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Dear Sir

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

Thank you for providing us the opportunity to comment on the Exposure Draft of the New Business Tax System (Entity Taxation) Bill 2000 (the Bill).

The start date for the legislation for non fixed trusts

We note that the majority of the measures concerning non fixed trusts commence on 1 July 2001. We ask the Government to consider that this provides taxpayers too little time to prepare themselves for the new measures. We raise this as an issue because, in our view, taxpayers and their advisers are struggling to cope with GST and PAYG changes.

Imposing these measures with only 6 months notice on the exact nature of the measures is a further burden on entities that are already burdened with the volume of tax change. We point out that many small businesses use discretionary trusts as their preferred vehicle to hold assets and operate a business. We consider that in spite of the revenue raising that Governments have to do, there is only so much tax change that can be addressed by a small business in a short period of time.

We also point out that tax reforming small businesses out of business due to the burden of change is not beneficial to revenue raising or the Australian economy in the long run. We would recommend change to occur over a longer period of time. For example, giving taxpayers a further 12 months to adapt to the changes. At that time, the Government could be in a better position to determine the impact of the GST and PAYG on small businesses and gauge whether taxpayers could cope with further change.

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In response to the invitation to comment on the measures contained in the Bill, we wish to make the following comments:

1. Non Commercial Loans made into a non fixed Trust

This measure is contained in section 157-115 of Schedule 1 to the Bill. The effect of this section is to treat a non-commercial loan made to a trust as contributed capital. In addition, under section 960-120, the holder of the rights to such a loan is treated as a member of the trust.

1.1 The start date for the measure being 22 February 1999

We are concerned that the start date for this measure has been *backdated* to 22 February 1999 because this measure was not made public before 21 September 1999 in Attachment P to the Treasurer's Press release No. 58.

Attachment P stated that this measure was foreshadowed in the Treasurer's Press release No. 10. Attachment P states that Press release 10 was accompanied by the letter from John Ralph to the Treasurer. Press Release 10 does not have John Ralph's letter attached. We know of no public release of John Ralph's letter that was ever made. Press Release 10 only stated that the Government will ***address*** the concerns raised in that letter but did not state what action would be taken.

Neither the press release nor the discussion paper referred to in Press Release 10 made this measure clear. There was no way that taxpayers could possibly have acted in a manner consistent with the measure between 22 February 1999 and 21 September 1999.

We consider it unfair to backdate this measure to 22 February 1999. If anything, the start date should be 21 September 1999 when the Government categorically announced what tax treatment will be imposed on non commercial loans to closely held entities.

In the alternative, we submit that the transitional rules should allow taxpayers to implement written loan agreements up to 30 June 2001 for loans that arose prior to the release of the Bill in Exposure Draft form. Further, that the time for the first repayment be extended to 30 June 2002 for loans in that transition period to give small businesses time to build sufficient cash reserves to make repayments.

We request this extension in light of the fact that small businesses have had to cope with GST and the PAYG instalment system. In addition to that, in the transition year of the PAYG instalment system's introduction, the Government will in effect be extracting from taxpayers the tax payable for the years ended 30 June 2000 and for 30 June 2001 in a 12 month period.

1.2 The policy of requiring trusts to repay interest or have the loan treated as contributed capital

We are in not in favour of the Government's policy of restricting taxpayers from getting their own capital investments out of a business structure like a trust or company.

First, the Bill requires all distributions out of a non fixed trust are made out of profits first. Second, in the case of a non fixed trust, you cannot pay back contributed capital unless all available profits are exhausted or you vest the trust, or you terminate a fixed interest in the non fixed trust. (Please see Subdivision 157-C in particular section 157-35).

In theory, a free market economy only works at its most efficient manner if there is a free movement of capital in the economy to exploit profit opportunities in that economy. This is a restriction in the movement of that capital in the economy.

Second, the shareholder or member who contributed that capital are the owners of that capital. It is their money and they should have the right to withdraw their own money without restriction when they see fit. Individuals that are sole traders are allowed to withdraw the money they invest in a business any time without restriction or taxation. The same applies to partners who invest in a partnership. There is no reason why someone who chooses to trade through a company or trust should not be able to do the same.

