict the flexibility of the ATO or to prevent flexibility where needed:

- For example, a company 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 major timing difference (eg, a payout of an entire long service leave provision or a substantial debt is written off against a provision for bad debts) or a large permanent difference, which means there is no tax to pay in that year. The company would then be unable to frank the dividend at the same level, yet the rules only permit a reduction of the franking rate to 80%. The company would have to pay overfranking tax. The proposed relief provisions do not permit relief in such a situation. It would appear that the entity is prohibited or unable to go the Commissioner for exercise of successive discretions.

- In reverse, a company may have tax losses at present, so its current dividends are unfranked. As soon as the losses are absorbed and the company pays full tax, it would be able to fully frank the dividends, yet the benchmarking rules would only permit the rate of franking to be increased by 20 percentage points each six months. It would take 2.5 years before the company would be entitled to fully frank its dividends.

We submit the benchmarking rules should be amended to permit corporate tax entities to vary the franking rate between years, without restriction.

We believe that the artificial restriction of the discretion operates inequitably. We recommend a dual solution:

- An ability of an entity to go to the ATO without restriction; and
- A "same shareholder" exclusion discussed below.

(b) Exclusions from the Benchmark Rules

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

No definition has been disclosed of "widely held" – see section 995-1. We submit that it is necessary at a minimum to ensure that:

- Subsidiaries of widely held entities are themselves treated as widely held; and
- Entities that are joint venture companies of multiple listed and widely held entities are treated as widely held.

We are very concerned that, for example, a company which is owned say 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.

(c) Same Class of Share Rule

In order to qualify for the exclusion, a widely held entity must have only one class of membership interest, which is defined in section 960-125.

We are concerned that this definition does not adequately allow for situations such as:

- Employee share scheme shares issued to employees;
- Financing shares issued to bankers and financiers (as is 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.

We strongly recommend that there needs to be:

- Express exclusions for the above situations;
- A de minimis test, and
- A stronger discretionary override on the part of the Australian Taxation Office ("ATO").

(d) Same Shareholder Exclusion

We accept the desire of the Government to restrict dividend streaming. However, it appears to us that where an entity can demonstrate that it has had the same members receiving dividends, and there has been no streaming-related activity (that is, no sales of material stakes of shares as between shareholders) that it is impractical and uncommercial to restrict the entity's ability to vary its franking percentage.

Assume that a private company is owned by Mrs X, Mr X and public company, the shareholders have held the company in identical percentages for the last 20 years, and all shares are the same class. In this situation the company is denied the ability of adjusting its franked dividend percentage equally across all shareholders, notwithstanding that there is absolutely no dividend streaming.

This seems to us clearly to be inappropriate and inefficient policy, with no foundation.

We reiterate that we understand the need for a benchmark rule but equally we submit that good policy should not trap taxpayers unduly. A "same shareholder test" properly structured, would provide ample protection to the revenue by way of a carve-out.

(e) Record Keeping for Small Business

The proposed new rules require businesses to actively tax-manage their affairs on a day-by-day basis, particularly in relation to the record keeping provisions. Any time a dividend or distribution is paid, a franking declaration must be made in advance and a distribution statement must be issued within 3 months.

This type of record-keeping is fine for large companies. It is not feasible or practical for small or medium sized businesses.

Most smaller businesses keep transaction records during the year and seek assistance from their accountants after year end. At that time, the accountant will advise what should have been done during the year and, in some cases, records will be produced purportedly documenting the transactions at the time of the dividend or distribution.

In earlier drafts of the imputation provisions, this issue was recognised by Treasury and the draft bill allowed some time after year-end for the records to be finalised. We submit that a further period after year-end, up to the date of filing of the tax returns, should be permitted for smaller businesses to document prior transactions.

(f) Franking Credits for Beneficiaries of Non-Family Trusts

Draft Section 161-210 outlines the tax effects of receiving a franked distribution directly. Subdivision 161-B is meant to permit non-fixed trusts to distribute franking credits to its members and to usually permit those members to obtain credits for the franking credits in their own tax assessments. Unfortunately, the effect is that many members of non-fixed trusts will not be able to get franking credits.

