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The Deputy Commissioner of Taxation
2 Constitution Avenue
CANBERRA ACT 2600

Attention: Mr Peter Mullins

3 November 2000

Dear Sir

We refer to the Exposure Draft – New Tax System (Entity Taxation) Bill 2000 and provide the following general comments.

Overall Comment

It is clear that the proposed rules do nothing to simplify what is already a complex tax system.

Whilst it is unclear as to the exact reasons for the policy decision to introduce new and complex rules, there is, in our view, a simpler way of achieving a fair and equitable outcome which will meet all of Treasury's objectives.

Taxation of unrealised gains upon the repayment of a non-commercial loan, a total "tax take" of 62.9%, the maintenance of complex franking accounts and profits first calculations are clear examples where the provisions are not in our view, fair and equitable.

In our view, the existing Division 6, combined with a withholding regime would seem to be a simpler way of ensuring that distributions from trusts are taxed. This would eliminate the need to have complex provisions such as non – commercial loan rules, profits first rules and franking measures.

All in all it would eliminate the complexity but would provide certainty of tax collection for Treasury.

Introduction

As a starting point, we make the observation that the thrust of the proposed provisions is completely at odds with the policy intention outlined in the August 1998 Plan for a New Tax System. Specifically at p.115 of the Booklet circulated by the Honourable Peter Costello MP, it was stated that:

> *"achieving consistency of treatment across companies and trusts under these redesigned company tax arrangements would provide simplicity, clarity and fairness in treatment"*

Despite that stated objective, the proposed provisions

(a) retain existing tax treatment for certain trusts ("fixed trusts");

(b) impose excessive and cumbersome rules upon other trusts ("non-fixed trusts"); and

(c) do very little in making the choice of a company or a trust as a business or investment vehicle, tax neutral.

If the draft legislation is enacted in its current form an enormous compliance burden will be placed on non-fixed trusts, with companies and fixed trusts being effectively exempted.

This burden will arise from the following concepts contained in the draft legislation:

(a) the concept of "non-commercial loans" from "members";

(b) the profits first rule; and

(c) the slice approach

Non Commercial Loans

Under the non-commercial loan concept, the mere repayment of loan funds to a "member" (who may in fact merely be a discretionary object) can result in the payment of tax by the "member", even if, for example, the loan repayment is funded from further capital injections or borrowings. At paragraph 288 of "A New Tax System Redesigned (July 1999), it was stated that:

> *"the Review proposes a broad definition of a distribution as occurring when value has been passed from an entity to a member in their capacity as a member"*

The draft proposal, however, will clearly extend beyond what was intended by the above statement. The rules will tax transactions (ie loan repayments) which provide no distribution of value, with the only safety net being the structuring of all loans from members such that they:

(a) are evidenced by a written agreement (which brings with it inherent stamp duty implications);

(b) bear interest at no less than a benchmark interest rate; and

(c) are for a term not exceeding that specified in the legislation or the regulations.

It is indeed unclear, having regard to the supposed policy intention, (ie to treat the "passing" of value to a member as a distribution), why the mere repayment of a loan to a member should be treated as a distribution.

If the relevant member had provided loan funds to the non fixed trust to support the trust's operations, it is obscure why Treasury considers that profits generated by the trust, (and which will be taxed under the proposed provisions in the hands of the trustee) should first be taken to have been distributed for tax purposes upon the repayment. The member receives no value upon repayment of a loan - the member receives what the entitlement is pursuant to the debtor –creditor relationship.

The rationale for bringing the repayment of non-commercial loans into the tax net would appear to be driven by:

(a) the policy decision to tax trusts as if they were companies (which in so doing creates a potential tax deferral tied to the difference between corporate and individual rates); or

(b) a desire to ensure that trusts do not derive income via the use of interest free funds from members, which can then be "streamed" to beneficiaries in a "tax preferred" position.

The fact that companies are not subject to the non-commercial loan provision as set out in the proposed legislation would suggest that (a) above is not the "driver" of the policy decision. If trusts are to be covered by these non-commercial loan rules, then trusts will be placed in a disadvantageous position relative to companies. Perhaps that is intended?

If the policy is driven by (b) above, the provision will do no more than place an impediment upon the conducting of legitimate business transactions, where members from time to time provide finance to meet business ends, as opposed to meeting tax planning objectives. We would suggest that the proposal will do little to combat actual tax planning of the type referred to in (b) above.

The treatment of non-commercial loan repayments as a distribution is contrary to the stated intention of defining distributions as transactions whereby value is passed to a member. This proposed treatment will impose unnecessary and costly impediments to normal business transactions.

Profits First Rule

Under the profits first rule, there will be a requirement for non-fixed trusts to first distribute profits. The existing tax law already has a provision which generally achieves this result. Section 99A of the 1936 Act applies to levy tax at the highest marginal rate where realised profits are retained ie where there is no beneficiary presently entitled. The adversity of a Section 99A assessment usually compels a trustee to distribute all income as and when it is derived. Additionally, Section 99B assesses other amounts distributed to beneficiaries unless specific exemptions apply eg, payments of corpus and amounts previously assessed to the trustee are not taxed.

At paragraph 294 of A Tax System Redesigned (July 1999), it is stated that the profits first rule:

> *"will prevent entities extending the period of tax deferral in respect of retained profits or streaming contributed capital and profit distributions to members in accordance with their tax preferences. The current law contains complex anti-avoidance provisions aimed at constraining these types of activity but the adoption of the proposed rule will allow these provisions to be repealed."*

It is implicit in the Statement that the need for a profits first rule is driven solely by the stated need to place companies and trusts on the same tax footing. Why is there this need? If there is trust income derived during a year of income which currently escapes tax, then why not legislate against those situations? Why impose a tax regime on certain trusts which creates a situation whereby tax deferral can occur? As indicated above, the current system contained in Division 6 does not allow tax deferral which is inherent in the proposed legislation.

