

kpmg

**KPMG**

**Submission on Simplified  
Imputation System  
New Business Tax System  
(Entity Taxation) Bill 2000  
Exposure Draft**

KPMG Tax

November 2000

*This report contains 22 pages*

Report for.docimputation.doc

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# 1 Operation of the benchmark rules

## 1.1 Benchmark rules drive some commercial decisions

*Issue:*

Benchmark rules 1 and 2 contained in sections 160-55 & 160-80 of the Exposure Draft legislation impose strict constraints on the allocation of franking credits to distributions by corporate tax entities ('CTEs'). A breach of benchmark rule 1 gives rise to an economic penalty for the CTE. Accordingly, these rules have the capacity to significantly influence a CTE's decisions as to the timing and quantum of distributions.

It is understood that the benchmark rules are generally in line with the recommendations made in *A Tax System Redesigned* ('ATSR'). It is possible that the full breadth of the operation of these rules has not been identified. The rules have the potential to operate in conflict with the policy design principle of investment neutrality as enunciated in ATSR (eg Section 1, Schedule 1, P1).

This potential for conflict is most likely to occur where the profit and taxable income of a CTE is subject to significant fluctuations. There are many CTEs in this situation due to exposure to commodity price or foreign exchange fluctuations, or, because they operate in a highly competitive, fast moving market. Such CTEs will not be able to accurately forecast future franking account balances to ensure a smooth distribution flow to members without economic penalty.

The key area of concern is the impact of Benchmark rule 2. It operates to restrict the variation in the franking percentage between franking periods. Under this rule, a CTE will take over two years to move from a 100 % franking percentage to 0% franking percentage.

Where a CTE moves from a loss to a profit position, it may wish to increase its franking percentage to pass franking credits through to its shareholders. If it was making unfranked distributions, it will take over two years before it can pay fully franked distributions. This significantly delays the passing of franking credits to shareholders.

Conversely, where a CTE moves from a profit to a loss position, it will want to reduce its franking percentage. If it was making fully franked distributions but now has insufficient franking credits to continue to do so, effectively Benchmark rule 2 will operate to reduce the quantum of future distributions until the franking percentage has moved to an appropriate level.

These examples illustrate how tax rules will drive commercial decisions as to the timing and quantum of distributions.

There may also be detrimental impacts on the share prices of listed companies. It will be known that a company cannot immediately frank dividends to the extent which it would otherwise do so.

*Suggestion*

It is necessary to improve the flexibility available under the benchmark rules. This can be achieved by a reduction in the franking period from the proposed 6 months to 3 months. A shorter franking period will maintain the integrity and policy objectives of the benchmark franking rules while improving the flexibility to move franking percentages.

Alternatively, increase the franking percentage variation imposed by benchmark rule 2 from 20% to 40%. This will also increase flexibility in the operation of benchmark franking rules.

Finally, it is suggested that the discretion available to the Commissioner to allow a deviation from the benchmark rules be widened and a ruling be issued outlining how and when the Commissioner will exercise such discretion. Factors that the Commissioner should take into consideration in exercising his discretion could include the nature and industry of the CTE and whether there is any "mischief" in a departure from the franking rules.

## 2 “Carve out” for companies from the benchmark rules

The application of benchmark rules 1 and 2 may have significant adverse commercial implications for a number of CTEs. Accordingly the “carve out” for companies provided in section 160-50 of the Exposure Draft legislation is of critical importance.

A number of issues arise out of this “carve out test” which are set out below.

### 2.1 “Widely held”

#### *Issue:*

The ‘carve out’ is available to companies that are “widely held”. The definition of “widely held” is critical but is yet to be provided. We understand the definition contained in Recommendation 6.21 of *ATSR* is under consideration. This definition consists of two parts:

- a minimum number of members test (300 persons), and
- a concentration of ownership test (20 or less persons hold 75% or more of certain interests).

A key policy objective of the benchmark rules is to reduce opportunities for dividend streaming and to ensure that the company is a genuinely broad-based membership company (*ATSR*, page 274). It is submitted that the 300 member test sets an arbitrary boundary. It may operate to exclude certain companies that may have a genuinely broad-based membership. The test for “widely held” should reflect the substance of the membership interests in a company, rather than impose a limit based on an arbitrary figure.

