National Farmers' Federation

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

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Executive Summary

NFF opposes the introduction of the Entity Taxation System and seeks that the Exposure Draft *The New Business Tax System (Entity Taxation) Bill 2000* be withdrawn.

The Exposure Draft contains many significant anomalies and unintended consequences and results in a tax system that is totally inconsistent with the taxation treatment of other entities, including companies.

The *New Business Tax System (Entity Taxation) Bill 2000* does not fulfil the Government's policy objectives for tax reform as spelt out in the original Government proposal titled *A New Tax System*, and the recommendations from the Ralph Review.

The exposure draft will tax non-fixed trusts, essentially discretionary trusts, under Ralph's proposed new measures. These measures will **not** apply to companies and fixed trusts. Therefore, from 1 July 2001 discretionary trusts and other non-fixed trust will be taxed differently, and more severely, than companies and other business entities, which broadly retain their current tax treatment.

Further, the taxing of unrealised gains, including the taxing of gains on pre-CGT assets results in a wealth tax and is unacceptable to the NFF. The proposals turn some potentially tax-free distributions into taxable distributions by taxing distributions out of pre-CGT unrealised gains under the profits first rule.

The Treasurer gave NFF an undertaking that loan or capital repayments will not be double taxed and stated that proper recognition would be given to returns of contributed capital. This has not been reflected in the proposals.

The NFF remains concerned that the proposed measures have not addressed the potential conflict between the policy initiatives that the Government specifically targets at agriculture, particularly with regard to farmers accepting responsibility for management of climatic risk.

Specifically, the measures will have consequences that will destroy the Farm Management Deposit as an effective risk management tool, negate the flow-through of the averaging provisions exposing farmers with fluctuating income to unfair marginal tax rates and claw back any potential concession under the forced disposal of livestock and Landcare provisions.

NFF has never supported the concept of taxing trusts like companies and has argued that companies should be taxed like trusts, if consistency and simplicity were truly the preferred outcomes. The NFF stated in the first Submission to the Review of Business Taxation, in December 1998:

> "Taxing trusts as companies could lead to the collection of more tax at entity level than will be required at final assessment, forcing the small business sector to make a permanent loan to the Government incurring significantly increased compliance costs in the process."

NFF believes that if the Government's agenda is to simplify the tax system and improve its consistency this Exposure Draft will not meet those objectives.

The NFF therefore cannot support in any way draconian proposals that result in blatant discrimination and unfair treatment of non-fixed trusts, in particular, small businesses and family trusts.

2. Introduction

The National Farmer's Federation (NFF) welcomes the opportunity to make a submission on the Exposure Draft *The New Business Tax System (Entity Taxation) Bill 2000.*

The *New Business Tax System (Entity Taxation) Bill 2000* does not fulfil the Government's policy objectives for tax reform as spelt out in the original Government proposal titled, *A New Tax System*, and the recommendations from the Ralph Review.

The original proposal was to address the anomalies contained in the current tax law that result in different business structures being subject to different tax treatment when conducting similar business activities. The Ralph Review endorsed this approach and proposed taxing companies, trusts, limited partnerships, co-operatives and non-complying superannuation funds in the same way. It suggested that the taxation of all entities, with the exception of Collective Investment Vehicles (CIVs) and certain excluded trusts, should be changed significantly with the introduction of 'entity tax measures' such as the profits first rule.

In addition, the original proposal sought revenue neutral tax reform that moved towards a company tax rate of 30 per cent and a more consistent treatment of business investments, roughly translated as the removal of accelerated depreciation.

The Exposure Draft proposes to tax non-fixed trusts, essentially discretionary trusts, under Ralph's proposed new measures. These measures will **not** apply to companies and fixed trusts. Therefore, from 1 July 2001, discretionary trusts and other non-fixed trust will be taxed differently, and more severely, than companies and other business entities. Companies, fixed trusts, limited partnerships and co-operatives broadly retain their current tax treatment.

We are faced with a proposal focused solely on discretionary and hybrid trusts, a vehicle typically used by family businesses when other business structures are not appropriate.

A primary purpose of the use of discretionary trusts is the protection of assets from misadventure of beneficiaries, such as divorce or bankruptcy of a beneficiary, and to protect the viability of the farm property for future generations. In particular, placing the farm into a discretionary trust to protect the family assets, demonstrates the valid use of a discretionary trust and should not be penalised.

The trust provides the means to encourage independent decision-making and commensurate reward whilst at the same time binding the business together into a larger unit, rather than having each child running separate marginal businesses. A discretionary trust provides both limited liability and asset protection as well as a means to distribute income fairly amongst family members who work on the farm according to their efforts and successes, which is likely to vary from season to season. It protects the farm as a viable capital asset and at the same time protects the interests of the next generation by providing the flexibility to distribute fairly amongst siblings at a later date. This is not available through a fixed trust.

In many ways, the measures appear to be aimed at anti-avoidance. However, it is unclear how they add substantially to recently introduced measures designed to address the use of trusts for tax minimisation. As non-fixed trusts are supposedly to be taxed the same as companies, the same dividend substitution anti-avoidance rules which currently apply to companies could apply to non-fixed trusts.

Ironically, the Government overview on Entities Taxation states that the exclusion for companies, fixed trusts and limited partnerships is in the interests of minimising compliance and restructuring costs. They have taken the opposite approach to non-fixed trusts.

The Ralph report proposed that the consistent entity rules will apply to companies, limited partnerships and trusts and the concept of a tax entity was one of the major building blocks of the new system. If this premise has now gone, what is the justification for proceeding with a piece of legislation that threatens the legitimate use of non-fixed trusts and the viability of the small businesses that currently use them?

