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Assistant Commissioner
Law Design and Development (Entities)
Australia Taxation Office
PO Box 900
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Dear Sir / Madam

EXPOSURE DRAFT
NEW BUSINESS TAX SYSTEM (ENTITY TAXATION) BILL 2000

PKF has reviewed the Exposure Draft Bill and Explanatory Material and we have some major concerns in relation to the approach taken. Attached is a detailed submission on the major issues that we have identified. In summary they are:

1. Horizontal Equity Issues

The stated aim of equity and reduced complexity as espoused in the ANTS document has not been realised. It appears that the only surviving aim of the "unified entity tax regime" is the addressing of techniques of high wealth individuals using complex structures. We suggest that this aim could be easily achieved by specifically targeted anti-avoidance provisions instead of the non-fixed trust entity tax provisions.

2. Fixed Trust /Non Fixed Trust Distinction

The distinction between fixed and non-fixed trusts needs further clarification particularly what is meant by the interests in income and capital being indefeasible. There are many unit trusts that are generally considered to be fixed trusts but may not be fixed under the definition in the Exposure Draft Bill.

3. Profits First Rule

The profits first rule is a most restrictive proposal that attacks the fundamental nature of trusts. It has the effect of beneficiaries paying tax on unrealised capital profits in the trust.

If the reason for introducing the profits first rule was to combat capital streaming why not use similar capital streaming provisions as there are for companies?

4. Distributions of Contributed Capital

The Explanatory Material issued with the Exposure Draft Bill indicates that discretionary beneficiaries receiving non-assessable amounts will be taxed under the CGT provisions. This has the potential for double taxation where the non-assessable amount is paid out of settled funds. We suggest that an exemption from the profits first rule apply when the distribution is paid out of settled funds.

5. Loans To Members

Why will commercial loans to non-fixed trust members have to be fixed rate loans, whereas commercial loans by companies to shareholders are variable rate loans?

6. Loans by Members to Trusts

Non-commercial loans from members to trusts being treated as contributed capital has the potential of stifling investment and entrepreneurial activity and could lead to business failures.

7. "Simplified" Imputation Rules

While the "simplified" imputation rules may be easier to read than the current rules, they create very complex decisions for company directors and trustees of non-fixed trusts. The commercial decisions of when and how much dividends should be paid will be dramatically affected by the new Benchmark rules. To simplify these provisions we suggest that all companies with only one class of share be excluded from the rules.

If you wish to discuss any of the issues raised in the attached submission you can contact me by phone on 02 9240 9736 or by email – "lance_cunningham@pkf.com.au".

Yours Sincerely

Lance Cunningham
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PKF Australia Limited

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

PKF Submission to
Assistant Commissioner Law Design and Development

Lance Cunningham
Director of Taxation
PKF Australia Limited

Following PKF's review of the Exposure Draft of the New Business Tax System (Entity Taxation) Bill 2000 ("the Bill") we have identified the following issues that we request be considered in relation to any further development of the Bill.

A. HORIZONTAL EQUITY ISSUES

The "Tax Reform not a new tax a new tax system" (ANTS) document identified as a major concern the inconsistency and complexity of the current system of taxing companies, fixed trusts and discretionary trusts. The proposed answer in the ANTS document was to introduce a consistent regime that taxed companies and trusts under a redesigned company tax system. Another purported advantage of this new system would be that it would address techniques that have come to light in the High Wealth Individuals Project, which identified tax advantages of using complex structures.

Equity and reduced complexity not achieved

Unfortunately the proposed entity tax system for non-fixed trusts does not achieve the stated aim of reducing inconsistency and complexity from the system. If fact the complexity of the system for non-fixed trusts would be dramatically increased under the proposed system. The inconsistency between non-fixed and fixed trusts has increased rather than decreased.

The proposed system purports to tax trusts in a similar manner to companies. Although non-fixed trusts will be taxed at the same rates as companies the process for calculating the trust's and the beneficaries'/members' tax position can be quite different form the treatment of companies and their shareholders. In particular the profits first rule that will only be applied to non-fixed trusts will result in vastly different tax results for trust members compared to company shareholders.

If we accept that the aim of reducing inconsistency and complexity will not be met under the proposed non fixed trust entity tax system, that only leaves the aim of addressing the techniques of minimising tax of a small number of high wealth individuals that have taken advantage of complex structures.

Alternative – Specifically Targeted Measures

It is suggested that rather than inflicting an other complex set of rules that affect almost all non-fixed trusts, instead the government introduces specifically targeted measures to combat the use of the tax minimisation techniques by the small number of high wealth individuals. This would leave the vast majority of non-fixed trusts that have been established for good commercial reasons to be treated under the current system.