#### *Suggestion*

The ‘300 members’ test should not be adopted. Instead, it is suggested that the definition in *A Platform for Consultation* (“Platform”) be followed. A widely held entity could be defined as one where there is no concentration of ownership (para.21.28 of Platform). The concentration of ownership occurs when 20 or fewer individuals hold, directly or indirectly, 75 per cent or more of the income and capital or voting rights of entity. This is broadly consistent with the well-known rules in Division 7 of the 1936 Act and the trust loss measures.

Public listed companies should automatically qualify for “widely held” status.

## 2.2 “Widely held” and subsidiaries

*Issue:*

There is little guidance on how the definition of “widely held” will apply to subsidiaries within a corporate group.

The draft legislation accompanying *ATSR* indicated that consideration was being given to extending the widely held status of a holding company to its subsidiaries (s.960-110). This is a similar approach to that taken in the trust loss measures where a wholly owned trust takes on the status of the parent trust (Schedule 2F of the 1936 Act, s272-127). Both of these sources recognise that subsidiaries should take on the status of their ultimate parent.

With the proposed introduction of the consolidated groups regime outlined in *ATSR*, companies will be able to elect to enter into a consolidated group. This will alleviate the issue for companies within a consolidated group but does not answer the issue for companies that do not form part of a consolidated group.

*Suggestion:*

Subsidiaries should take on the widely held status of their ultimate parent company where they are not part of a consolidated group regardless of whether the parent is located in Australia or offshore.

Further, where a company is not a subsidiary but is owned by shareholders that are themselves widely held, for example a joint venture company, it should take on the widely held status of its shareholders.

## 2.3 “Widely held” and offshore members

*Issue:*

For the purposes of the “widely held” test, it is necessary to identify the members and the interest they hold in the company. This becomes difficult when members are located offshore. In some countries, there is no requirement to maintain detailed records of shareholder information. If the widely held status of an Australian company is determined by reference to its ultimate foreign parent company, there may be difficulties in tracing share ownership.

To illustrate this problem, section 160ZZS of the 1936 Act / Division 20 of the 1997 Act contain a requirement for testing and tracing the ultimate beneficial ownership of share interests. The tracing of such share interests often extends to offshore companies and practical difficulties are experienced in conducting this test. It can be extremely difficult to

obtain the necessary information in the detail required. These difficulties are acknowledged as these provisions allow for a “reasonableness” approach in certain circumstances.

While tracing of a change in the ultimate underlying beneficial ownership may be different to identifying the member and membership interest, the practical difficulties of obtaining the relevant information are the same. This problem becomes more apparent where foreign shareholdings are held through several corporate tiers or through a type of entity that is not recognised in Australia.

These problems can be alleviated by the use of special deeming rules. Ideally, the deeming rules will determine the nature and identity of the membership interest based on the information available where reasonable steps have been taken to identify the members. This will reduce the practical difficulties and compliance burden associated with tracing membership interests.

#### *Suggestion*

Introduce special deeming rules to apply in determining the identity and nature of the membership interest. The deeming rules will determine the nature and identity of certain membership interests where reasonable steps have been undertaken to establish the membership interest.

## **2.4 “Class” of membership interest**

### *Issue:*

The second requirement for the benchmark rules not to apply to a company is that the company must have only one “class” of membership interest. “Class” is defined in the Exposure Draft (section 995-1(1)) to mean, in respect of companies, interests that have “the same or substantially the same rights”.

The meaning and application of the “same or substantially the same” needs to be clarified. It is preferable for such clarification of these terms to be provided in the legislation to avoid recourse to the courts.

For example, the legislation should be able to be clearly applied to the following situations:

- Partly paid shares and fully paid shares;
- Different classes of shares which have identical rights and entitlements (eg Class A and Class B);
- Shares subject to an employee share acquisition scheme;

- Shares which carry full voting rights and shares which carry reduced voting rights (eg only able to vote on specific matters), but which are otherwise identical;
- Shares which have a full entitlement to income and capital and shares which have a full entitlement to capital, but a slightly reduced entitlement to income but otherwise identical.
- Shares which have full entitlements to income and capital and shares which have a slightly reduced entitlement to capital, but a full entitlement to income.