Sub-section 161-210 (2)(b) requires that the recipient of the franked distribution must be a "qualified person" in relation to the franked distribution. We note that this term, "qualified person" is to be defined. However, we also note that the current definition of the term means that the recipient must be a member of the family group and that the trust making the distribution must have made a family trust election.

In very many cases, it will not be possible to make a family trust election. For example, three different families may have set up a unit trust to conduct a business. That trust may not be a fixed trust, since there may be a discretionary ability to distribute income to a church or charity. So it is a non-fixed trust. Because there are three families and a charity named as beneficiaries, the trust cannot make the family trust election. The result, therefore, is that the trust would pay 30% company tax. The beneficiaries would pay up to a further 48.5% tax on the remaining 70%, a combined effective tax rate of 63.95%.

This issue is known to impact some rock bands, as well as service trusts of accounting, law and engineering firms and medical practices. It is expected to also affect numerous other business structures that have been set up to pool the interests of more than one family group in a business venture, such as in the acquisition of hotels, properties, retail outlets, etc.

There is no equitable economic reason why franking credits should be denied in such circumstances.

When this issue was put informally to the Treasury/ATO, the response was:

> "At this stage it is intended that the existing law relating to limiting flow through of franking credits to members of a family group would apply to NFTs. However, it is also recognised that the rule may be too harsh in certain cases. As you are aware, the difficulty is that most members of a NFT (basically discretionary beneficiaries) will fail the 45 day rule because they do not have sufficient interest in the NFT. If the 45 day rule was ignored for NFTs it would arguably allow too much scope for franking credit trading. Therefore the rule needs to balance these two objectives. We would appreciate any suggestions in your submission."

The conclusion that can be drawn from this response is that there is an anti-avoidance measure to be protected, but the equity for small businesses that operate in this way is not as important, to the Treasury/ATO. We submit that before such a change to the taxation of trusts can be implemented, the equity issue for taxpayers MUST be resolved. Otherwise, the change should be deferred indefinitely.

(g) Franking Deficit Tax

In paragraph 7.184 of the EM, it says that additional franking deficit tax of 30% may be imposed where an entity's franking account is more than 10% in deficit. The Commissioner is then given a power to remit. The New Business Tax System (Franking Deficit Tax) Bill 2000 is still to come. The note in the EM however suggests it will operate like franking additional tax which is one of the penalty provisions under the current system. This would appear to be an unduly harsh result. This is particularly harsh where a company or trust can not reduce its benchmarking franking rate by more than 20%.

Previously this type of penalty was applied because the deficit tax was only effectively a prepayment of ordinary corporate tax and as such this was used as a penalty to discourage people from overfranking and then just paying the deficit tax to make up the shortfall. However, now the deficit tax (overfranking tax) has moved to being a penalty, instead of a prepayment. This has the effect of lifting the effective tax rate to 78.5% (30% company tax rate, 30% as a deficit tax and the additional amount paid by the shareholder 18.5% (48.5% - 30% credit). The imposition of franking additional tax or a variation of it, would have the effect of increasing this by a further 9% (30% of 30%) so giving an effective tax rate of 87.5%. While it may be argued the Commissioner would exercise his discretion, it seems unjust to even give him the option to impose the further penalty.

We first of all question the decision to now treat the overfranking tax as a penalty instead of a prepayment. However, if it is to be treated as a penalty, we submit there is no justification for imposing an additional 30% franking deficit tax as a further penalty.

8 Restructuring of Non-Fixed Trusts

The Exposure Draft Bill contains provisions for restructuring relief in two specific circumstances, yet none of the proposals impacts non-fixed trusts. In our submission, we recommend that the proposed restructuring rules be expanded substantially in order to permit the unwinding of non-fixed trust structures.