3. Profits First Rule

The proposals seek to apply a profits first rule to ensure that there is a sequence by which the trust pays distributions to avoid preferential distributions being made to certain members. The Government claims that the profits first rule mirrors the rules that apply to companies in relation to the distribution of profits.

Under the non-fixed trust proposals, the profits first rule applies to **all** distributions. The proposals state that distributions are to be paid first out of available profits. Available profits not only include operating or trading profit but also unrealised gains.

The concept of unrealised gains is a concept that was embedded in the Option 2/Tax Value Method which has now been delayed indefinitely. To continue to include this concept in the trust legislation is confounding.

The Tax Value Method, however, proposed to determine taxable income by recognising the net annul cash flows from the use of relevant assets and liabilities and the change in tax value of those assets and liabilities. In the Ralph report, both at paragraph 147 of the Overview and paragraph 1, page 157 of the recommendations, it is stated:

> "Recognising the practical constraints in taxing the annual change in value of all assets, the use of tax values ensures that taxpayers will generally continue not to be taxed on unrealised increases in asset (balance sheet) values."

The Ralph report therefore recognises that the taxing of unrealised gains should **not** occur. Further, the current proposals require that a valuation be undertaken at the time of **each and every** distribution! This certainly does not recognise the practical constraints of valuing assets.

The basis for the Ralph proposal to apply this concept to entities taxation was to be in accordance with the Tax Value Method, also proposed to be implemented from 1 July 2001. However, this was in line with a taxation treatment that applied to all entities. To maintain this concept now when the Tax Value Method has been all but aborted and the new measures only apply to non-fixed trusts is nonsensical!

The NFF was given an undertaking by the Treasurer that loan or capital repayments would not be double taxed. The Treasurer also gave an undertaking that proper recognition will be given to returns of capital. This has not been enunciated in the proposals.

In his letter of 2 December 1999, the Treasurer stated:

> "However, loan or capital repayments will not be double taxed. Proper recognition will be given to returns of contributed capital"

In fact, the inclusion of unrealised gains under the profits first rule **will** mean double taxation.

When a distribution is made out of actual capital from the trust to a member, it may be deemed to come out of unrealised gains and be taxable in the hands of the member. Upon actual sale by the trust of the asset, the trust will be taxed on the capital gain, even though the unrealised gain has already been taxed in the member's hand. This is double taxation.

If a family member makes an interest-free loan to the trust and it is not repaid within 2 years, it will become part of contributed capital. When this family member is repaid, if the trust has appreciating assets, this repayment is likely to be taxed, even though the contribution from the family member in the first place was out of after tax money! Further, if the assets are depreciating there is no recognition of a distribution out of a loss. Again, this is double taxation.

Available profits need to be determined at the time of each distribution, requiring a valuation to be undertaken. However, if the accounting records indicate that there are book profits greater than the amount of the distribution, the accounts will be sufficient evidence to treat the distribution out of available profits.

This is supposedly a concession to business so that they do not have to value assets every time they make a distribution, if the distribution is treated fully as being out of actual profits. However, this assumes that the trust has profits to distribute in the first place. In situations where the trust has made a loss and still wishes to distribute, not an uncommon occurrence in the farming sector due to seasonal fluctuations, a valuation will need to be undertaken to determine the unrealised gains.

When a company revalues it's assets, it can then distribute out of a revaluation reserve as unfranked dividends to the extent of the balance in the reserve. In the case of a trust, every time a distribution is made, the unrealised gain is the difference between the market value and the cost base of the asset. It is very difficult to imagine how a member will ever be able to access their contributed capital in a trust with appreciating assets. Further, if the trust has depreciating assets, or if the market value falls below cost base in a year, there is no mechanism to allow the loss to flow through to the member.

It has been suggested that the application of the profits first rule to non-fixed trusts merely replicates the rules that already apply to corporate entities. In particular, it is suggested that there is a de facto profits first rule applicable to companies by virtue of sections 45 to 45C of the *Income Tax Assessment Act*

1936. This goes back to the key objective of *A New Tax System*, as announced by the Treasurer in August 1998, which recommended the consistent treatment of discretionary and fixed trusts like companies.

This consistent treatment of different entities was proposed to remove the existing inconsistencies and uncertainties applying to distributions to shareholders, and a profits first rule was put forward in meeting this objective. In particular, it was stated that a profits first rule would ensure that the current complex dividend streaming provisions would no longer be needed.

The final report of the Review of Business Taxation, in recommending the adoption of a profits first rule for all entities subject to the entity taxation system, commented:

> "The existing law gives companies and trusts some discretion as to whether distributions are out of profits or contributed capital. This can result in deferral of tax, as well as to the streaming of profits and the contributed capital according to members' tax positions. Currently, complex specific anti-avoidance provisions are aimed at limiting tax benefits flowing from such discretion. Implementation of the profits first rule and other related entity reforms will enable the specific anti-avoidance provisions to be repealed (recommendation 6.6), reflecting the structural nature of these proposals."

It would therefore seem that the reason for the introduction of the profits first rule to all entities is now being pointed to as justifying the application of a profits first rule to only non-fixed trusts and as being unnecessary for companies.

However, under the non-fixed trust proposals, the mandatory application of the profits first rule goes a lot further than the anti-avoidance provisions contained in sections 45 to 45C of the 1936 Act. The different application of these anti-avoidance provisions to companies, when compared to the more certain application of the profits first rule to trusts, is detailed below.

The current position for companies: a profits first rule?