*Suggestion*

The definition of “class” should be substantially expanded to reduce uncertainty. Alternatively, a *de minimus* test should be introduced to exclude those classes of shares that constitute small parcels.

*Issue:*

The broad policy thrust of the benchmark regime is designed to overcome streaming opportunities. The rules are designed to ensure that there is no differential treatment of distributions based on the class of shares. It is submitted that an election mechanism should be available to companies with more than one class of share to allow them to elect that the benchmark rules do not apply. Such election will only be available to a company that, in a specific franking period, makes equivalent distributions to all members, regardless of their class of membership interest. Such distributions would be franked to the same extent. This mechanism is consistent with the policy of preventing dividend streaming, while removing the difficulties faced by widely held companies with more than one class of share.

*Suggestion:*

Allow widely held companies to be able to elect out of the benchmark rules during a specified franking period. The election will require the company to make equivalent distributions, franked to the same extent, to all members, irrespective of class. The election mechanism will maintain the integrity of the franking system and is consistent with the policy objective of anti streaming.

*Issue:*

Under the proposed Taxation of Financial Arrangements (TOFA) regime, the boundary of debt and equity may change. Therefore it possible that the TOFA regime may introduce the concept of quasi equity. Quasi equity is debt with certain rights attached that result in it being considered to be an equity interest, for example, convertible notes. It is submitted that quasi equity should be excluded as a "class" of membership interest for the purposes of the

“carve out” rule. The basis of this submission is that the nature of quasi equity interests are not always consistent. The rights attached to each quasi equity interest may be different and give rise to a separate class of membership interest, and hence result in the company failing the “carve out” rules. In addition, quasi equity does not generally give rise to voting rights.

*Suggestion:*

If the TOFA regime is introduced, quasi equity should be excluded from the definition of “class” of membership interest for the purposes of the carve out rule.

## **2.5 Commissioner’s discretion to permit departure**

*Issue:*

A large number of Australia’s listed companies have more than one “class” of share or stock. For example, they may have non-redeemable preference shares, non-participating shares and many other different classes of shares. In many cases they exist for historical reasons and are not easily removed. As a result, these listed public companies will be subject to the benchmark rules. As discussed above, compliance with the benchmarking rules is difficult for companies in industries that experience fluctuations in income producing activities from period to period.

It is noted that, under section 160-85 of the Exposure Draft, the Commissioner is empowered to permit a departure from the benchmark rules in exceptional circumstances. From a reading of the Explanatory Material, an exceptional circumstance occurs where it is unforeseeable and beyond the control of the company. The circumstances in which the Commissioner may exercise discretion are not sufficiently wide enough to deal with situations where a breach of benchmark rule 2 may result from fluctuations in business activity which are foreseeable.

*Suggestion:*

The Commissioner's discretion to depart from the benchmark rules be widened to specifically take into consideration the nature and industry of the company.

The Australian Taxation Office issue a ruling detailing when the Commissioner will exercise his discretion and providing some timeframe and turnaround time for that discretion to be exercised.

## **2.6 Extend “carve out” to all CTE’s**

*Issue:*

The “carve out” from the operations of the benchmark rules is only available for companies.

*Suggestion:*

It is suggested that the “carve out” should be extended to all CTEs.

### **3 Benchmark rule 2 should not apply to exempt foreign dividend amounts**

*Issue:*

Where an Australian resident company is foreign owned, its distributions will be subject to dividend withholding tax to the extent that they are unfranked or have not been subject to a foreign dividend account declaration. The impact of the benchmark rules is that a company may have to allocate franking credits to a distribution, even where it has a foreign dividend account surplus, and potentially become liable to franking deficit tax as a result of the benchmark rules. However, owing to the foreign dividend account surplus there would otherwise have been no loss to the revenue had the franking allocation not been made as the obligation to deduct withholding tax would not have arisen. It is submitted that suffering franking deficit tax in this scenario is unduly harsh.

*Suggestion:*

In circumstances where, owing to the availability of a foreign dividend account surplus, a liability for withholding tax would not otherwise be triggered, the benchmark rules should not operate to increase a company's benchmark franking percentage above the maximum based on available franking credits.

