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

Submission by Pitcher Partners

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This submission has been prepared in three parts:

Part A - Introduction - Designed to scope the Submission;

Part B - Overview & Key Submission Points - The taxation of trusts as companies involves a number of new concepts. The Overview is intended to set the scene for the benefit of the later discussion. The Key Submission Points highlight the key significant issues;

Part C - A detailed consideration of the Bill and EM on a 'cradle to grave' principle as follows:

1. Fundamentals;
2. Establishment of an Trust subject to the regime;
3. Transition of an existing trust into the regime;
4. Taxation of the trust;
5. Distribution from a trust within the regime;
6. Reductions of capital of a trust and vesting of a trust within the regime; and
7. Other

It is difficult to comment fully on the Bill and the EM in the absence of the details of a complimentary Consolidation regime and in the absence of the details of many consequential and transitional measures. That which follows should be read with this qualification. Further analysis and comment will be submitted once this information is available.

We note that over 500 professional hours have been spent in reviewing the legislation and compiling this submission.

PART A – INTRODUCTION

Pitcher Partners is a large Melbourne based business advisory and public accounting firm with approximately 300 Partners and staff and 2,000 clients conducting businesses. We welcome the opportunity to make this submission on the *New Business Tax System (Entity Taxation) Bill 2000 ("the Bill").*

In particular, in developing this submission, we have had regard for the following statistics released by the Australian Taxation Office in respect of 1997/98[1].

Trusts by Industry

Industry	Number	Proportion
Property	118,530	32.9%
Finance, Insurance, real estate & business services	114,881	31.9%
Retail trade	25,862	7.2%
Primary Production	25,523	7.1%
Construction	19,627	5.4%
Sub-Total	304,423	67.1%
Other Industries	149,206	32.9%
Total	453,629	100%

Trusts by Business Segment

	Individual Non Business	Small Business	Large Business & International
Number of Trusts	174,492	277,398	1,739
Total Business Income ($b)	$0.1	$93.9	$48.9
Total Assets ($b)	$28.2	$122.9	$40.6
Total Liabilities ($b)	$15.1	$97.5	$25.8

Broadly, therefore, the following may be noted:

(i) Trusts conduct business activities over a range of industries;

(ii) Trusts are predominantly operate in the Small and Medium business sectors. For the purposes of this submission, these latter businesses (i.e. the 99%) are referred to as SMEs; and

(iii) SME Trusts have substantial assets liabilities and turnover.

Trusts meeting these criteria are typically run by their principals very informally and have limited access to sophisticated advice.

[1] Taxation Statistics 1997-98 per ATO Website;

Our thrust in reviewing the Bill therefore has been to consider the likely impact, compliance cost and risk for inadvertent error, of its measures to SMEs. Whilst the focus has been on SMEs, many of the comments are equally valid when considered in the context of all trusts impacted by the Bill.

In August 1998, the Federal Government released "Tax Reform: not a new tax, a new tax system", which set out a tax reform plan aimed at removing the “inequities, inefficiencies and unfairness of the current system”.

The document identified the need for improvement to Australia’s business tax system, in particular, the requirement for reform across three key problem areas:

(i) Inconsistent entity treatment. There is different treatment for investment income channelled through different entities at both the entity level and individual investor level.

(ii) Inappropriate taxation of company groups. Companies are able to achieve unintended tax benefits from the present grouping provisions such as the creation of artificial losses by cascading losses through the company chain and by manipulating transactions between companies in the group.

(iii) Inconsistent treatment of company distributions. There are currently various ways of distributing profits from companies (ie. dividends, share buy-backs and on liquidation) that are treated inconsistently which may, in some circumstances, result in double taxation. Furthermore, refunds of excess imputation credits are not available, which disadvantages low income shareholders that may face the company tax rate on dividend income rather than their own marginal tax rates.

The following plan was formulated with a view to remedying the above deficiencies:

(i) taxation of trusts like companies under a redesigned company tax system with the following key features:

- simplified imputation system;
- refunds of excess imputation credits;
- transitional arrangements to avoid an inappropriate impact on existing trusts

(ii) allowing groups of companies, trusts and co-operatives to consolidate their taxation position. A group would only prepare one tax return and have a single franking account, one capital loss account and one revenue loss account.

(iii) achieving consistent treatment of entity distributions. This would include the introduction of a general “profits first rule” (with transitional measures applying to trusts taxed under the entity tax regime).

Approximately 80 of the 279 recommendations in July 1999 in the Review of Business Taxation ("the Review") were specific to the addressing these issues in what was described as the Unified Entity Regime ("UER"). Of particular importance these include the taxation of trusts analogous to companies; franking account simplification; a comprehensive definition of "distribution"; the profits first rule and slice approach re entity distributions; and the consolidation regime. The issues for most forms of business structure whether public or private were significant and with an effective operative date of 1 July 2001 the time to understand and react to these changes is limited.

Draft legislation was released with the Review which to a reasonable degree fleshed out the particular Recommendations. This draft legislation was entitled "A New Tax System (Income Tax Assessment) Bill 1999". It is referred to generically within as "the Draft Legislation".

Explanatory Notes explaining the operation of the Draft Legislation and in part commenting upon the specific Recommendations within the Review supported the Draft Legislation.

It should be noted that both the Draft Legislation and the Explanatory Notes formed part of the Review's report.

On 11 October 2000 (more than 2 years after its original policy statement) the Government significantly pared back its policy releasing the New Business Tax System (Entity Taxation) Bill 2000 (“the Bill”) and supporting Explanatory Material (“EM”). Broadly, the Bill restricted the reform to those principles relevant to taxing some trusts analogous to companies and simplifying and re-structuring the imputation provisions to suit companies and those trusts taxed as analogous to companies. We await the Governments announcement(s) in relation to "Tax Consolidation Rules - Company and Trust Groups". This paper does not consider this latter element of the Review.

It is understood that the Bill is a new regime for non-fixed trusts and that it is not the first tranche of a unified entity regime that provides consistent treatment of all entities including non-fixed trusts.

Section references within this Submissions are to sections within the Bill unless otherwise noted.

PART B - OVERVIEW AND KEY SUBMISSION POINTS

It is difficult to comment fully on the Bill and the EM in the absence of the details of a complimentary Consolidation regime and in the absence of the details of many consequential and transitional measures.

OVERVIEW

The Object of the non-fixed trust rules is set out in S. 153-20 of the Bill as follows:

“The object of the non-fixed trust rules is to provide tax treatment for non-fixed trusts, and for distributions made by non-fixed trusts, that is ***comparable*** with the treatment for companies and dividends paid by companies.” (emphasis added)

Accordingly having regard for the type of taxpayer principally subject to this regime and to this object our terms of reference in reviewing the Bill have been as follows:

1. To focus on comparability of the treatment of companies and non-fixed trusts;
2. To identify those elements of the existing company regime that are inappropriate in their current form to companies or non-fixed trusts;
3. To avoid opportunities for double taxation; and
4. To have regard for the fact that these provisions will predominate in their effect on SMEs and that they therefore need to have regard for the compliance and potential inadvertent tax cost to those entities and their Members.

In this respect we note the following key differences:

Treatment	Company	Trust
Controllers as “members”;	No	Yes
Loans from “members” or associates to the entity as “equity” generally;	No	Yes
Taxing distributions from “anticipated profits” of the entity;	No	Yes
Concept of “prior taxed amount”;	No[2]	Yes
Profits first rule;	No[3]	Yes

[2] Not a relevant consideration for companies;
[3] It is acknowledged that certain anti-avoidance provisions contribute toward a profits first rule for companies;

Slice rule;	No[4]	Yes
Taxation concessions on realisation and/or distribution of certain capital gains;	No	Yes
Denial of franking credit tax offsets to members, on tax paid by the entity, simply because the entity can make discretionary distributions;	No	Yes
Denial of the treatment of a contribution as equity unless it has been made with that "sole purpose";	No	Yes
Overvaluing "available profits" by undervaluing equity;	No	Yes

Further features of the proposed regime are inequitable for both companies and trusts. These include:

1. A key feature of the company tax regime repeated in the non-fixed trust rules is Division 7A of the Income Tax Assessment Act, 1936 ("the 1936 Act"). This provision has been the subject of considerable adverse comment by professional bodies and commentators due to its absolute breadth, its unforgiving operation where inadvertent mistakes arise and because it double taxes and in certain circumstances can triple tax. These difficulties were at least in part recognised in A Platform for Consultation (refer page 413, Table 1). However these recommendations have not been adopted.

2. Accelerating the recovery of entity losses by adopting the "gross-up and credit" approach to inter-entity distributions.

[4] It is acknowledged that certain anti-avoidance provisions contribute towards a slice rule for companies;

KEY SUBMISSION POINTS

Whilst accepting the broad policy approach of taxing trusts like companies there are key features that need to be addressed as a matter of urgency.

Our key submission points in relation to the Exposure Draft in relation to Entity Tax are as follows -

General comments

1. The overall effect of the non-fixed trust regime seriously departs from the Ralph Recommendations of a unified entity regime.

2. The provisions are unnecessarily complex.

3. Taxpayers will be faced with significantly increased compliance costs in relation to the non-fixed structures arising both in respect of understanding the provisions and also in terms of complying with the necessary record-keeping.

4. The non-fixed trust regime will lead to tax structure distortions in the sense that there are significant differences between a non-fixed trust, a fixed trust and a company in respect of capital gains treatment and member loans made to or from such entities.

5. The operation of the provisions can produce some unduly harsh results and in particular can lead to double tax in many situations.

6. The commencement date of 1 July 2001 is simply too soon to give taxpayers time to review their structures. The commencement date should be deferred.

7. The legislation should be extended to provide a comprehensive regime for non-fixed trusts, e.g. in relation to CGT issues such as resettlements, etc.

Specific Issues

The attached submission details the specific issues but in summary form, the key issues are as follows -

1. **Definition of non-fixed trust -** The current definition of non fixed trust needs to be refined. Currently, it would appear that a far greater range of trusts will be included within the regime,

e.g. the majority of unit trusts may be regarded as non-fixed trusts.

2. **Transitional Relief -** A broader form of transitional relief should be permitted to allow non-fixed trusts to remove themselves from the regime. This should either be on an open-ended basis or as a minimum for a moratorium period, e.g. until 30 June 2002. In tandem with such relief, the States should allow stamp duty relief.

3. **Loans by trusts -** The non-fixed trust regime essentially replicates Division 7A in relation to loans made by trusts. Significant submissions were made in relation to Division 7A when it was introduced. These issues still exist in respect of Division 7A and are replicated in the non-fixed trust provisions.

4. **Non-commercial loans by members -** The definition of contributed capital together with the application of the profits first rule can have extremely harsh operation in relation to treating loan repayments as a dividend. This is a particularly harsh rule given that member loans are an extremely common source of working capital funding for businesses. The impact of these provisions should be narrowed in effect.