Apart from the anti-avoidance provisions of sections 45 to 45C of the 1936 Act, companies can return capital to their shareholders without the distribution being taxed as a dividend.

In fact, the very reason for the introduction of sections 45 to 45C was the relaxation of the Corporations Law in 1997, which made it easier for companies to make distributions to shareholders, and the consequent perceived need to introduce “an appropriate taxation framework” (Explanatory Memorandum paragraph 1.7 to Taxations Law Amendment (Company Law Review) Bill 1998) in order to avoid any revenue loss or deferral because of the greater ease with which companies may stream capital to shareholders.

Sections 45 and 45A apply respectively to the distribution of bonus shares and, more generally, capital benefits. Being anti-avoidance provisions in relation to streaming arrangements, such sections are not relevant when comparing the position of companies to the proposed position for non-fixed trusts under a profits first rule. Nevertheless, it is worthy of comment that the profits first rule, if it applied to companies, would largely remove the need for section 45A.

It is section 45B to which regard must be had if a company is to distribute capital in substitution to a dividend.

Unlike the profits first rule proposed to be introduced for non-fixed trusts, section 45B is an anti-avoidance provision which depends for its application on the satisfaction of essentially two tests:

- Whether or not, objectively determined, the relevant taxpayer pays less tax in respect of the capital distribution than would have been the case if the distribution had been a dividend; and
- Whether or not a significant purpose of a person who entered into, or carried out the scheme, was to obtain a tax benefit in respect of the capital benefit.

Thus, unlike the mandatory application of the profits first rule to non-fixed trusts, a company may distribute its capital to shareholders if either of the preceding tests are not satisfied. It is apparent, therefore, in view of the anti-avoidance purpose of section 45B, companies remain in an advantageous position when compared to non-fixed trusts with respect to achieving capital distributions.

In particular, it would seem that a company could make a distribution of capital to its shareholders, even without a disposition of shares, as such generally would not fall within the anti-avoidance provisions of section 45B. The position may be otherwise, of course, if it can be inferred that such a return of capital is in substitution for a dividend which, over the years, would normally have been paid.

Furthermore, the abovementioned Explanatory Memorandum provides the example of a company disposing of a substantial part of its business at a profit and distributing it back to shareholders as part of a share capital which could reasonably be regarded as the share capital invested in that part of the business, as not falling within section 45B. Under a profits first rule, this could not be achieved in the circumstances where the company had undistributed profits.

In short, companies are still in a position to be able to distribute capital to shareholders in circumstances where the distribution is, in effect, not in substitution of a dividend. This would not be the case if a profits first rule applied.

The Government has also attempted to draw comparisons between Division 7A of the ITAA 1936 and the non-fixed trust proposals in relation to the profits first rule. The Government claims that companies apply an equivalent of the profits first rule under this Division.

Division 7A of the ITAA 1936 was enacted to have effect from 3 December, 1997. It was essentially designed to deal with the distribution of profits from a company.

The Division is solely relevant in determining whether a loan from the company, member or associate will be 'converted' or effectively treated as a distribution of profits under the Division.

The Division does not impact on the legal right of a company to make a distribution of capital to shareholders in certain circumstances. In effect, the definition of a 'distributable surplus' is essentially relevant to the operations of Division 7A and not to determine what might otherwise occur within a company structure.

A definition of 'distributable surplus' is included in Section 109Y(2) of the 1936 Act. It applies essentially to a transaction which is covered by the Division.

Therefore, the application of a profits first rule to all distributions under the non-fixed trust proposals is more onerous than the treatment of a distributable surplus under Division 7A of the ITAA 1936.

The position of non-fixed trusts: a profits first rule

In contrast to a company, under the proposed profits first rule regime, non-fixed trusts have no opportunity to return capital to their members, other than where no profits exist or on extinguishment of the membership interest.

Furthermore, practically, unlike companies, while undistributed realised and unrealised profits exist, a discretionary trust cannot distribute capital to its members, other than on dissolution of the trust. It must be questioned why a discretionary trust must be lumbered with these cumbersome rules when, as with a company, ultimately the capital can be returned to members free of tax. Any concerns as to the deferral of tax could be overcome by the application to non-fixed trusts of the same anti-avoidance provisions which apply to companies.

Companies will continue to be permitted to distribute capital to shareholders, whether or not on extinguishment of the member's interest, without the need to satisfy mandatory profits first rules. To achieve consistency of treatment between entities, non-fixed trusts should not be in a different position to companies in having to satisfy the profits first rules.

If the Government's intention is to tax non-fixed trusts as companies, the same dividend substitution anti-avoidance rules which currently apply to companies could apply to non-fixed trusts.

4. Revenue Impact

No details have been provided of a Regulation Impact Statement to substantiate why the Government is proceeding with these non-fixed trust measures.

Further, the increase to Government revenue has not been quantified, neither has the revenue loss to Government under the current regime, nor has the number of taxpayers that these proposals will affect.

The proposed legislation will not achieve the objectives of the Ralph Review, to move to a consistent entity regime. Rather the measures merely look to tax existing trusts in a different way - at the entity level rather than at the member level, and in doing so the legislation brings with it a whole myriad of complexities and impracticalities that make it unworkable.

We must therefore assume that different objectives are being pursued. If one of these objectives is to address opportunities for avoidance, NFF questions the efficacy of this approach.

Further, the proposed legislation will not increase the number of trust income tax returns lodged. There is nothing in the legislation that will bring into the tax net entities that are avoiding tax at the moment.