## **4 “Gross up and credit” approach for the receipt of dividends**

*Issue:*

The application of the new “gross up and credit” approach will severely impact a CTE that is in losses. In fact, the grossing up of dividends will increase the absorption of tax losses by more than 40% compared to the current rules. The impact on CTEs is exacerbated by the fact it is proposed that CTEs will be unable to get a refund of franking credits where they cannot be used (Explanatory Material paragraph 7.194). Accordingly, CTEs in a tax loss will lose the benefit of such franking credits.

The increased loss absorption rate for CTEs under the new gross up and credit approach can be mitigated by an election to choose the proportion of carry forward losses to be absorbed against assessable income. This was broadly recommended in *ATSR* (recommendation 11.5). However, the Exposure Draft does not contain any provisions to this effect. A similar election should also apply for current year losses.

*Suggestion:*

It is suggested that recommendation 11.5 of *ATSR*, that a CTE be able to elect not to use prior year losses, be implemented. A similar treatment for current year losses should also be provided.

## 5 Loss of franking deficit off-set

*Issue:*

The removal of the franking deficit tax offset, combined with the penalties that arise from a breach of benchmark rules, the imposition of franking deficit tax and additional franking deficit tax are significant and may impact corporate behaviour. Companies are likely to be more conservative with franking projections in light of the consequences of a breach of the rules. In turn, shareholder returns and expectations will be significantly effected. Tax is likely to be a major driver in distribution policy. It is submitted that the effective and efficient tax system as envisaged in *ASTR*, will not be promoted where corporate decision making is significantly influenced by tax considerations. Accordingly, the franking deficit tax offset should continue.

Alternatively, it is submitted that, in circumstances where the franking account is in debit at year end due to unforeseeable circumstances beyond the taxpayer's control, that the franking deficit tax offset should be reinstated at the discretion of the Commissioner.

*Suggestion:*

Franking deficit tax offset should not be removed.

Alternatively, if the franking deficit tax offset is not retained in certain circumstances where a franking account deficit has arisen due to circumstances beyond the taxpayers control, the Commissioner should be empowered to allow the offset of franking deficit tax against future tax liability. The exercise of such discretion in these circumstances will not alter broad policy objectives.

## 6 Franking Additional Tax

*Issue:*

The benchmark rules may apply to require a CTE to frank a distribution in excess of available franking credits. Accordingly this may result in the CTE being in a franking deficit at the end of its income year. (The alternative is that the CTE reduces the quantum of the distribution.)

The Explanatory Material (paragraph 7.184) indicates that an additional franking deficit tax ('AFDT') will be imposed where a CTE's franking deficit is greater than 10% of the total of its franking credits.

It is submitted that, with the removal of the franking deficit tax offset, the imposition of an AFDT will result in double taxation. Under the Exposure Draft, franking deficit tax is a penalty tax as it cannot be offset against future tax liability. Therefore, if a CTE suffers a franking deficit at the end of its income year, it will be liable to pay franking deficit tax and, depending on the size of the deficit, potentially AFDT. The CTE will be penalised twice in respect of the same franking deficit. Given that franking deficit tax will no longer be able to be offset and is a penalty tax, it is unnecessary to continue to impose AFDT.

*Suggestion:*

Additional franking deficit tax will operate as a double penalty tax following the removal of franking deficit tax offset. Accordingly, AFDT should not be introduced.

## **7 Franking credits for foreign withholding tax**

### *Issue:*

The Exposure Draft introduces the ability to claim franking credits for foreign dividend withholding tax paid on distributions from non-resident companies. However, there are a number of qualifications that need to be satisfied in order to be eligible for this credit.

The first and most important element is that the foreign distribution must be “an equivalent frankable distribution”. An “equivalent frankable distribution” is defined at section 160-160(2) of the Exposure Draft. While this definition is very broad, it will also operate to eliminate foreign distributions that are not consistent with our franking rules even though withholding tax has been paid.

Further, in some foreign jurisdictions, for example, Ireland and Singapore, there are no “withholding tax” obligations on distributions to non-residents even though tax may have been paid at the entity level. Accordingly, there is no entitlement to franking credits on distributions from these countries.