5. **Roll-over relief -** Rollover relief should be extended to non-fixed trusts. Such rollover relief could allow non-fixed trusts to roll into fixed trusts or companies or perhaps allow trusts to be vested and the tax attributes of the underlying assets carried forward by the beneficiaries receiving the assets.

6. **Profits first rule -** The wide definition of profits can have the effect of creating double taxation in many situations. The provisions should be amended to eliminate any double taxation.

7. **Prior Taxed amounts -** The definition of prior taxed amounts should be amended to include loans by members of previously taxed distributions and CGT concessional amounts realised before commencement of the non-fixed trust regime to enable such amounts to be distributed at any time.

8. **Contributed capital -** The definition of contributed capital should allow for pre CGT assets to be included as contributed capital based either on cost (to the extent to which it can be established) or market value at the start of the regime. In the absence of such an amendment, gains on pre CGT assets could inadvertently become subject to tax.

9. **Slice rule -** The slice rule should apply not only to termination of membership interests on termination of a non-fixed trust but

also to termination of a membership interest on repayment of a non-commercial loan.

10. **Imputation -** Although not apparent from the Exposure Draft, it appears that a non-fixed trust will be required to make a family trust election to enable beneficiaries to obtain franking credits. This will simply not be possible where the beneficiaries/unitholders are "joint venturers" and not members of a family group. This must be eliminated from the legislation as it clearly gives rise to two tiers of tax - once at the trust level and again at the beneficiary. This could give rise to an effective tax rate of up to 64%.

11. **Grandfathering of pre 24.12.99 acquired assets -** In determining whether a CGT discount is available in respect of a CGT asset disposed of by a non fixed trust it is appropriate that acquisition dates be preserved in situations where the assets of the trust are acquired after 23 December 1999 under one of the CGT rollover provisions (eg. same asset, replacement asset or scrip for scrip rollover etc.)

PART C – DETAIL OF SUBMISSION POINTS

1 FUNDAMENTALS

Fixed versus non-fixed trust

Recommendation

1.1 More certainty in determining if a trust is fixed or non-fixed

There is a need for more certainty in determining whether a trust is a fixed trust or a non-fixed trust.

The proposed definitions of "fixed trust", "non-fixed trust" and "fixed entitlement" mean that many unit trusts may be treated as non-fixed trusts, which is completely contrary to the conventional view that they are fixed trusts. This will result in significant confusion for some taxpayers and their advisers.

The rules contained in Part 3-5 of the Bill generally apply to non-fixed trusts and members of non-fixed trusts.

Proposed amendments to section 995-1 will introduce the following definitions:

non-fixed trust means a trust that is not a fixed trust

fixed trust: a trust is a ***fixed trust*** if entities have fixed entitlements to all of the income and capital of the trust

fixed entitlement: an entity has a ***fixed entitlement*** to a share of the income or capital of a trust covered by the non-fixed rules if the entity has a fixed entitlement to that share within the meaning of Division 272 of Schedule 2F to the *Income Tax Assessment Act 1936*

The impact of these definitions is that the new entity tax regime clearly applies to discretionary trusts and also to the circumstances of most hybrid trusts. This is recognised at paragraph 2.11 of the EM:

"It follows that trusts that have both fixed and non-fixed elements (hybrid trusts) are also non-fixed trusts for the purposes of the proposed legislation. For example, where some part of the income or capital of a trust may be distributed at the discretion of the trustee or another entity, the trust is not a fixed trust."

However, significant uncertainty may arise in relation to the classification of unit trusts as fixed trusts or non-fixed trusts even though unit trusts are conventionally treated as fixed trusts. This uncertainty derives from the definition of “fixed entitlement” in section 272-5 of the Income Tax Assessment Act 1997 (“the 1997 Act”).

Subsection 272-5(1) of the 1997 Act defines “fixed entitlement”:

“If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a ‘fixed entitlement’ to that share of the income or capital.”

However, subsection 272-5(2) provides that, in certain circumstances, a unit holder’s interest in the income or capital of the unit trust is not defeasible by the mere fact that units are redeemable, or that further units are able to be issued. For example, in the case of an unlisted unit trust, if the trust deed empowers the trustee to redeem the units, or issue units, for a price other than net asset value, there is an implication that any existing interests in the unit trust are not vested and indefeasible. Accordingly, such interests would not constitute fixed entitlements and the unit trust would be a non-fixed trust.

In the context of the trust loss provisions, it became necessary to review the trust deeds of unit trusts in order to determine whether they were fixed trusts or non-fixed trusts. This task, even though it was confined to unit trusts with prior year revenue losses, imposed an extremely onerous compliance burden on taxpayers and their advisers. **In the context of new entity tax regime, adopting an identical definition of “fixed trust”, which references back to the definition of “fixed entitlement” in the trust loss provisions, will be devastating in terms of the cost and compliance burden on taxpayers.**

The use of these definitions will result in significant uncertainty when attempting to determine if a unit trust is within the new entity tax regime.

Furthermore, it is noted that there may be other circumstances where the interest that a unit holder has in a unit trust is not vested and indefeasible and therefore the interest is not a fixed entitlement and the unit trust is not a fixed trust. For example, a unit trust might have issued different classes of units, some of which might entitle the unit holder to income of the unit trust, and others of which might grant a right to capital of the unit trust. If the unit trust deed contains a clause to the effect that the trustee can determine what is income or capital, a particular unit holder may not have a vested and indefeasible interest.

Recommendation

1.2 Introduction of opt in and opt out alternatives

In addition to developing more taxpayer-friendly definitions of “non-fixed trust” and “fixed trust”, it is also recommended that some measures allowing taxpayers to either opt in or out of the entity tax regime be introduced. Some potential measures are as follows:

(a) Specify a certain date until which taxpayers have to get their affairs in order.

(b) Permit trusts to make an election to be a “fixed trust” subject to certain provisos.

(c) Modify the definition of “fixed trust” so that some unit trusts will be fixed regardless of any ability of the trustee to issue or redeem units at a discount.

(d) Treat all trusts as non-fixed trusts unless they make an election to be a fixed trust.

(e) Define “excluded trust”.

(f) Introduce a “de minimus” threshold

Deadline for taxpayers to arrange their affairs

This measure would grant taxpayers until, say, 1 July 2002, to prepare for the introduction of the new entity tax regime.

Taxpayers will have an opportunity to review their affairs and, in the context of groups of entities, determine how those entities will be treated under the new entity tax regime. This would include a determination of whether any trusts were fixed or non-fixed.

It would then be possible for taxpayers to restructure groups of entities, for example, by rolling-over the assets of non-fixed trusts into companies.

If this measure is adopted, the deadline should allow taxpayers sufficient time to review their affairs and restructure if necessary. It is submitted that 1 July 2001 is much too soon, especially in the context of the other taxation changes that taxpayers are still attempting to come to terms with (eg. GST and PAYG) and the yet to be released Consolidation regime. A more appropriate date would be 1 July 2002.

Election to be a "fixed trust"

This measure would allow unit trusts that would otherwise be treated as non-fixed trusts, to make an election be fixed trusts. For example, under the proposed definitions, a unit trust will be treated as a non-fixed trust if the trustee has the ability to issue units at a discount to net asset value. Such trusts could be allowed to make an election to be fixed trusts as long as the trustee agrees never to issue units at a discount to net asset value.

Modify definition of "fixed trust"

Under this measure, the definition of "fixed trust" would be modified so that some unit trusts would always be fixed regardless of any power within the trust deed to issue or redeem units at a discount to net asset value. An example of such a trust might be a unit trust with more than 300 members.

Non-fixed unless an election made

The final measure involves treating all trusts as non-fixed unless an election is made to be fixed. This measure has the advantage of eliminating the compliance costs involved in determining whether a trust is fixed or non-fixed.

Definition of "excluded trust"

Subsection 153-25(1) of the Bill states that the non-fixed trust rules apply to a trust for an income year if at any time during the income year the trust is a non-fixed trust unless it was at that time an "excluded trust".

The definition of "excluded trust" has not been finalised. It is recommended that the definition should include some types of unit trusts regardless of any power within the trust deed to issue or redeem units at a discount to net asset value. An example of such a trust might be a unit trust with more than 300 members.

Introduction of A "De Minimus" Threshold

It might be possible to exclude some trusts from the ambit of the proposed non-fixed trust rules if they have gross turnover below a certain threshold. For instance, the same business taxpayer definition of less than $1 million average annual turnover could be adopted.

Rollover Relief

Recommendation

1.3 Restructure rules

On a transitional basis the direct transfer of all the assets, or the direct transfer of an entire business, from a non-fixed trust to any of:

(i) a fixed trust;

(ii) a company;

(iii) a partnership;

(iv) an individual ownership; or

(v) a joint venture

— provided that:

(i) the person or persons have a membership interest in the assets or business before the transfer or in the transferree company or fixed trust after the transfer;

(ii) the tax attributes of the assets immediately after the transfer is completed are the same as their respective tax attributes immediately prior to the transfer;

(iii) the entity which transfers the assets or business ceases to exist once the transfer is complete;

(iv) at the date of transfer, all of the assets are transferred to the new entity; and

(v) the transfer occurs between the date of announcement and 1 July 2002.

Attachment K to the Treasurer's Press Release 074 of 11 November 1999 stated:

Why the change is needed

A Tax System Redesigned[5] *recommended (13.10) providing ongoing relief for rollovers into entities where there is no change in economic ownership. This measure will add to the neutrality and consistency of the tax system, and will allow commercial decisions on business structure to be made without undue effects from taxation consequences."*

As a transitional measure, A Tax System Redesigned recommended (13.11) that there be rollover from a fixed trust to a company and a company to a prospective CIV.

In regard to the recommendation noted above *A Tax System Redesigned* makes the following comments at page 482:

Rollovers out of an entity taxed like a company

Allowing rollover relief for the transfer of an asset, or the transfer of an entire business, of an entity to an individual, partnership or joint venture of individuals would allow amounts treated as untaxed income at the entity level to flow out tax-free to shareholders or beneficiaries. Ongoing rollover relief is not considered appropriate in these cases.

A rollover from a discretionary trust to an individual, partnership or joint venture cannot preserve continuity of ownership, as discretionary objects do not have proportionate interests in assets before such a transfer. The transitional rules for treating capital gains on existing assets in trusts and the proposed rules for return of capital by discretionary trusts mean that a discretionary trust will be able in practice to distribute its transitional assets under the new system without triggering tax liability on unrealised gains. The transitional assets will be available for reinvestment as contributed capital. As there is no immediate adverse consequence of transition to the new system, special rollovers for discretionary trusts to encourage restructuring before transition to the new system are necessary."