A substantive anti-avoidance measure was implemented as part of the immediate changes associated with *A New Tax System*. This measure requires trustees of closely held trusts to identify the ultimate beneficiary, by providing a tax file number in the case of Australian residents of a distribution, or to pay tax at the highest marginal rate. This ensures that distributions can be identified and taxed correctly in the hands of the beneficiary. If the undisclosed information relates to tax preferred amounts, penalties apply. Discretionary trusts are by definition closely held trusts.

NFF's preference for a system that taxes income and capital in the hands of the individual is on record as are our views that the above measure should be an adequate and effective anti-avoidance measure for the vast majority of discretionary trusts used in agriculture and by small business. (*First and Second NFF Submissions to the Review of Business Taxation*.)

Other recent tax changes, notably the introduction of GST and PAYG, mean that the Government is already getting revenue from trusts on an ongoing basis. Where the farm business is operated through a trust, that trust will not only have an Australian Business Number (ABN), it will most likely be registered as a GST taxpayer and will be submitting returns at least as frequently as quarterly.

In addition, the Government is collecting, or will collect, revenue from the members through the PAYG instalment regime. Taxpayers do not gain from these measures; compliance costs either have increased, or will increase significantly.

With the requirement to have Ultimate Beneficiary Statements, the Government collects revenue at either the member's marginal tax rate or, if not distributed, at the highest marginal tax rate of 48.5%. It appears that with tight anti-avoidance measures already in place for trusts, the only revenue gain to Government must from the double taxation consequences of these proposals.

The success of these measures in addressing concerns, real or imaginary, regarding the integrity of the taxation system with respect to discretionary trusts has yet to be assessed.

Government needs to determine exactly what concerns exist in relation to discretionary trusts, demonstrate the extent to which these concerns are not addressed by integrity measures already instigated, and then address any issues by way of specific anti-avoidance provisions in the existing trust law. The NFF is sure the Government will find that the number of non-fixed trusts that they have concerns around are so few that to address these concerns with over 100 pages of new legislation is going to unnecessary and costly lengths for all parties, to say the very least.

5. Capital Gains Tax

Where it is not possible to establish the cost base of an asset, the value of the asset will not be added to contributed capital until the asset is sold. Therefore, distributions cannot be made out of contributed capital without selling the asset.

There are special provisions to be written in relation to distributions of contributed capital to family members, whereby these amounts will not be assessable at all. However, the application of the profits first rule and definition of available profits have a significant impact on being able to access the capital contributed to the trust.

The proposals allow for an exception to the rule for dealing with distributions out of contributed capital under the CGT provisions. This exception is where some membership interests have a zero cost base. In this instance, the distribution from contributed capital will not be assessable provided that the members receiving the distribution are part of the same family group and only individuals or members of the family group have contributed capital to the family trusts.

Yet again, the profits first rule may apply in relation to any distribution and if the trust has unrealised gains, then distributions to members may be taxable. In circumstances where the trust has no unrealised gains, it appears that the contributed capital can be distributed to members with no tax consequences.

However, what if a member is not part of the same family group? For example, if a school received a regular distribution from the trust. In addition, what if a second trust has gifted money to the trust? The money will be treated as contributed capital as it would not be from an individual or member of the family group. In these circumstances, even if the trust was able to access the contributed capital, the distribution will be considered assessable in the hands of the member.

Any form of distribution out of unrealised gains on pre-CGT assets must be treated as a taxable distribution even though a distribution out of realised pre-CGT assets would normally be exempt from tax. This will be the case for many assets in family trusts that were pre-CGT assets and have no cost base. Therefore, the distribution to the member will be taxed in the hands of the member, if it is taken to be out of unrealised gains, when pre-CGT assets should be free of tax.

Further, subject to the distribution within 12 months after the end of the income year rule, there is no further recognition that the asset may have been subject to the active asset exemption or 15 year rollover exemption under the CGT concessions for small business. The distribution may still be taxed in the hands of the member if the trust has unrealised gains.

In his letter to NFF of 2 December 1999, the Treasurer stated:

> "You have expressed concern that the 15 year exemption from CGT on the sale of active assets will not be available if the assets are held by an entity and the controller of the entity plans to retire. I can confirm that the benefits of the 15 year and small business CGT retirement exemptions will be available for small business assets disposed of by trusts (provided their respective eligibility criteria are met) and will flow through to the CGT concession stakeholders of the trust. An individual is a CGT concession stakeholder of the trust if the individual is:
>
> - a 'controlling' individual of the trust; or
> - a controlling individual's spouse who is entitled to the income or capital of the trust, or may be entitled to receive any of the income or capital of the trust."

Due to the profits first rule, if the trust has unrealised gains this can effectively prevent the CGT concession flowing through to the member.

The only way around this is not to have appreciating assets in the trust, which defeats the purpose of using a trust for protection of assets. Another alternative would be to have a level of debt in the trust which matches the market value of the assets. In fact, this demonstrates that those who wish to utilise the non-fixed trust as a mechanism for preferentially distributing to members will find a way around the provisions. For those genuine, farming, small business and family trusts, this will not be a feasible option.

Distribution out of trusts that have unrealised gains on post–CGT assets may be treated as being taxable distributions even though the asset has not been realised. In fact, the asset may never be realised, however, if it is, this gives rise to double taxation.

Taxing of unrealised gains is a wealth tax as is the taxing of gains on pre-CGT assets and assets not subject to tax under the CGT concessions, and therefore is totally unacceptable to NFF.

6. Non-Commercial Loans

Where a member draws money from the trust, it will be regarded either as a loan or a distribution. The loan will be regarded as non-commercial if there is no written agreement and no interest charged. In this case if the loan is not fully repaid by the end of the current income year it will be taken to be a distribution to the member and the trust will need to pay tax at 30%.