There is also the availability of the “top up” to 15% for franking credits where the entitlement to franking credit is less than 15%. A key requirement for this concession is “the chain of entities” test. Many offshore jurisdictions impose legal restrictions on foreign ownership and therefore it is not possible to wholly own a subsidiary. This may cause a break in the “chain of entities”, although the Australian parent still retains ultimate control of the foreign subsidiaries. Accordingly, it is submitted that the “chain of entities” test should be relaxed to enable “top up” franking credits in such situations.

### *Suggestion:*

It is suggested that foreign dividend withholding tax franking credit concession be extended to capture tax paid at the entity level which is imputed into a distribution received by an Australian resident. Franking credits could then arise to the same extent as an entitlement to the foreign tax credit on the foreign distribution.

In respect of the franking “top up” requirements, that the foreign subsidiary ownership requirement be at least 40% to satisfy the “chain of entities” test.

## 8 Substituted accounting periods

### *Issue:*

It is understood that the new legislation will commence on 1 July 2001. In the absence of transitional provisions, it is unclear how the new rules will apply to companies with substituted accounting periods. This is of particular concern for early balancing companies. If the proposed legislation applies from the start of their income year, there is significant work to be undertaken in the review of their distribution policies and forecast franking requirements.

The start date for entities with substituted accounting periods is also significant in the context of franking deficit deferral tax. If the new franking rules commence at the start of the income year of a late balancing company, it is possible that the franking year under current legislation may overlap with a franking period under the Exposure Draft. A mismatch in timing could result in a company being liable for franking deficit deferral tax under the current legislation with a potentially offsetting tax payment being captured under of the new legislation. Transitional rules are required to address this issue.

Further, it is submitted that the alignment of the franking year and income year should be optional. For some public listed companies, distributions follow established patterns to meet shareholder expectations. In respect of some late balancing companies, it is possible that the alignment of the franking year with the income year will result in three franking periods as opposed to two. Therefore, it is quite possible that during the transitional period, a distribution is made in line with shareholder expectation within a short franking period. As there may be insufficient franking credits to meet the distribution, a lower than expected franked distribution may be declared. This may impose commercial pressures on the company.

### *Suggestion:*

The start date for SAPs requires urgent clarification. If it is a "soft" date, it is suggested that the start date be deferred for the 2002 income year. This will allow early balancing SAPs sufficient time to prepare for the new rules.

Transitional rules are also required to address the possible overlap of the current and proposed imputation regimes in respect of franking deficit deferral tax. It is quite possible that the end of franking year under the current rules will coincide with franking period under the proposed rules.

The alignment for franking year and income year should be optional.

## 9 The '45 day' rule

*Issue:*

We understand that the 45-day is currently under review by the Australian Taxation Office and there are suggestions to reduce this holding period to 15 days. The purpose of the 45-day rule is largely to combat streaming and anti avoidance. It is submitted that with operation of the benchmarking rules, anti avoidance provisions and various other streaming rules, opportunities for franking credit trading are largely covered. Accordingly, there appears to be no need for the arbitrary 45 day rule.

*Suggestion:*

The 45-day rule be removed. There are sufficient streaming and anti avoidance rules to cover franking credit trading.

## 10 Distribution statements

*Issue:*

Under s160-95 of the Exposure Draft, there is an obligation to provide a distribution statement to a member whenever a frankable distribution is made. This statement must contain certain particulars and must be given within 3 months of the actual distribution (section 160-100). This requirement imposes additional compliance burdens for family trusts, that fall within the definition of a non-fixed trust. These trusts are subject to the imputation rules, and it is common for these trusts to have very frequent distributions.

*Suggestion:*

Collective distribution statements be available for all distributions made within a period for each class of member. Such statements would contain the same information as outlined under section 160-100 of the Exposure Draft.

## 11 Transitional Provisions

*Issue:*

It is understood that transitional provisions will be released shortly. The need to clarify the application of the legislation to companies with substituted accounting periods, particularly those that are early balancing, has been mentioned above.

Another potential issue arises where there are a number of dividends are to be made both pre and post 1 July 2001, but subject to a resolution and franking declaration already in place.

*Suggestion:*

It is suggested that the transitional provisions be released as soon as possible to clarify these issues, especially with regard to early balancing companies.