The first paragraph noted above regarding the distribution of untaxed amounts refers to "ongoing" relief rather than transitional relief. Transitional relief is clearly appropriate for non-fixed trusts that are discretionary trusts. Untaxed income currently derived by a discretionary trust can be distributed to beneficiaries in a tax free manner. The availability of wider pre 1 July 2001 rollover for non-fixed trusts would only potentially preserve existing treatment (for example, in the case of rollover from a non-fixed trust to an individual). In addition it would allow taxpayers to simplify

[5] "A Tax System Redesigned" – Review of Business Taxation Report, July 1999.

arrangements and not be subject to the uncertainty and complexity of the proposed non-fixed trust regime.

Current rollover relief provisions only allow rollover from a non-fixed trust to a company. The current provisions are flawed as they do not allow preservation of pre 23 December 1999 CGT status for trust assets or shares received in exchange for such assets and therefore are generally not currently viable.

It is strongly submitted that non-fixed trust taxpayers be given the choice of whether or not to enter into non-fixed trust arrangements from 1 July 2001, and that rollover relief mechanisms be made available to allow opting out of existing entities.

Broadly, the transitional rules for treating capital gains on existing assets in trusts are as follows -

1. Realised gains on pre-CGT assets can be distributed tax-free;

2. In respect of post-capital gains tax assets held by trusts prior to 24 December 1999, any capital gains tax concessions arising on disposal can be transferred to contributed capital and/or distributed within 12 months after the year of realisation;

3. On an ongoing basis, the capital gains tax concession on the sale of a business can be transferred to contributed capital and/or distributed in the year of realisation within 12 months after the year of realisation.

It is important to note that it is only realised gains that receive the benefit under the transitional arrangements.

Accordingly it would not seem correct to say that "...a discretionary trust will be able in practice to distribute its transitional assets under the new system without triggering tax liability on unrealised gains".

Ordinarily such a distribution will in fact be taxed as a distribution to the beneficiary where the transitional concession is not available. Accordingly there are "...immediate adverse consequences of transition to the new system..." if a discretionary trust seeks to restructure."

Secondly, A Tax System Redesigned considers that continuity of ownership could not be preserved where rollover was granted from a discretionary trust to an individual, partnership or joint venture.

This is clearly an incorrect statement as there is currently no continuity of ownership of discretionary trust assets other than by recourse to statutory provisions where continuity is deemed to arise by reason of making “family trust” elections.

A rollover from a non-fixed trust to say individual ownership would generally create beneficial ownership and thus continuity of ownership. It is submitted that if rollover was allowed for "family trusts" to transfer assets to "family group" members this would preserve continuity of ownership, as it is presently statutory widened for the purposes of the Income Tax Assessment Act 1997.

Finally as noted above, it is considered in A Tax System Redesigned that there are no immediate adverse consequences of transition to the new system and special rollovers for discretionary trusts are unnecessary. This statement overlooks the potential ongoing adverse consequences that relate to unrealised profits on transitional assets held in non-fixed trusts.

That is, only the "cost" of a transitional asset is available for immediate investment as contributed capital. In the case of existing post-CGT internally generated goodwill held by a discretionary trust, there would be no amount added to contributed capital on 1 July 2001, and any unrealised value will potentially fall within available profits (refer to proposed section 157-85(3)).

Thus, a Tax System Redesigned statement that: "the transitional assets will be available for reinvestment as contributed capital", as a discretionary trust will be able to in practice distribute its transitional assets under the new system without triggering tax liability on unrealised gains are clearly incorrect.

As the Exposure Draft legislation does not allow for distribution of transitional assets without realisation of a tax liability, it is submitted that rollover relief be extended as outlined above to achieve this objective.

Recommendation

1.4 Grandfathering of CGT assets

That in determining whether a CGT discount is available in respect of a CGT asset disposed of by a non fixed trust it is appropriate that acquisition dates be preserved in situations where the assets of the trust are acquired after 23 December 1999 under one of the CGT rollover provisions (eg. same asset, replacement asset or scrip for scrip rollover etc.)

Recommendation

1.5 Grandfathering of CGT assets

That the acquisition rules in section 115-30, providing the time when a company or trust is taken to have acquired certain assets for the purposes of applying the CGT discount provisions, be extended to preserve the acquisition date of assets acquired by a non fixed trust in the manner described above.

In Press Release No 93 issued by the Treasurer on 23 December 1999 it was announced that where assets are acquired by a trust after 23 December 1999 and disposed of on or after 1 July 2001 the trust will be taxed at the entity rate on any gain.

In the context of entity taxation we accept the policy as outlined above.

However, in recent discussion with officials of both the ATO and Treasury we have been advised that it is not intended that assets acquired by a trust after 23 December 1999 pursuant to one of the CGT rollover provisions, such as replacement asset or scrip for scrip rollover, will have their acquisition dates preserved to the acquisition date of the original asset that was acquired by the trust.

If this is to be the case we consider that this is an extremely harsh and unwarranted treatment of assets acquired by a trust in the circumstances described above.

Rightly or wrongly many advisors have because of commercial imperatives entered into transactions, rollovers, floats and restructures of trusts since 23 December 1999 on the assumption that the acquisition date of replacement assets acquired by a trust as a result of a CGT rollover would be preserved.

It is unacceptable that after 10 months since the date of announcement that we have yet to sight draft legislation implementing the Treasurer's announcement. It is also unacceptable that it was not made clear in the Treasurer's Press Release that assets acquired by a trust pursuant to CGT rollover would not have their acquisition dates grandfathered to the date of acquisition of the original asset.

Given the section 115-30 exists to preserve the acquisition date of assets acquired by a company or trust as a result of a same or replacement asset rollover it was entirely reasonable for advisors to assume that this provision would also preserve the acquisition date for the purposes of 23 December 1999. After all Section 115-30 was specifically enacted to ensure that the CGT discount would apply in certain circumstances.

In fact it is noted that it would require a specific amendment to override the application of section 115-30.

CGT Rollovers Affected

For the sake of completeness we note that the following rollovers will be affected;

- Section 122 Rollover of Trust assets to a wholly owned company
- Section 124E Rollover - Exchange of shares or units
- Section 124F Rollover - Exchange of rights or options
- Section 124G Rollover - Exchange of shares in one company for shares in another.
- Section 124H Rollover - Exchange of units in a unit trust for shares in a company.
- Section 124M Rollover - Scrip for Scrip
- Proposed Division 125 - Restructure Relief

Unless the acquisition date of assets acquired as a result of the above rollovers is preserved to the date of acquisition of the original asset the benefits of the CGT discount and hence the CGT rollover will be lost. This is clearly an inappropriate outcome.

This outcome is inconsistent with the policy outlined in relation to the CGT discount and Section 115-45. At paragraph 6.7 in the Explanatory Memorandum to Taxation Laws Amendment Bill (No 7) 2000 it is stated that:

> "Section 115-45 operates to deny a CGT discount for a CGT event happening to a share in a company or an interest in a trust, if the CGT discount would not have been allowed if the taxpayer owned the underlying assets of the company or trust and CGT event has happened to those assets".

Consistent with the policy outlined above, if a trust were to sell an asset it acquired before 23 December 1999 and assuming it had held that asset for more than 12 months it would be entitled to the CGT discount on any capital gain. We see no reason therefore to deny the CGT discount where the trust transfers that asset under CGT rollover after 23 December 1999 and subsequently disposes of a replacement asset.

Commercial Impact

If Government were to deny the preservation of the original acquisition date in respect of those assets that are transferred from a trust to another entity or where the trust has availed itself of one of the other CGT rollover concessions outlined above it will have a detrimental impact on commercial transactions.

For instance there have been many recent example of businesses which have been conducted in a trust which have been transferred to a company under CGT rollover and subsequently floated on the ASX or where the business has been transferred in preparation for a float. The denial of the CGT discount in the circumstances described above will clearly be a disincentive to the growth of businesses through a public float.

It will also be a disincentive for trusts to restructure assets and simplify group structures in order to gain efficiencies.

If Government was to deny the CGT discount on those assets acquired by a trust after 23 December 1999 as a result of one of the CGT rollover concessions, it would in our view be a grossly unfair and unjustified outcome. If this were the case Government could expect a good deal of adverse publicity from professional bodies, advisors and also taxpayers.

Recommendation

1.6 Flow through treatment for all fixed trusts

It is submitted that the requirement for company transferors to have 300 members be removed in light of proposals to extend "flow through" tax treatment to all fixed trusts (not just CIV's).

Under proposed Division 125, it is easier for a fixed trust to rollover to a company, rather than a company to a fixed trust, as the company transferor needs to have 300 members. Now that the Government has moved away from "flow through" taxation treatment for CIVs only, (and effectively allowed "flow through" treatment for all fixed trusts), it is submitted that it is no longer necessary to retain the company 300 member requirement.

Recommendation

1.7 Period for restructure of entities

It is submitted that either further time should be allowed for restructure or that relevant legislation be issued immediately.

The timing of the release of Exposure Draft legislation (and the ultimate deferred release of any legislation) means that it may be ultimately practically difficult to achieve rollover relief under these measures. In that regard it is submitted that either:

- More time is allowed to restructure under these measures; or

- Legislation is passed as soon as practicable in relation to these rules to allow immediate planning for restructure, including clarification of the State Taxes position arising from the Government's intention to "seek early consultations with the States and Territories with the objective of removing any tax obstacles to entity restructuring". Refer further to Recommendation 1.9 below.

Recommendation

1.8 Clarification of taxation status of assets transferred to the transferee

It is submitted that any ultimate legislation clarifies the income taxation status of assets transferred to the transferee.

The proposed provisions in Division 125 allow pre-CGT assets to retain their status. However, clarification is required regarding:

- Whether "cost" is reset for depreciation purposes in the hands of the transferee as tax written down value of assets, or whether the transferee "inherits" all depreciation characteristics of the transferor such as "cost" and "written down value";
- Whether debts incurred by the transferor that subsequently become bad in the hands of the transferor can be claimed as tax deductions;
- Whether tax losses, capital losses, excess foreign tax credits and other tax preferences are lost on transfer;
- Whether it is necessary to have regard to relevant debt forgiveness provisions when debts (assets and liabilities) are transferred;
- The potential for the CGT discount to be lost if assets transfer from a trust to a company; and/or
- The potential for the CGT discount for pre 24 December 1999 assets transfer from a company to a trust to be lost.

Recommendation

1.9 Rollover extension for group of entities under common ownership

It is recommended that rollover relief be extended to allow any number of entities with common economic ownership to be transferred to a single entity.

For example, proposed section 125-30 appears to allow a single fixed trust to become a company. It is submitted that in this instance, by way of example, that rollover relief should be extended to allow multiple fixed trusts with the same beneficial owners to be rolled over into a single company. This would allow taxpayers the opportunity to simplify group structures. Provided common beneficial ownership was maintained and there was no asset leakage outside the group there appears to be no policy reason against this.

Recommendation

1.10 Stamp duty relief

That the Commonwealth, State and Territory Governments agree a mechanism to remove tax obstacles to entity restructuring.