The proposals state that the written agreement must be in place at the time of entering into the loan. Therefore, any loans that currently exist will be taken to be non-commercial loans at 1 July 2001 if they have not been repaid, as it is likely that there was no written agreement in place at the time of entering into the loan. The legislation is therefore retrospective, as there is no provision to enable a member to take steps to have the monies drawn down treated as a commercial loan, if that is their desire.

Where a member lends money to a trust that is not fully repaid within 12 months after the end of the year in which it was paid, it will form part of the contributed capital of the member. This applies to loans from member to non-fixed trusts from 22 February 1999.

It is not uncommon for farmers to contribute additional capital to the trust in order to carry the farm business through times of drought or low commodity prices. For example, to purchase livestock feed or seed and fertiliser to establish next season's crop. It is not unheard of for Dad to contribute additional capital to the trust to fund a son or daughter attempting to establish a new enterprise and thereby diversify the farm business. In both circumstances, it is unlikely that the trust will be in a position to repay the loan within twelve to eighteen months.

What is the logic of requiring the trust to pay interest on the loans when the same would not be required if the business structure used in the example was a company?

As all loans from 22 February 1999 from the member to the trust are affected by the new measures, a loan that was taken out in April 1999 needs to be repaid by 30 June 2000 or it will be included in the trust's start-up contributed capital. The loan needs to be repaid four months before the Exposure Draft was even released! This is retrospective legislation at it's worst.

For the loan to be commercial, interest must be charged at a rate equal to at least the benchmark interest rate for the income year in which the loan is made. Interest **must** be paid – it cannot just accrue. This imposes unnecessary hardship on small business.

Example

A farming trust makes substantial losses during the year due to a downturn in commodity prices. To enable the trust to pay it's bills, the farmer, a member, puts $50 000 of his own (after-tax) money into the trust. The trust will be unable to repay this loan for several years. Unless there is a written agreement and interest paid at the end of the income year, the loan will be taken to be non-commercial and form part of the farmer's contributed capital.

Producing a written agreement is one thing, but forcing the trust to pay interest, when it does not have the money to even pay it's bills, is ridiculous. Especially when it is considered that the reality for most discretionary trusts is that the farmer **is** the trust; the owner **is** the business. These proposals do not recognise the practical realities of small business and attack non-fixed trusts as if they are avoidance vehicles rather than recognising them as commercially viable entity structures.

7. Deceased Estates

The Ralph Review proposed that deceased estates be excluded provided certain conditions were satisfied, such as the administration must be completed within two years (or longer as the Commissioner determines) from the date of death, and provided they result from a will or an intestacy. The draft list of excluded trusts, provided by Treasury, does not include deceased estates.

However, if we are to assume that deceased estates are to be considered as excluded trusts under the Ralph proposals, the possibility now exists for deceased estates to be treated initially as an excluded trust and then reclassified as a non-fixed trust, therefore adding to the cost of compliance for the administration of the estate.

Both treatments could occur in the one year, notably the year of income and the year in which the basic administration of the estate is completed, and the testamentary trust commences (with variable income distribution rights).

During this period of time, the estate would be treated as an excluded trust. After either administration is completed, or two years, it would be potentially liable to the operations of the non fixed trust proposals.

The position would be further complicated if a distribution is made by the trustee to members in this two year period, as it may then be considered that the trust is no longer automatically considered an excluded trust.

There appears to be no justification for complicating estate administration in such a way.

It is understood that the Government is proposing that testamentary trusts would not automatically fall within the definition of an excluded trust. In the circumstances, where there were discretionary members, then the operations of the non-fixed proposals would apply.

The above rules would appear to apply to all testamentary trusts including those already in existence. If this is the case, then there is a strong degree of retrospectivity being contemplated in the present proposals.

How can the Government justify such an approach, particularly when in many cases it will not result in increased revenue; only substantially increased costs of compliance, and when the tax regime will result in substantial changes to the outcomes of the trust, depending on changes in circumstance beyond the control of the beneficiaries and trustees?

Example

A testamentary trust makes provision for discretionary beneficiaries. The trustee, in accordance with the terms of the will, distributes income in the year 2002/2003 to minor beneficiaries.

At 30th June, 2003 the taxable income of the minor beneficiaries is below the tax free threshold.

Under the non-fixed trust proposals, the trust would be liable for tax on the net income of the testamentary trust. Minor beneficiaries would then have to lodge an income tax return to claim the refund of imputation credits available to them.

Further, the time difference between distributing the income and refunding the imputation credits could be 12-18 months, in which time the Government has effectively had an interest free loan from the trust and its beneficiaries.

In Australia, there may be a large number of wills in existence which provide for a testamentary trust in the future. In some cases the relevant testator may not be in a position to legally change the terms of their will.

Hence, these families are effectively thrust into the new regime because of the age, health and potential incapacity of the testator to restructure their affairs at this point in time.

Example

The testator's will provides that part of the estate is left to a specified list of beneficiaries with the remainder being subject of a testamentary trust.

The trust could be for the benefit of the grandchildren of the testator, with the right to variable income distributions at the discretion of the trustees.

Consider that the basic administration of the estate becomes complicated and delayed because of a claim lodged by a dissatisfied beneficiary. At the end of the two year period, no distribution has been made to the beneficiaries of the estate.

In this situation, the trustee of the estate would then have to consider the definition of a non-fixed trust and whether it applied to this particular estate.

In year 3, there is still no distribution of the trust net income because of the disputes.

In the above set of circumstances, it can be reasonably argued that there was no beneficiary presently entitled to a share of the net income of the estate.