1.3 Forcing small businesses to repay loans within 7 years if they are unsecured.

A commercial loan is defined in subdivision 960-G. The definition required that an unsecured loan would not be a commercial loan unless it is repaid in full within 7 years.

Where taxpayers are funding a new business venture by way of loan, the Government is saying that the business has to be sufficiently liquid to repay the loan within 7 years or the taxpayer will have the loan treated as capital. In addition, counting against the taxpayer is the fact that the new business has to service the interest of the loan during that period otherwise the loan will be treated as non commercial and therefore as part of contributed capital.

If the business is not sufficiently successful in that time, the Government is forcing the taxpayer either to shut the business down, to repay the loan or have their loan treated as contributed capital. Nevertheless, the business could turn out to be sufficiently liquid in the 8th, 9th or 10th year to repay the loan in full. However, at that time, as the draft now stands, the taxpayer will be subject to the profits first rule.

We consider that a 7 year repayment period for unsecured loans to a trust is too short. Seven years may be the correct period of time in terms of loans out of a trust to a member. Ideally, we would like to see an indefinite repayment period rather than a 7 year repayment period. However, we argue that the term for repayment of loans into the non fixed trust should be extended to at least 10 years. We consider that period should give a new business sufficient time to develop the necessary liquidity to repay the loan.

1.4 The policy of requiring annual interest payments to be made on non commercial loans

We raise this as an issue because taxpayers who fund trusts to start up a new business have to choose between a commercial loan and equity.

In a start up business, the trust may not have the cash to fund any interest payments in the first or second year. In which case the loan will be automatically be treated as non-commercial.

Placing interest payment requirements on trusts under written commercial loans could also mean that a trust could be technically insolvent in its early years when the business is starting up. Being insolvent is a breach various arm's length loan agreements from Banks and financial institutions.

As such, forcing the trust to pay interest or repay debt to a member is a further barrier that a new business has to overcome to survive. We do not consider placing extra burdens on new businesses is a sound policy.

Further, we submit that the Government should extend the period of time for repayment of loans to trusts who use the funds to start up a new business. This would be to give the controllers a chance of being able to make a commercial loan in a start up business held by a trust.

We would submit that the requirement of annual interest payments on loans to start up business be relaxed for at least 3 years to give start up business sufficient chance to meet interest repayments and the commercial loan tests.

2. The Profits First Rule

Having regard to the above, we make the following comments about the *profits first rule* contained in Subdivision 157-B:

2.1 The formula to calculate *profits first* does not accurately reflect available profits. In short, not all *liabilities* are included in formula (eg. Contingent liabilities), the *Accounting provisions* exclude certain key provisions such as provision for tax and contributed capital does not properly reflect contributed capital.

2.2 A trust will have available profits until the contingent liabilities become present liabilities. As far as the provision for tax is concerned, it is certain that the tax liability will arise. The tax liability only becomes a present liability on assessment even though under the self-assessment tax system, the taxpayer self determines what their tax liability is.

2.3 We also query the rationale that after available profits and contributed capital are exhausted, the amount is deemed to be paid out of future profits. The formula assumes that the trust will make profits in the future. What if the trust does not make any profits in the future? At present, the formula has the potential to tax profits that do not and may never exist.

2.4 In the trust's accounts, these amounts would be treated a trust corpus. Nevertheless, they may not form part of *contributed capital* as defined because they are represented by a reduction of profits caused by providing for deprecation and leave entitlements. Payments out of these provisions may never be replenished by profits, but for example, by further loans or capital contributions.

2.5 Provisions are excluded from available profits formula. In that respect, we note that companies do not have the same problem as non fixed trusts because they are not permitted to make a dividend payment unless there are retained earnings. The exclusion of depreciation and leave entitlements from profits means that they are also excluded from a company's retained earnings.

2.6 In contrast to companies, non fixed trusts are allowed to pay out of corpus as well as profits.

2.7 We criticize the use of the *profits first rule* for non fixed trusts. The formula is a close copy of the tax value method of accounting proposed by the Ralph Committee reforms and contained in their draft legislation. That tax value method has been referred to a further Committee to see if the tax value method can be practically applied to business.