It appears to us, from reading the exposure draft bill and related material, that the Government is on a deliberate course to discourage Australians from using non-fixed trusts for any purposes, let alone effective tax planning. If that is so, then for those who have created trusts in the past, they should be permitted the opportunity to unwind their previously permitted structures, without tax cost.

(a) Need for Restructuring Relief

Given the desire of some people to unwind existing structures, as a result of a series of tax law changes, there are potentially several tax-cost obstacles. They include capital gains tax, State stamp duty and GST.

To deny restructuring relief would amount to changing the rules half way through the game and imposing penalties for those wishing to leave the field of play.

We recognise the legitimate concern of Treasury/ATO officials in relation to the possibility of distributing assets widely to discretionary objects of trusts. On the other hand, if assets were realised fully, the trustee would still have the ability to exercise the discretion widely anyway, so we fail to see that this concern is of any effective magnitude.

(b) Type of Relief Required

Clearly, the relief should not be allowed for an unlimited period. We recognise that the relief must only be given for a limited period, as a result of the change in tax law.

However, the types of relief must be wide enough to permit maximum flexibility and to cover a multitude of fact situations. For example, some businesses may simply wish to convert the trust from a non-fixed trust to a fixed trust, through a variation to the trust deed. This possibility was discussed at the workshop meeting in Canberra.

However, this limited form of relief may not be adequate for those businesses desiring to retain the benefits of the small business CGT concessions, which would be lost in a fixed trust. Accordingly, the ability to completely wind up non-fixed trusts would be a further option that should be permitted. We submit that in some circumstances, this form of relief might only be permitted where the non-fixed trust is a family trust and has elected accordingly. However, we also foresee that this could be too harsh in other cases, such as where the business is carried on in a trust for more than one family.

We note that there are three specific types of tax where relief would be sought, namely capital gains tax, GST and State stamp duty. Discussions so far have only focussed on the possible capital gains tax relief and not GST or stamp duty. It is recognised that it may be politically difficult to obtain the agreement of the States to allow such stamp duty relief. Therefore, a practical solution needs to be found that will enable the effects of winding-up to be achieved without the tax costs becoming an issue.

(c) Alternatives

One alternative that might be considered would be to provide a restructure period during which the Federal Government could continue to negotiate with the State Governments for stamp duty relief. Until then, the profits first rule and the non-commercial loan rule would have no application.

Otherwise, we submit the Federal Government should consider reimbursing stamp duty costs to taxpayers out of GST revenues that might have been paid to the States, where the States are reluctant to give up the windfall stamp duty gains.

If the above alternatives are not acceptable, then we submit that non-fixed trusts should be permitted to nominate fixed beneficiaries and then be given a form of “tick-the-box” option as to how the entity will be treated for tax purposes in the future. This could include taxation like partnerships, as joint ventures or as companies. Such treatment would allow the beneficiaries to obtain the tax benefits of winding up non-fixed trusts while avoiding the necessity to obtain the agreement of State Treasurers to provide restructure stamp duty relief.

This latter proposal was contained in our submission of June 2000. The following is an extract from that submission:

> "An alternative to the complexity of rolling assets to new entities (which may endure UER better than the former owners) would be for Australia to adopt a form of the US style "tick the box" election for taxation as if the "entity" is either a company or a "look thru" basis taxpayer depending on whether it "qualifies" according to criteria similar to that established for the rollovers discussed. A significant advantage of this simple form of change in status is that Stamp Duty should not apply and the original "entity" would remain intact thereby reducing the prospect of Part 1VA applying to the change or related transactions to ease the transition (where rollovers are the only way) attracting attack under the avoidance rules."

We have had no feedback on this original proposal. The trust might elect to be taxed as a fixed trust, as a bare trust for a single beneficiary or as a partnership for a group of designated individuals, companies or family trusts. We suggest that the issues merit further development. The tax outcome might be rather similar to the position under the trading trust fixed trust provisions, whereby the trust is deemed to have the status for tax purposes of another form of trust or entity.