There has been no statement regarding State stamp duties generally and particularly where they may be triggered by a restructure. This is a major cause of restructures being put on hold presently. Resolution of this issue is an imperative.

2 ESTABLISHMENT OF A TRUST SUBJECT TO THE REGIME

Contributed Capital

Recommendation

2.1 Amendments to sole purpose test

The sole purpose test in S. 157-90(1) requires modification in order to avoid unintended outcomes

In particular S. 157-90 (1) expressly provides:

“You contribute capital to a *non-fixed trust if you:

(a) make a payment to, or transfer an asset to, the trust as consideration for the issue or granting of a *membership interest in the trust; or

(b) make a payment to, or transfer an asset to, the trust with the sole purpose (emphasis added) of:

(i) allowing membership interests in the trust to be created; or

(ii) allowing the trust to be created; or

(iii) enhancing the value of existing membership interests in the trust; or

(iv) enhancing the value of the assets in respect of which a discretion may be exercised in favour of *members of the trust.”

Per paragraph the EM –

“6.21 The contributed capital of a non-fixed trust includes amounts provided to the trust with any of a range of sole purposes. One is the sole purpose of allowing membership interests in the trust to be created [Schedule 1, item 23, subparagraph 157-90(1)(b)(i)]. An example is subscribing for units in a trust to be formed, or for additional units in an existing trust.

6.22 A sole purpose test applies in order to distinguish effectively between dealings in respect of membership interests and dealings between taxpayers and the non-fixed trust which affect membership interests only incidentally. Thus, where a contribution is made with another purpose in mind, for example, in order to pass out value under the guise of contributed capital to a member, it will not be contributed capital.

Example 6.1

ACE Enterprises owes Charles $500 for services rendered. Charles is a member of a non-fixed trust. ACE Enterprises pays $500 to the non-fixed trust so that it can distribute it, either as contributed capital or a franked distribution, to Charles. ACE Enterprises did not have the sole purpose of enhancing membership interests. Its purpose was to pass value to Charles other than by way of wages. The $500 will therefore not be a contribution of capital to the non-fixed trust."

This example would seem to imply that the Commissioner would not seek to apply other available provisions such as S. 19 of the 1936 Act, Part IVA of the 1936 Act. Both these provisions would comfortably negate the example. On the other hand requiring "the sole purpose" presents other difficulties in very conventional commercial circumstances. What is the circumstance for example of a person who makes a gift to a non-fixed trust thereby increasing the net assets of that trust where the gift is for the purposes of an asset protection strategy? Is "the sole purpose" test satisfied? If it is not satisfied the gift becomes part of available profits and thereby taxed on its return to Members.

Recommendation

2.2 Definition of the terms "pay" and "payment"

A definition of "pay" and "payment" (including derivatives thereof) be added to the Dictionary. That definition should make it clear that the term encompasses:

- **the transfer of an asset in satisfaction of the amount due; and**

- **the set off of another obligation.**

This amendment is suggested in order to provide certainty as to the meaning of an oft-used word.

Recommendation

2.3 Amendment to repayments of non commercial loans rules

Section 157-120(1)(d) be reworded so as to provide temporal consistency as follows:

“(d) either:

(i) the required interest payment for the loan for an income year that occurs after the income year in which the loan is made remains unpaid at the end of the income year; or

(ii) the principal amount of the loan remains unpaid at the end of the term of the loan.”

Per the EM-

“6.32 A commercial loan made by a member (or their associate) to a non-fixed trust gives rise to a contribution of capital where either:

- *the ‘required interest payment’ for the loan in the year following the income year in which the loan was made is not paid; or*
- *the loan principal is not fully repaid before the end of the term of the loan.*

[Schedule 1, item 23, subsection 157-120(1)]

6.33 The ‘required interest payment’ is calculated by using the following formula

$$\text{principal remaining unpaid at the end of the previous income year} \times \text{interest rate provided for in the loan}$$

[Schedule 1, item 23, subsection 157-120(4)]”

Note that technically the formula ignores repayments during the year in relation to which interest must be determined. Accordingly a loan could be wholly repaid on 1 July and interest is nonetheless payable for the entire year including that 1 July. However nothing would seem to turn on this as the amount of the contribution is the amount of the principal that remains unpaid as at the time the contribution of capital is taken to occur, which as noted immediately below is the end of the first income year in which the non-fixed trust does not make the required interest payment

A commercial loan becomes contributed capital pursuant to Section 157-120(l)(d)(ii) where the trust "does not fully repay the principal of the loan before the end of the term of the loan". Ordinarily the principal becomes repayable at the end of the term of the loan, not before the end of the term of the loan. Read literally, this subsection requires the repayment before it is in fact due.

Section 157-115 provides that the trigger for the deemed contribution is the fact of the loan remaining unpaid “at the end of the loan year”. As currently drafted, section 157-120 applies if:

- the required interest payment is not made “by the end of the income year”; or
- the principal amount is not repaid “before the end of the term of the loan”.

Recommendation

2.4 Amendment to forgiveness of non commercial loans rules

Section 157-135(1) be amended by substituting for “The amount contributed is the amount forgiven” the following

“The contribution is taken to occur at the time the loan is forgiven and the amount contributed is the amount of the loan that is forgiven”

This amendment would clarify the timing of the deemed contribution to capital.

Recommendation

2.5 Amendment to valuation method for CGT assets

Section 157-165 be amended by:

a) replacing “the *cost base of any *CGT asset that” in Item 1.1 in the table in subsection 157-165(1) with “subject to section 157-165(1A), the *cost base of any *CGT asset that”;

b) adding a new subsection 157-165(1A) –

“Taxpayers may elect to calculate the amount to be include under item 1.1 in respect of an asset of the kind referred to in item 1.1 that would generate a special credit under section 157-150 by using the market value of that asset at 1 July 2001.”

or in the alternative that such an election be permitted only in respect of pre CGT acquired assets.

This amendment will ensure that the special credit to contributed capital provided by section 157-150, item 5 is not inadvertently included in available profits prior to realisation.

Recommendation

2.6 Amendment to prior taxed amount rules

The table in section 154-55(1) be amended by adding a further item (item 5) as follows:

"An amount that would have been assessable to a beneficiary or the trustee within the meaning of items 1-4 but for the operation of any one of the CGT concessions referred to in the table in section 157-150(2)."

This amendment addresses the treatment of CGT concessional amounts realised before commencement of the non-fixed trust regime.

That part of the gain realised on the disposal of an asset before 1 July 2001 as is sheltered from capital gains tax by one of the concessions identified in the table in section 157-150(2) will not be included in prior taxed amounts as it is neither assessable to a beneficiary nor the trustee (section 154-55).

This amendment would clarify the timing of the deemed contribution to capital.

Recommendation

2.7 Amendments relating to establishing the cost base of pre-CGT assets

Section 157-165(2) should be replaced with:

"The amount to be added in respect of an asset acquired before 20 September 1985 under item 1.1 in the table in subsection (1) may be the amount that would be the cost base of the asset to the extent to which it can be substantiated.

In the absence of an optional market value rule, taxpayers are unable to include any amount in respect of a pre-CGT asset unless they can substantiate both:

. the fact of acquisition before 20 September 1985;
. the assets full cost base as defined in Subdivision 110-A of the 1997 Act.

An amount should be added under the valuation method for a pre-CGT asset to the extent to which the trustee can establish its cost base, if the non-fixed trust can establish that it was acquired before 20 September 1985.

Per the EM at paragraph 6.101 –

> *"However, an amount should not be added under the valuation method for a pre-CGT asset if the non-fixed trust cannot establish both that it was acquired before 20 September 1985 and its cost base* ***[Schedule 1, item 23, subsection 157-165(2)].*** *In that case, no amount will be added on commencement, but the whole of the proceeds will be added on disposal if the trust can nevertheless establish that it was acquired before 20 September 1985* ***[Schedule 1, item 23, subsection 157-150(2), item 5 in the table].****"*

Whilst generally a trustee should be able to establish that an asset was acquired before 20 September 1985, the trustee may not be able to establish the cost base of the asset because, among other things, the records of the trustee (simply due to the effluxion of time) may not be able to establish the five elements of an asset's cost base as set out in subdivision 110-A of the 1997 Act being broadly -

(i) The acquisition cost of the asset (Section 110-25(2));

(ii) The incidental costs of acquisition and disposal (Section 110-25(3));

(iii) The non-capital costs of ownership of the asset (Section 110-25(4));

(iv) Capital expenditure incurred to increase the asset's value (Section 110-25(5)); and

(v) Capital expenditure incurred to establish, preserve or defend the trustee's title to the asset for a right over the asset (Section 110-25(6)).

In this regard, note particularly Section 157-165(3) of the Bill which reads as follows -

> *"The cost base of an asset covered by Item 1.1 in the table in subsection (1) is to be worked out under Subdivision 110-A as modified by Division 112 but excluding the amount of any indexation under Division 114."*

Section 110-25(1) of the 1997 Act being the opening subsection within Subdivision 110-A is to the effect that "the ***cost base*** of a CGT asset consists of five elements subject to subsections (7) and (8)".

Accordingly, it is quite conceivable that a trustee may not have all the information necessary to establish the cost base of a pre-CGT asset in which event it would seem that that particular asset and its cost base cannot be taken into account under the valuation method in calculating the opening balance of the contributed capital account. As this has the effect of inflating ***available profits*** until the asset is disposed of this is an inappropriate outcome.

Recommendation

2.8 Allocation of contributed capital

That the contributed capital of a discretionary trust should be allocated:

- **at the time of a distribution;**
- **to the recipient of that distribution; and**
- **to the extent of the lesser of the balance of the contributed capital account at the time or the amount distributed (or the market value of an in specie distribution).**

The typical family discretionary trust will provide that income and capital may distributed amongst a class of objects at the discretion of the trustee and, in default, to one or more named default beneficiaries. How is the settled sum, and any later addition thereto, allocated?

Section 157-110 requires that a contribution of capital be credited to a particular sub-account in two situations:

a) The contribution is made in relation to membership interests of that class

   Arguably, the contribution comprising the settled sum can only be made in relation to the default beneficiaries. Unless and until the trustee exercises the discretion and appoints to a particular object, the discretionary object has no interest in corpus.

b) The contribution is made in relation to an asset in respect of which a discretion may be exercised in favour of members who hold membership interests of that class

> The reverse conclusion would appear to hold in respect of any contribution in this category. The interest of the default beneficiaries is not dependent upon the exercise of any discretion. In fact, their interest is contingent upon the discretion not being exercised.

The analysis becomes more difficult where the terms of the trust provide that particular objects are to have an interest in income (maybe with a power in the trustee to appoint capital for certain purposes – for example, the education of a minor) while others have only an interest in capital.

