2 November 2000

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

Dear Assistant Commissioner,

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

I have set our below the NTAA's comments on the exposure draft of A New Business Tax System (Entity Taxation) Bill 2000.

Executive Summary

In his Press Release of 11 October 2000, which accompanied the release of the exposure draft, the Treasurer stated that the legislation will implement the Government's policy which was announced in *A New Tax System* of introducing greater consistency in the taxation of entities.

It was also stated by the Government in *A New Tax System* that the design of Australia's tax laws will be improved, streamlined and simplified. Unfortunately the exposure draft is complex and voluminous. Accountants and tax lawyers are currently having great difficulty in trying to interpret and understand the proposed laws. This means the lay person has no hope whatsoever.

When tax laws are complex, and taxpayers cannot understand them, then taxpayers are unaware of their obligations. This means they often inadvertently do not comply with the tax laws. If tax laws are clear and simple so that everyone understands their obligations then it is more likely that taxpayers will comply with them.

The NTAA strongly recommends that the laws be simplified before being introduced into Parliament and in particular the Explanatory Memorandum provide many simple and clear examples of how the new laws are meant to work.

In respect of the actual application of the proposed new laws, the three major concerns of the NTAA are:

1. Loans to a non-fixed trust by its members being treated as contributed capital;

2. The definition of "available profits" including unrealised gains; and

3. The profits first rule.

The vast majority of small businesses being run through companies and trusts are funded by non-interest bearing loans from the owners or their relatives. Without these 'related party loans' many small businesses simply would not exist and thousands of jobs would be lost. It is inequitable to require these people to pay tax where they are simply being repaid their 'own money'. If introduced, these rules are likely to cause many small businesses to fail as their primary (and in many cases only) source of funding will cease.

These rules will seriously affect the viability of many small businesses and can lead to some extremely unfair and bizarre results, such as farmers being required to pay tax even though they have been making losses for many years as a result of severe drought. An example is provided in the detailed discussion below.

Also of concern is that these particular rules do not accord with the Government's policy as stated in *A New Tax System*. On page 113 of *A New Tax System*, the Government stated:

> "It does not make sense for exactly the same investment to attract very different tax treatment simply because it is put through a trust rather than a company."

If the final legislation includes the above rules, then one type of investment in a company (non-commercial loan) will attract very different tax treatment if that same investment is put through a trust. This is clearly against the Government's stated policy.

It is NTAA's view the Government could achieve its outcome of taxing distributions of tax preferred income and distributions from asset revaluation accounts (including internally generated goodwill) by specific anti avoidance legislation rather than broad based legislation that will adversely affect thousands of small businesses who do not distribute tax preferred income or make distributions from asset revaluation accounts.

The NTAA applauds the release of the legislation as an Exposure Draft so that it can be commented upon, and hopefully amended, before being introduced into Parliament. However, the NTAA is concerned that only part of the legislation has been released. It is difficult to provide meaningful comments when the full impact of the legislation cannot be ascertained because important aspects of it have not yet been released. For example, the proposed CGT implications where a distribution is made from a discretionary trust, as well as all the transitional rules. These measures should also be released in exposure draft form for comment before being introduced into Parliament.

Detailed Submission

1. Clearly the most objectionable, inequitable and unnecessary rule in the Exposure Draft Bill is the non-commercial loans rule contained in proposed sections 157-115 to 157-140. These proposed provisions should be excised from the Bill

   The majority of small businesses in Australia survive primarily because they are funded by interest free loans provided by the principals or the principals' family members. Treating these loans as contributed capital will cause some clearly unintentional and bizarre results (see the example in 4 below) and more importantly will have a devastating effect on small business. Either principals will limit their funding of small businesses, and as a result they will not grow, or they must charge a high rate of interest which will decrease the profitability of small businesses. In either case, the growth of the business is stifled which means **loss of jobs** and lower revenues, which in turn means less taxes.

   There is no compelling tax reason to include the non-commercial loan rule. The trust has already paid tax on its taxable income at the company rate of tax so there is no loss to the revenue. And if the business was being run by a company, the loan could be repaid without any tax consequences, so there would not be any inconsistency between the two types of entities if there was not a non-commercial loan rule. In fact, having a non-commercial loan rule causes inconsistency.

2. The profits first rule should be removed. This rule does not provide consistency of taxation with companies. The Government has made a policy decision not to include a profits first rule for companies and therefore for consistency purposes, there should be no such rule for non-fixed trusts.