Alternative – De-minimus Rule

As a further alternative, a de-minimus rule could be introduced to apply these rules only to non-fixed trusts that went over a set level of Capital or income and or a set level of complexity of its structure (subject to grouping provisions). This would reduce the complexity and compliance costs of the majority of non-fixed trusts that are not being used for blatant tax avoidance.

Alternative – Carve outs

A further alternative is that the list of trusts to be excluded from the Non-fixed trusts entity tax rules be extended to include:

1. Trusts that have made a family trust election;
2. Trusts that qualify for and have elected to be in the Simplified Tax System for small business;
3. Trusts that meet the basis conditions for small business CGT relief in Division 152A of the 1997 Act.
4. Trusts established in conjunction with Employee Share Schemes

B. FIXED TRUST / NON FIXED TRUST DISTINCTION

The proposed definitions of "non-fixed trust", "fixed trust" and "fixed entitlement" in proposed section 995-1 are crucial in determining which trusts the proposed non-fixed trust entity tax rules will apply to. In summary the non-fixed trust entity tax rules will apply where any part of the income or capital entitlements of the trust are not held by an entity with vested and indefeasible interest in the capital or income of the trust.

Although the draft Explanatory Memorandum has a short description of the meaning of "vested " and "indefeasible" there should be more details and examples of where an interest would not be vested and indefeasible. For example:

1. **Power to amend Trust Deed –** Where the trust deed allows the deed to be amended at the discretion of the beneficiaries, the trustee or some other person, does this make the interests that the beneficiaries have in the trust defeasible? If so many unit trusts would be considered to be non-fixed trusts as most unit trust deeds contain a power of amendment.

2. **Accumulated income –** The Explanatory Material to the Draft Bill states that for a trust to be a fixed trust, the unitholders must have a fixed entitlement to a share of any income accumulated in the trust, which is not defeasible. This assumes that the members with an interest in the income when it is derived and accumulated will also receive the income at some time in the future when it is distributed.

   When a unitholder sells their units and looses their interest in the share of accumulated income does the trust cease to be a fixed trust? There should be a provision to ensure that trusts do not become non-fixed trusts as a result of members trading in their units.

Non-fixed Trust for Life

Proposed s 153-25(2) makes any trust that was a non-fixed trust at any time after 1 July 2001 (even for one second in a year of income) subject to the new rules for all future periods, even if it later becomes a fixed trust. This has the effect that a trust that at any time fails to meet the fixed trust definition, will be rendered a non-fixed trust and taxed as such for the remainder of its existence.

Why is there no provision for a non-fixed trust to returning to fixed trust taxation?

C. PROFITS FIRST RULE

As stated above the stated aim of the entity tax system as espoused in the ANTS document was to tax distributions from trusts in a consistent manner to distributions from companies. The introduction of the profits first rule for non-fixed trusts goes against this stated aim. The profits first rule disadvantages taxpayers using non-fixed trusts compared to taxpayers using companies as their preferred investment or business structure.

1. Capital Streaming Rules

The only provisions in the current company taxing provisions that has similar effect to the profits first rule are the anti-capital streaming provisions of sections 45,45A, 45B and 45C. However these are specifically targeted provisions that only have effect in limited circumstances and in the case of sections 45A, 45B and 45C only have application if the commissioner determines that a capital benefit was provided under a scheme that was entered into for a purpose of enabling the relevant taxpayer to obtain a tax benefit. Compare this to the profits first rule for non-fixed trusts, which applies to almost all distributions irrespective if there was a purpose of obtaining a tax benefit.

This leads to the conclusion that to obtain some consistency between companies and non-fixed trusts, the profits first rule has to be replaced with specifically targeted anti-capital streaming rules with a similar effect to rules for companies.

2. Available Profits

Under the profits first rule, where there are available profits in the non-fixed trusts, a distribution of an amount up to the amount of available profits is treated as a taxable distribution. This requires a calculation of available profits each time a distribution is made. This calculation is in proposed section 157-85 and inter alia requires the calculation of the net market value of assets.

Valuation of Assets required at each Distribution

To determine the net market value of the assets a valuation of the non-fixed trust's assets and liabilities would be required every time there is a distribution.

Subsection 157-85(2) provides that where a non-fixed trust's accounting records shows the trust has sufficient profits to fund the distribution the non fixed trust is taken to have available profits at least equal to the amount of the distribution. Although this appears to mean that in these cases the non-fixed trust will not need to value its assets and liabilities when a distribution is made, it is likely that the trustees would still have to value the assets to comply with the trustee's responsibilities as trustee.

Proposed subsection 156-85(3) provides that the Commissioner can substitute a value if he considers that the non-fixed trust's accounting records significantly undervalues the net market value of the its assets. The effect of this subsection is that in order for trustees to carry out their trustee responsibilities correctly they would have to value the assets and liabilities of the assets for each distribution to ensure that they have not undervalued the net assets in the trust's accounts.