The fact that the profits first rule does not apply to companies nor to fixed trusts, makes the stated reason for taxing trusts at odds with the proposed provisions.

Franking of Distributions

In addition to the above concerns, the proposed provisions would appear to impose penal tax rates in situations where a "member" receiving entitlements is not a "qualified person". This arises because the member will not be entitled to franking credits. Whilst the term "qualified person" is yet to be defined, it is understood that the current intention is that a beneficiary of a discretionary trust (ie with no fixed and indefeasible interest in the trust) will not be a "qualified person" if the relevant trust is unable to make a "family trust election".

Many businesses are operated by non-fixed trusts. Having regard to the trustee's obligations to all beneficiaries it may not appropriate for such trusts to make a family trust election. The proprietors controlling the trust are either not "family", or the trust provides benefits to beneficiaries who in some situations may not be

"family". Some trusts for example distribute to certain charities which cannot be part of a family group. Members of these trusts will be penalised severely, either through ongoing tax costs, or costs associated with unwinding business structures. Is it appropriate that as shown below, these structures will suffer tax at up to 62.9% (excluding Medicare levy) on a flow through basis to beneficiaries?

	$
Trust taxable income	100.00
Tax paid by the trust	30.00
Distribution to beneficiary (not being a "qualified person")	70.00
Tax paid by beneficiary @ 47%	32.90
Total tax paid	62.90

Whilst it is true that the above result currently exists in respect of the flow through to beneficiaries who are not "qualified persons" of corporate dividend income derived by a trust (ie where the beneficiary is presently entitled to the income in the year that the dividend is paid to the trust), the current law at least provides a safety net where the trust can accumulate the dividend income resulting in an assessment at the highest marginal rate. Such income assessed to the trustee at the highest marginal rate is not thereafter assessed to the beneficiary. The proposed legislation has no such safety net.

The stated intention of the proposed legislation is to:

> *"claw back tax preferences generated by a non-fixed trust in a manner consistent with the rules that apply to companies" (paragraph 1.6 of draft explanatory memorandum)*

At paragraph 1.11 of the explanatory memorandum, it is also stated that:

> *"broadly, those rules (ie the imputation rules) ensure that the total income tax on a member's share of a non-fixed trust's distributed profits will be limited to the member's marginal tax rate."*

As indicated above, the proposed rules go beyond clawing back tax preferences.

The proposed rules will impose penal tax rates to certain trusts and their members, and in so doing will not limit total tax paid to the member's marginal tax rate.

The only alternative for trusts in this situation would be to unwind business structures, and suffer other adverse tax implications (such as capital gains tax) as well as costs such as stamp duty and legal fees. We understand that consideration is being given to a special rollover which would enable a non-fixed trust to become a fixed trust. However, a concession which enables non-fixed trusts to be wound-up

would also be appropriate for trusts which simply do not wish to cope with the proposed regime.

Clearly if there is a policy desire to eliminate the use of trusts to obtain tax preferences, the provisions should not be as draconian so as to eliminate the legitimate use of trusts for other purposes such as for example, asset protection and estate succession planning. Just because a particular trust is not able to make a family trust election, penal rates of tax will be the outcome. Is that a fair result?

In attempting to recommend a solution, there is a need to fully understand the "mischief" that the provisions are directed at. The proposed provisions are clearly not directed at aligning the taxation of trust income with that of companies. If it is income splitting, the Government has already legislated against specific income splitting arrangements (ie alienation of personal services income arrangements) with such income being taxed at the marginal rate of the relevant personal services provider. If the current proposals are intended to address income splitting arrangements not covered by the recent amendments, then all trusts should be affected and not just those which cannot make a "family trust election". As it is presently proposed, trust income will be taxed at the corporate rate, but total tax paid by the trust and beneficiaries where the trust is a "family trust", may well conceivably be zero. In respect of other trusts, total tax paid will range between 30% and 62.9%.

One alternative approach may be to limit the franking credit entitlement to the lower of the average tax rate payable by the beneficiary and the company tax rate of 30%. All trust income would thus be effectively taxed at no less than 30%. Whilst this treatment will be different to the treatment of dividend income from companies received by members, the proposed provisions already distinguish between companies and trusts eg non commercial loans, the profits first rule and the slice approach. The limit on franking credit entitlements should not apply to excluded trusts however (eg a beneficiary of a protective trust established by a court should obtain the benefit of the refund of any excess credits).

A second alternative may be to retain the existing provisions within Division 6 and impose a withholding regime at the corporate tax rate, with the beneficiary's credit entitlement on assessment, being limited to the lower of the average tax rate of the beneficiary and the amount withheld. This approach would not only preserve the fairness of a tax system that taxes real distributions, (as opposed to taxing loan repayments), but it would also eliminate the complexities associated with trusts needing to maintain franking accounts. How is small business meant to cope with

franking rules designed with inherent complexity to counter "streaming arrangements" far beyond the comprehension or financial reach of small business.

If this approach was adopted, the task ahead would be to ensure that Division 6 is amended to clarify "grey" issues, and to ensure that tax equity is maintained.

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We would be pleased to discuss any issues with you at your convenience.

Yours sincerely
PricewaterhouseCoopers

GJ Dunn
Partner