   It appears the only reason there is a profits first rule is so that tax preferred income can be taxed in a similar manner as it is taxed when it is distributed from a company. In the NTAA's view, the anomaly is with companies and distributions of tax preferred income should not be assessed to shareholders when its distributed. But given that the Government intends that it be so taxed, then it should be specifically targeted because the proposed profits first rule, combined with the non-commercial loans rule will have extreme adverse consequences for many struggling small businesses.

   For example, say Joe works on the family farm that was commenced by his father many years ago. The farm business has always been carried on by the family discretionary trust.

   As the business has been struggling for the last five years due to drought, Joe has occasionally lent money to the trust, interest free to help it pay its debts.

   Assume now Joe's father lends $10,000 to the trust on 10 August 2001 interest free so the trust can pay some of its debts. The trust continues to make losses. Two years later Joe's father is diagnosed with cancer and needs immediate treatment. Joe's father calls on the trust to repay the loan of $10,000. Under the proposed rules, the $10,000 repayment to Joe's father will be treated as a distribution of profits and assessed as an unfranked dividend. This is so even though the business continues to make losses. It will be treated as a distribution of available profits because the market value of the farming land has increased and so under the definition there will technically be "available profits" even though in reality there are none.

   So there is a ludicrous situation where Joe's father must pay tax on the repayment of a $10,000 loan he made to the trust. It is not a valid solution to say that Joe's father should have charged a commercial rate of interest to the trust because all that means is that the trust would continue to make greater losses in a time when it could not afford to pay interest or to make greater losses. It is the combination of the profits first rule, non-commercial loans rule and the inclusion of unrealised gains in available profits that has caused this extremely unfair situation.

   If these rules are introduced, small business operators will not be able to make loans to their businesses and as such businesses will fail resulting in job losses. The vast majority of small businesses in Australia are funded in some part by interest free loans provided by family members. These amounts are funded by way of debt, so should the family member making the loan need the money, then he or she can easily call on the business to repay all or part of the loan.

   Given the significant reduction of tax benefits provided to taxpayers over the years, it is the NTAA's view that the amount of tax preferred income that is distributed from a small business discretionary trust is likely to pose minimum risk to the revenue compared to the devastating effect the proposed laws will have on small businesses should they proceed. In fact, by driving many small businesses out of business, the effect on the revenue is likely to be larger than the small amount of revenue that the Government is trying to obtain on the distribution of tax preferred income. As stated above, it would be much more cost effective to bring in legislation that specifically targets the distribution of tax preferred income.

   If the family business in the Joe example above was being carried on by a company, rather than by a trust, Joe's father could make the $10,000 loan to the company and be repaid without any tax consequences. Clearly the profits first rule and non-commercial loans rule are inconsistent with the Government's stated policy of consistent treatment between entities.

3. The definition of available profits should not include unrealised gains. The value of many items, such as goodwill, fluctuate regularly. A very real example is what has happened to the recent dot.com companies. On one day the unrealised gains are astronomical and therefore significant tax would be paid by members receiving repayments of loans or distributions of capital. The next day, there are no unrealised gains as the market value of the business has decreased significantly. So essentially, tax has been paid on non-existent profits. This is inequitable.

   Also, trusts would be required to waste a lot of money valuing their assets every time they make a distribution that will not be entirely out of profits.

   If the definition of available profits includes unrealised gains, the Government is effectively introducing a wealth tax. Australia's taxation system has always been based on taxing realised gains. The taxation of unrealised gains is inequitable and cannot be supported.

   If all the Government is endeavouring to do is to prevent trusts from making distributions out of asset re-valuation accounts, then specific anti avoidance legislation should be introduced.

4. Few tax professionals, let alone taxpayers, understand the concept of when an entity has a vested and indefeasible interest in the income or capital of a trust. Therefore it is extremely difficult for anyone to be able to precisely determine when a trust will be a non-fixed trust. The definition of a non-fixed trust should be drawn so that any taxpayer can easily determine whether or not the new laws apply to them.

   Either the distinction between non-fixed trusts and fixed trusts should be based on something that ordinary taxpayers can easily understand or alternatively, the legislation should contain clear notes and examples explaining the distinction.

   Under the current definition, it is unclear whether most ordinary unit trusts are fixed trusts or non-fixed trusts. If a unit trust deed states the beneficiaries have an interest in the trust fund as a whole, as opposed to the assets of the trust, is it a fixed trust? Refer to the 1999 High Court case of *MSP Nominees Pty Ltd v FCT*. What if the unit trust deed can be amended by the trustee does this mean it is not a fixed trust? These uncertainties should not exist.