The requirement for trustees to obtain valuations of the trust's assets every time there is a trust distribution places unacceptable compliance costs on the trustees and is another reason why the profits first rule should be replaced.

3. Unrealised Gains as part of Available Profits

In the profits first rule, the calculation of available profits in proposed section 157-85 includes unrealised profits. This means that the distribution of corpus of the trust will be treated as a distribution of profits even where there are no realised profits in the trust. This is of particular relevance for discretionary trusts where the is a requirement to make a corpus distribution to a beneficiary under the terms of the trust deed.

Child Maintenance Trusts

For example, a child maintenance trust is established as a discretionary trust for the benefit of a taxpayer's children. The trustee has distributed the income of the trust for the regular maintenance of the children and has no further income but a trust asset has an unrealised gain attached to it. If one of the children has a health problem that requires additional funds to be supplied for their benefit, the trustee may have to make a distribution of part of the corpus of the trust to pay for this expense.

Payment of Tax on Unrealised Gains

Under the profits first rules this distribution of corpus would be treated as a taxable distribution because of the unrealised gain in the trust asset. This means the child would be required to pay tax on the distribution even though the gain has not been realised by the trust and there may be no funds available to pay this tax. This could force the trustee to sell the trust asset to make a further distribution to the beneficiary for them to pay the tax. This is a most inequitable result.

Alternative – Family Trust exclusion

To at least partially rectify this problem there should be an exclusion from this rule for family trusts.

D. DISTRIBUTIONS OF CONTRIBUTED CAPITAL

Paragraph 5.14 of the Explanatory Material attached to the Exposure Draft Bill indicates that distributions of contributed capital to a member will be treated as a capital gain to the extent that it exceeds the cost base of the member's membership interest. This is understandable where the member has fixed entitlement to capital or income of the trust and is in accord with the current treatment under section 104-70 of the 1997 Act. However, paragraph 5.15 of the Explanatory Material indicates that this treatment will be extended to membership interests that have a zero cost base (with some exclusions for family trusts). It appears that this would also apply to discretionary beneficiaries of a trust receiving a distribution of contributed capital. As discretionary beneficiaries have not paid anything for their membership interests, they have a zero cost base, so that the whole of the distribution would be considered to be a capital gain.

Distributions of non-assessable capital distributions to discretionary beneficiaries are not currently subject to section 104-70 because they are not considered to have sufficient interest in the trust for the purposes of paragraph 104-70(1)(a). In addition it is unlikely that the payment is made to the discretionary beneficiary is in respect of the interest that the discretionary beneficiary does hold, ie a right to due administration of the trust. This treatment is confirmed in TD 97/15.

Double Taxation

Without any draft legislation in relation to this issue it is difficult to comment with much detail. However, it appears that there will be amendments to the CGT provisions to treat the proposed "membership interests" of a discretionary beneficiary as interests in the trusts for the purposes of section 104-70. If this is the case it will dramatically affect many trusts that were not established for any tax reasons and can result in double taxation.

For example, where a person settles an amount of capital in a non-fixed trust, that capital has usually come from tax paid income or capital gains. If the trustee of the trust subsequently distributes that capital to a beneficiary (under the terms of the trust deed), under the proposed rules that distribution of capital will be taxed again to the beneficiary. This effectively amounts to a gift tax.

Although it is proposed that there be an exception for family trusts, it leaves any trusts with beneficiaries outside the family group subject to double tax on distributions of settled trust funds.

Alternative – Targeted anti-value shifting measures

If the reason for introducing these proposed provisions is to stop the shifting of value from one entity to an other where they are attempting to avoid tax on income or a capital gain it would be better achieved by the use of targeted anti-avoidance measures instead of this scatter gun approach.

Alternative – Exclude Distribution of Settled Funds

Another alternative approach could be to exclude from the operation of section 104-70 the distribution of contributed capital that has come from settled funds. Under this approach there should be no double tax for genuine gifts and other value shifting distributions would still be taxable.

E. LOANS TO MEMBERS

1. Fixed Rate Loans

The definition of non-commercial loan in proposed section 960-180 includes a condition that the interest rate payable on the loan for an income year after the income year in which the loan is made is less than the benchmark interest rate **for the income year in which the loan was made**. In effect this makes it a fixed rate loan.