Accordingly, the net income would be taxed under Section 98 of the ITAA 1936. It should be noted that the application of the concept of **present entitlement** could create difficulties. Indeed, the Australian Taxation Office (ATO) has paid very little attention to this issue in recent years. However, the ATO has provided some basic guidelines through Income Tax Ruling IT 2622.

If the Government's proposals are adopted, then it conflicts with the present arrangement of providing concessional tax treatment for a period of up to three years, provided the beneficiaries are not presently entitled to net income.

The proposal to reduce the time period is, therefore, placing greater pressure on executors of Estates to administer them within a shorter time frame.

Example

A farmer died in June 1985, leaving two surviving children aged 5 and 2 at the time of death.

The will provided that the farm, plant, livestock and a sum of cash, be left in trust until each child turned 21, at which time the eldest child would be entitled to receive an amount equivalent to one half of the net value of the assets of the trust at that time, with the youngest child then receiving the remainder.

The trustee has successfully invested the cash in the share market, and has a portfolio of post-CGT shares with large gains.

The eldest child turns 21 in July 2001. This child has no interest in farming. However, the youngest child has expressed the wish to continue farming.

The balance sheet of the trust when the oldest child turns 21 is:

	Cost base	Market value
Land (pre-CGT)	$200 000	$800 000
Plant and livestock	$50 000	$200 000
Shares	$200 000	$1 000 000

The trustee believes that the farm would be unviable if one half was sold, and elects to sell the shares to meet the obligation to the eldest child. This results in an $800 000 capital gain, of which one half would be exempt.

As the child's membership interest is to be terminated, the slice rule will apply.

The contributed capital of the trust at that time will be $650 000 (the cost base of the plant and equipment and shares ($250 000), plus the exempt portion of the realised gain on the shares ($400 000)). The value of the pre-CGT land will not be added to contributed capital until it is realised. The eldest child's share of contributed capital will be $325 000, making $675 000 of the distribution taxable.

When the youngest child turns 21, the farming assets are distributed *in specie* to the child – a deemed disposal. Assume for simplicity that the market value of the assets have remained constant. The contributed capital of the trust would then be $325 000 plus $800 000 (the market value of the land) making the whole distribution tax free. Furthermore, $125 000 of contributed capital would be 'wasted'.

Now consider the case where it is the eldest child who wishes to continue farming, while the youngest child has stated explicitly that they have no interest in the farm. The trustee therefore decides to distribute the farm assets *in specie* to the eldest child, while retaining the shares to satisfy the youngest child's entitlements.

In this case, the contributed capital of the trust at the time of the distribution to the eldest child would be $800 000 (the market value of the land) plus $50 000 (the tax value of the plant and equipment) plus $200 000 (the cost base of the shares), a total of $1 050 000. The child's share of contributed capital would be $525 000, leaving $475 000 taxable.

When the distribution was made to the youngest child, contributed capital of the trust would increase by $400 000, the exempt portion of the gain, making their share of contributed capital $925 000, leaving only $75 000 taxable.

In either case, there are variable outcomes, and it seems to pay to be the youngest child. Other examples and numbers would produce other outcomes.

However, it appears the only way to achieve equal outcomes under the proposed definition of contributed capital would be for the trustee to realise all assets at the time of distribution.

8. Rollover Relief for Restructure of Non-Fixed Trusts

The proposals provide for roll-over relief for fixed trusts to companies and for widely-held companies to widely-held trusts. However, there is no roll-over relief for non-fixed trusts. Astonishing, as the proposals are aimed at non-fixed trusts only.

It is outrageous that taxpayers who wish to move to another business structure in response to the obvious incentives implicit in the introduction of such an onerous change to the taxation system, should be burdened with significant re-structuring costs.

If non-fixed trusts wish to restructure to a fixed trust, company, partnership or individual, there should be full rollover relief available. This should include relief from CGT, GST and State stamp duties, as well as preserving any roll-over and pre-CGT status.

This relief should apply to all assets include real property, livestock, plant and machinery and trading stock and preserve any capital gains tax concessions.

Although the Ralph recommendations included rollover relief and stamp duty relief for entity restructuring, this has not been provided for in the non-fixed trust proposals. In fact, the final paragraph of Recommendation 13.12 of the Ralph report states:

> "The taxation treatment by the States and Territories of entities restructuring as a result of the new entity tax system is an issue that should be resolved by the Commonwealth, State and Territory Governments so as to remove tax obstacles to restructuring. Until there is an exemption from stamp duty on reconstructions permitted under the provisions recommended by the Review, an unnecessary obstacle to the encouragement of a more dynamic economy will remain."

The NFF would have expected that the proposals would have been accompanied by an agreement with the States to allow rollover relief for stamp duty on restructuring.

The definitions of fixed and non-fixed trusts are particularly important because "once you are in, you are in forever". If the trust does not meet the requirements of a fixed trust it is a non-fixed trust and subject to the proposals until it is wound up.

We are therefore faced with the situation that if the trust believes that it is a fixed trust, but falls foul of any of the proposals, the trust will be taken to be a non-fixed trust for ever! There is no provision to enable the trust to reassess their structure and become a fixed trust once again. One must ask, what is the aim of this measure? The NFF could not support a proposal that does not permit a taxpayer to elect out of the system at any time.

9. Primary Producer Concessions

NFF has been repeatedly assured that the primary producer specific tax measures, particularly those that promote the achievement of policy objectives contained in Advancing Agriculture Australia, would not be affected under taxation reform.

The Treasurer gave an undertaking to the NFF that primary production concessions such as Landcare would be retained and that he would look at whether such concessions will be allowed to pass through trusts and be distributed tax-free to members. This has not been achieved with the current proposals.