9 Summary and Conclusions

The proposed measures contained in the Exposure Draft of the *New Business Tax System (Entity Taxation) Bill 2000* are complex and provide for a tax system for non-fixed trusts that is considerably different and more harsh than the existing tax system for companies.

As a result of the differences of treatment, the draft bill measures could lead to significant anomalies that have not been adequately considered in the drafting stages. Attention appears to have been given to anti-avoidance issues of concern to the Treasury and ATO and insufficient attention has been given to the impacts the measures will have on businesses and investors, particularly small and medium sized businesses.

The proposed measures go beyond what the Government proposed in the ANTS document and the recommendations of the Ralph Committee, by creating substantial differences between the taxation of companies and the taxation of non-fixed trusts. These measures could impose effective tax rates on some smaller and large businesses of up to 63.95%. Before this bill is introduced to parliament, these many anomalies must be removed. Significant further consultation is required to eliminate the anomalies and unintended consequences, before the bill is introduced, let alone debated in parliament.

We submit that, in the first instance, the profits first rule and the (member-to-entity) non-commercial loan provisions must be withdrawn. This would eliminate many of the anomalies. There is no sound economic reason, any longer, to introduce these measures for non-fixed trusts when they have not been introduced for companies or other entities.

Further, the proposed imputation measures must be amended so that franking credits can pass out of non-fixed trusts that are not family trusts, to the ultimate beneficiaries.

If the profits first provisions and the non-commercial loans provisions are not excised, then wide-ranging and flexible restructure measures must be introduced at the same time, providing relief from capital gains tax, GST and State stamp duty on “unwinding-type” restructures.

We look forward to working further with you during the further consultative period to ensure the measures are effective and workable and to ensure the anomalies and unintended consequences are removed before the bill is submitted to parliament.

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Attachment A

Employee Share Acquisition Scheme (ESAS) Trusts

ESAS Trusts are created for the central purpose of acquiring and / or holding shares or options over shares for the benefit of employees in accordance with ESAS Plan documents.

The "core" functions of the trustee will include:-

- receiving moneys for the purpose of acquiring the shares or options
- acquiring the shares or options in accordance with the Trust Deed and Plan
- holding the shares or options (or shares arising from options exercised) for the benefit of the employees generally or as allocated in accordance with the plan
- receiving dividends paid on the shares held in trust
- borrowing moneys (from the employer company or an associate –eg a holding company of the employer company) for the purpose of acquiring the shares or options
- lending moneys (interest free or at interest) to the employees to fund the acquisition of the shares or options
- making payments to or crediting the provider of the shares or options to reduce amounts owing to the provider for the shares or options (this may include making payments to other parties for the same purpose)
- making payments to or for the benefit of or crediting the entity which will issue the subject shares by way of exercise of options as instructed by employee beneficiaries or otherwise in accordance with the Trust deed or Plan
- paying or crediting amounts to the employee beneficiaries out of the dividends received (this may include making payments assimilated with amounts of tax likely to be payable by beneficiaries in respect of the dividends received)
- receiving moneys or value from employee beneficiaries in respect of loans made to them and crediting those amounts to the account of the beneficiary and / or making payments to third parties which made loans to the employee beneficiaries
- transferring shares or options to employees when the obligations of the employee beneficiaries have been satisfied or selling shares or options (or arranging for them to be cancelled or re-purchased by the issuer or an associate) and crediting the employee member with the proceeds (this activity may occur as a consequence of default by the employee in respect of a provision in the Plan (typically, failure to repay loan moneys as scheduled)
- applying any amounts not creditable to a specific employee to the benefit of the employees generally or paying or crediting such amounts to the employer or an associate of the employer in accordance with the Trust Deed and Plan
- administering and recording all or any of the above functions in accordance with the Trust Deed and Plan documents

As a consequence of all or any of the above transactions, the trustee will be either paying or crediting amounts to the employee beneficiaries or accumulating income on their behalf or paying or crediting amounts to the employer or an associate of the employer. Generally, this latter activity is only to reduce amounts owing for shares or options.