5. When the new regime commences, a trust's franking account will have a nil balance therefore any distributions in the first year will be unfranked and the trust's level of franking will be nil percent. Under the proposed changes to dividend imputation, the trust could only increase its preferred rate of franking by 20 percentage points each 6 months. This means when the trust pays tax at the end of the 2002 financial year and has available franking credits, it will not be able to fully frank its dividends for three years.

   There does not seem to be any valid reason why a trust should be denied from being able to fully frank its dividends for three years. There is no such rule for companies. The NTAA recommends that there should be no 20 percentage point restriction. This problem would also arise with a newly established trust or company.

   The NTAA also recommends that a transitional rule be introduced so that distributions in the first year can be franked fully.

6. In calculating the opening balance of contributed capital sub accounts, how are the different classes of discretionary interests to be valued? The Explanatory Memorandum in paragraph 6.85 only considers the situation where there is only one class of discretionary interest. What happens if there is more than one class of discretionary interest?

7. Section 156-175 is also inequitable. In many small business situations, for example farms, the business property is owned by a discretionary trust for asset protection and family succession purposes, and the business is carried on by the individual family members in partnership. A bank will generally only lend money to the partnership if the trust guarantees the loan. This is because the trust holds the business real property.

   As a result of S.156-175, if the individuals default under the loan and the bank calls on the guarantee, the payment by the trust to the bank will be treated as an unfranked assessable distribution to the individuals. The reason the individuals defaulted on the loan was because they were unable to afford to repay it. So on top of debts to the bank, they will now have a significant debt to the tax office.

   Section 156-175 should be removed. The fact that the Commissioner has a discretion to not apply the section is not sufficient to warrant its inclusion.

8. It appears under sub-section 960-195(6), that if a non fixed trust re-finances it debts, the debt will be taken to be forgiven and S.156-90 will apply. Clearly this is not what the Government intended and the section should be amended accordingly.

9. Many non-fixed trust deeds do not provide the trustee with the power to accumulate the income of the trust. The income must be distributed to the beneficiaries by the end of each financial year. This means in the year ending 30 June 2002, all the income of those non-fixed trusts must be distributed to the beneficiaries and as there will be no franking credits available, will be assessed in full to those beneficiaries after the trust has already paid tax at 30% on that income.

   For example, if the trust derives $100 of taxable income, it will pay tax of $30. The $70 must then be distributed to the beneficiary who will pay tax on it as an unfranked dividend. Tax on $70 at 48.5% equals $33.95. This means the total tax paid on the $100 is $63.95, or a tax rate of 63.95%. This is inequitable.

   Non-fixed trusts have been established bona fide by taxpayers for many years based on the tax laws at the time they were established. It is extremely inequitable to foist new punitive tax laws on these taxpayers with no possible relief. Whilst it may be possible for some of these trust deeds to be altered to grant the trustee the power to accumulate, others may not be able to be amended. Often the scope for amending trust deeds is extremely limited. In these cases transitional rules should be introduced so that the beneficiaries are not unfairly penalised. A beneficiary should be able to access the franking credits that the trust will eventually obtain in relation to the income being distributed to that beneficiary.

10. As a result of the proposed laws, many taxpayers will want to restructure their affairs, however, under the proposed laws there is no CGT, income tax or GST relief if a non-fixed trust restructures. It is inequitable not to provide any such relief because many small businesses and ordinary Australians established non-fixed trusts relying on the tax laws at the time the trust was established and before there was any indication that non-fixed trusts would be penalised in the future. Restructure relief should be extended to allow non-fixed trusts to convert to a fixed trust or to transfer assets to other entities without CGT, income tax or GST being applicable before 1 July 2001.

    Approaches should also be made to the State Governments to ensure that there is relevant stamp duty relief where the restructuring takes place prior to 1 July 2001. If the final legislation is not passed by Parliament before 31 March 2001, then the relief for restructuring should be available until 31 October 2001 to allow everyone time to restructure.

As there are still many more amendments to come, such as those relating to the CGT implications of distributions and additional transitional measures, we strongly recommend the Government consult the NTAA and other professional and business associations before such amendments are introduced into Parliament.

If you wish to discuss any of the above matters, please do not hesitate to telephone me on 03 9862 7777.

Yours faithfully

Robert Warnock
Legal Counsel