3 TRANSITION OF AN EXISTING TRUST INTO THE REGIME

Non-commercial loans to trusts

Recommendation

3.1 Non commercial loans and contributed capital

That a non-commercial loan made to a non-fixed trust should not be a contribution of capital.

The notion that a member contributes capital when the member provides a non commercial loan to a non-fixed trust assumes that certain loans by members to non-fixed trusts are equity rather than debt.

This is simply not the case as most non-fixed trusts have funds moving between members and their entities as required by the need for working capital. This flexible financing has been carried on by small and medium trusts for years, and provides a flexible and economic way for these businesses to finance their survival and growth.

Imposing a form onto the funds that contradicts the substance of the transaction is an arbitrary re-badging of the funds.

Taxing the repayment of these loans will be double taxation. Members would have first paid tax on earnings before lending them to the non-fixed trusts. Taxing the repayment of these loans will cause the member to be taxed twice.

An alternative to recommendation 3.1 is recommendation 3.2

Recommendation

3.2 Source of non commercial loans

That a non-commercial loan made to a non-fixed trust should not be a contribution of capital when the source of the non-commercial loan is outside the non-fixed trust.

This recommendation seeks to distinguish non-commercial loans arising from tax preferred distributions to a member, particularly a distribution of an unrealised pre CGT gain to a member being lent back to the non-fixed trust, from all other "non-commercial" loans by members to the non-fixed trust.

As there is no real basis to re-characterise loans into equity, the proposal must be driven by revenue concerns. The objective is clearly to restrict the capacity of non-fixed trusts to make certain distributions, such as distributions of unrealised gains. It is better that the measures focus on specific tax minimising distributions that are peculiar to trusts, rather than impose a severe blanket tax on all loans to non-fixed trusts.

Recommendation

3.3 Conversion of non commercial loans

That a non commercial loan can be converted into a commercial loan without penalty if it is done within 12 months after the end of the year in which the loan was made.

The harsh non-commercial loan rules should not apply to short term loans in particular.

From our experience there is no doubt that inadvertent non-commercial loans will occur. Under the proposed non-commercial loan rules, if a member makes an inadvertent non-commercial loan, the member cannot later correct the situation by converting the loan to a commercial loan. This is because proposed section 157-115(1)(d) requires the whole amount of a loan to be repaid within 12 months after the end of the year in which the loan was made, otherwise the loan becomes a contribution of capital.

However if the member repays the loan and then obtains a commercial loan from the non-fixed trust of a similar amount, section **960-190(2)** operates to disregard the repayment of the non-commercial loan. Section 960-190(2) prevents a conversion of the loan to a commercial loan.

Furthermore, section 960-180(1)(a) requires commercial loans to have a written agreement before the loan is made. This section also prevents the conversion of a non-commercial loan into a commercial loan. If the loan is recognised shortly after it arises, it will be too late to put a written agreement in place.

The severity of the proposed non-commercial loan rules becomes extreme if short-term loans are not excluded in a realistic manner.

Recommendation

3.4 Prior taxed amounts should include amounts taxed and lent back.

Prior taxed amounts should include amounts distributed to a beneficiary and lent back by the beneficiary and upon which they have paid tax under Section 97 of the 1936 Act.

Per paragraph 5.23 of the EM

> *"an amount will not qualify as a prior taxed amount if it has been applied for the benefit of a beneficiary, for example, by crediting it to the beneficiary's loan account where there is an implied or explicit agreement to lend the amount. Depending on the nature and the timing of when the loan was made, the amount may be part of the trust's contributed capital. Furthermore, if the prior taxed amount has been distributed at a time when the trust was not subject to the non-fixed trust regime, it will no longer qualify as a prior taxed amount* ***[Schedule 1, item 23, subsection 154-55(2)].****"*

Many non-fixed trusts are funded by members leaving in the non-fixed trust amounts that have been distributed to them and upon which they have paid tax under Section 97 of the 1936 Act. In particular, many such amounts will have arisen after 22 February 1999. Will they be regarded as "**prior taxed amounts**"?

There are two ways that a beneficiary who is presently entitled under Section 97 can deal with that entitlement ordinarily. These are -

1. The amount can continue to be held by the non-fixed trust on what it is typically referred to as a sub-trust with the beneficiary being absolutely entitled to that amount; or

2. The amount can be regarded as having been distributed and lent back by the beneficiary.

It would seem reasonably clear that the amount pursuant to (1) is a prior taxed amount. Economically there is no difference between the amounts per (1) and (2).

Why should there be a distinction in substance between an amount which is assessable income of a beneficiary under section 97 of the 1936 Act and retained by the trust and effectively the same amount "if it has been applied for the benefit of a beneficiary, for example, by crediting it to the beneficiary's loan account where there is an implied or explicit agreement to lend the amount"? The differences would seem to be form only. The effect of the latter approach, as noted elsewhere herein is potentially to double tax and certainly to bring forward tax payments.

4 TAXATION OF THE TRUST

Recommendation

4.1 Recommendation 11.5 of the Review should be adopted

In order to avoid excessive absorption of losses under the gross-up and credit approach through the entity chain "entities (including consolidated groups) should be able to choose the proportion of their carry-forward losses to be deducted in a year.

Per paragraph 7.7 of the EM –

> *"Thirdly, the new imputation system provides a simple and consistent treatment of distributions through the entity chain and out to individual investors. Greater integrity and consistency is provided by bringing companies and other corporate tax entities receiving franked distributions wholly within the imputation system instead of relying on the inter-corporate dividend rebate in section 46 of the ITAA 1936. The new system uses a consistent 'gross-up and credit' approach to prevent double taxation. Under this approach, as is currently the case for individuals, distributions to entities are 'grossed-up' for tax paid by the distributing entity and are taxable in the receiving entity's hands. A corresponding credit equal to the amount of the 'gross-up' is available to offset tax payable on the distribution or other income."*

It would seem that a franked trust to trust distribution to a trust that has losses (though this can ordinarily be avoided) will cause those losses to be utilised more quickly than would otherwise be the case.

This would also seem to be the case in terms of trust to companies, companies to companies and companies to trusts.

The effect is illustrated in the following table. For completeness it is noted that this outcome was identified in the Review and that Recommendation 11.5 was intended to overcome this result. There is no suggestion of Recommendation 11.5 separately being adopted.

Year	**1**	**2**	**3**		**1**	**2**	**3**
Assumptions	**Rebate Method**				**Gross Up Method**		
Tax Losses in holding entity	$100		$30		$100		$0
After tax dividend received		$70				$70	
Profit made			$140				$140
Balance Sheet of Holding Entity							
Paid up capital	$1	$1	$1		$1	$1	$1
Accumulated losses/Retained Profits	-$100	-$30	$77		-$100	-$30	$68
Capital and Reserves	-$99	-$29	$78		-$99	-$29	$69
Represented by							
Borrowings	-$99	-$29	$78		-$99	-$29	$69
Net Assets/-Liabilities	-$99	-$29	$78		-$99	-$29	$69
Tax Paid		$0	$33			$0	$42
Franking Credits		$70	$147			$70	$168
Recommendation 11.5 - Choice of Application of Losses							
Assumptions					**Gross Up Method**		
Tax Losses in holding entity					$100		$100
After tax dividend received						$70	
Profit made							$140
Balance Sheet of Holding Entity							
Paid up capital					$1	$1	$1
Accumulated losses					-$100	-$30	$98
Capital and Reserves					-$99	-$29	$99
Represented by							
Borrowings					-$99	-$29	$99
Net Assets/-Liabilities					-$99	-$29	$99
Tax Paid						$0	$12
Franking Credits						$70	$98

5 DISTRIBUTION FROM A TRUST WITHIN THE REGIME

Loans by trusts (Division 7A Equivalent)

Recommendation

5.1 The deemed distribution provisions are too complex and onerous.

The deemed distributions provisions in the proposed tax regime for non-fixed trusts repeats and widens the numerous unsolved difficulties for family groups and small businesses that are found in Division 7A of the 1936 Act. Many of these difficulties and associated recommendations are set out below.

This part of the submission deals with the proposed rules in subdivisions 156-C, 156-D, 156-E and 156-F. We commence with some preliminary comments about these provisions and expand on these points in more detail below.

Division 7A of the 1936 Act was introduced to replace and strengthen the provisions of section 108. The policy objective of these provisions was to stop the practice of making distributions from private companies that are disguised as loans or certain types of payments. There is no issue with this policy objective.

The problem with Division 7A is that those provisions:

1. Result in severe taxation consequences.

2. Create deemed dividends in situations where there are no tax avoidance motives;

3. Are too complex for the type of taxpayer to which they are directed;

4. Are unforgiving if inadvertently breached; and

Submissions have been made to the ATO regarding these aspects. We are therefore disappointed to see these problematic provisions being repeated in the draft law. The proposed legislation for non-fixed trusts will apply these same provisions to families and businesses run through non-fixed trusts without resolving the problems.

The fact is that private companies mainly observe Division 7A in the breach. This is because the law is too complex and too hard to comply with. Indeed it is our observation that there are very few taxation advisers that appreciate the width of application of these provisions. Applying Division 7A type principles to non-fixed trusts will substantially widen the number of taxpayers that will experience the problems of this legislation due to the number of beneficiaries of non-fixed trusts.

It must be appreciated that Division 7A and the proposed provisions in subdivisions 156-C, 156-D, 156-E and 156-F are directed at some of the least sophisticated taxpayers in the taxpaying community. Enacting complex rules that are too hard to comply with assists no one.

We have no issue with treating non-fixed trusts on the same basis as companies. Further, we have no issue with legislation that prevents the in substance distribution of profits by way of loans, payments etc. However, we submit that these rules should take account of the lack of sophistication of the taxpayers to whom the rules are directed. The rules should be drafted so that taxpayers who have a genuine intention to comply with the law can do so easily.

The points below expand on this.

Recommendation

5.2 Provisions should be enacted to assist taxpayers with inadvertent errors

Because the legislation is complex and it is easy to make an inadvertent error:

(i) the legislation should contain a provision that enables the problem to be rectified by the time that the tax return for the non-fixed trust is lodged; and

(ii) the Commissioner should be given discretion to treat an amount as not being a distribution even though there is deemed to be one.

As stated above, the proposed deemed distribution provisions are unforgiving if the taxpayer makes an inadvertent error.

For example, it is common practice for families to use the bank account of their family trust for family needs. Typically these people will not understand that a loan agreement is required before a borrowing can be made from their trust. This is particularly because the existing law has never required such agreements.

Another example is where an amalgamated loan (proposed section 156-86) requires a minimum repayment by the end of the year of income. A member to whom the loan has been made may simply forget to draw a cheque for the amount by the end of the year of income.

The Australian small and medium business community has become used to the idea that problems can be rectified by their public accountant after the end of the year of income when the annual tax returns are prepared. The deemed distribution provisions require positive action during the year of income and, it is submitted, for most taxpayers to which the proposed law will apply, this is too hard to comply with. Compliance requires a detailed knowledge of these complex provisions and this is an unreasonable expectation for people who are not accountants or lawyers.