This is in contrast to the criteria in section 109N of the 1936 Act (Division 7A) for a loan, from a company to shareholders or associates, not to be treated as a dividend under section 109D of the 1936 Act. Section 109N provides that the interest rate for years after the year in which the loan is made must equal or exceed the benchmark interest rate **for the year**. Although the term “the year” in section 109N may be ambiguous in that it could refer to either the year in which the interest is being paid or the year in which the loan was made, the Replacement Supplementary Explanatory Memorandum to Act No 47 of 1998 indicates that "benchmark interest rate for the year" is intended to refer to the benchmark interest rate for each of the years of income in which the interest is payable. In effect this makes it a variable rate loan.

Is there any reason why the loans by Non Fixed Trusts have to be treated as fixed rate loans while the loans by companies are treated as variable rate loans?

2. Loans to Members Forgiven

Proposed Section 156-100 provides circumstances where the forgiveness of a loan to a member will not be a deemed dividend under proposed section 156-90. Subsection 156-100(3) gives this relief where the Commissioner is satisfied that:

1. the repayment of the debt would cause you hardship;
2. you had the capacity to repay the debt when it was incurred; and
3. you lost the ability to repay the debt in the **foreseeable future** as a result of circumstances beyond your control

What does the term “foreseeable future” mean in this context? In addition what is to happen in the “foreseeable future”? It is assumed that it refers to the possibility of your repayment of the debt, but it could also be read as referring to when you lost your ability to repay the debt. The provision should be rewritten to be unambiguous.

F. NON-COMMERCIAL LOAN BY A MEMBER TO THE TRUST

It is understood that the treatment of members' non-commercial loans to non-fixed trusts as contributed capital is required to support the "profits first rule". If the recommendation above to replace the profits first rule with specific anti-capital streaming rules is accepted, then there would be no need to treat non commercial loans by members as contributed capital.

Different Treatment for Companies and Non-fixed Trusts

These rules are a further departure from the stated aim of taxing trusts like companies. Companies are not required to include non-commercial loans from shareholders as shareholder's funds. As a result of this the choice of whether to use a company or non-fixed trust as an investment or business vehicle will in many case be clouded by the apparent tax disadvantages of using a non-fixed trust.

Could lead to Business Failures

If this measure is introduced small businesses operators that operate through non-fixed trusts will be curtailed from investing in their businesses which is likely to result in the growth of the business being stifled or even the failure of the business.

Recommendation

It is recommended that both the profits first rule and the non-commercial credit loans from members rules be replaced with specific integrity measures to combat the perceived tax avoidance techniques. However if the introduction of the Non-commercial credit loan rules are unavoidable we recommend that they be relaxed to allow taxpayers more flexibility in their business and investment operations. For example a de-minimus rule could be applied so that a repayment of the loan of up to a threshold amount could be exempt from the profits first rule.

G. "SIMPLIFIED" IMPUTATION RULES

Although the proposed "Simplified" imputation rules are easier to read than the rules they replace, they enforce a new level of complexity for corporate entities in their decisions on when and how much dividends they should pay. In particular, the benchmark 2 rules will result in entities deciding to make distributions not on their ability to pay the distribution or the markets perception of their worth but rather whether they will be franking the dividend within 20% of the dividends paid in the previous franking period.

The Explanatory Material issued with the exposure draft indicate that the benchmark rules have been introduced to prevent the streaming of franked and unfranked benefits to members in a way that maximises the benefits to members. While the purpose of these rules may be acceptable, the method of achieving the required result is overly complex and restrictive. The 20% limit required by Benchmark 2 does not account for situations where an entity's ability to pay a franked distribution significantly changes from one franking period to the next.

For example if a company has $300 in its franking account but considers that its shareholders are expecting a dividend of $7,000 so it pays a dividend of $7,000 franked to 10%. In the following franking period, as part of it usual business cycle the company's turnover and profits jump as so that it pays PAYG instalments of $300,000. The shareholders want the company to pay a dividend of $700,000 franked to 100% but benchmark rule 2 will effectively limit the franking percentage to 30%. It is difficult to see what dividend streaming benefits the shareholders would obtain if the company were allowed to pay a dividend franked to 100% in these circumstances.

Commissioner's Discretion only in "Extraordinary Circumstances"

Although proposed section 160-85 allows the entity to apply to the commissioner for him to allow a franking percentage that differs by more than 20% from the immediate preceding franking period, the Commissioner can only exercise this power in "extraordinary circumstances". The circumstances described in the example are not extraordinary as the increase in turnover and therefore franking credits was a result of its usual business cycle. Therefore, the Commissioner would not be able to exercise his power under proposed section 160-85.

The concept of an entity having to request the Commissioner to exercise a discretion for it to pay a dividend where there is no apparent tax benefit being obtained is hard to understand. However, if we are to have these rules the Commissioners discretion should be made much more flexible.

Alternative – Exclude Companies with only One Class of Share

Alternatively the exclusion for widely held entities with only one class of share could be extended to closely held entities. If there is only one class of share the scope for the streaming of dividends is much reduced.