2.8 Seeing an ostensibly impractical tax value method formula applied to non fixed trusts under the title of the *profits first rule* only suggests that this legislation is discriminating against taxpayers that operate through trusts. It also suggests that the Committee is only a making a token review of the tax value method.

2.9 We also submit that the Available profits formula should be reviewed having regard to any findings of the Committee.

3. Definition of *Distribution*

3.1 *Distribution* is defined to arise where the trust *distributes* money or property or credits an amount to a member (see section 156-20). The definition of *distribution benefit* contained in subsection 156-75(2) is defined in terms of transfer of property, crediting of an amount or payment of money.

3.2 Neither definition arguably covers the use of trust property by a beneficiary. On one view, the use of trust property does not result in a *transfer* nor a *payment* nor is there a *crediting* of an amount. If anything, this is a grant of a right to use trust property. Therefore, in that case there would be no *distribution benefit*. The issue then is whether the grant of a right to use trust property results in the trust distributing something to a member.

3.3 The ordinary meaning of the word *distribution* under the Oxford English dictionary involves a notion of a spreading of assets. Specifically the definition includes:

> *The action of dealing out in portions or shares among a number of recipients; apportionment, allotment; Econ. the dispersal of commodities among consumers effected by commerce*[1]

3.4 The Oxford dictionary meaning of the word *distribute* is slightly broader:

> ***distribute*** *| dstrbjut, dstrbjut | v.t. Pa. pple* ***-uted****, (long rare, obs. exc. Sc.)* ***-ute****. LME.* ***[****L distribut- pa. ppl stem of distribuere, f. as DIS- 1 + tribuere grant, assign.****]*** ***1*** *Deal out in portions or shares among a number of recipients; give a share of to each of a number of people. LME.* ***b*** *Deal out, administer, (justice etc.). E17-M18.* ***2*** *Spread or disperse throughout a region; put at different points over an area; spread generally, scatter. LME.* ***3*** *Divide (a whole or collective body) into parts with distinct characters and functions. L15.* ***4*** *Divide mentally into classes, classify. Formerly also (Math.), divide. L16.* ***5*** *Printing (chiefly Hist.). Separate (type that has been set up) and return each character to its proper place in the case. E17.* ***6*** *Logic. Use (a term) in its full extension so that it refers to every individual of the class it designates. E19.* [2]

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3.5 That definition encompasses the concept of dividing up something. Granting a right to use a trust asset, on one view it is a division of a trust assets and could amount to a *distribution*. However, that concept arguably does not fit well in the context of subparagraph 156-20(1)(c) where the words say *distributes property*. The context of that subparagraph appears to be confined to the division of all the trust property but not the division of a trust asset into their parts.

3.6 There has been no decided case on the meaning of *distribution* except where there in the context of an appropriation or taking of company assets by shareholders. (see the High court decision of *FC of T v Blakely* (1951) 82 C.L.R. 388).

3.7 This was a case of a shareholder using company assets for their own benefit without the sanction or permission of the company. The company did not resolve to allow the shareholders to use the asset. Nevertheless, it did nothing to stop the use of the assets by the shareholder. At law, it could restrain the shareholders from using the assets and seek recovery of those assets.

Latham CJ found (at p.398)

12. But, in my opinion, an appropriation by shareholders of the assets of a company by their own act cannot be regarded as a distribution by the company. The shareholders would be subject to estoppels inter se, but this would not alter the fact that the company did nothing. It did not make any distribution of anything to anybody. The shareholders took, and wrongfully took, the assets of the company. (at p398)

3.8 The case highlights that a passive use of assets of the company does not amount to a distribution because the company did not positively resolve to allow the shareholders to use the assets. It was not a distribution by the company. Likewise, by analogy, a trust failing to prevent a beneficiary from using a trust asset would not be a distribution *by the trust* as is required by section 156-20.