This again raises the wider concern regarding the flow through of primary producer specific measures and the potential conflict between this measure and the achievement of Government's agriculture specific policy objectives. For example, encouraging farmers to prepare for drought, to involve the younger generation in management from an early stage, to secure the farm for the next generation and a range of environmental and land reparation objectives.

Primary Producer Averaging

Under the proposals, primary producer averaging will not flow through to the individual in years when the trust makes a distribution that is less than $1 040. Therefore, where a trust makes a loss, or simply fails to distribute, the member will not be considered to be a primary producer and is not entitled to apply the averaging provisions.

This will negate the flow-through of the averaging provisions exposing farmers with fluctuating income to unfair marginal tax rates, at a time when the averaging provisions are intended to come into play.

This is incredible and totally unacceptable to the NFF, particularly as the interaction of PAYG with the trust proposals in the first year of implementation will be a disincentive for the trust to make any distribution. In particular, the $1 040 threshold may force farmers to withdraw Farm Management Deposits with no notice.

Under current law, a beneficiary is entitled to apply averaging if they are entitled to a share of the trust's net income in the relevant year.

The Government has suggested that non-fixed trusts can simply distribute a nominal amount, such as $1 to members, to enable them to retain primary producer status.

However, due to the threshold, a distribution of a nominal amount less than $1 040 will deny the member being able to apply averaging.

Further, Government suggestions to distribute a nominal amount to allow the member to retain their primary producer status is a direct contradiction of the proposed legislation, which states, at subsection 392-19 (2):

> "However, you are not taken to carry on the primary production business if the total of the distributions made to you by the trust in the income year is less than $1 040, unless the Commissioner is satisfied that your interest in the trust was not acquired or granted wholly or primarily to enable your income tax to be adjusted under this Division"

Clearly, a nominal distribution of the kind suggested by Government would be primarily to enable the income tax of the member to be adjusted and therefore the Commissioner would be denied exercising his discretion.

Farm Management Deposits

Members of a trust will be primary producers if they receive a distribution from the trust in the year that the trust qualifies as a primary producer. This entitles the member to make a Farm Management Deposit. However, if the trust does not distribute in a year, the member ceases to be a primary producer for that year. The consequence of this is that Farm Management Deposit must be repaid when the member ceases to be a primary producer.

This is clearly unacceptable to NFF as it will remove any element of choice the producer has over when to draw down on the Farm Management Deposit, and by how much.

At worst, it will prevent members of farm trading trusts from utilising the Farm Management Deposit as an effective risk management tool as proposed under Advancing Agriculture Australia. At best, it will impose transaction costs in terms of lost interest and any penalty charges associated with early withdrawal of the Farm Management Deposit.

Death or forced disposal of livestock

Concessional tax treatments may be available to a taxpayer where assessable proceeds arise from the death or forced disposal of livestock. The taxpayer can elect to spread the tax profit over 5 years.

In the case of a trust, the trust will have the proceeds from a forced disposal in the bank, but will only need to return 1/5th of this amount each year for the current and following 4 years. If, however, the trust needs to make a distribution, say a maintenance payment to a surviving spouse, that is more than the operating profit of the trust, this will result in the trust making a partially unfranked distribution.

Example

A trust makes a forced disposal of livestock due to drought for $100 000. The trust includes $20 000 of this amount as assessable income in the first year. The trust has incurred significant expenses during the year due to the drought and therefore the $20 000 is the total taxable income of the trust. The trust pays tax on the taxable income but is required, under the trust deed, to make a maintenance distribution of $40 000 to a surviving spouse.

Under the profits first rule, the available profits will include the money from the forced sale of livestock in the bank. The distribution will therefore be partially franked. The franked component will relate to the $1/5^{th}$ of the income that has had tax paid on it at the entity level, but the balance of $20 000 will be taxed in the hands of the surviving spouse.

In the following 4 years, when the trust returns the balance of the forced disposal proceeds as assessable income, the trust will pay tax at the entity level.

When the distribution was made to the surviving spouse there was no recognition that tax will be paid at the entity level in future years and not only has double taxation resulted but the supposedly concessional tax treatment of forced disposal of livestock is clawed back.

Landcare

If the trust spends money on Landcare activities, the trust will be able to claim a tax deduction for that year. However, the effect of the Landcare activities is that the market value of the farm may well have increased due to this activity.

When the trust distributes to members this increase in market value will be included in unrealised gains effectively clawing back the Landcare concession.

This is in contradiction to the Treasurer's undertaking which states:

> "As regards primary producer provisions such as Landcare, these will be retained. I am also looking at whether such concessions will be allowed to pass through trusts and be distributed tax free."

The non-fixed trust proposals do not preserve primary production concessions and as such, are unacceptable to NFF.

10. Compliance costs

The Government is already collecting revenue from trusts and beneficiaries under the GST and PAYG regime. The increased amount of paperwork and ongoing compliance necessary, is becoming insurmountable. Beneficiaries will now have to complete an income tax return just to get back their imputation credits, even if they are below the taxable threshold. This is certainly not simplification.

In addition, for the farm businesses where the farmer **is** the trust there will be additional cashflow impacts to consider. This is especially so where the trust will pay tax at 30 per cent and the members will claim a refund because their average tax rate is closer to 22 per cent. Funding the cashflow impact is likely to prove difficult for many small businesses. The additional paperwork required to 'manage' the imputation credits is large and completely unnecessary.

Further the restructuring costs and compliance costs that will apply to non-fixed trusts only make a mockery of the proposal announced in both the ANTS document and Ralph report with respect to a new tax system that is more certain, equitable and durable.