## **12 Drafting issues**

### **12.1 Definition of franking percentage (section 160-45)**

*Issue:*

The definition of franking percentage contained in section 160-45 refers to the “franking credit allocated to the frankable distribution”. A franking credit is allocated pursuant to sections 160-35AA or 160-35AB (specific and standing allocation determinations). These provisions require that the determination must state the franking percentage for the distribution (or, for specific allocation determinations, sufficient information for the franking percentage to be worked out). In other words, the franking percentage must be known to be able to allocate franking credits. The definition is circular.

*Suggestion:*

The definition of franking percentage be expanded so that where a determination has not been made, the formula refers to “the franking credit to be allocated to the frankable distribution pursuant to a determination”.

### **12.2 Interaction of benchmark franking percentage & Benchmark rule 2**

*Issue:*

Section 160-65 sets out the necessary requirements for a CTE to declare its benchmark franking percentage for a franking period. Section 160-65 makes it clear that if the declared percentage would breach benchmark rule 2, it is not the CTE’s benchmark franking percentage for the franking period. The interaction of this provision with section 160-80 which operates to re-set a declared percentage is unclear. The same issue also arises under section 160-70 for default benchmark franking percentage.

*Suggestion:*

It is suggested that sections 160-65 and 160-70 be expressed to operate subject to sub-section 160-80(2) and that a note be inserted into the legislation to clarify the position.

### **12.3 Purported Allocation**

*Issue:*

Section 160-130 sets out when a debit to a franking account will arise. Item 1 refers to a “purported allocation”. It is unclear what it is in reference to.

*Suggestion:*

This reference should be clarified.

## 12.4 Definition and other terms

Attached is a copy of a list of definitions previously sent to your office outlining terms that were either undefined or required further clarification.

<b>Definition</b>	<b>Details</b>
<b>sub-accounts</b>	A sub account is an asterixed term at s157-145, and the definition is further explained at s.157-180 through to s.157-205. However, in the definition section does not contain a definition of "sub-account".
<b>bonus units</b>	This term is an asterixed term at s158-10, but it is not further defined in the dictionary section. Note that a bonus unit issue is explained at s156-94, but the draft legislation fails to reference this.
<b>mutual life insurance</b>	Mutual life insurance is an asterixed term, but is not defined in the dictionary section. It appears at s160-20, which states that life insurance company cannot be a franking entity. While, a mutual insurance company is defined in the 1997 Act, this may be different to a mutual life insurance company. This matter should be clarified.
<b>sufficiently resident</b>	This term is used throughout s.160-115, and is also an asterixed term. It is not defined in either the draft legislation or the 1997 Act (there is a definition in the 1936 Act).
<b>qualified person</b>	This is to be defined (as per draft legislation). This term appears at s160-160 in relation to franking credits for foreign withholding tax.
<b>widely held</b>	This is to be defined (as per draft legislation).
<b>Australian resident</b>	This is to be defined (as per draft legislation).
<b>excluded trust</b>	As stated in the consequential amendments, this is yet to be defined.
<b>former member</b>	This is defined a term in the consequential amendments section (p.165). A reference to former member can only be found at s.153-

	10, which is in the broad overview section. The real substance to the meaning "former member" can be found at s.156-75, 156-80 and s.156.90, where the test is whether a reasonable person would conclude that a benefit was provided at <i>some time</i> because they are a member. Although the term former member appears in the definition section, it states the obvious, and makes no reference to the reasonableness test.
<b>closely held</b>	There is no reference to the term closely held in the draft legislation except in s.154-55, which relates to prior taxed amount. Although, "closely held" is defined in s102UC of the 1936 Act, this is in context of the trust loss rules. This term should be defined.
<b>credit</b>	A distribution is deemed to arise in some circumstances where an amount is credited to the member (eg s156-75(2)(b)). The term "credit" is not defined further in the draft legislation.
<b>constituent loans</b>	"Amalgamated" loans is a defined term in the draft legislation. However, for the non-commercial loan provisions, there is a reference to the term constituent loans (eg 156-86).
<b>anticipated profits</b>	The term "anticipated profits" is not an asterixed term, but is used to describe the situation where the profits first rule exhausts the available profits and contributed capital, it will be treated as coming from anticipated profits (s157-5).