3.9 The definition of *distribution benefit* would also not catch an acquiescence by the trust to prevent a beneficiary from using an asset because the trust did not pay or credit an amount to a beneficiary, or transfer property. If anything, it may have granted a licence. But even if it did resolve to grant the licence, the grant is not a payment, transfer or crediting that is required by subsection 156-75(2) to result in a *distribution benefit*.

3.10 From a policy perspective, the asset is still trust property and the benefit received by the member is the value of the use of the asset. Unless the trust pursues the member to account for the value of the benefit lost by the trust, the member will be benefited by the value attached to that use.

3.11 We understand that the provisions were deliberately drafted in their current form with the intention of taxpayers to hold property through a trust for asset protection purposes only and allow them to use the assets tax free. Those trusts typically do not earn any income on the assets held or claim any expenses as deductions in respect of those assets.

3.12 Assets commonly held in that manner include family homes and other personal assets. The trust is naturally subject to capital gains tax (CGT) on the sale of family home. If the home were held directly by the controlling beneficiaries, it would not be subject to CGT.

3.13 However, as we just highlighted above, on one view, a passive use of trust assets is not a *distribution* and on the other, it is a *distribution*. We request that the Government confirm its intention by making specific provision for it in the legislation.

3.14 Otherwise, if it is the intention that a passive use of trust assets should amount to a distribution and be taxable, we consider that some allowance should be made to allow trusts to be used as asset protection vehicles and permit members to use trust assets tax free. ***We submit that a distribution should not arise where***:-

(i) a member uses a trust asset (other than a non commercial loan) for the whole or part of a year; and
(ii) the trust does not return any income nor claim as deductions any expenses in respect of the trust asset for the period the beneficiary uses that asset;

We also submit that as a minimum, taxpayers should be allowed to hold their family homes and personal use assets in trusts and use those assets without risk of taxation. The revenue would not be adversely affected. In fact, quite the opposite because the trust would be subject to CGT on the disposal of those assets in circumstances where the if those assets were held by individuals, no CGT would be payable.

Franking credits and Refunds

We share the concern of the Institute of Chartered Accountants on the availability of franking credits that there is a question mark over whether trust beneficiaries will receive the benefit of franking credits from trust distributions. Specifically, those concerns were raised in the Australian Tax Practice Latest Tax News on 31 October 2000 paragraph 5:

[5] ICAA: ENTITY TAX BILL INTENDED TO DISADVANTAGE NON-FIXED TRUSTS

After reviewing the recently released draft entity tax bill, the ICAA has expressed concern that the imputation tax credit proposals, if passed without amendment, will adversely affect the arrangements for non-fixed trusts (NFTs) currently in place for many professional and family businesses. According to the ICAA, these NFTs will be affected as the wide spread of potential beneficiaries means they cannot be classified as family trusts, notwithstanding they will pay tax and pass out the income to family trusts or individual beneficiaries associated with the partners. The problem is apparently that, although the trusts will pay company tax, the beneficiaries will be ineligible to receive the franking credits (proposed s 161-210). Franking credits will be available only if certain criteria are satisfied, including that the recipient is a "qualified person", an as yet undefined term.

The ICAA said "The problem is not just a restriction to the flow-through of franking credits but also on credits from the tax payable by the NFT. The effective tax rate, therefore, can be up to 63.95%, ie, 30% payable by the trust, then 48.5% of the remaining 70% distributed, with no franking credits". The ICAA said it received this ATO comment, which it understood to mean the tax disadvantage is intended by the ATO: "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."

`Source: ICAA "Tax Bulletin" No 42/2000, 30 October 2000`

4.1 Further, it has not been stated whether trust beneficiaries will be entitled to a refund of excess trust franking credits at all. It has been left to later legislation. We submit this practice of leaving the fine detail to later legislation makes it difficult to advise taxpayers on the appropriate way of complying with the legislation and pointing out the tax implications of the proposed law. It makes it difficult for taxpayers to review their affairs and make alternate arrangements.

4.2 We would hope that this practice together with the backdating of tax measures ceases in the future. We also submit that no tax changes should be announced before the legislation drafted. Draft legislation should be released at the time of the announcement.