We therefore submit that the legislation should be drafted on the basis that the requirements of the law with respect to a particular year of income need to be met by the time of lodgement of the income tax return of the trust for that year. For example, loan agreements would not need to be completed for a borrowing in a particular year until the lodgement of the tax return of the trust for that year. Further, minimum yearly repayments of loans could be made after the end of a year of income by the time the tax return is lodged.

This provision would enable taxpayers that have a genuine desire to comply with the law to do so without the severe penalty that can flow from an inadvertent error.

We further submit that the Commissioner should be given a discretion to treat a deemed distribution as not being a distribution. We note it is proposed that the Commissioner will have power under section 156-140 to negate the operation of section 156-85 if the minimum yearly repayment is not made on an amalgamated loan in the case of undue hardship resulting from circumstances beyond the control of the taxpayer. However, the applicability of this provision is very narrow. We submit that the Commissioner should have a general power to treat a deemed distribution as not being a distribution.

Recommendation

5.3 Section 960-190 should permit re-borrowing on commercial terms

Due to section 960-190, taxpayers that make a genuine attempt to comply with the legislation may not be able to do so. There should be a provision that will stop the operation of this section where a repayment and re-borrowing was for the express intention of ensuring that the new borrowing was on commercial terms.

Proposed section 960-190, which is similar to section 109R of the 1936 Act, is an anti-avoidance provision that treats repayments as not being repayments where the repaid amount is, in substance, re-borrowed. The policy objective underlying this provision is understandable but it can have adverse consequences for taxpayers genuinely trying to comply with the law.

For example, assume an amount is borrowed from a non-fixed trust and a written agreement has not been entered into with respect to the loan, thus making it a non-commercial loan. The people that control the trust subsequently become aware of the need to have a loan agreement and that the loan should be on commercial terms. It is therefore decided to repay the amount and to re-borrow the same amount as a ‘commercial loan’ per section 960-180 in order to comply with the law.

It will be seen that subsection 960-190(2) will treat the non-commercial loan as not having been repaid and a deemed distribution will arise under subparagraph 156-80(1)(c).

It is therefore submitted that the wording of section 960-190 should be altered to permit repayment and re-borrowing of similar or larger amounts where the dominant purpose of doing this is to ensure that a non-commercial loan is changed to a commercial loan.

Recommendation

5.4 Deemed distributions should be frankable with no debit to the franking account

Deemed distributions should be frankable and section 156-210 should be extended to prevent punitive taxation. Further there should be no debit to the franking account when there is a deemed distribution under subdivision 156-C.

Deemed distributions under subdivision 156-C are generally unfrankable. There is no logical policy reason why this should be so as making the distribution unfrankable results in punitive taxation. A simple example will illustrate this. Assume all individuals have a marginal tax rate of 48.5%.

A non-fixed trust derives $1000 of taxable income (also the net income). This is the only income it has ever derived. It pays $300 tax in relation to this, leaving $700 as the accumulated profits. The trust then lends $700 to a member (member A) on non-commercial terms and this is deemed to be an unfranked distribution. The member pays $339.50 tax on this ($700 x 48.5%). There is also a debit to the franking account of $300 resulting in a franking account balance of zero. The member then repays the loan. Subsequently, the trust distributes the $700 (unfranked) to another member of the trust. This member also pays $339.50 with respect to the distribution.

This means the total tax paid on the original $1000 of taxable income is $979 – an effective tax rate of 97.9%. Nearly the whole of the profit is consumed through taxation.

Section 156-210

This section will prevent triple taxation if a 'later distribution' is set off against some or all of an amount taken under subdivision 156-C to be a distribution previously made by a non-fixed trust. This would operate in the above example where member A repaid the loan by way of a distribution to member A which was set off against the $700 loan account. In this situation the total tax payable would be $639.50 ($300 + 339.50). This is still a punitive tax rate of 63.95%.

However, section 156-210 only has operation in the limited circumstance of an amount being set off against a deemed distribution. In practice, this may not occur. The proposed legislation effectively treats non-commercial loans as distributions but it ignores the fact that these transactions are actually loans that will be repaid.

Submission

We therefore submit that:

1. Deemed distributions should be frankable;

2. There should not be a debit to the franking account under item 10 of proposed section 160-130 when subdivision 156-C deems a distribution; and

3. The operation of section 156-210 should be extended so that it applies to any subsequent actual distribution of a deemed distribution.

Recommendation

5.5 A drafting error needs to be rectified with regard to the definition of a non-commercial loan

In determining the criteria for a non-commercial loan, the interest rate applicable for each year should be the benchmark interest rate for the relevant year rather than the year in which the loan was made.

We submit that there is a drafting error in subparagraph 960-180(1)(b). This provision stipulates the minimum interest rate for a commercial loan. It is expressed as the benchmark interest rate for the income year **in which the loan is made**. This does not permit the interest rate to vary over the course of the loan as is the case with section 109N(1)(b) in Division 7A.

The result of this is that the interest rate stipulated in the written loan agreement may not be sufficient to prevent a deemed distribution arising under section 156-85. This section, per subsection 156-86(4), requires the interest rate to be calculated by reference to the benchmark interest rate for the income year for which the minimum yearly repayment is being worked out and not the benchmark interest rate for the year in which the loan was taken out.

It is therefore submitted that, like Division 7A, the interest rate in the loan agreement should be the same interest rate used to calculate the minimum yearly repayment. Refer subsections 109N(2) and 109E(6).

Recommendation

5.6 The interposed entity provisions should include a dominant purpose of tax avoidance test

The inclusion of the onerous interposed entity provisions in the deemed distribution rules will cause hardship, compliance costs and should include a dominant purpose of tax avoidance test before they are applicable.

The Government must appreciate that the interposed entity provisions in Division 7A, and repeated in subdivision 156-E are very onerous. These provisions will very frequently create deemed distributions in family situations where there is not the slightest intention of avoiding tax.

Broadly whenever money passes between three entities, one of which is a non-fixed trust and one of which is a member of the trust, a deemed distribution will potentially arise. This is a very frequent occurrence in family groups and if the interposed entity provisions are enacted as proposed they will either cause considerable hardship to families with trusts or, alternatively, the provisions will be ignored (at their peril) by the taxpaying community.

Several submissions have been made to the Government and ATO on the draconian nature of the interposed entity provisions in Division 7A. We believe that the problems are understood by the ATO and accordingly we are disappointed to see these provisions being again proposed. Some examples will illustrate how far reaching these provisions are.

1. Mr and Mrs A decide to take a holiday. They arrange for their non-fixed trust to make a distribution to Mr. A by paying him $10,000 on which he will pay tax. Mr. A then gives $2,000 of that amount to Mrs A as spending money for the holiday. Under section 156-165, the $2,000 is a deemed unfranked distribution to Mrs A causing the amount to be taxed again and with a corresponding debit to the franking account of the trust.

   Explanation – The trust has provided a 'distribution benefit' to Mr A (the first interposed entity) as it has made a payment to him (subsection 156-75(2)). It is clear that the distribution to Mr A involved and contemplated a subsequent payment to Mrs A (subsection 156-165(1)(b)). Mr A then provided a distribution benefit to Mrs A because of the payment of $2,000. Further, subdivision 156-C had no application to Mr A's receipt.

   Despite the obvious unfair taxation outcome, subsection 156-190(1)(b) specifically ensures that the excessive taxation occurs.

2. On 30 June 2003 trust A makes a distribution to trust B which is then distributed to X. These distributions form part of the assessable income of B and X. The X family controls trusts A and B. The distribution to X by B will be the provision of a distribution benefit under section 156-165 resulting in punitive taxation outcomes.

   Explanation – the distributions from A to B and from B to X are both the provision of distribution benefits. It must be concluded that the distribution from A to B was part of making a distribution to X.

   Even though X will have paid the proper amount of taxation on the distribution, the proposed law appears to have been drafted with the deliberate intention of punitively taxing the amount again. This is because of the exclusion from the operation of section 156-115 of amounts that are assessable under subdivision 156-C and subparagraph 156-190(1)(b).

   In the above two examples, the taxpayers are left with the uncertainty of the operation of section 156-180. This provision requires the Commissioner to determine the amount of the distribution benefit.

3. Bob runs his business through a non-fixed trust. His trust has excess funds of $100,000 and places these on deposit with a bank. Due to the fact that these funds have been deposited with the bank, Bob is able to borrow $50,000 on commercial terms, from the bank

to build an extension to his house. There is a strong risk that this purely commercial arrangement would result in a deemed distribution.

Explanation – The trust has made a loan to the bank (the first interposed entity) and there is a strong risk that a reasonable person would conclude the loan was solely or mainly as part of an arrangement to lend the $50,000 to Bob.

Accordingly the taxpayer is left with considerable uncertainty as to whether this arrangement, which has no tax avoidance connotations, results in a deemed unfranked distribution with a debit to the franking account of the trust.

Further, even though this is an entirely commercial arrangement, it appears to be the intention of the proposed law to outlaw even commercial arrangements. See subsection 156-190(2).

These are just a few examples of the numerous normal, family or commercial arrangements that raise the real prospect of deemed unfranked distributions that have no tax avoidance motives. If the law is enacted as proposed, it will be very frequently the case that taxpayers will have to concern themselves with whether the interposed entity provisions apply because families frequently pass money through the hands of more than two entities.

We understand that having interposed entity provisions are necessary as some taxpayers will seek to circumvent the deemed distribution rules by channelling profits through interposed entities. However, these cases have a dominant purpose of avoiding the rules in Division 156. It is therefore submitted that the interposed entity provisions should only apply where there is a dominant purpose of avoiding the non-fixed trust distribution rules in Division 156.

Recommendation

5.7 There should not be deemed distributions out of non-existent profits

Unlike the Division 7A treatment of private companies, there can be deemed distributions out of non-existent profits. This should not occur.

The policy underlying Division 7A and its forerunner, section 108, is that deemed dividends can only arise to the extent that there are loans and payments out of profits or the distributable surplus. The proposed legislation in relation to non-fixed trusts takes this concept far beyond that applying to companies by deeming distributions to occur when there are no profits. This results in highly punitive taxation outcomes.

To illustrate this simply, assume a non-fixed trust borrows $1000 from a bank and lends this to a member of the trust and this is deemed to be a distribution under subdivision 156-C. Assume that the trust has no other assets, liabilities or income and that it has a zero balance in its franking account. The result will be that the member will pay $485 of tax (assuming the top marginal tax rate) and the trust will pay franking deficit tax of $428. Therefore, for no economic gain, there is a total tax liability of $913.

Recommendation

5.8 Amendment to section 109K is required.

Section 109K of the 1936 Act should be amended so that loans and payments from a private company to a non-fixed trust do not give rise to a deemed dividend.