From a compliance perspective, the proposals will create a nightmare for farmers and their advisers. Whether the trust should be wound up needs to be considered, as will the implications of changing the entity structure.

All existing trust deeds will need to be reviewed to determine whether the trust is a fixed or non-fixed trust; that is, **all** trust deeds not just those for discretionary trusts.

Trust deeds will also need to be examined to determine whether the trustee has the power to accumulate income in the trust. If not the trust deed will need to be amended, if it can be amended, to include such a power, triggering CGT and stamp duty implications.

A non-fixed trust will be required to maintain contributed capital accounts and sub-accounts for each class of membership interest. Work needs to be undertaken by the farmer and adviser to determine the trust's tax balance sheet at 1 July 2001.

This will substantially increase the record keeping requirements for small business in relation to contributed capital accounts and increase their fees to advisers.

With the implementation of the *A New Tax System* and the additional compliance costs to farmers due to the GST, PAYG and BAS, expecting farmers to be able to come to grips with these proposals as well as have time to determine whether they need to restructure their affairs is totally unrealistic.

11 The Imputation System

The proposals state that the benchmark franking percentage for a franking period cannot differ by more than 20 percentage points from the franking percentage for the prior period.

There is no recognition of the fact that small business and family trusts simply will not be able to comply with this rule.

Further, although the Commissioner has a discretion to allow the franking percentage to differ by more than 20 percentage points, this discretion may only be exercised in extraordinary circumstances.

Farming trusts, due to seasonal fluctuations, will be unable to predict the extent to which it will be able to pay franked distributions. Therefore, the trust may be unfairly penalised because it breaches Benchmark rule 2.

Many non-fixed trusts will be in this situation and the proposals impose further onerous compliance costs on already overburdened small business.

12. Practical Example of Effect on Farmers

ASSUMPTIONS

- Discretionary trust owns family grazing property and is conducting the grazing business
- Mum, dad and two (2) sons are employees of the trust in receipt of an annual salary from the trust
- Beneficiaries of the trust are limited to direct family members

Consider the following scenario and the potential impact of the proposed new Legislation

YEAR 1 – 2001/2002

❖ A good financial year for the trust. Derives a net profit. Distributes income to beneficiaries including Mum, Dad and the two sons.

❖ Dad decides to lodge $20 000 in Farm Management Deposit (FMD) prior to 30th June, 2002 (noting that the amount is less than the grossed up income distribution that he would have effectively received)

YEAR 2 – 2002/2003

❖ Severe drought occurs

❖ Trust incurs trading loss

❖ No distribution is available to the beneficiaries

Impact of the operating loss

The beneficiaries of the farm trading trust **lose their entitlement** to continue on the averaging table.

Dad is deemed to have ceased business of primary production because he receives no distribution from the trust.

Note: It is uncertain as to the deemed date of cessation of the business of primary production. This is probably 30th June, 2003, being the last day of the financial year in which the trust incurred the loss and hence, the last day that the trust might have otherwise been able to make a distribution.

Impact on farm management deposits

The proposals would deem Dad to have ceased to have been a primary producer for the purpose of FMD and hence, the full amount of the deposit would be payable either in 2003 or 2004, depending upon the operations of section 393 of the ITAA 1936. Note that the law is not clear in this area.

Dad's tax return for 2003 would include the repayment of the FMD as assessable income. *(We will presume that the deposit had been held in the FMD for more than twelve months.)*

YEAR 3 – 2003/2004

- ❖ Dad actually applies for a refund of the FMD of $20,000.
- ❖ The family trust is in financial difficulties and is struggling and Dad decides to loan $20 000 to the trust.
  - No written agreement is executed. Dad was not aware of the new non-commercial loan provisions.
- ❖ The trust continues to operate in a genuine loss situation for the year, due to poor wool prices.
- ❖ The trust has **NO FUNDS** to pay interest on the loan, even if there had been a written agreement.

YEAR 4 – 2004/2005

- Again, the trust continues to operate in a genuine loss situation for the year, due to poor wool prices.

- Again, the trust has **NO FUNDS** to pay interest on the loan, even if there had been a written agreement.

YEAR 5 – 2005/2006

- Wool prices rise substantially

- The trust now makes a profit and has the capacity to make a distribution to beneficiaries, subject to recouping prior year losses.

- Dad seeks repayment of his $20 000 loan unaware of the new tax provisions.

- The loan has now become part of contributed capital as it a non-commercial loan and any distribution would effectively be caught by the proposed profits first rule.

General comments

The above scenario sets out a series of events which could be reasonably classified as **"NORMAL BUSINESS TRANSACTIONS".**

However, this series of transactions would now be trapped by the new measures. The family members are then potentially penalised in a tax environment as if they were embarking upon some tax avoidance measures, when in reality they were merely trying to financially survive.

11. Summary

Both ANTS and the Ralph Report proposed a consistent regime for the taxation of entities. We do not have this with the proposed legislation. Instead, we have a piece of law that **only** is directed at non-fixed, basically, discretionary trusts.

With the carve out from the original Ralph proposals on entities for companies, fixed trusts, limited partnerships and co-operatives, the consistent treatment of entities has not been reached and the Government appears to have walked away from trying to achieve a level playing field with all entities.

The proposals do not recognise that trusts are effective, legitimate, commercial vehicles for protecting assets for succession planning and these new rules effectively force a different treatment on these entities.

The NFF opposes the introduction of the Entity Taxation System and seeks that the Exposure Draft *The New Business Tax System (Entity Taxation) Bill 2000* be withdrawn.