4.3 We note that under section 161-210, to obtain the tax effects of a franked distribution, you need to be a *qualified person*. The definition of *qualified person* has not yet been written. The definition is intended to implement the anti franking credit trading measures under the Income Tax Assessment Act 1936.

4.4 At present, generally, subject to certain concessions, a discretionary trust cannot pass on the benefit of franking credits unless it has elected to be is a family trust. Our concern is that if a non fixed trust must elect to be a family trust to pass on any franking credits to beneficiaries, this will severely disadvantage those taxpayers that use trusts as a vehicle to hold a joint venture business. In that case, the joint venturers are arm's length parties. As such, the trust is not controlled by a family group and therefore cannot make family trust elections.

4.5 There are many trusts in that position that make distributions to other trusts that are not family trusts. This is common in the case of a professional practice operating a service trust whose beneficiaries are the respective trusts of the partners of the professional practice.

4.6 As a service trust is not controlled by any one family, it cannot make a family trust election. However, it would have paid tax on its profits but no member could take advantage of the credits on those profits. The credits for that tax cannot be passed through a chain of trusts to an ultimate beneficiary. The result is double taxation on the profits of a single business.

4.7 The franking credit trading measures are meant to deal with trading in equities that can be readily sold or exchanged like company shares. Interests in non fixed trust that are not unit trusts or listed trusts are not generally sold or exchanged. The purpose of having anti franking credit trading in respect of a discretionary trust interest for franked distributions from a trust makes no sense. A discretionary trust beneficiary cannot trade in their discretionary trust interest.

4.8 In the case of an interest in a service trust, the unit holders are invited to join the unit trust. They cannot practically be acquired and sold in the same way as a listed share or security. As such, denying franking credits under the franking credit trading rules on distributions out of those trusts and others like it would be penal in nature.

4.9 Put another way, if the franking credit trading rules do not accommodate legitimate business operations a trust or chain of trusts, we would not view this as an anti avoidance provision but a discriminatory penal provision. Specifically a penalty for using a trust as a business holding vehicle in circumstances where there is no threat to the revenue. We do not believe we will be the only accounting firm or body that would have that view.

4.10 We also note that the rules that allow refunds for excess franking credits have not yet been written. We would submit that they should be comparable to the current refund rules for company dividends. Further, we submit that those rules should allow a refund where the recipient of the distribution is another trust that has an excess of franking credits.

4.11 We submit that companies should also be allowed a refund for excess franking credits from trusts and companies.

4.12 We make the submission on the basis that the intercorporate dividend rebate has been removed. If the Government is forcing companies and trusts pay any shortfalls in tax on receipt of a dividend or trust distribution from a subsidiary or controlled entity, then holding entities should be allowed a refund where there is an excess in those credits.

4.13 We point out that if the franking credits measures are not amended to accommodate legitimate business operations through trusts, the reaction by taxpayers will be to operate through other structures that have comparable effects to the existing trust arrangements. In the case of a service entity, typically, there are few assets that have unrealised revenue or capital gains.

4.14 This makes it easier to move the assets from a non fixed trust to a fixed trust or company. We submit that the Government will not raise any significant revenue if it persists with the legislation as drafted.

5. Fixed trusts

5.1 Under the Bill, a *fixed trust* is a trust where beneficiaries have a vested and indefeasible interest in the all of the trust capital and income. In the case of a typical unit trust, one view is that this does not exist because the trustee has the ability to accumulate and apply trust income and capital for the purposes of the trust (whatever they might be). The interest of the unit holder only becomes vested and indefeasible when the unit trust vests.

5.2 This issue has been raised ever since the legislation introducing the trust loss provisions was released. The Government has not proposed any legislation to address and correct this problem.

5.3 We recommend that a review of the definition of a *fixed trust* be made to make the definition workable and practical. We would submit that the legislation should contain examples of what a *fixed trust* is.

We thank you again for providing us with the opportunity to provide our comments. Please call Bob Neill or Noel Beharis on (03) 9642 3444 if you wish to discuss any aspect of this submission further.

Yours faithfully

Robert Neill	Noel Beharis
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