Section 109K provides that a loan or payment by a private company to another company does give rise to a deemed dividend. In order to provide consistency, this provision should be extended to cover loans and payments from a private company to a non-fixed trust.

Recommendation

5.9 Removal of written loan agreements

There will be a huge compliance and cost burden in relation to the compulsion to enter into written loan agreements prior to the loan being entered into. There is no revenue cost from not having loan agreements and the requirement for these should be discarded or in the alternative a loan agreement only be required by the time of lodgement of the tax return for the lender for the year in which the loan is made.

Due to the severe taxation outcomes that result from having a deemed distribution and the prevalence of loans to members of non-fixed trusts it is possible that over 1 million loan agreements will need to be entered into by members of non-fixed trusts with the trusts. This is a huge, costly and unnecessary compliance burden to be placed on those who use non-fixed trusts to manage their affairs.

It is submitted that there would be negligible loss to the revenue if the requirement to enter into written loan agreements was discarded. Most requirements of the taxation law are dealt with without the need for formal agreements between parties. As long as taxpayers know the requirements to make minimum yearly repayments and those payments are made, there is no need to put taxpayers to the trouble and expense of entering into formal loan agreements. If the minimum yearly repayment has not been made, a deemed dividend will arise. The making of the loan agreement does not add anything further to this.

Recommendation

5.10 Section 109UB should be repealed

If section 109UB is not repealed, the interaction between the proposed non-fixed trust deemed distribution rules with section 109UB will result in punitive taxation.

Section 109UB was introduced to prevent loans being made by trusts that had made a corporate beneficiary presently entitled to an amount but had not paid that amount to the company. With the introduction of the non-fixed trust rules, there is no further need for section 109UB. The new rules in proposed subdivision 156-C will cater for the mischief that section 109UB was enacted to counteract.

If it is not repealed there will be a deemed distribution from both the trust and the company of the same amount. There will also be debits to the franking accounts of both the trust and the company.

Recommendation

5.11 The requirement to make actual payments on amalgamated loans should be ameliorated

Subparagraph 156-85(1)(c)(i) requires that the borrower pay minimum yearly repayment. This will cause undue hardship for many families because in many cases there will be insufficient funds to be able to make the repayments. Due to the operation of subsection 960-190(2) it is not possible to re-borrow the amount of the repayment.

It is submitted that the repayments should be able to be made, in total, at the end of the term of the loan. This would make debit loans consistent with credit non-commercial loans.

Recommendation

5.12 Subsection 156-120(b) should not be enacted.

The operation of section 156-120 is too narrow due to the requirement for 'usual terms on which the trust makes similar loans to parties at arm's length'. This will not recognise some genuine commercial arrangements.

It is submitted that if a trust carries on a business any loan in the course of that business should be exempt from the deemed distribution provisions. Placing the added restriction of terms that are similar to loans to parties at arm's length will mean that some genuine business loans to related parties, that are made without any tax avoidance motives, will be deemed to be distributions. This is because loans to related entities in the course of conducting a business are typically the only loans of that type that are made. That is, there are ususally no 'similar loans' to arm's length parties. Therefore the addition of subparagraph (b) severely restricts the concession provided by section 156-120.

Recommendation

5.13 There should be a provision similar to section 109NA of the 1936 Act with respect to the vesting of trusts.

An equivalent of section 109NA should be introduced to prevent deemed dividends arising on winding up trusts.

When winding up a company it is normal practice to liquidate all assets and lend the amounts out to shareholders so that the company does not earn any more income. This assists with terminating the company's existence. Section 109NA was introduced to prevent a deemed distribution applying to these loans.

It is conceivable that a similar circumstance will arise when a trust is vested. Accordingly a similar provision should be enacted to cater for this.

Recommendation

5.14 Payment of amounts by a trust to be reimbursed to the trust should not be distributions

Section 156-105 does not stop a deemed distribution arising where a non-fixed trust incurs an expense on behalf of a member and the member later reimburses the trust for that expense.

Under section 156-75 a payment by a non-fixed trust on behalf of a member that is not a distribution will result in a deemed distribution as the payment is made on behalf of the member or for the member's benefit (see subsection (2)). If the amount was a distribution the provisions of section 156-25 would apply and this includes a provision that reduces the amount of the distribution by any consideration provided to the trust. However, there is no provision that provides for such a reduction in subdivision 156-C.

Section 156-105 only covers situation where the payment of the amount by the trust discharges an obligation of the trust to pay money to the member. This provision does not cover the payment of an expense on behalf of a member that is later to be reimbursed by the member.

It is therefore submitted that a provision be enacted that would stop a deemed dividend arising when a trust incurs an expense on behalf of a member that is to be reimbursed.

Imputation System

Recommendation

5.15 Distribution of franking credits by non fixed trusts

Enable non-fixed trusts other than family trusts to distribute franking credits.

All non-fixed trusts should be able to pass franking credits generated by the payment of entity income tax to their members.

The overview document “Entity Taxation” released by the Treasurer with the Exposure Draft contains the statement:

“Consistent with the current rules governing the flow-through of franking rebates to beneficiaries of non-fixed trusts, beneficiaries of a non-fixed family trust will be entitled to a franking rebate.”

The definition of “qualified person” for the purpose of proposed section 161-210 is not contained in the Exposure Draft. We submit that clarification should be given that a non-fixed trust will not be prevented from distributing franking credits to its members, where the franking credits have been generated by the payment by the non-fixed trust of entity income tax, merely because the trust is not a “family trust” as defined in section 272-75 of the *Income Tax Assessment Act 1936*.

To impose such a restriction would be grossly unfair. It would result in double taxation of commercial profits and gains whenever a business or other activity is conducted for the benefit of more than one family group by a non-fixed trust. Given that many unit trusts will be non-fixed trusts, the consequences would be far reaching.

Recommendation

5.16 PAYG transitional rules for non fixed trusts

Non fixed trusts should have the option of electing to pay PAYG instalments during the year ending 30 June 2002 in order to have the ability to frank distributions during that year.

In the absence of specific transitional rules non-fixed trusts that customarily distribute all of their income annually will not have any liability to make PAYG instalments. The voluntary payment of a PAYG instalment would not satisfy proposed Section 160-120 and a franking credit would not arise.

Accordingly it is submitted that non fixed trusts should be allowed the option of bringing forward their PAYG instalment liability in order to generate franking credits during the year ending 30 June 2002. In the absence of such a provision any distribution from available profits during the year ending 30 June 2002 will not be able to be franked without creating a liability to franking deficit tax and possibly additional franking deficit tax of 30%.

In addition, in the absence of appropriate transitional rules, assuming distributions are not overfranked the benchmark franking percentage in the first franking period during which a distribution is made, or during which a declaration is made, will be nil. Due to the operation of benchmark rule 2 this will mean that the maximum benchmark franking percentage for the second franking period of the year ending 30 June 2003 will generally be 40%. This unfairly limits the extent to which non-fixed trusts should be able to allocate franking credits to frankable distributions in the early years of the new regime.

It is submitted that the optional PAYG instalment liability could be calculated on the basis of the trust's net income for the year ending 30 June 2001.

Recommendation

5.17 Modifications to benchmark rule 2.

Benchmark rule 2 should be modified so that it does not apply to certain specified types of distribution, or the maximum movement of the franking benchmark should be increased from 20% to 50%.

If left in its current form, benchmark rule 2 will apply unfairly in the case of various types of distributions. Examples include -

1. Share buy-backs;
2. Liquidations;
3. Dividends paid on preference shares;
4. Dividends paid to employees in respect of shares issued under an employee share plan.

In these cases, the restriction imposed by benchmark rule 2 will operate unfairly and will hinder commercial transactions. For example, if a company wishes to buy-back a particular number of shares but does not have sufficient franking credits to frank the deemed dividend component of the buy-back at the prevailing benchmark rate, the company will suffer a penalty in the form of franking deficit tax and possibly additional franking deficit tax of 30%.

In the case of a liquidation, a similar result may arise. Alternatively, the application of benchmark rule 2 may result in wasted franking credits if the prevailing benchmark is below that required to absorb all remaining credits. Over-franking would result in over-franking tax under proposed section 160-55(2)(a). The result is to impose double tax in circumstances where there is simply no rationale for doing so.

Further examples are where a company may be obliged to pay a specific return to holders of preference shares or holders of shares issued to employees under an employee share plan. Benchmark rule 2 may cause the company to unavoidably incur a penalty due to its inability to frank the dividends to the required extent.

The penalties arising as a result of the inflexibility imposed by benchmark rule 2 are considered to be unduly harsh, particularly as franking deficit tax is not able to offset the company’s income tax liability.

These examples are considered to be inadequately dealt with under the Commissioner's general powers contained in proposed Section 160-85.

Alternatively, it is submitted that benchmark rule 2 should provide for a 50% movement rather than a 20% movement. This would enable a corporate tax entity to alter its benchmark franking percentage by 100% over the course of a financial year. This would provide more flexibility in dealing with the above examples of distributions made otherwise than in the ordinary course, whilst retaining the policy objective of preventing the streaming of distributions franked to varying extents.

Recommendation

5.18 Extend the benchmark rule exceptions to all companies.

The exceptions in proposed Section 160-50 for companies that are widely held with only one class of membership interest should be extended to all companies with only one class of membership interest.

There would seem to be no rationale for restricting the proposed exceptions to the benchmark rules to companies that are widely held. Companies having only one class of membership interest will be prevented from streaming franking credits under the remaining provisions such that there is no need to impose the benchmark rules. The benchmark rules unnecessarily restrict the franking policies of companies in cases where no streaming is possible.

To extend the exception to widely held companies unfairly discriminates against other companies.

Recommendation

5.19 Additional franking deficit tax should be removed

As it is proposed that franking deficit tax is not able to offset a corporate tax entity's income tax obligations, there is no rationale for imposing additional franking deficit tax.

Under the existing regime, franking deficit tax can be applied against a company's income tax liability. If, as is proposed, this feature is to be removed from the imputation system, the rationale for applying an additional penalty of 30% will no longer exist. This is because all imputation credits that have been distributed to members will be fully funded by corporate tax entity tax payments. There is no loss to the Revenue. To impose additional tax is not equitable and simply imposes double tax. Given the benchmark restrictions, franking deficit tax will often arise simply as a result of an innocent failure to comply with the rules. Therefore double tax will be imposed in circumstances where it is completely unwarranted.

As the New Business Tax System (Franking Deficit Tax) Bill 2000 has not been publicly released, it is not clear whether additional franking deficit tax will generate franking credits.

Source of distributions and the profits first rule

Recommendation

5.20 Removal of anticipated profits rule

That, in accordance with recommendation 12.3 of the Review of Business Taxation Report "A Tax System Redesigned", distributions from entities to members should be treated as coming from profits to the extent of available profits of the entities.

To this end, paragraph 157-20(c) should be deleted.

The Profits First rule in section 157-20 goes further than the recommendation of the Ralph Review. It introduces the concept of anticipated profits and can have the effect of taxing "profits" which may never materialise. As noted above section 156-210 does not satisfactorily prevent double taxation and the position is further exacerbated where a distribution has been taxed as income but the anticipated profits are never realised.

The concept of anticipated profits goes further than the deemed dividend rules for private companies in Division 7A of the Income Tax Assessment Act 1936 which limits the amount of a loan which can be deemed to be a dividend to the company's distributable surplus .

Recommendation

5.21 Exclusion of unrealised gains on pre-CGT assets

The calculation of an entity's available profits should exclude unrealised gains on pre-CGT acquired assets held by the entity. Accordingly, the definition of Net market value of assets for the purposes of the formula in section 157-for calculation of an entity's available profits should be amended to exclude pre-CGT acquired assets.

The concessional treatment that was promised to entities in respect of pre-CGT assets may be rendered nugatory by the operation of the profits first rule. In particular, the inclusion of pre-CGT assets in the Net Market Value of Assets will overstate the available profits in circumstances where:

- the pre-CGT assets constitute a large part of the net market value of assets of the entity, or

. a member draws benefits in excess of available profits recorded in the entity's accounts.

Recommendation

5.22 Definition of components used in determining available profits

That the components of the formula for calculating available profits be defined to ensure that the stated objective in section 157-65(b) is achievable. To avoid overstatement of available profits all proper commercial liabilities should be taken into account, with the general anti-avoidance provision being adopted to counter excess provisioning

Subsection 157-85(4) lists a number of assets and liabilities which are to be excluded from the calculation of the non-fixed trust's market value of net assets. The inference to be drawn from this is that the term asset is to be broadly defined.

However, save for a few exceptions which are to be prescribed by regulation, liabilities must be present legal obligations. This has the potential to distort the net market value of assets. The following are some examples.

Unearned revenue

Amounts received by a non-fixed trust in advance of providing services or goods will add to its assets. For accounting purposes, the advance amount will be booked as a liability because it is not yet earned. On the basis of the decision in Arthur Murray, the amount will not be taken to be derived until the services have been provided. The liability is contingent on the non-fixed trust providing the service or good. Excluding the amount because it is not a presently existing liability has, in substance, the effect of overstating the entity's net assets.

Assets under finance lease

Many non-fixed trusts are not required to and do not comply with accounting standard AAS 17 [capitalisation of assets under finance lease]. The requirement to calculate the net available profits to include such assets will impose a further compliance burden on the non-fixed trust. It is also not clear whether the liability under the finance lease constitutes a present legal obligation. Does the term present legal obligation encompass liabilities which are debitum in praesenti, although solvendum in futuro.

Per paragraph 4.12 of the EM –

> *"The following provisions (as shown in the trust's accounting records) are subtracted from the net market value of the trust's assets:*
>
> - *provision for depreciation;*
> - *provision for annual leave and long service leave;*
> - *provision for the amortisation of intellectual property and trademarks; and*
> - *any other provision that may be prescribed by regulation.*
>
> ***[Schedule 1, item 23, subsection 157-85(1)]***"

Broadly, a trust is deemed to have made a distribution out of available profits where it has such profits.

Further, broadly, in calculating available profits, you are not allowed to take into account provisions other than those statutorily determined which, for the moment, are limited to -

- Provisions for depreciation;
- Provisions for annual leave and long service leave; and
- Provisions for the amortisation of intellectual property and trademarks

Obviously the fewer the provisions that one is able to take into account the higher the ***available profits*** and the greater the potential for taxable distributions.

It is understood that provisions for depreciation and for the amortisation of intellectual property and trademarks are to be excluded from the final Bill as the equivalent amounts are reflected in the market values of the relevant assets.

However many common provisions relevant to obligations, the absence of which would usually cause financial statements to be qualified where the amounts are material are also excluded. These include:

- Provision for taxation;
- Provision for sick leave;
- Provision for warranty payments;
- Provision for restructuring costs;
- Litigation provision;

- Provision for site restoration; and
- Provision for environmental costs (if present obligation to incur)

Recommendation

5.23 Double taxing of profits should be avoided

A mechanism should be introduced to avoid double taxation of initially unrealised profits to members and then on realisation to the non-fixed trust.

Per the EM-

> *"4.9 The net market value of the non-fixed trust's assets is the market value of its assets less the amount of its present liabilities [Schedule 1, item 23, subsection 157-85(1)]. Available profits therefore capture all accumulated profits, whether realised or unrealised, and whether taxable at the trust level or not. These net gains should be captured, as they need to be taken into account in working out whether the remaining value of the trust after a distribution is enough to match the contributed capital of the trust."*

With the effect that available profits includes unrealised gains, there would not seem to be any amelioration when the unrealised gain is later realised and subject to tax in the non-fixed trust.

Recommendation

5.24 Non-commercial loan to a non-fixed trust should not produce double taxation

A mechanism should be introduced to avoid double taxation of non-commercial loan repayments

Per the EM-

> *"6.26 A 'non-commercial' loan made by a member (or their associate) to a non-fixed trust, that is not fully repaid within 12 months after the end of the income year in which it was made, gives rise to a contribution of capital.*
>
> *6.27 The contribution is taken to occur at the end of the 12 month period and the amount contributed is the amount that*

remains unpaid at the end of the period. ***[Schedule 1, item 23, subsection 157-115(1)]***

6.28 A contribution of capital under this provision also gives the member an additional membership interest ***[Schedule 1, item 23, subsection 157-140(1); Schedule 7, item 1, subsection 960-120(1), item 5(d) in the table].*** *The cost base of the membership interest at the time it arises is the amount of the loan that remains unpaid at that time* ***[Schedule 1, item 23, subsection 157-140(3)].*** *Subsequent repayments of capital or interest in respect of such loans are treated as a distribution from the trust to the member that is subject to the profits first rule* ***[Schedule 1, item 23, subsection 157-140(2)].***

6.29 Together these rules enhance the structural integrity of the non-fixed trust regime. In their absence, debt financing could be used as a substitute for equity funding. That is, loans could take the place of contributing capital and taking a membership interest in the entity. This would allow the trust to avoid the profits first rule by repaying the loan ahead of retained profits."

The following table illustrates that in fact this structural integrity measure can result in double taxation and a substantial advancing of taxation payments in typical circumstances.

Assumptions	
Trust established on 1 July 2001 with a settled sum of	$10
Borrows on 1 July 2001 from a third party	$100,000
Borrows non-commercially on 1 July 2001 from a beneficiary	$150,000
Buys asset on 1 July 2001 for	$250,000
Sells asset on 1 July 2003 for	$550,000
Pays tax in 2004/2005	$90,000
Repays loans on 1 July 2004	
Trust vests on 1 July 2005	
Beneficiary taxable at top marginal tax rate of	48.50%

Tax position of Beneficiary - 2004/2005	
Trusts taxation characteristics on 1 July 2004	
Available Profits calculation	
Net Asset Value	$300,010
Less - Contributed capital	$150,010
Available Profits	$150,000
Beneficiary tax position	
Unfranked dividend	$150,000
Return of Contributed Capital	$0
Tax on Unfranked Dividend	-$72,750
After tax cash in hand	$77,250

Tax position of Beneficiary - 2005/2006	
Trusts taxation characteristics on 1 July 2005	
Available Profits calculation	
Net Asset Value	$210,010
Less - Contributed capital	$150,010
Available Profits	$60,000
Beneficiary tax position	
Franked dividend	$60,000
Return of Contributed Capital	$150,010
Tax on Franked Dividend	-$15,857
After tax cash in hand	$194,153

Beneficiary Net Position	
Pre tax Profit	$300,000
Less-	
Tax to Trust	-$90,000
Tax to Beneficiary in 2004/2005	-$72,750
Tax to Beneficiary in 2004/2005	-$15,857
Net Return after Tax	$121,393
Effective Tax Rate	59.54%

Proof	
Tax rate differential	11.04%
Equivalent Tax	$33,107
Represented by	
Tax on Unfranked Dividend	$72,750
Less - Tax on equivalent franked dividend	-$39,643
Difference	$33,107

6 REDUCTIONS OF CAPITAL OF A TRUST WITHIN THE REGIME

Slice rule

Recommendation

6.1 Correct ambiguity for distributions under slice rule

Section 157-45(1) be rearranged as follows:

" The profits first rule does not apply to a distribution to you if the distribution is made as part of a process that results directly in:

(a) a fixed membership interest of yours in the non-fixed trust ceasing to exist (whether by the interest being cancelled or redeemed, the trust being dissolved, an obligation being satisfied or otherwise); or

(b) proportional rights attaching to a fixed membership interest of yours in the trust in relation to distributions by the trust being reduced; and

(i) is not consideration for a proportionate rearrangement of membership interests; and

(ii) is for not less than market value consideration.

The distribution is dealt with under the slice rule in Subdivision 157-E instead unless it is a distribution of a prior taxed amount."

This amendment to section 157-45(1) removes any ambiguity that could suggest an interim distribution on terminating a non-fixed trust is a "proportionate rearrangement of membership interests".

Recommendation

6.2 Slice rule and membership interests from non commercial loans

Section 157-140(2) be deleted.

Section 157-45(3) ensures that the slice rule only applies in place of the profits first rule for a non-fixed membership interest when the trust terminates.

The slice rule should also apply to all non-fixed membership interests existing at the time of the termination of the trust.

No reason exists for section 157-140(2) to exclude membership interests arising from non-commercial loans.

7 OTHER

Recommendation

7.1 Ending of a Trust and Trust Resettlements generally

That Recommendation 13.7 in the Review to the following effect be adopted:

That … the ending of the trust for tax purposes be constituted by:

(i) the complete vesting of the trust; or

(ii) the distribution of all the assets of the trust by the trustee.

There is nothing in the Bill addressing this issue and the only comment in the EM is limited to that in paragraph 1.39 as noted above..

As A Platform for Consultation acknowledges there remains serious uncertainty regarding when a trust may be reconstituted in such a way that the existing trust ends and a new trust starts. The taxation issues arising are many and various including the 'freshening up' of pre CGT assets, deemed asset disposals of post CGT assets and forfeiture of taxation losses. The Review proposed the following recommendation to deal with this.

13.7 Ending of a trust for tax purposes
That … the ending of the trust for tax purposes be constituted by:
(i) the complete vesting of the trust; or
(ii) the distribution of all the assets of the trust by the trustee.

If adopted this is a welcome Recommendation as it promotes certainty.

It would not appear that the effect of this Recommendation is to provide free reign for the restructuring of discretionary trusts in particular. A reader should note that at least in some circumstances the impact of Recommendation 13.9 (discussed elsewhere herein) dealing with the pre-CGT status of trust assets and trust losses and bad debt write-offs might have the effect that negative consequences arise in the event that new beneficiaries are added to existing trusts.